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Investment Funds

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Han Kun Law Offices have about 50 fund specialised lawyers located in offices in Beijing, Shanghai, Shenzhen and Hong Kong and are one of the first investment funds practices in China to provide services to set up and operate onshore RMB and offshore investment funds. The firm's investment funds practice specialises in forming and operating onshore RMB and offshore investment funds of various types, and are highly knowledgeable of every aspect of investment funds, including fundraising, investment, man-

agement and exiting from investment funds. Han Kun is an outside consultant to the Asset Management Association of China (AMAC) and often advises on and assists with the development of draft laws and regulations for the private equity departments of CSRC and AMAC; it is an affiliate member of AMAC and is one of the law firms recommended for private equity funds as published on the organisation's website.

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1. Fund Formation

1.1 Formation of Investment Funds

In the People's Republic of China (the PRC, which, for purposes of this chapter, excludes Hong Kong SAR, Macau SAR and Taiwan), investment fund managers and advisers are generally subject to strict regulatory registration requirements. In addition, investment funds are subject to filing requirements and ongoing supervision. As a result, the PRC is not a popular destination for international advisers and managers to form investment funds, unless capital is to be raised within the PRC and/or invested in portfolios established in the PRC.

In the PRC, investment funds are generally classified as publicly offered funds and private investment funds. Publicly offered funds may only invest in securities. Private investment funds are further classified into private securities funds, private equity funds, private venture capital funds (together with private equity funds, 'PE/VC funds') and other types of private investment funds.

According to publications of the Asset Management Association of China (AMAC), which is the self-regulatory organisation for investment funds in the PRC, (i) as of 30 November 2018, there were 24,418 private fund managers registered with the AMAC and 75,220 private investment

funds filed with the AMAC, including 36,053 private securities funds, 27,115 private equity funds, 6,442 private venture capital funds and 5,610 private investment funds of other types (such as commodity sector funds); and (ii) as of 30 September 2018, there were 119 management companies of public offered funds and 5,459 publicly offered funds.

1.2 Raising Capital from Investors

Most PRC investment fund managers raise capital from domestic investors because generally it is impracticable for investment funds formed in the PRC to accept foreign investors, unless approved by the competent authorities under limited circumstances introduced below.

For PE/VC funds, in a few pilot cities, such as Beijing, Shanghai, Shenzhen, Tianjin and Chongqing, registered fund managers may apply to the local financial supervision and administration authorities to set up foreign-invested equity investment partnerships under local qualified foreign limited partners (QFLP) pilot policies. QFLP funds are private equity funds permitted to accept foreign investors and their contributions in foreign currency. As these policies are intended to attract high-quality foreign investors, foreign investors are subject to many eligibility requirements. Significant regulatory requirements also exist for QFLP fund managers, including high registered capital and management personnel experience requirements and requirements

for the QFLP funds themselves, such as fund size and minimum investor commitments. Even if an applicant meets all of the requirements, the final decision on QFLP fund formation is still subject to comprehensive consideration by the local authorities.

Foreign investors may indirectly invest in publicly offered funds in the PRC through the Pilot Programme of Securities Investment in China by Qualified Foreign Institutional Investors or the Pilot Programme of Securities Investment in China by RMB Qualified Foreign Institutional Investors, approved by both the China Securities Regulatory Commission (CSRC) and the State Administration of Foreign Exchange.

1.3 Common Process for Setting Up Investment Funds

The common process for setting up a private investment fund is as follows.

- Establish a private fund manager. Before setting up any private investment fund in the PRC, a qualified private fund manager must first be set up and registered with the AMAC.
- Identify offering targets. In order to avoid being considered a public offering, fund managers need to determine the ability of prospective subscribers to identify and tolerate risk through a questionnaire survey or other methods prior to promoting a specific fund. Suitable investors will need to confirm their qualified investor status in writing.
- Make risk assessments and match investors with suitable funds. The fund-raisers will estimate the risk level of the private investment funds and promote to subscribers only those funds that match their ability to identify and tolerate risk.
- Disclose risk factors of the funds to subscribers.
- Verify whether the subscribers are qualified investors. The fund-raisers will require subscribers to provide necessary proof of their qualified investor status, such as proof of assets or income.
- Execute fund subscription documents.
- Undergo a cooling-off period. The fund contract will provide for a cooling-off period of no fewer than 24 hours for investors (except for certain exempt persons). The cooling-off period for private securities funds commences after the fund contract has been signed and the subscriber has made payments for the subscribed funds. The cooling-off period for other private investment funds can begin as agreed upon by the fund participants. During the cooling-off period, the subscriber may revoke the subscription and the fund-raisers are not permitted to contact the subscriber.
- Make call-back confirmations with the subscribers. Upon expiry of the cooling-off period, fund-raisers may follow up with the subscribers to confirm whether the subscrib-

ers wish to revoke the subscription. This step is not currently compulsory.

- The private fund manager submits a fund filing to the AMAC.

Subscription documents for private investment funds usually consist of investor information tables, a risk tolerance assessment questionnaire, risk disclosures, a qualified investor status investigation questionnaire, capital subscription letters, tax residency statement documents, as well as a fund contract.

The common process for setting up a publicly offered fund is relatively simpler, including:

- apply to establish a publicly offered fund manager;
- fund-raising registration with the CSRC;
- risk assessment and matching investors with suitable funds;
- execution of fund subscription documents;
- capital verification and fund record-filing; and
- public announcements made by the fund manager on the day subsequent to the receipt of the CSRC's confirmation documents.

Subscription documents for publicly offered funds mainly consist of investor information tables, a risk tolerance assessment questionnaire, fund risk disclosure statements, a prospectus, tax residency statement documents, as well as a fund contract.

1.4 Regulation of Fund Structures

Investment funds formed in the PRC are, in practice, required to be managed within the PRC and have a place of business in the PRC. Investment fund managers must be established in the PRC and registered with the AMAC or the CSRC. During the investment fund manager registration process, applicants need to confirm and certify that they have an actual place of business for daily operations. Although not explicitly stated in the relevant regulations, the actual place of business for investment fund managers needs to be situated within the PRC in practice.

1.5 Limited Liability

Investors generally enjoy limited liability protection in funds organised in typical legal forms. In the PRC, investment funds are usually structured as limited partnerships, contractual funds, or as companies.

Limited partners may avoid liability for the debts and obligations of the limited partnership in excess of their capital commitments. To enjoy this benefit, the limited partners may neither manage the partnership affairs nor represent the limited partnership with third parties. Where a third party believes a limited partner to be the general partner of the limited partnership and conducts business transac-

tions on that basis, the limited partner may be deemed to be a general partner and lose its limited liability status with respect to these transactions.

In the case of contractual funds, the fund's debts are to be repaid with fund assets only, and the owners of fund interests are liable for the fund's debts only to the extent of their respective capital contributions, unless otherwise agreed in the fund contract.

With respect to company funds, under normal circumstances, investor liability is limited to each investor's subscription commitment to the company. Investors may not abuse their shareholder rights and limited liability protection in a manner which violates the Company Law of the PRC (2018); otherwise, an investor may be subject to extra damage compensation liabilities and/or joint liabilities for the company's debts.

1.6 Common Tax Regimes

A private investment fund in the form of a limited partnership or contractual fund will be treated as fiscally transparent for income tax purposes. In other words, the investors are liable to pay taxes on income realised from a limited partnership or contractual fund, not the fund itself. Where an investor is also fiscally transparent, the income tax obligations will flow upwards.

With respect to company funds, a 25% company income tax rate will apply to net income. Company fund investors are also generally subject to income taxes on their share of any distributions received from the fund. Certain exceptions exist, for example equity investment income such as dividends, between qualified resident enterprises and are considered income tax exempt.

Private investment funds and/or their managers are also liable for value-added tax, when a private investment fund recognises gains through financial product transactions, such as the sale of stock in a listed company. For contractual funds, value-added taxes are paid by the funds' management company. It remains unclear for limited partnership funds and company funds whether the fund itself or its managers are liable for value-added taxes with respect to the fund's gains from financial product transactions.

1.7 Investment Sponsors

With respect to PE/VC fund establishment and investment, the PRC is not a popular jurisdiction for investment sponsors from other jurisdictions or in other particular jurisdictions or regions because of the country's foreign exchange controls and restrictions on both inbound and outbound investment. The PRC also does not present any particular tax advantages compared to other jurisdictions.

1.8 Disclosure Requirements

Under PRC regulations, private investment funds are all subject to ongoing disclosure obligations to investors, including fund-raising information disclosures, fund operation information and interim disclosures. False records, misleading statements or material omissions are strictly prohibited at every disclosure stage.

As for fund-raising information, a private placement memorandum (PPM) is required to be provided to targeted investors and submitted to the AMAC as a filing document. To protect investors' rights to understand operation of the private investment fund and related risks, certain content must be included in the PPM, such as basic information of the fund and its manager, key terms of the fund contract and risk disclosures.

In the terms of fund operation information, the AMAC has established disclosure guidelines to provide mandatory requirements for the content and frequency of information disclosures. The frequency of mandatory disclosure requirements differs substantially for different private investment fund types. Private securities funds are required to at least provide investors with monthly reports containing the unit net value and basic fund information, quarterly reports to update more information associated with portfolio securities, and annual reports which generally include detailed investment and fund financial information. However, PE/VC funds are only mandatorily required to provide investors with semi-annual and annual reports to disclose the latest financial and/or investment information.

When specified events occur which may have a significant impact on the rights and interests of investors, interim disclosures are required to be timely provided to the investors in accordance with the fund contract.

Publicly offered funds, which are more strictly regulated, must fulfil more disclosure obligations than private investment funds. For instance, a draft prospectus is required to be submitted to the CSRC as one of the fund registration materials and a final prospectus is required to be published at least three days before the offering.

1.9 Legal Forms

Private investment funds typically take the form of limited partnerships or contractual funds. PE/VC funds generally prefer limited partnerships, while contractual funds are typically used to form a private securities fund. Both limited partnerships and contractual funds are fiscally transparent and are not themselves subject to income taxes. However, several key differences between these two forms cause there to be a distinct preference for different fund types. Private investment funds can also legally take the form of a company, but, in practice, very few private equity funds take the

form of a company due to tax and management flexibility considerations.

There are a number of competitive advantages that a contractual fund has over a limited partnership. The first is the limit on the aggregate number of investors. A limited partnership can only admit up to 50 partners while a contractual fund is allowed to have up to 200 investors, which may benefit fund-raising. The second is that contractual funds are not subject to local Administration of Industry and Commerce (AIC) procedures since they are not considered an entity separate from their investors. Limited partnerships are, however, required to comply with AIC procedures from establishment to dissolution, which may be considered inflexible and time consuming.

Despite the advantages of the contractual fund form that appeal to private investment funds, a clear drawback causes PE/VC fund managers to be hesitant to organise PE/VC funds as contractual funds. Portfolio companies of PRC PE/VC funds typically issue IPOs on domestic stock exchanges (A-share IPOs) since this is considered the most profitable exit strategy. Contractual funds, however, are subject to a much more rigorous review with respect to equity ownership and stability, which may result in a portfolio company requiring the contractual fund to exit before an A-share IPO. Despite this drawback, there has been some improvement in regulatory policies with respect to the clarity of A-share IPO reviews where a contractual fund is a direct or indirect shareholder. It is therefore possible in the future that PE/VC funds will prefer contractual funds.

Publicly offered funds can use any of the investment forms discussed above, but usually take the form of a contractual fund, presumably due to the flexibility of the contractual fund form with respect to the subscription and redemption of fund shares and the fact that there are no limits with respect to the number of investors as compared to other forms.

1.10 Regulatory Status

Investment funds are all under CSRC supervision and administration of the CSRC and its local branches, and/or the AMAC. The CSRC is the competent authority of the securities markets and is subordinate to the State Council, whereas the AMAC is the self-regulatory organisation for the investment funds industry and is under professional guidance and supervision of the CSRC in practice.

More specifically, the CSRC is in charge of fund manager registration and recording of funds for publicly offered funds, while the AMAC plays a more important role in regulating private investment funds. The AMAC performs self-disciplinary regulation over business operations of private investment funds, including but not limited to being

responsible for registration of private investment fund managers and private investment fund filings.

1.11 Legal, Regulatory or Tax Legislative Changes

A series of regulations were implemented in 2018 related to asset management business operations which unified the regulatory requirements for similar categories of asset management products. These regulations had a clear impact on the fund-raising and operation of private investment funds by redefining qualified investors, restricting the investment and structure of asset management products and imposing other restrictions. The regulatory framework around private investment funds, however, requires more clarification to co-ordinate with the new regulations and existing AMAC requirements.

The Interim Regulations on Administration of Private Investment Funds (Draft for Comment), once officially enacted, is expected to dispel some of the uncertainty around private investment funds. The Interim Regulations on Administration of Private Investment Funds has been in draft form for over a year and is expected to be formally promulgated in the near future.

In addition, the tax policy with respect to individual investors of private investment funds organised as limited partnerships has previously not been clear and unified. Recent policies, however, have clarified that individual venture capital investors can choose to apply an income tax rate of 20% to their dividend and equity transfer income beginning from 1 January 2019. This has led the market to suspect individual investors of limited partnership private investment funds may separately be subject to a tax rate of 5% to 35% in the future.

2. Fund Investment

2.1 Types of Investors

According to this firm's experience and reports published by the AMAC, as well as third-party research institutions, the main types of investors in PE/VC funds in recent years include high net worth individuals, family offices, listed companies, other private companies and asset management plans. These investors contribute nearly 80% of all investment capital in PE/VC funds.

Other types of investors include trust companies, insurance companies, banks, social security funds, commercial funds of funds, governmental funds of funds, fund managers and their employees and so on.

2.2 Legal, Regulatory and Investment Structures

For PE/VC funds, investors generally prefer to invest in the form of a limited partnership compared to other forms of PE/VC funds. As limited partners, investors' liability is lim-

ited to their capital commitments to the fund. Besides this, the limited partnership form results in no income taxes levied at the partnership level, and each partner only needs to pay its own income taxes.

PE/VC funds in the form of a company are liable for income taxes at both the fund and investor levels. Thus, the limited partnership form may help investors to reduce taxes, especially for individual investors. In addition, the limited partnership form will not become an obstacle if the portfolio company applies for an A-share IPO in the same manner as a contractual fund. As discussed above, the contractual fund form may present a challenge for the fund's portfolio companies when applying to the CSRC for an A-share IPO.

However, securities investment funds often use the contractual fund form, and the detailed reasons for this have been discussed in **1.9 Legal Forms**.

2.3 Legal, Regulatory or Tax Themes/Issues

Any investor investing in a private investment fund is required to meet the qualified investor standards (as further explained in **2.4 Restrictions on Investors**). Investors may not use loans or non-self owned funds raised by issuing bonds to invest in a private investment fund. Investors must pledge in writing that he or she has purchased fund interests on behalf of him or herself. Investors may not purchase fund interests for the purpose of later dividing those interests in an illegal manner.

Investors may be subject to different tax treatment depending upon the investment type and form of the private investment fund. Company income tax rates are relatively straightforward. However, individual income tax rates can be complicated in the case of investing through partnerships and may vary under different circumstances, thus presenting issues for certain investors (more analysis will be given in **5 Tax Environment**).

2.4 Restrictions on Investors

In the PRC, publicly offered funds are offered to the general public, while private investment funds are only offered to qualified investors.

According to the Interim Measures for Supervision and Administration of Private Investment Funds (2014) promulgated by the CSRC, qualified investors of private investment funds refer to those entities and individuals with the corresponding ability to identify and tolerate risk who invest in private investment funds an amount not less than RMB1 million and comply with one of the following requirements: (i) with respect to entities, their net assets are not less than RMB10 million and (ii) with respect to individuals, their financial assets may not be less than RMB3 million or their personal average annual income in the last three years is not less than RMB500,000.

The following types of investors are inherently considered to be qualified investors:

- pension funds, such as social security funds, enterprise annuities, and social non-profit foundations such as charitable funds, etc;
- investment plans established according to the law and filed with the AMAC;
- private fund managers and their employees who invest in the private investment funds they manage; and
- other investors specified by the CSRC.

Also, certain look-through rules apply to verify whether the ultimate investors are qualified investors if the capital of multiple investors is collected in a form which has no legal personality (such as a partnership or by contract) and is directly or indirectly invested in private investment funds.

The 'Guiding Opinions on Regulating the Asset Management Business of Financial Institutions', published in April 2018 (Guiding Opinions), provide another definition of qualified investors for all types of privately offered asset management products, which is similar but not identical to the definition above. More detailed implementation regulations are being awaited to clarify how to co-ordinate the Guiding Opinions with existing regulations issued by the industry authorities and whether the new standards for qualified investors stipulated by the Guiding Opinions will apply to private investment funds.

2.5 Marketing Restrictions

For private investment funds, marketing is carried out by private investment fund managers registered with the AMAC or institutions that have registered with the CSRC and obtained fund sales business qualifications. Sales personnel must also have fund services qualifications.

Fund-raisers need to classify their prospective investors into different categories mainly based on their risk tolerance. Fund managers or their fund sales agents will conduct due diligence investigations and analyse the investors, evaluate the risks of each fund, and inform each investor whether the risk level of the fund for sale is appropriate based on each investor's risk profile.

Fund-raisers of private investment funds may not issue any public offerings. Fund-raisers may not engage in the following activities when promoting interests in private investment funds to investors:

- using materials that contain false records, misleading statements or material omissions;
- undertaking in any form that investors will not lose their principal or the investors will receive a minimum return from the fund;

- using certain words, such as “secure”, “promise”, “commitment”, “insurance”, “guarantees”, “high returns” and “risk free”, that may mislead investors;
- using certain phrases to underline the limited marketing time, such as “purchase the fund as soon as possible” and “a good opportunity to subscribe to the fund”;
- promoting or partially selecting the past overall performance of less than six months or performance of past fund products managed by the fund manager;
- carrying congratulatory, complimentary or recommendatory words by any individuals or entities about the fund;
- using phrases such as “best performance” and “largest scale” to compare with others;
- belittling competitors;
- allowing individuals not employed by the fund-raisers to promote private investment funds; and
- promoting private investment funds that are not established by the fund manager or for which the fund-raiser is not in charge of raising money.

3. Regulatory Environment

3.1 Regulatory Regime

In the PRC, managers of publicly offered funds are required to register as publicly offered fund managers with the CSRC before engaging in fund-raising. Private investment fund managers are also required to register as private fund managers for the specific funds that they manage (such as PE/VC funds) before engaging in fund-raising.

The threshold for registering as a private fund manager is much lower than for a publicly offered fund manager. However, in order to pass regulatory scrutiny, a PE/VC fund manager still needs to meet comprehensive requirements, including but not limited to its name and business scope, minimum contributed capital, independent and separate workplace, adequate office facilities, sufficient employees with fund business qualifications and relevant experience. In the case of a private securities fund manager, all of the managing officers must possess fund business qualifications, whereas only the legal representative and risk control officer need to possess fund qualifications for private PE/VC fund managers. Applicants must also fully disclose their actual ultimate controller and related parties. In addition, applicants and their managing officers are required to be in continuous compliance with laws and regulations and have no adverse records.

A legal opinion on the above matters issued by a qualified PRC law firm is necessary for the application. Once the legal opinion together with other application materials are submitted to the AMAC, it usually takes several rounds of questions before the final decision on the registration application is given. If an application moves to the fifth round of responses and the AMAC is still not satisfied with the

applicant’s answers, the application may be suspended for three months.

3.2 Territorial Reach of Regulators

Investment funds formed within the PRC are subject to supervision from the CSRC and/or the AMAC. A manager registered outside the PRC is not permitted to provide marketing, management or advisory services for an investment fund formed in the PRC. As an alternative, foreign managers can set up subsidiaries in the PRC and have these subsidiaries register with the AMAC as private fund managers to provide services to private investment funds in the PRC. According to current policy, the offshore shareholder of a foreign-invested private securities fund manager (other than the manager of PE/VC funds) is required to be a financial institution authorised and governed by the shareholder’s local financial regulatory authority, and there must be a mutual memorandum of understanding on securities regulatory co-operation between the local jurisdiction and the PRC. Foreign investors currently cannot in aggregate control more than 51% of shares in foreign-invested publicly offered fund managers until 2021, at which time this investment restriction will be cancelled.

3.3 Regulatory Approval

In the PRC, only registered fund managers are allowed to raise funds under their own management, while fund sales agents registered with the CSRC or the AMAC may promote funds entrusted by registered fund managers. Registered fund sales agents are also required to become AMAC members in order to market private investment funds.

3.4 Authorisation of Marketing Activities

Only registered publicly offered fund managers may publicly offer funds. Private investment funds are not allowed to publicly offer funds, which includes raising capital from unspecified investors and raising capital from more than 200 specified investors in aggregate.

Fund-raisers therefore may not promote private investment funds through public media channels such as publications, leaflets, bulletins, manuals, correspondence and faxes directed towards the public, posters and outdoor advertisements, web portal link advertisements, blogs, or public telecommunications media including but not limited to television, film, radio and other audio/video media.

Nevertheless, with establishing procedures for determining specified investors, it is permissible for fund-raisers of private investment funds to promote private investment funds through internet-based media such as official websites and mobile apps, telecommunications media such as telephone, SMS and e-mail, seminars, reporting meetings and analysis meetings.

There is no restriction on advertising activities with respect to a private investment fund manager's brand, development strategy, investment strategy, management team and publicly available information disclosed by the AMAC, which does not include a fund's distribution strategies, investor rights and obligations, and other detailed terms and conditions related to the fund.

3.5 Investor-Protection Rules

The fund-raisers of either publicly offered funds or private funds will classify investors as general investors or professional investors, and further classify general investors into several categories based on risk tolerance, usually ranging from C1 to C5. General investors enjoy special protections provided by the fund-raisers with respect to information disclosures, risk warnings, suitability matching, etc. Investors who belong to the lowest risk tolerance category cannot invest in any fund with a risk rating above their risk tolerance. Other investors may invest in riskier funds after accepting special risk warnings that the fund-raiser will issue in writing, although fund-raisers may not actively market to these investors any funds of a risk rate higher than the investors' risk tolerance.

In addition, certain special classes of investors, such as insurance funds and commercial bank wealth management products, are restricted from investing in funds which do not meet specified industry investment requirements. For example, insurance funds which seek to invest in PE/VC funds must ensure that these funds fully comply with standards put forward by the China Banking and Insurance Regulatory Commission, including but not limited to the fund manager's investment experience, management scale and professional team, as well as the fund size, limitations on investments in listed companies or a single portfolio and fund information disclosures. In the case of commercial banks that invest in private investment funds through private wealth management products, the funds must be managed by an AMAC member who has been registered as a fund manager for at least one year and has no record of significant violations.

3.6 Approach of the Regulator

While the AMAC is an industry-oriented social organisation under CSRC guidance, the organisation acts as the sole self-regulatory body for the PRC private investment fund industry, including acting as the registration authority for private fund managers, fund practitioners and private investment funds, and has become the most direct and approachable regulator in the industry. The AMAC has long set up telephone hotlines and received email enquiries in order to provide answers regarding several online information filing platforms and relevant regulations. On the other hand, the AMAC has also instituted many unofficial requirements, which may cause some degree of ambiguity in its regulatory activities. The AMAC keeps in communication with fund managers, scholars, government officials and fund lawyers,

through various lectures and forums, and is receptive to the general public for suggestions regarding various details of the self-regulatory system.

The AMAC may take disciplinary action in the case of violations by funds or fund managers, which include blacklisting, public reprimands, cancelling fund manager registrations and cancelling the fund manager's employees' fund practice qualifications. The AMAC has the power to conduct routine or unscheduled on-site or off-site inspections of private investment fund managers. The AMAC may sometimes cooperate with the CSRC to complete these inspections.

4. Fund Finance

4.1 Access to Fund Finance

Funds in the PRC are permitted to access fund finance for leverage subject to a statutory debt ceiling limitation, which is calculated on the basis of net value of fund assets and does not include unfunded capital commitments. However, it is impractical for funds to issue public or private bonds.

In practice, institutional investors are not inclined to allow funds to borrow money at the sole discretion of a fund manager, without the prior consent of investors.

4.2 Borrowing Restrictions/Requirements

The Guiding Opinions set an upper limit on leverage ratio for different types of funds. For private investment funds and closed-end publicly offered funds, total assets may not exceed 200% of net assets. That is to say, these funds must maintain total debt at or below the net value of their assets. For open-end publicly offered funds, total assets may not exceed 140% of net assets.

Details in relation to borrowing are governed by the terms of the fund agreement, including but not limited to the prior approval process of each borrowing and its maximum duration, approved purposes, and upper limits on outstanding balances.

4.3 Securing Finance

In the PRC, nearly all banks require borrowers to provide pledges against real property or marketable securities for bank loans. However, only a few private investment funds hold assets that are suitable to be pledged. As a result, debtor-creditor relationships between private investment funds and private enterprises, even with the fund manager's affiliated enterprises, are relatively more common than bank loans. In these cases, the fund may borrow money by virtue of its market reputation without providing any security, or it may provide a pledge against its portfolio investments for the lender, especially in leveraged buyout deals.

Private investment fund investors typically require that the outstanding balance of debts incurred by the fund does not exceed the fund's unfunded capital commitments or 10% to 30% of the fund's subscribed capital, in order to prevent the fund from being overleveraged.

4.4 Common Issues in Relation to Fund Finance

Private lending is more popular for PE/VC funds, although this lending tends to be in the form of related-party transactions and prior consent of the fund investors is usually necessary in accordance with the fund contract.

Lately, debt financing has become less common for private investment funds since government-backed investors now play an increasingly important role in the private investment fund market in the PRC, and because government-backed investors are likely to request that funds not make borrowings due to the regulatory requirements that apply to these investors.

5. Tax Environment

5.1 Tax Framework

Generally, tax treatment (tax categories and tax rates) varies according to the types of taxpayers and income. Income taxes are the most commonly considered tax for PE/VC funds and their investors. Among different types of fund entities, companies pay a 25% income tax (if no other preferential enterprise income tax treatment is available), contractual funds and partnerships are generally considered fiscally transparent for income tax purposes. Investors and carried interest participants are also subject to income taxes, and the rule is the same when it comes to investors in the case of the company and partnership forms. Tax treatment for individual taxpayers is more complex since their income is generated from partnership interests. Carried interest participants may also need to pay value-added taxes with respect to their carried interests if this income is considered to be from the sale of services.

With respect to withholding obligations regarding resident investors, company funds are required to withhold income taxes for individual investors, and partnership funds are liable for making tax declarations for individuals' income taxes and are generally responsible for withholding. Contractual funds are generally considered not liable for withholding under the current tax regime.

5.2 Tax Treaty Network

The PRC has signed three tax multilateral conventions, namely:

- Multilateral Conventions on Mutual Administrative Assistance in Tax Matters;

- Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information; and
- Multilateral Conventions to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

The PRC has also signed double taxation agreements with Hong Kong, Macao and Taiwan (not yet effective). As of 1 October 2018, the PRC has signed 106 double taxation treaties with other jurisdictions (of which 100 have come into effect) and ten tax information exchange agreements.

These tax treaties have together enhanced tax compliance and mitigated cross-border tax risks for investment funds. On the other hand, non-resident investors of PRC investment funds may benefit from these agreements/treaties where applicable and may receive support in resolving international tax disputes.

5.3 FATCA and CRS Regimes

The PRC has signed the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information and committed to the first exchange of information in September 2018. Domestic legislation and reporting formats have been adopted to implement the Common Reporting Standard (CRS), which provides guidelines and clarifies a timetable for financial institutions to carry out due diligence of both investment accounts and new accounts and to recognise financial accounts owned by non-residents and report to the relevant taxation authority by May 31st of each year. In addition, financial institutions are required to establish an internal monitoring mechanism to assess the compliance with CRS annually, and to report in writing to the relevant taxation authority by June of the following year.

Both investment funds and their managers are considered reporting financial institutions, and are therefore required to conduct due diligence on their accounts to identify whether those accounts are considered 'reportable accounts' under CRS, and to report information on these reportable accounts and to submit internal inspection reports to the taxation authority annually.

5.4 Tax Structuring Preferences of Investors

PRC tax residents pay income taxes on their worldwide income, both from domestic and foreign sources. PRC tax resident investors are generally allowed to offset the amount of income tax paid overseas against their taxes payable in the PRC up to a specified amount. For a company, the income tax rate is usually 25% if no other preferential income tax treatment is available. However, equity investment income such as dividends and bonuses between qualified resident enterprises are considered income tax exempt. Individual investors invested in company funds are generally subject to a 20% income tax rate on income from the funds. However, individuals invested in partnerships may be subject to different tax rates based on recent policies as mentioned in 1.11

Legal, Regulatory or Tax Legislative Changes in the case of private venture capital funds and, potentially, in other types of investment funds.

In view of the current tax regimes in the PRC, sponsors of PE/VC funds usually prefer the partnership rather than the company form when establishing investment funds. However, it remains an open question for sponsors and investors as to how to structure fund and investment vehicles in a tax-efficient manner due to ongoing public speculation about the trends in relevant tax policies. Nonetheless, local tax rebates and preferential treatment for qualified capital funds are still expected to be major concerns when establishing fund entities.

6. Miscellaneous

6.1 Asset Management Industry Bodies

In the PRC, social organisations are required to be registered with the Ministry of Civil Affairs (MCA) or its local counterparts and be guided by a competent industry authority. Asset management (including but not limited to related services provided by banks, trusts, securities, funds, futures and insurance asset management institutions) are separately subject to self-discipline by their respective industry bodies.

The China Banking Association aims to exercise self-regulation in the banking industry and is a national and industry-oriented social organisation under the guidance of the China Banking and Insurance Regulatory Commission and the MCA.

The China Insurance Industry Association aims to exercise self-regulation of the insurance industry and is a national and industry-oriented social organisation, under the guidance of the China Banking and Insurance Regulatory Commission and the MCA.

The AMAC aims to exercise the self-regulation of the investment funds industry, is a national and industry-oriented social organisation under the guidance of the CSRC and the MCA.

6.2 Preference for Courts or Arbitration

Generally, arbitration is the preferred dispute resolution method for private investment funds due to its flexibility and confidentiality.

6.3 Level of Litigation/Arbitration

The fast development of the investment funds market in recent years has resulted in more fund-related disputes, and the relevant dispute resolution mechanisms have also become more mature. For example, the Supreme People's Court issued a well-known case in 2018 in which the court affirmed the effectiveness of a redemption clause under

which the portfolio company was jointly and severally liable for the redemption obligation made by the company's founder to the investors. This decision changed the market's opinion established in a 2012 Supreme People's Court case which found that these redemption arrangements against portfolio companies under valuation adjustment mechanisms were invalid. It is arguable that the 2018 decision is more investor-friendly in practice, has redefined the legal boundaries of certain investor rights and will be influential to the future investment practices.

There are currently no particular arbitration proceedings or special national courts aimed at resolving investment fund-related disputes, although a substantial development occurred in 2017 with the formation of the first fund court in Beijing Fund Town in Fangshan District. This fund court resolves various disputes that arise from the operation of fund institutions such as corporate disputes, equity disputes, contract disputes, etc. It is possible that this attempt, once proven to be practicable and beneficial to the funds industry, can be introduced nationally.

6.4 Periodic Reporting Requirements

In addition to the disclosure requirements to investors, private fund managers are subject to periodic AMAC reporting requirements. Private fund managers are required to regularly report fund operation information to the AMAC through an online system. Private securities fund managers will monthly update the fund size, unit net value and investor information, while other private investment fund managers are only required to report quarterly. These reports are required by the AMAC only to monitor the operation of every private investment fund, and are not publicly available. Disclosure reports provided to investors are also submitted to the AMAC for recordkeeping as well, through another online AMAC system.

Private securities fund managers are required to submit monthly disclosure reports within five business days after the close of each month, submit quarterly disclosure reports within ten business days after the end of each quarter, and submit annual disclosure reports before April 30th of the following year. Unless otherwise agreed in the fund contract, investors can access these reports through the AMAC's website.

PE/VC fund managers are required to submit semi-annual disclosure reports to the AMAC before September 30th, and submit annual disclosure reports by the end of June of the following year. These reports are not publicly available, unlike private securities fund reports.

The periodic back-up requirements are of great significance to managers. If a manager twice fails to timely submit reports (except monthly disclosure reports), the manager will be publicised as an 'abnormal institution'. The abnormal status

will continue to apply for six months following rectification. Besides this, the AMAC will suspend any filing of private investment funds made by an abnormal manager, unless the manager completes the corresponding rectification requirements.

Publicly offered funds are required to publicly disclose quarterly portfolio reports on fund assets, financial accounting reports and semi-annual and annual fund reports, and any ad hoc reports. Disclosure information can be found published on a CSRC information disclosure website.

6.5 Powers of Attorney

Investors may delegate full authority to manage fund affairs to a fund manager or even enable a fund manager to execute relevant documents on behalf of the investors through the fund contract. However, an autographic signature or separate power of attorney is typically required where an investor seeks to transfer or dispose of an interest or any other important changes occur with the fund which would result in filings with the competent authorities, such as the AIC.

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