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Chapter 6

CHINA

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I GENERAL OVERVIEW

After the promulgation of the Interim Measures for the Supervision and Administration of Private Investment Funds (PIF Interim Measures) by China Securities Regulatory Commission (CSRC) on 21 August 2014 and the first year of implementation of 2015, the private equity (PE) and venture capital (VC)[2] industry, especially with respect to the fundraising activities in China,[3] witnessed a sea change in the regulatory landscape with the strict supervision and regulation of China Securities Regulatory Commission (CSRC), the Asset Management Association of China (AMAC), the Administration of Industry and Commerce (AIC) and other relevant authorities. AMAC, the self-regulatory organisation of the fund industry and the registration authority for the filing of private investment funds (PIFs) and the registration of private fund managers in China, issued a series of rules, guidelines and notices regulating the registration of private fund managers and fundraising activities and AIC registration of investment and investment management entities in many cities (e.g., Beijing, Shanghai, Tianjin) were largely suspended in 2016, which had a significant impact on the market participants and fundraising activities. Despite the PRC government's tightened regulation of the PE/VC industry, however, the industry continued its fairly rapid growth momentum in 2016.

The concept of VC investment was first introduced in China in the late 1980s, and the government began to officially encourage foreign VC firms to invest in China in 1995. From 1995, the Chinese PE market grew at a rapid pace in respect of both fundraising and investments, and the number of PE and VC firms skyrocketed.[4] According to an AMAC report, the self-regulatory organisation of the fund industry in China, by the end of December 2016, a total of 17,433 private fund managers[5] managing 46,505 PIFs have been registered with AMAC with total capital commitments of 10.24 trillion yuan and total capital

1 James Yong Wang is a senior investment funds expert at Han Kun Law Offices. The author acknowledges the assistance of his colleague Wei (Abby) Mei in preparing this chapter.

2 For the purposes of this chapter, the terms 'private equity', 'PE' and 'PE fund' encompass 'venture capital', 'VC' or 'VC fund' unless indicated or where the context requires otherwise.

3 For the purposes of this chapter, China or the PRC (People's Republic of China) does not include Hong Kong, Macao and Taiwan.

4 While there were only a handful of PE and VC firms in 1995, the number jumped to over 6,000 in 2012.

5 After the publication of the Announcement on Matters concerning Further Regulating Registration of Privately Offered Fund Managers on 5 February 2016, AMAC cancelled the registration of 12,834 private fund managers as those private fund managers were not able to complete the rectification requirements under the above mentioned announcements. After the publication of such announcement, 3,308 private fund managers were newly registered with AMAC by 13 January 2017.

contributions of 7.89 trillion yuan, comparing to 24,0544 PIFs filed with AMAC with total capital commitments of 5.07 trillion yuan and total capital contributions of 4.05 trillion yuan as of the end of December 2015. With regard to the fund managers, the number of management companies with an AUM above 10 billion yuan and between 5 and 10 billion yuan is 133 and 157, respectively, compared to 87and 99 as of the end of December 2015. The government guidance funds mushroomed in 2016. There were only 457 government guidance funds with aggregate target commitments of 1.28 trillion by the end of 2015,while the aggregate disclosed fund size jumped to 3.3 trillion as of September 2016. A relevant development of the domestic securities market is the New Third Board (NTB). Established in 2006, the NTB was discovered by smart private fund managers as a way to tap the public market in recent years, as demonstrated by the NTB listing of the first private equity fund manager Jiuding in April 2014, followed by about 24 other fund managers by February 2016, including CSM, Cowin Capital, Heaven-Sent Capital, Zheshang VC, Bright Stone, China Equity Group, CURA Investment, Eagle Investment, New Margin Capital etc.[6] More than 20 additional fund managers are on the waiting list, including Legend Capital, CITIC Capital, China Soft Capital, etc. As a result of this development, the potential NTB listing became an important consideration in the fund structuring process for an increasing number of private fund managers. Leading NTB-listed private fund managers such as Jiuding and CSM raised brain-numbing amounts of capital through equity and debt offerings on the NTB in 2015, which were used to acquire mutual fund managers, brokerage firms, CTAs, insurance companies and public companies, fundamentally changing the private fund landscape in China. Due to concerns of CSRC over, and the need to investigate, the fundraising and capital deployment plan of NTB-listed private fund managers, CSRC put a temporary hold on the approval of the NTB listing of private fund managers in December 2015 and financial institutions in general in January 2016.[7] The NTB listing of private fund managers was reopened at the end of May 2016 with eight new listing requirements set for private fund managers and one-year rectification period for existing NTB-listed private fund managers. Only a small number of the largest private fund managers in China may be able to meet the new listing requirements. On the IPO side, after domestic IPO was suspended for about four months in 2015, the IPO market made a comeback in 2016 with 247 approved IPOs in the year, and the number is expected to reach 500 in 2017. The first 10 private fund managers authorised to conduct market-making business in NTB were also announced in 13 December 2016.

Prior to 2007, China's PE and VC market was dominated by offshore PE and VC funds organised in offshore jurisdictions (typically the Cayman Islands). During that period, most foreign PE and VC funds made their investments into offshore holding vehicles of Chinese companies (the restructuring of such Chinese companies to establish offshore holding vehicles for offshore financing and IPO is called the 'red-chip' model) and sought lucrative returns through the IPO of such companies on US or other foreign stock exchanges. The red-chip model was dealt a significant blow with the release of Circular 10 by the Ministry

6 For a more in-depth case study on the NTB-listing of private fund managers, please refer to Han Kun Private Equity Commentary 'Legal Analysis of NTB-Listing of Private Fund Managers', available at www.hankunlaw.com/downloadfile/newsAndInsights/8556712513dac9c9db2c4f7c81b26488.pdf.

7 With an AUM of 21.4 billion yuan, less than 1 per cent of Blackstone's AUM of US$332.7 billion, the NTB-listed Jiuding was valued at 1.025 billion yuan as of 11 December 2015, very close to the market cap of US$185 billion for Blackstone.

of Commerce (MOFCOM) in 2006, which subjected red-chip restructuring to MOFCOM scrutiny, with no approval having been granted to any case to date. While the overseas IPO exit route has not been completely cut off (thanks to creative counsel finding ways to get around Circular 10), the domestic capital market naturally became an increasingly important part of the exit strategy of PE funds, especially as the government launched the Small and Medium-Sized Enterprise Board in 2004, the Growth Enterprise Board in 2009 and NTB in 2012 in an effort to create a more dynamic, multilayered capital market. Another significant step taken by the government to stimulate the growth of the domestic PE market was the revamping of the Partnership Enterprise Law in 2006 to create the new legal form of 'limited partnership' (LLP) commonly used by PE and VC funds in the developed world. Following the amendment of such Law, yuan-denominated funds mushroomed.

Due to China's strict foreign investment regulation and foreign exchange control, and with the increased intensity of competition for deals, offshore funds increasingly find themselves at a significant disadvantage when competing with yuan funds for domestic deals. Many foreign PE and VC sponsors have thus started to incorporate a yuan fund strategy into their overall China strategy, as further described in Section II, *infra*. At the same time, many Chinese PE and VC sponsors with a successful track record managing yuan funds started to form and manage offshore funds in order to be more nimble when competing for offshore (red-chip) deals.

II LEGAL FRAMEWORK FOR FUNDRAISING

i General

PE versus VC

When a fund sponsor embarks on the task of forming a fund in China, one of the first things it needs to determine is whether to form a PE or VC fund.[8] The distinction is not just a difference in terminology; it carries significant ramifications, because PE and VC funds were created by different enabling regulations and were to some extent also regulated differently. VC funds were created by and operate under the regulations of the National Development and Reform Commission (NDRC),[9] historically the principal regulator for the VC industry, while PE funds were created by local (e.g., provincial and municipal) regulations (literally translated from Chinese as 'equity investment enterprise' or 'EIE', as opposed to 'venture capital enterprise' or VCE). PE and VC funds differ in many respects, including required minimum fund size,[10] minimum investor subscription amount, record-filing requirements, capitalisation for its management company (MC), preferential tax policies, subsidies and

8 Note that the label of PE or VC of a particular fund does not necessarily indicate its investment strategy. An early stage venture fund could very well be formed as a PE fund. However, in order to become eligible for preferential tax and other treatments as a VC fund or raise capital from pools of capital administered by the NDRC or its local counterparts, a fund has to be formed as a VC fund and remain in compliance with the relevant NDRC guidelines.

9 The NDRC, for a short period of time, also regulated PE funds through its mandatory national record-filing regulation.

10 Local AICs generally follow the minimum size requirement for VC funds of 30 million yuan. The minimum size for PE funds may vary depending on the specific location of formation of the PE fund, with the typical requirement being 100 million yuan.

other preferential treatments, and investability by certain limited partners (LPs). In fund formation practice, the distinction between PE and VC funds may significantly complicate the structuring process, as discussed later.

The effectiveness of the amended Securities Investment Funds Law, the first national level legislation covering PIFs, on 1 June 2013, and other related regulations may help harmonise the differences in the regulation of PE and VC funds to some extent over time. The PIF Interim Measures are the first national regulation on PIFs generally. It officially brings both PE and VC funds under the supervision of the CSRC and AMAC, and explicitly specifies the registration and record-filing system for PIFs and their managers, defines 'qualified investors', and clarifies the private placement activities and disclosure requirements for private fund managers. As part of the amendment to the PRC Company Law, effective as of 1 March 2014, the 20 per cent minimum requirement for the first instalment of registered capital and the previous strict capital contribution schedule for limited liability companies (LLCs) (five years for investment companies and two years for other companies) have been abandoned in favour of a more flexible capital commitment system, which should make it easier for fund managers to structure their general partner (GP) or MC entities.[11] However, VC funds that intend to file with the NDRC and apply for preferential tax treatment are still subject to the previous capital contribution requirements in some cities.

The PIF Interim Measures regulate 'investment funds established by way of raising capital from investors in a non-public manner within the territory of China'. Substantially all of the AMAC-registered managers and funds are formed in China. Offshore fund managers and offshore funds targeting Chinese investors or conduct fundraising activities in China, or both, are not expressly excluded from the registration and record-filing requirements. However, since AMAC has not yet published specific rules to regulate this area, such offshore fund managers and funds are currently not subject to the registration and filing requirements. For foreign asset managers, it is also important to note that foreign-owned private fund managers may register with AMAC as a private PE/VC fund manager, and since 30 June 2016, they (including wholly/majority foreign-owned private securities fund managers) are also allowed to apply for the AMAC-registration as securities investments managers.[12] Fidelity became the first foreign firm to obtain the AMAC registration on 3 January 2017 as a wholly foreign-owned private securities fund manager.

Out of their desire to insulate the risks of public market turbulence and the PE/VC industry, the CSRC and AMAC are promoting differentiated regulations and supervisions not only for private securities fund managers and PE/VC managers but for PE and VC managers. VC funds may be prohibited from making any public securities investments in the A-share market (although investing in NTB-listed companies is permitted). We shall wait and see if such prohibition and differentiated treatment will be reflected in mandatory rules and regulations down the road.

11 In practice, AMAC may doubt if a MC entity has sufficient funds to support its fundraising or management activities for more than at least half a year if the MC entity's paid-in capital is no more than 2 million yuan. So now, for purposes of AMAC registration, equity holders of a private fund manager generally need to make capital contributions of at least RMB 2 million.

12 For a more in-depth description of AMAC rules on registration of wholly/majority foreign-owned private securities fund managers, please refer to Han Kun Private Equity Commentary 'AMAC Opens Registration to Wholly/Majority Foreign Owned Private Securities Fund Managers', available at www.hankunlaw.com/downloadfile/newsAndInsights/37d511cfe7a26596241aebe6d55ac091.pdf (English) and www.hankunlaw.com/downloadfile/newsAndInsights/b621a5c04399896c626c52a44ec2b477.pdf (Chinese).

Registration

AMAC released the Interim Measures on the Administration of Registration of Non-public Investment Fund Managers and Record-filing of Funds (Record-filing Measures), effective as of 7 February 2014, and many related guidance and announcements to further regulate manager registration, disclosure requirements and internal control of fund managers in 2016. Pursuant to the Record-filing Measures and the Announcement on Matters concerning Further Regulating Registration of Privately Offered Fund Managers released by AMAC on 5 February 2016 (Registration Announcement) in PE/VC industry, any private fund manager is required to register with AMAC prior to carrying out any fundraising activities and complete its record-filing with AMAC for the private fund (regardless of whether it is set up as a PE, VC or hedge fund) within 20 working days of the closing of such fund. Senior management of PIF managers is required to obtain fund professional qualification and PIF managers are required to submit legal opinions on a laundry list of items at the time of their initial registration with AMAC or any subsequent material change. Some basic information regarding the fund, such as the name of the fund, date of establishment, major area of investment, fund manager and custodian, is required to be provided to AMAC through its electronic record-filing system. The private fund manager is also required to update information (such as the total amount of commitment and contribution, total number of investors and any change in the fund's investment focus), in the case of a private securities fund, on a monthly basis, and in the case of a PE/VC fund, on a quarterly basis, and on the manager itself on an annual basis. In addition, fund managers are required to report to AMAC certain significant matters, such as any change in senior management or the controlling shareholder of the private fund manager, merger, division, bankruptcy of the private fund manager, significant amendment to the fund agreement and liquidation of the fund. Further regulations on private funds are also being developed. Although laws and regulations do not prohibit private fund managers from managing PE/VC funds and securities funds, since the launch of a new registration and filing system for private fund managers on 8 September 2016, private fund managers may only be able to choose one of the following: securities fund manager, PE/VC fund manager or other types of fund manager. Thus, in practice, a private fund manager recently registered on the new system may not be able to be classified as both securities and PE/VC fund managers and manage PE/VC and hedge funds at the same time.

In addition to private funds and their fund managers, effective as of 1 February 2015, third-party service providers to which the private fund or its manager outsource services, such as a fund sales agent, transfer agent, valuator, fund administrator and other fund intermediaries, are also required to register with AMAC and be subject to its supervision pursuant to the Guidelines on Fund Business Outsourcing Services (Trial Implementation). As of the date of this writing, registered third-party service providers are generally commercial banks, securities companies and public funds. Moreover, according to the Interim Administrative Provisions on the Operation of the Private Asset Management Business of Securities and Futures Operation Institutions, effective as of 18 July 2016, only securities and futures operation institutions that are allowed to be engaged in the asset management business and private securities investment fund managers having registered with AMAC for more than one year and obtained AMAC membership[13]are qualified third parties to provide investment advice to

13 Application for AMAC membership is a separate process from the registration of private fund managers and subject to different and higher requirements for the applying manager.

securities and futures operation institutions on the private asset management business. The above-mentioned interim administrative provisions applies to private securities investment fund managers on a *mutatis mutandis* basis.

In an effort to demonstrate that the registration system has real teeth, the CSRC and AMAC have also strengthened their self-disciplinary actions and conduct examination and inspection on the registered private fund managers. Several private fund managers and law firms that issued legal opinions for the registration of such private fund managers were sanctioned by AMAC in 2016.

ii Domestic sponsors and investors

General

PE funds raising capital exclusively from domestic investors may generally be structured as LLPs[14] under the Partnership Enterprise Law or LLCs under the Companies Law and other national and local regulations. While many Chinese LPs, especially state-owned enterprises (SOEs), were (and to some extent still are) more familiar and comfortable with LLCs, LLPs have gradually become the dominant form for PE funds in general in recent years.

Under the Partnership Enterprise Law, an LLP may have up to 50 partners, including at least one GP and one LP. The number of shareholders of an LLC likewise is limited to 50 under the Companies Law. In addition to LLPs and LLCs, PIFs are also allowed to be structured as 'contractual funds' that do not have legal personalities and are managed by fund managers through investment management agreements or other similar agreements. Contractual funds have a number of advantages and drawbacks compared to LLPs and LLCs, as further discussed below.

A PIF may be offered through private placement in China to no more than 200 qualified investors in the case of a contractual fund, or 50 qualified investors[15] in the case of an LLP or LLC, each of whom:

a shall make a minimum commitment of 1 million yuan to the fund; and
b is an entity with net assets in excess of 10 million yuan, or a natural person with individual financial assets in excess of 3 million yuan or an average individual annual income in excess of 500,000 yuan for the past three years.

Deviating from the previous private placement practice in China, where most investors only executed an LLP agreement or a simple subscription form, fund managers are now required to use risk surveys to determine the qualification and risk tolerance of their investors, ask investors to complete investor questionnaires and submit asset ownership certificates to identify investors' qualifications and prepare a written risk disclosure to be signed by investors. This new practice is consistent with the practice common in the Western world.

The PIF Interim Measures have adopted 'look-through' rules for the calculation of the number of investors. However, the following investors are deemed qualified investors[16] and not subject to the look-through rule: (1) social security funds, enterprise annuity schemes and other pension funds, charitable funds and other non-profit funds; (2) investment vehicles and asset management schemes (AMSs) that have been duly established and duly

14 'LLP' is customarily used as the acronym for 'limited partnership' to distinguish it from 'LP'.

15 Those deemed as qualified investors are discussed below.

16 Except for the three categories, private fund managers and their practitioners who invest in the PIFs under their management are deemed as qualified investors but are subject to the look-through rule.

filed with AMAC; and (3) other investors prescribed by the CSRC. PE, VC and hedge funds (whether structured as LLCs, LLPs or contractual funds), AMSs, trust schemes and other similar investment funds and schemes that are filed with AMAC fall within the second category. Thus, fund sponsors may use multi-tiered structures to effectively get around the 50 or 200 investor limitations at the time of formation of the fund, although such structures may still be subject to heightened scrutiny and challenged by CSRC at the time of the IPO of a portfolio company.

Securities companies participate in PE/VC market and engage in private fundraising and PIF management activities through their direct investment subsidiaries and their subordinated institutions. Those PIFs shall be recorded at Securities Association of China(SAC) since 2012. On 13 March 2016, AMAC released a notice requiring that direct investment subsidiaries of securities companies record their direct investment funds on AMAC's securities company private funds filing system. More and more PIFs are under the regulation and supervision of AMAC.

Contractual funds and other AMSs

Contractual funds and other AMSs issued by registered PIF managers, licensed trust companies, brokerage firms and mutual fund manager subsidiaries have a number of advantages over LLPs and LLCs: (1) the formation and amendment of an AMS are in the hands of the manager and its investors without the need to go through inflexible and cumbersome local Administration of Industry and Commence (AIC) procedures, (2) an AMS is allowed to have up to 200 investors (compared to 50 for an LLP and LLC), a feature particularly appealing to retail funds formed by asset or wealth management firms, and (3) AMSs also have certain tax advantages such as no tax at the AMS level (compared to an LLC), no mandatory withholding requirement on natural person investors (compared to an LLP) and some other tax planning opportunities to bring the tax payment obligations of the fund sponsor and the investors more in line with the economic deal stricken by them. Thus, in additional to hedge fund managers, AMSs, especially contractual funds, are also finding innovative use in the formation of traditional PE and VC funds recently, often in conjunction with an LLP structure.

Adopting an AMS structure has its drawbacks too, the principal one of which is that it will be looked upon unfavourably at the time of IPO of a portfolio company as the regulators tend to view this structure as an easy way to hide the real owners of the IPO candidate company. As of this writing, there has been no disclosed case of a successful IPO of a company in which an AMS is a direct shareholder; however, recently there have been three approved IPO cases where several AMSs formed by subsidiaries of mutual fund management companies are used somewhere up the shareholding chain (through an LLP private fund) and the ultimate beneficiary owners are disclosed in such cases too. Although CSRC has not officially confirmed that an AMS is acceptable in IPO cases, it is still encouraging news to AMSs formed by licensed financial institutions. As for NTB listing, in October 2015, the NTB released a Q&A that for the first time expressly allows AMSs properly registered with AMAC to invest in pre-NTB companies, and the first NTB listing case (Xinlv Gufen) with an AMS shareholder (an AMS fund managed by Founder Fubon Asset Management Co) was successfully approved in late 2015. An AMS is allowed to invest in companies that are already public or NTB-listed, although since October 2015, CSRC requires any investor in a PIPE deal involving an AMS to be looked through to its ultimate beneficial owners for the purpose of counting the number of investors towards the 200-person limit for a non-public offering.

It is also worth noting that unlike other AMSs that are regulated by CSRC and AMAC, trusts are regulated by CBRC and subject to more stringent IPO/NTB listing rules and thus should generally be avoided in any pre-IPO or pre-NTB company.[17] On 14 December 2016, in a breakthrough case, the material asset reorganisation of Ningbo Xinhai Electronic Holding Co (limited by shares) was approved by CSRC, the first back-door listing case where a record filed contractual fund was fully disclosed as a beneficiary owner several layers up from the direct shareholder.

iii Foreign investors

The form of fund with foreign participation (either as a GP or investors or both) has evolved over the years.

Foreign-invested venture capital enterprise (FIVCE)[18]

Before the advent of the LLP in China, foreign fund sponsors primarily formed onshore funds in China in the form of an FIVCE under the Administrative Regulation for Foreign-Invested Venture Capital Enterprises (FIVCE Regulation) promulgated on 30 January 2003. An FIVCE may be set up either as a 'non-legal-person sino-foreign cooperative joint venture' (non-legal-person FIVCE) or as an LLC (corporate FIVCE). A corporate FIVCE is typically used by one or more foreign fund sponsors to set up an onshore fund exclusively with foreign currency capital, whereas a non-legal-person FIVCE was the popular form for a foreign fund sponsor to pool onshore and offshore capital together, often in partnership with a Chinese fund sponsor.

An FIVCE (whether in non-legal-person or corporate form) is required to have a 'requisite investor', which plays a role similar to a GP to a partnership fund. The requisite investor is required to satisfy certain requirements, including having VC investment as its main line of business; having cumulative capital under management of at least US$100 million (or 100 million yuan in the case of a Chinese investor acting as the requisite investor) in the past three years; and subscribing for and contributing at least 1 per cent (in the case of a non-legal-person FIVCE) or 30 per cent (in the case of a corporate FIVCE) of the total size of the FIVCE.

A FIVCE is required to have a minimum fund size of US$5 million or the yuan equivalent (in the case of a corporate FIVCE) and US$10 million or the yuan equivalent (in the case of a non-legal-person FIVCE). Each investor other than the requisite investor is required to invest at least US$1 million or the yuan equivalent.

The non-legal-person FIVCE was very popular before the advent of the LLP because it was the legal form closest to an LLP. The FIVCE Regulation allows the investors of a non-legal-person FIVCE to agree that the requisite investor assume joint liability to the

17 For a more in-depth discussion of AMSs, please refer to Han Kun Private Equity Commentary 'Legal Anatomy on Contractual Private Equity Funds' and 'Investment by AMSs in Pre-NTB and Pre-IPO Companies', available at www.hankunlaw.com/downloadfile/newsAndInsights/57905dfd9ba30dd26ccfdb78849e5a1e.pdf and www.hankunlaw.com/downloadfile/newsAndInsights/3c66dcf7508ade3beb850234689e423e.pdf (Chinese).

18 For a more in-depth discussion of FIVCEs, please refer to Han Kun Private Equity Commentary 'Will FIVCE Fade Away – Tax Pass-through Status of FIVCEs Officially Ended', available at www.hankunlaw.com/downloadfile/newsAndInsights/621f96184cfa886935c765f471e3a88c.pdf (English) and www.hankunlaw.com/downloadfile/newsAndInsights/2ae32de1676104cb84c11bf378faa356.pdf (Chinese).

FIVCE and the other investors to assume limited liability up to their capital commitments (in contrast, all investors of a corporate FIVCE enjoy limited liability protection). Non-legal-person FIVCEs were also allowed to choose to be a tax pass-through entity like a partnership, in which case the income of the FIVCE will not be taxed at the fund level but will be allocated and directly taxed in the hands of the investors. The tax pass-through treatment, however, was not well understood by many local tax authorities, causing many non-legal-person FIVCEs to not be able to enjoy the tax pass-through status in many local jurisdictions. As the LLP form was made available to foreign-invested PE funds in 2010, and the provision granting tax pass-through status to non-legal-person FIVCEs was officially repealed in 2011, the FIVCE became a much less desirable legal form for foreign-invested funds in China. Certain foreign sponsors have decided to dissolve FIVCEs if such funds have not made substantial investments or their investments have not significantly appreciated in value. To the extent that such dissolution or restructuring requires the transfer of investments to an LLP established by the same group of investors, it would unfortunately trigger enterprise income tax (EIT), as it would be unlikely to qualify as a tax-free reorganisation. Other foreign sponsors have been exploring ways to restructure FIVCEs into LLPs without transferring the underlying portfolio interests. However, as there is currently no law or regulation authorising the restructuring of FIVCEs into LLPs,[19] this can only be done on a case-by-case basis (if at all). To our knowledge, so far there has been no successful case of such restructuring.

Qualified foreign limited partner (QFLP) and yuan-QFLP (R-QFLP)[20]

As discussed earlier, the Partnership Enterprise Law was amended in 2006 to permit the LLP form, which spurred the growth of domestic LLPs (DLPs). As foreign investment and foreign exchange is tightly regulated in China, however, foreign fund sponsors and investors had not been able to avail themselves of the new LLP structure until the State Administration of Industry and Commerce (SAIC) promulgated the Administrative Regulations on the Registration of Foreign-invested Partnership Enterprises in 2010 and Shanghai released trial regulations on its QFLP pilot programme in January 2011.[21] The pilot programme opens the door for foreign sponsors to set up onshore funds in China in the form of LLPs and has clear

19 By comparison, certain local authorities (e.g., Tibet, Xinjiang and Shanghai Pudong District) have introduced local regulations permitting the restructuring of an LLC into an LLP, although the success of the implementation of such local regulations varies among different provinces/districts.

20 For a more in-depth discussion of the QFLP/R-QFLP programmes in various cities, please refer to the following issues of Han Kun Private Equity Commentary: for Shanghai QFLP, www.hankunlaw.com/downloadfile/newsAndInsights/c62418c065e436082cfb853a81b127cc.pdf (English) and www.hankunlaw.com/downloadfile/newsAndInsights/2ac6cbbabefd9fda11ede072f90a666e.pdf (Chinese); for Beijing QFLP, www.hankunlaw.com/downloadfile/newsAndInsights/7ed1b1ec937559e67827278d14602b6e.pdf; for Tianjin QFLP, www.hankunlaw.com/downloadfile/newsAndInsights/30061ab3916d999d0b77a781975b5d88.pdf (Chinese); for Shenzhen QFLP, www.hankunlaw.com/downloadfile/newsAndInsights/2f35dd4551b2bccfb0bc8ce8f372dddc.pdf (Chinese); for comparison of Beijing, Tianjin and Shanghai QFLP programmes (Chinese), www.hankunlaw.com/downloadfile/newsAndInsights/c01e5068177a72c0e4159faedb44e1c3.pdf; and for R-QFLP, www.hankunlaw.com/downloadfile/newsAndInsights/a853cc028c36ccbf1c346031b123260d.pdf (Chinese).

21 Beijing, Tianjin, Chongqing and Shenzhen followed suit in adopting their own versions of the QFLP pilot programme, which were all modelled on the Shanghai version. Of all the cities with a QFLP pilot programme, the Shanghai programme is by far the most successful, while the Tianjin programme is more time-efficient.

advantages over the traditional FIVCE or offshore fund model. In particular, in contrast with a FIVCE, which is now subject to a 25 per cent EIT, a QFLP fund as a partnership enjoys tax pass-through treatment at the fund level. Second, an offshore fund needs to go through the time-consuming approval process with the State Administration of Foreign Exchange (SAFE) for each investment, and the portfolio company would receive foreign currency capital from the fund and must seek SAFE approval to convert it on each occasion when it needs to use such capital. In contrast, SAFE approval for a QFLP fund is done at the front end (namely, at the time of the fund formation), and foreign currency capital may be converted into yuan directly with the custodian bank in a prompt manner (typically about one week), thus avoiding the lengthy SAFE approval process for each investment and also saving the portfolio company the trouble of having to seek SAFE approval for foreign exchange settlement. With the promulgation of Circular 19 in March 2015, the previous stringent payment-based foreign exchange settlement system for foreign-invested enterprises (FIEs) has been replaced by a foreign exchange settlement system for FIEs where FIEs are allowed to convert foreign exchange-registered capital at their discretion and then make equity investments with yuan. Circular 19 is intended to put the rest of the country on the same level playing field as the several QFLP pilot areas. However, the several QFLP pilot areas are still ahead of the rest of the country in terms of the implementation of the QFLP regulations and thus remain the preferred location for foreign PE/VC firms contemplating a QFLP fund formation at this time.

For those fund sponsors that have not managed an onshore fund before, a QFLP fund could also bring certain reputational and other intangible benefits. To date, about 40 foreign sponsors have received QFLP licences for their PE funds in Shanghai, including leading PE firms such as Blackstone, Carlyle, TPG, 3i, Hony Capital and SAIF. Due to the PRC government's encourage of inflow of foreign capital against the backdrop of the foreign exchange imbalance, 2017 should continue to be a favourable year for foreign asset managers desiring to apply for QFLP licences.

Over the past few years, three main models have emerged for QFLP funds: (1) the DLP model, where the foreign fund sponsor sets up a wholly foreign-owned enterprise (WFOE) to act as the GP/MC of a DLP and raises capital solely from domestic investors in yuan (as exemplified by the Blackstone QFLP fund);[22] (2) the co-GP/joint venture foreign limited partnership (FLP) model, where the foreign fund sponsor partners up with a Chinese fund sponsor to set up a joint venture MC and raises capital from both domestic and offshore investors (as exemplified by the Carlyle–Fosun QFLP fund); and (3) the wholly foreign-owned FLP model (as exemplified by the Fidelity QFLP fund). For each model, there are different variations, and the QFLP pilot programme is quite flexible in accommodating such variations. QFLP funds and their MCs are required to include 'equity investment' and 'equity investment management' in their company names and business scope, and thus are PE funds. Sometimes, the foreign sponsor of a QFLP fund also intends to raise capital from capital pools administered by the NDRC or its local counterparts, which is an example of when the incompatibility between the two lines of regulations over PE and VC funds becomes particularly obvious and poses a significant structuring challenge to the fund sponsor and its counsel.

22 Even though this structure does not involve a foreign LP, the MC and the fund still need to apply for QFLP licences because PRC law would otherwise prohibit the FIE-MC from using its foreign currency-registered capital to make its GP commitment and contribution to the fund.

The nature of a QFLP fund as a domestic or foreign fund is also an important issue. Under PRC law, it is very clear that QFLP funds under models (2) and (3) above are deemed to be foreign investors in terms of their investments and are required to go through the same foreign investment approval process as an offshore fund (except for the differences in the foreign exchange approval and conversion process as described earlier). The nature of a QFLP fund under model (1) above, however, is less than clear. The Shanghai QFLP regulation was designed by the Shanghai Financial Services Office to permit a QFLP fund that raises capital exclusively from Chinese investors in yuan, and whose foreign element is limited to the capital commitment and contribution by the GP (in the form of a WFOE or other FIE) to the fund of up to 5 per cent of the fund size, to be treated as a purely domestic yuan fund free from any foreign investment restrictions. The Blackstone QFLP fund was structured exactly to fit into such exception. However, the hope of domestic treatment was dealt a big blow by a written reply from the NDRC to its local counterpart in Shanghai on the classification of the Blackstone QFLP fund in April 2012, which clearly provides that the investments by such funds still need to comply with the Foreign Investment Industries Guidance Catalogue (e.g., with respect to the prohibition against and restrictions on certain industries, even though such fund is issued a business licence as a DLP rather than an FLP and the portfolio company is not required to be converted to an FIE). Following the NDRC Blackstone reply, new structures have been developed to minimise the adverse impact of such reply on the investment of similarly situated funds.

Another variation of the QFLP fund is the R-QFLP fund, where offshore yuan as opposed to foreign currency capital is used to set up the fund. The R-QFLP pilot programme has been less successful, partly because it is subject to additional regulation by the People's Bank of China with respect to the use of offshore yuan by the fund. To date, only two R-QFLP funds have been set up in Shanghai.

Important variation

It is very common for foreign sponsors to seek to raise capital exclusively from PRC investors in yuan, namely, under model (1) above. To avoid the time-consuming process of applying for a QFLP licence and foreign investment restrictions, it is desirable for such foreign sponsor to set up a pure DLP without any foreign investment restrictions. One way to structure a pure DLP is to use Chinese nationals (e.g., Chinese members on the team or family members of the relevant principals) to set up a purely domestic LLC and putting a series of contractual arrangements in place between the GP and the WFOE-MC. Careful advance legal and tax planning are required to ensure that such contractual arrangements provide effective control over the GP and are enforceable under PRC law, and that the economics of the fund (e.g., carried interest and management fee) are structured in a way consistent with the commercial intentions of the fund sponsor.

iv LPs

Compared with the LP market in the developed countries, China's LP market still remains at a primitive stage. Currently, the main LPs for the PE market in China are the National Social Security Fund Council (NSSFC), SOEs, insurance companies, successful entrepreneurs and high net worth individuals, third-party wealth management firms and fund of funds (FoFs). College endowments and foundations are still in their infancy and are not yet major players in the field, and local and corporate pension funds are not yet permitted to invest directly in PE funds.

In comparison with mature PE markets where the GP-LP model is more developed and the boundaries between GP and LP are highly respected, in China such boundaries are less clear. LPs (especially successful entrepreneurs) often desire to get significantly involved in the investment process of the fund by way of a seat on the investment committee or veto rights with respect to investments. Such involvement is risky, as LPs may lose their limited liability protection under PRC law by participating in the investment and management of the fund. However, as there has been no reported case against an overly active LP yet, such risk has not been sufficiently appreciated.

SOEs are a major source of capital for PE funds, and in recent years they have also become active in seeking to act as the GP, either alone or in partnership with other parties. According to a survey conducted by State Asset Regulatory Commission in May 2016, about 50 per cent of the enterprises directly controlled by the central authorities participated in the PE/VC industry. The participation of SOEs as GP or LPs in a fund creates a myriad of issues. For example, SOEs are expressly prohibited from acting as GP under the Chinese Partnership Enterprise Law. It is unclear, however, what constitutes an SOE for the purposes of this prohibition, and different government agencies apply different standards. According to the SAIC definition, SOEs only refer to wholly state-owned entities, while the NDRC used to consider SOEs to be any type of entity where the direct or indirect aggregate state ownership is no less than 50 per cent. Another important issue is the obligation of state-owned shareholders (SOSs) to mandatorily transfer (for free) up to 10 per cent of the issued shares of their portfolio company to the NSSFC upon its IPO. A fund with a significant level of expected SOE participation should determine in advance whether it may be deemed an SOS subject to the mandatory transfer requirements, and the rules for determining such SOS status are less than clear and not consistently applied. If significant state ownership cannot be avoided, provisions should be built into the partnership agreement and other documents to ensure that other non-SOE LPs and the GP will be made whole by the SOE LPs for the impact on their economic interests.

The fast-growing fundraising activities in 2016 benefited from the rapid development of guidance funds and government-sponsored industry investment funds that provide a large amount of capital for PE/VC funds. By the end of 2016, 1,013 yuan FoFs with more than 1.4 trillion yuan under management are active in the PE/VC market in China, among which 66.7 per cent are guidance funds representing 81.4 per cent of the total capital under management.

For first-tier PE/VC sponsors, the deep-pocketed LPs to go after in fundraising in China are the NSSFC and insurance companies. Since May 2008, the NSSFC has been permitted to allocate up to 10 per cent of its assets (the equivalent of about US$278.6 billion (as at the end of 2016)) to domestic PE funds (investments in offshore PE funds are not yet permitted). Chinese insurance companies have also been allowed to invest up to 10 per cent of their total assets in both domestic and offshore PE funds and equity of privately held companies since 2012, which translates into 1.5 trillion yuan of investible capital for PE funds as of the end of November 2016. Further, since December 2014, insurance companies' have been allowed to invest up to 2 per cent of their total assets as at the end of the last quarter (approximately 300 billion yuan as of the November 2016) in VC funds. By the end of 2015, Chinese insurance companies have invested a total of 198.6 billion yuan in PE funds. PE and VC firms seeking insurance LPs are required to meet two sets of somewhat different criteria.

In addition to being permitted to invest as LPs into PE/VC funds, insurance companies have recently also been allowed to sponsor PE funds as a GP. Everbright Yongming and

Sunshine Insurance have been approved by the China Insurance Regulatory Commission (CIRC) to set up PE funds as a GP in 2015 and more 'manager licences' are expected to be issued by CIRC in 2017.[23]

For most of the fund sponsors, LPs like the NSSFC or insurance companies are beyond their reach. With the rapid growth of high net worth individuals and the wealthy middle class in China, asset and wealth management firms such as trust companies, brokerage firms, mutual fund managers or their subsidiaries and third-party wealth management firms are playing an increasingly important role in the fundraising of PE funds. The involvement of such asset and wealth management firms may significantly complicate the fund formation process, as they are subject to different regulations by different regulators, and requirements for investor suitability are inconsistent across different types of firms. Trust companies are regulated by CBRC as noted earlier, brokerage firms, mutual fund managers and their subsidiaries are regulated by CSRC, while third-party wealth management firms remain largely unregulated.

v Taxation

Tax is critical to the fund structuring process in China, even more so than in other developed countries, as tax rules with respect to PE funds and their partners are less settled and the room for tax planning and the downside for lack of or inappropriate tax planning may be more significant than in more developed countries.

Under PRC tax law, dividend income between two LLCs is exempt from EIT in order to avoid double corporate taxation (inter-LLC dividend exemption). For the same reason, dividend income from a corporate PE fund to an investor that is an LLC (a corporate investor) is also exempt from EIT. Since a fund typically receives most of its income from the disposition of portfolio interests, which is then allocated and distributed to its partners, for a corporate investor, it makes no difference whether the fund is an LLC or an LLP as far as EIT is concerned, because only one layer of EIT will be incurred, either at the corporate PE fund level or at the corporate investor level.

Individual investors, on the other hand, care deeply about the form of the fund. Individual investors are generally subject to individual income tax (IIT) at a rate of 20 per cent with respect to investment returns from the fund.[24] Since a fund in the LLC form would be subject to an additional layer of tax (EIT) on its income from the sale of portfolio interests, LLP funds are clearly more tax-efficient for individual investors as well as other entity LPs (such as an FoF in LLP form) that are comprised primarily of individual investors.

23 For an in-depth discussion of investment by insurance companies in PE and VC funds, please refer to the following issues of Han Kun Private Equity Commentary: 'How Insurance Companies Invest in PE Funds', available at www.hankunlaw.com/downloadfile/newsAndInsights/64aac151192fb36b67703d4042e1fe9a.pdf (Chinese) and 'Deep into PE Terrain – Insurance Companies Licensed to Invest in VC Funds and Sponsor PE/VC Funds', available at www.hankunlaw.com/downloadfile/newsAndInsights/3c8fae29f5becf636d14eee2a25ce3c6.pdf (Chinese).

24 It is clear that dividend income to an individual investor from an LLC fund shall be taxed at a 20 per cent IIT rate. It is less clear whether income from the disposition of portfolio interests received by an LLP fund and allocated to an individual investor is also subject to 20 per cent IIT. A number of provincial regulations provide for 20 per cent IIT on such disposition income from an LLP fund, even though some national tax rules that predated the LLP legislation, read literally, would require such income to be taxed at a progressive rate from 5 to 35 per cent, which is often less favourable to individual investors.

The taxation of an FLP, or more specifically, its offshore partners, remains unclear. One school of thought among the PRC tax community was that the withholding tax (WHT) at a rate of 10 per cent applicable to foreign invested enterprises in the form of LLC shall apply to dividend income from the FLP to an offshore partner, including carried interest to the offshore GP, the WHT of which may be reduced to 5 per cent if the offshore partner is able to avail itself of such reduced WHT pursuant to a tax treaty between China and the jurisdiction of formation of the foreign partner, unless the offshore partner is deemed to have a 'permanent establishment' in China, in which case it will be subject to the 25 per cent EIT. This school of thought, however, has not been accepted by PRC tax authorities, and efforts of tax advisors to negotiate and convince local tax bureaus to accept a 10 per cent WHT have had little success to date. In practice, given the lack of clear guidance on the taxation of offshore partners of an FLP (such as a QFLP fund), some local tax bureaus have been requiring a 25 per cent WHT on dividend income before it may be repatriated to its offshore partners (without distinguishing GP or LP).

Corporate VCIEs that are duly registered with the NDRC enjoy special preferential tax treatment. If they hold investments in qualified small or medium-sized companies with a high-tech qualification certificate for a period of at least two years, they are permitted to apply 70 per cent of its total investment amount in such qualified companies to offset their taxable income, with any excess carried forward to subsequent years. In the case of VCIEs formed as LLPs, effectively as of 1 October 2015, the 70 per cent tax benefits may also be passed along to their corporate LPs pursuant to Guoshui (2015) Circular 81. The high-tech qualification certificate, however, is not easy to obtain in practice.

vi Structuring of outbound investment funds

In 2016, China saw huge growth (an increase of 44 per cent) in outbound direct investment (ODI), with a total of over US$170 billion invested outside of China even though the PRC government has significantly tightened the ODI and other outbound investment filing and approval channels due to significant concerns about capital flee and foreign exchange imbalance. Outbound mergers and acquisitions reach a new peak, with a large number of mergers in the manufacturing and information technology industry. The US and Europe face challenges from Chinese investors, and it is said that about 30 transactions worth US$750 have been cancelled due to the difficulty in obtaining government approval for ODI, national securities and other sensitive reasons. The devaluation pressure on yuan and the benchmark interest rate cut by the People's Bank of China (PBOC) also underpin the rising need for ODI and international allocation of assets of domestic entities and high net worth individuals. Many domestic PIFs participated in the outbound investment wave, most of which were through the ODI channel. As general ODI filing procedures are complex and time-consuming, many PIF managers establish special purpose LLPs in Free Trade Zones in Shanghai, Tianjin, Qianhai or elsewhere to take advantage of the more convenient and fast ODI filing procedures. In the case of investing in offshore secondary markets or offshore PE/VC funds or hedge funds, the Qualified Domestic Limited Partnership (QDLP) pilot programmes in Shanghai, Tianjin and Qingdao, the Qualified Domestic Investment Enterprise (QDIE) pilot programme in Shenzhen and the Qualified Domestic Institutional Investor programme provide alternative options for managers provided that they shall be qualified and get approvals under relevant programmes. SAFE released Circular Huifa (2017) No. 3 on 26 January 2017, and strengthened the examination of authenticity and compliance of ODI. Supervision of individual foreign exchange businesses has also been reinforced since 1 January 2017.

III REGULATORY DEVELOPMENTS

i Interim measures for the administration of government-sponsored industry investment funds

Recently, NDRC issued the Interim Measures for the Administration of Government-sponsored Industry Investment Funds (Measures for Government Funds), effectively as of 1 April 2017. The Measures for Government Funds, on the basis of a clear definition of 'government-sponsored industry investment funds', further provide that government-sponsored industry investment funds may be established in various organisational forms, such as a corporation, partnership and a contractual form, and that a variety of means, such as the equity participation in funds, joint investment, financing guarantee, and a mode under which the governments make capital contributions and surrender appropriate part of profits, can be made use of in an integrated manner to bring the functions of funds into full play. PIFs accepting government investment may not invest more than 20 per cent of their aggregate capital in any single portfolio company and shall make relevant reporting and disclosures on the government-sponsored funds credit information registration system.

ii Management practices for the private investment fund subsidiaries of securities companies and the management practices for the alternative investment subsidiaries of securities companies

In order to improve the self-discipline management systems and prevent systematic risks relating to the mixed operation and competition of subsidiaries of securities companies, on 30 December 2016, SAC promulgate Circular on Issuing the Management Practices for the Private Investment Fund Subsidiaries of Securities Companies and the Management Practices for the Alternative Investment Subsidiaries of Securities Companies. In principle, only one subsidiary can be established to do either PIFs or alternative investment, and relevant subsidiaries shall carry on professional business, and shall not conduct business concurrently. The circulars provide a 12-month rectification period for securities companies. If the existing business of the direct investment or investment management subsidiaries of the securities companies does not meet the requirements herein, they may only continue to operate or manage existing PIFs and may not raise or manage new PIFs or open up existing PIFs for new subscriptions. PE/VC business and fundraising activities of subsidiaries of securities companies may be slowed down for a certain period of time at the beginning of 2017.

IV OTHER NOTEWORTHY DEVELOPMENTS

i VAT reform regarding asset management products

The Chinese Ministry of Finance and SAT jointly issued Notice on Implementing the Pilot Program of Replacing Business Tax with Value-added Tax in an All-round Manner (Caishui [2016] No. 36) on 23 March 2016, which provides the detailed implementation guidance on the further rollout of the VAT reform pilot programme to sectors such as construction, real estate, financial services and lifestyle services, as well as modifications to the current value-added tax (VAT) rules for transportation services, modern services, postal and telecommunication services. The VAT reform in China takes a big step forward and attracts heated debate in the asset management industry recently. At the end of 2016 and the beginning of 2017, Circular on Value-added Tax Policies for Financial, Real Estate Development, Education Ancillary

Service and Other Services and Supplementary Circular on Issues concerning Value-added Tax Policies for Asset Management Products were published, which require that managers of asset management products pay value-added tax in connection with their taxable activities during the operation of the asset management products as of 1 July 2017.

ii Expansion of negative list regime

Historically, all direct investment by foreign investors to a Chinese company (either greenfield investment or through merger and acquisition of existing Chinese companies) as well as foreign investors' disposition of their direct equity interests in foreign-invested enterprises require the approval from MOFCOM or its local counterparts. On 3 September 2016, the Standing Committee of the PRC National People's Congress passed a decision to revamp the PRC Law on Wholly Foreign Owned Enterprises, the PRC Law on Sino-Foreign Equity Joint Ventures, the PRC Law on Sino-Foreign Cooperative Joint Ventures, and the PRC Law on the Protection of Investments by Taiwanese, officially extending the 'Negative List' regime previously tested in the several free trade zones to the whole country effective as of 1 October 2016. The investments into domestic companies other than those engaged in an industry on the Negative List will not require prior approval by MOFCOM or its local counterparts and can be completed through submitting to MOFCOM or its local counterparts for recording and registering with the administration of industry and commerce. On 8 October 2016, the National Development and Reform Commission and the MOFCOM jointly published the Announcement No. 22 of Year 2016 (Announcement No. 22), in which they clarified that the scope of the Negative List shall be consistent with the Catalogue for the Guidance of Foreign Investment (2015 revision), jointly issued by MOFCOM and NDRC. On the same day, the MOFCOM promulgated the Interim Measures for the Record-filing Administration for the Incorporation and Change of Foreign-invested Enterprises (FDI Record-filing Measures). Announcement No. 22 and FDI Record-filing Measures became effective on the date of their respective promulgation. These 'open-door' rules will certainly be warmly welcomed by foreign PIFs and increase the competition in the PE/VC market in China.

V OUTLOOK

As a concept learned from the Western world, the PE and VC market in China has grown at a phenomenal rate over the past 20 years and helped create many of the leading companies in China. At the same time, this phenomenal rate of growth has also prompted myriad business and legal issues, some of which are unique to China. PRC laws and regulations have seriously lagged behind the development of the industry in many respects, and are also characteristically vague in many others, and the regulators are working hard to play catch-up while protecting their own turf. It is a most dynamic market in which the law changes much faster than in developed countries, and in which great opportunities and great challenges coexist.

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James Wang has 15 years of experience in the investment funds and asset and wealth management field. He has represented international and Chinese fund clients in the structuring of over 600 domestic and offshore PE, VC, hedge, real estate, mezzanine, film and media, energy and infrastructure funds, QFLP and R-QFLP funds, QDLP and QDIE funds, QFII and R-QFII funds, and QDII funds with total capital commitments in excess of US$40 billion equivalent. He also regularly represents trust companies, broker-dealers, mutual funds, insurance companies and wealth management companies in joint venture and partnership transactions, M&A transactions and the structuring and issuance of various asset and wealth management products. He has been consistently ranked as a 'Leader in Investment Funds, Private Equity and Venture Capital' for China by *Chambers*, *IFLR* and *Legalband*. He was also named as market leader for investment funds in China by the London-based Legal Media Group's *Global Expert Guides* for banking, finance and transactional law for 2015 and 2016 (the only lawyer at a PRC law firm named by the *Global Expert Guides* for investment funds in China). He is a member of the expert review committee of the QFLP and QDLP pilot programmes administered by Shanghai Financial Services Office, and also served as adviser to it on PE secondary market initiatives. James is also active in PE and VC investments, M&A and capital markets transactions. Prior to Han Kun, James worked at several major international law firms in the US and China including Clifford Chance, Kirkland & Ellis and Greenberg Traurig, and was a partner at Greenberg Traurig in New York. James is a CFA and CAIA charterholder.

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