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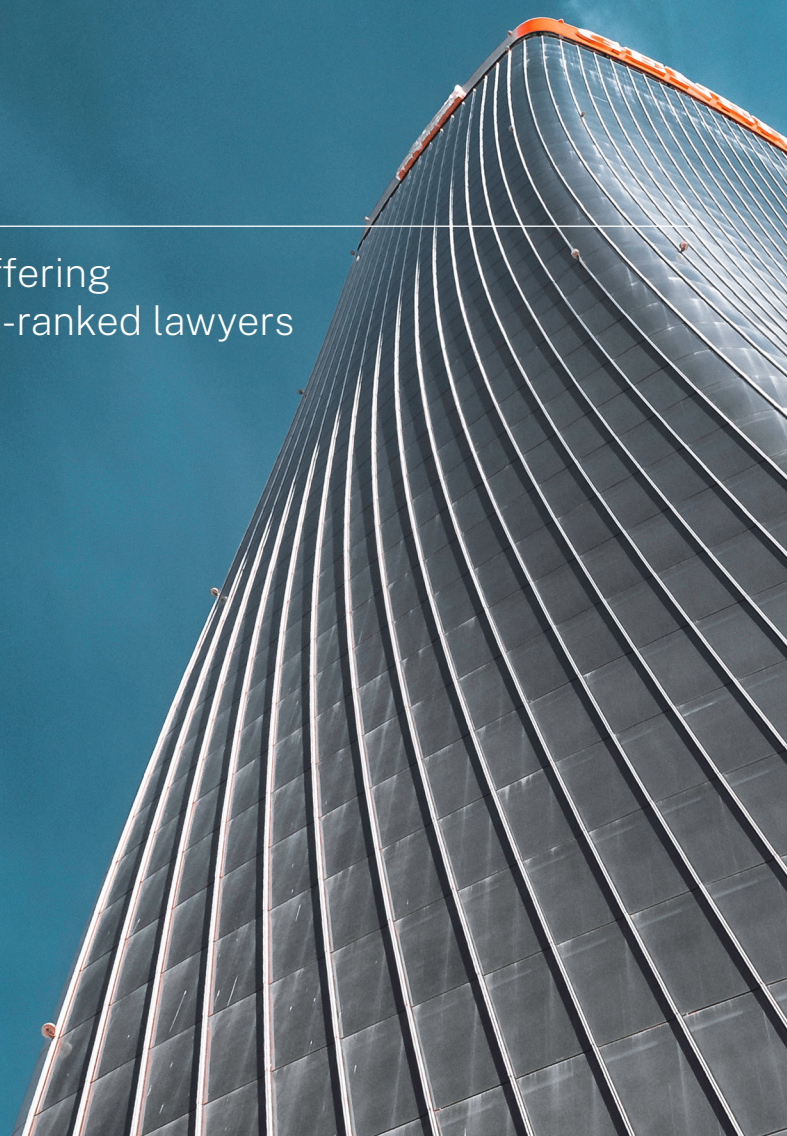
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# Alternative Funds 2023

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Definitive global law guides offering  
comparative analysis from top-ranked lawyers

**China: Law & Practice  
and Trends & Developments**  
Lu Ran, Pei Zhao, Shiye Yuan  
and Zhichao Duan  
Han Kun Law Offices



# CHINA

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## Law and Practice

### Contributed by:

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**Han Kun Law Offices**

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**Han Kun Law Offices** is a leading full-service law firm in China widely recognised for advising on complex cross-border and domestic transactions, and for providing tailored legal services and effective solutions to clients. Han Kun has more than 800 professionals located in seven offices in Beijing, Shanghai, Shenzhen, Hainan, Wuhan, Hong Kong and Singapore. Most of Han Kun's practices have been consistently

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## 1. General

### 1.1 General Overview of Jurisdiction

The past ten years have been a decade of vigorous development in the investment fund sector in China, and domestic private equity/venture capital (PE/VC) firms and renminbi-denominated funds have witnessed dramatic developments. By the end of August 2023, a total of 21,948 private fund managers (PFMs) managing 152,961 private investment funds (PIFs) had been registered with the Asset Management Association of China (AMAC), the self-regulatory organisation of the fund industry in China, with total assets under management of CNY20.82 trillion.

Due to the geopolitical volatilities and disruptions caused by the COVID-19 pandemic, the PE/VC market has had ups and downs in the past three years. Five main trends in domestic PE/VC markets have emerged in recent years:

- Firstly, state-guided funds (SGFs) and government-guided funds (GGFs) are the major source of capital for PE/VC funds.
- Secondly, fundraising periods have become relatively longer. For example, around 2016 a PE/VC fund took, on average, approximately three months to complete its first closing (in fact, a few PE/VC funds completed their first closing within one month) and took an additional three to nine months to reach its final closing. However, in the past three years, it has been quite common for PE/VC funds' first closing to take six to 12 months, and for the final closing to take an additional 12 months.
- Thirdly, compared to the market practice in recent years, fund structures have become more complicated to accommodate fundraising needs. PE/VC funds have commonly utilised a parallel fund structure, multi-parallel fund structure, connecting fund structure,

umbrella fund structure and combinations of these structures.

- Fourthly, it is obvious that only certain “top-quartile performance” funds have successfully launched with smooth fundraising. Many PE/VC firms at “middle waist” are still under great pressure in their fundraising activities.
- Fifthly, there are fewer new PE/VC firms coming to the market compared to previous years. Due to the internal and external environment, there has been a significant decrease in the generation of new market players in China's PE/VC market.

It is a primary trend that the investment fund practice will continue to maintain its Blue Ocean status. However, laws and regulations governing the investment fund sector have been strengthened – particularly the Regulations on the Supervision and Administration of Private Investment Funds published on 9 July 2023, which came into effect on 1 September 2023 (the “New PIF Regulations”) – which will cause the PE/VC industry to develop in a more standardised and robust way. Meanwhile, with the “first generation” PE/VC funds set up around 2010 entering their exit period, it is a significant task to arrange an orderly liquidation of such funds. The value of secondary funds and secondary transactions to the liquidity and continuity of the PE/VC market will become more notable. Additionally, the investment fund sector will enter a new era of cross-border capital allocation, with the liberalisation of qualified foreign institutional investor (QFII), qualified foreign limited partnership (QFLP), qualified domestic limited partnership (QDLP), qualified domestic investment entity (QDIE) and qualified domestic institutional investor (QDII) policies and quotas, and the growing importance of allocating capital to the Chinese market.

## 2. Funds

### 2.1 Types of Alternative Funds

The categories of PIFs in the Asset Management Business Electronic Registration System (AMBERS) include the following:

- Private securities investment fund – this is a private investment fund that primarily invests in stocks of public companies, bonds, futures, options, fund units and other securities and derivatives, as provided by the China Securities Regulatory Commission.
- Fund of private securities investment fund – this is a private investment fund that primarily invests in private securities investment funds, trust plans, brokerage asset management plans, special fund accounts and other asset management plans.
- Venture capital fund – this is a private investment fund that primarily makes equity investments in unlisted growth enterprises at various stages of business.
- Fund of venture capital fund – this is a private investment fund that primarily invests in venture capital funds, trust plans, brokerage asset management plans, special fund accounts and other asset management plans.
- Private equity investment fund – this is a private investment fund that invests in shares issued privately by unlisted companies or by listed companies (including private placement, bulk trading, and transfer by agreement of listed companies), convertible bonds, etc.
- Fund of private equity investment fund – this is a private investment fund that primarily invests in private equity investment funds, trust plans, brokerage asset management plans, special fund accounts and other asset management plans.
- Private alternative funds – this is a private investment fund that primarily invests in

assets other than securities, derivatives of securities, and equities.

- Fund of private alternative funds – this is a private investment fund that primarily invests in private alternative funds, trust plans, brokerage asset management plans, special fund accounts and other asset management plans.
- Private asset allocation fund – this is a private fund that primarily makes cross-category asset allocation investments in securities, equities, etc, as funds of funds, where more than 80% of the fund assets will be invested in private funds and public funds that have been filed with the AMAC or other asset management products established in accordance with the applicable laws.

### 2.2 Fund Structures

There are three main legal forms adopted by PIFs in the Chinese market – limited partnership, limited company and contractual type fund. In August 2006, the Standing Committee of the National People’s Congress adopted the newly amended Law on Partnership Enterprises and introduced the concept of “limited partnership”, after which, limited partnerships quickly emerged as the primary form of PE/VC funds in the market. The legal form of limited company is widely used by SGFs and GGFs, as the sponsors of SGFs and GGFs are almost all state-owned enterprises (SOEs) and SOEs are expressly prohibited from acting as the general partner (GP) under the Law on Partnership Enterprises. In August 2014, the China Securities Regulatory Commission (CSRC) promulgated the Interim Measures for the Supervision and Administration of Private Investment Funds (the “PIF Interim Measures”), which established the registration system of PFMs and record-filing system of PIFs. In addition, the legal form of the contractual type fund was first officially recognised under the PIF Interim Measures. The contractual

type fund is the most popular form for private securities investment funds, and comparatively for a small group of PE/VC funds, due to its loose relationship with other parties.

Limited partnerships and limited companies are required to be registered with the local Administration of Regulation (AMR). For entities to be operated and managed in the long term, efficiency is the key factor when determining PE/VC funds' location. However, most GGFs may designate the location of the PE/VC funds they invest in, typically choosing the location of such GGFs.

### 2.3 Regulatory Regime for Funds

PFMs must file the record of the PIFs under their management with AMAC within 20 business days upon completion of fundraising. Before the completion of record-filing with AMAC, the PIFs may not make any investments. When filing a PIF, AMAC will examine whether the PFM's fundraising procedures are in compliance with relevant rules issued by AMAC through the paperwork and information submitted by the PFM, including whether the PFM has adopted suitable measures to make sure that the interests in such PIF are offered to qualified investors. It usually takes one to two weeks to complete the filing procedure.

### 2.4 Disclosure/Reporting Requirements

As AMAC has promulgated several regulations regarding information disclosure by PFMs and PIFs, PE/VC funds must comply with these disclosure requirements. Under the Regulatory Measures of Information Disclosure for Private Investment Funds and the No 2 Guideline for Information Disclosure for PE/VC Funds, PFMs are required to periodically, or at such time as a material change occurs, update both their own registration information with AMAC and the infor-

mation filed for the PIFs under their management via an online system. In addition, PFMs are also required to disclose to investors the information in relation to PIFs under their management, according to fund documents. Of course, some investors may have their own requests on information disclosure, such as SGFs, GGFs and insurance companies, which PIFs will usually make an effort to satisfy for fundraising purposes. Only basic information relating to PFMs and PIFs (such as registered name, stake holders, partners, registered capital, controlling person, chief compliance officer, etc) is publicly available.

### 2.5 Tax Regime for Funds

As with the regulatory regime, there is no specific set of tax rules applicable to alternative funds. General tax rules are followed for private funds, and the tax position of private funds established in China is mainly determined by their legal form.

#### Limited Partnerships

For PIFs in the form of a limited partnership, the layer of partnership is look-through from a tax perspective. Corporate limited partners (LPs) are taxed at the LP level at a rate of 25% on taxable gains from a PRC corporate income tax perspective. Individual LPs are taxed at the layer of partnership at 5–35% on taxable gains from a PRC individual income tax perspective. Specifically, individual LPs are taxed at a reduced tax rate of 20% for dividend and interest income. For various reasons, the taxation of individual LPs in limited partnership in China is far from mature, and thus uncertainties arise from time to time.

#### Limited Companies

For PIFs in the form of limited companies, their tax position is almost the same as corporate LPs



in a limited partnership, that is, 25% corporate income tax charged on taxable income.

## Contractual Type Funds

For contractual type funds, investors are responsible for filing and settling their income tax liability from their side, that is, 25% corporate income tax for corporate investors and 20% individual income tax for individual investors.

## Tax Incentives for PIFs

In the meantime, there are some tax incentives available for PIFs. For example, the individual LPs of a qualified limited partnership may enjoy a reduced 20% individual income tax rate on investment gains. Qualified corporate PIFs may enjoy a reduced corporate income tax burden in accordance with their individual shareholder.

For contractual PIFs, the total proceeds are subject to value added tax at a rate of 3%, and the profit is taxed at the level of LPs on their side.

## QFLPs and Offshore Funds

QFLPs and offshore funds have more complicated PRC tax implications as a result of transactions being cross border. Basically, QFLPs and offshore funds are charged 10% PRC withholding income tax upon disposal of PRC investments. Where a QFLP is considered as having a permanent establishment in China, the applicable tax rate would rise to 25%.

## 2.6 Loan Origination

The Registration and Filing of Private Investment Funds issued by AMAC in December 2019 (the “2019 PIF Registration Notice”) further embodies the terms under the Asset Management Guidance regarding the operation of PIFs, restating that PIFs’ primary business may not cover borrowing or lending activities. According to the 2019 PIF Registration Notice, any

PIF conducting private lending activities as its regular business or setting up valuation adjustment mechanisms to engage in disguised loan activities (which separate the PIF’s income from the profits from the invested companies), will not be permitted for PIF registration. The CSRC’s rules provide that all PIFs are prohibited from providing loans or guarantees to other persons or entities, except in the following instance – a PIF may provide a loan or guarantee with a term of no more than one year to its portfolio company in accordance with relevant contracts for the purpose of making an equity investment in such portfolio company, provided that: (i) the maturity date of such loan or guarantee may not be later than the exit date of the equity investment in such portfolio company; and (ii) the balance of the loan or guarantee may not exceed 20% of the contributed capital of the said PIF. The New PIF Regulations reiterate these compliance requirements.

## 2.7 Non-traditional Assets

As PIFs are only allowed to conduct private equity investments, they are not permitted to invest in non-traditional assets, such as digital assets, credit and other loan portfolios, cannabis/cannabis-related investments and litigation funding, under the PRC laws.

## 2.8 Use of Subsidiaries for Investment Purposes

It is common for PIFs to use special purpose vehicles (SPVs) to make their investments where:

- there are multiple co-investment parties and such SPVs can be used as a platform for pooling the funds of co-investment parties; or
- the PIF intends to exit its investment in a portfolio company through trade sale and the equity interest in such SPVs, rather than

equity interests in the portfolio company, can be transferred or disposed of directly.

relevant administrative authorities and AMAC at a later stage.

## 2.9 Requirement for Local Investment Managers

A PIF must be managed by a PFM pursuant to PRC laws. An investment manager's business activities in China are subject to registration with the relevant administrative authorities for market regulation as a partnership (including a limited partnership) or a corporation. Before an investment manager undertakes any fundraising activities for a PIF, such investment manager is required to be registered with AMAC as a PFM. A PFM registered with AMAC is allowed to explore and conduct its business throughout China.

## 2.10 Other Local Requirements

So far, no substance requirement has been imposed on PIFs under PRC laws.

## 2.11 Rules Concerning Other Service Providers

Contractual type funds are required to engage a custodian, while other types of funds have flexibility to engage a custodian. However, if no custodian can be engaged, a PIF is not permitted to set up an SPV to make its investment and is not permitted to increase its fund size after registration with AMAC. A custodian must be a domestic financial institution with a custodian qualification, which could be either a commercial bank or a security company. There are no compulsory requirements regarding the administrator, money-laundering reporting officer or compliance officer under PRC laws.

## 2.12 Anticipated Changes

As the New PIF Regulations took effect on 1 September 2023, it is anticipated that the updated rules on PIFs will be further promulgated by the

## 3. Fund Managers

### 3.1 Origin of Promoters/Sponsors of Alternative Funds

Most promoters or sponsors of alternative funds in the Chinese market are domestic institutions or individuals. There also appears to be a growing trend for foreign sponsors to establish or intend to establish PFMs either independently or by co-operating with domestic institutions.

### 3.2 Legal Structures Used by Managers

Two main legal forms are generally adopted by PFMs in the Chinese market – limited partnership and limited company. As there are fewer tax planning methods for private securities investment funds, the form of limited partnership is widely used by private securities investment fund managers.

### 3.3 Regulatory Regime for Managers

PIFs in China are required to comply with various operational and compliance requirements. Before engaging in any fundraising activity, PFMs established in China (including PFMs with direct or indirect foreign shareholders) must register with AMAC in accordance with the regulations formulated by AMAC. After the completion of fundraising, a PFM must register the PIFs managed by them with AMAC under the PFM's name.

### PIF Interim Measures

The PIF Interim Measures promulgated in August 2014, which established the system of registration of PFMs and record-filing of PIFs, defined qualified investors, and specified non-public fundraising and disclosure requirements

for PFMs. According to these rules, PFMs must apply for PFM registration with AMAC before initiating any substantial business operations. This registration requires the PFM:

- to engage qualified legal counsel to conduct due diligence on the PFM to confirm its compliance in all aspects with applicable laws and regulations, to issue a legal opinion thereon; and
- to submit any other materials requested by AMAC.

To qualify for PFM registration, PFMs must employ professionals with AMAC-recognised qualifications for certain positions, including investor relations manager, risk and compliance officer, etc.

## The Three Types of PFM

When applying for registration with AMAC, a PFM is only allowed to choose one of three business types:

- Type 1: private equity fund manager;
- Type 2: private securities investment fund manager; or
- Type 3: fund manager to manage other types of private funds.

A fund manager that manages PE/VC funds (including a QFLP fund manager if required to be registered as a PFM) must be registered as a Type 1 PFM, and then the PIFs it manages must have their records filed with AMAC under such fund manager's name, after completing the first round of fundraising but prior to such PIFs undertaking any investment. A fund manager that manages securities investment funds must be registered as a Type 2 PFM, while a QDLP fund manager must be registered as a Type 3 PFM.

## Denial of Registration

In November 2017, AMAC clearly defined for the first time the circumstances under which PFMs will be denied registration in Q&As Related to the Registration and Filing of Private Investment Funds ("Q&A No 14"). These include illegal fundraising, making a false statement, engagement in conflicting business, being listed as enterprises that have taken part in serious illegal or dishonest acts, or that have discredited senior executives. In December 2018, AMAC restated the circumstances under which PFMs will be denied registration via a PFM Registration Notice, in which AMAC also listed the main requirements for PFM registration. Basic information about registered PFMs is publicised by AMAC on its official website.

## Circulars and Measures Affecting Registration

In 2020, AMAC promulgated the Circular on Issues Concerning Facilitating Application for Registration of PFMs in February and the Circular on the Issuing List of Application Materials for Record-Filing of PIFs in March, listing the materials necessary for the registration of PFMs and the record-filing of PIFs, which represents AMAC's effort to enhance service efficiency and improve the chances of compliance in related applications. In February 2023, AMAC issued new Private Investment Fund Registration and Filing Measures and these updated self-regulation rules established the principle of "favour top students and reject underachievers" in the PFM registration process. These new measures took effect on 1 May 2023, raising the bar and conditions for the registration of a PFM. The List of Application Materials for Record-Filing of PIFs was renewed in April 2023.

### 3.4 Tax Regime for Managers

For PFMs, there are no specific tax rules. PFMs in the form of a limited company are subject to corporate income tax at a rate of 25% and PFMs in the form of a limited partnership are subject to taxation at LP levels. Qualified corporate PFMs in certain areas (eg, Hainan Province) may enjoy a reduced 15% corporate income tax rate.

### 3.5 Rules Concerning Permanent Establishments

There is generally no exemption or other rules to ensure that alternative funds with a manager in China do not have a permanent establishment or other taxable presence in China. If offshore funds have been identified as having a permanent establishment in China, PRC corporate income tax at a rate of 25% will be charged unless there is applicable tax treaty protection.

### 3.6 Taxation of Carried Interest

The current PRC tax regime does not have any specific rules on carried interest. This means that carried interest is taxed as normal profit. One interesting note is that sometimes certain tax authorities charge 6% VAT instead of income tax on carried interest but this only happens occasionally, depending on the discretionary judgement of the relevant tax authorities.

### 3.7 Outsourcing of Investment Functions/Business Operations

PFMs are allowed to outsource or delegate some of their investment functions or business operations to other persons. There is no specific regulatory requirement or restriction on such outsourcing or delegation under PRC laws. However, a PFM must exercise due care in selecting appropriate and qualified agents to undertake certain of its functions and there are some implications regarding such delegated agents. For example, only qualified agents, such as quali-

fied custodians, qualified financial institutions and independent holders of a retail licence can be engaged for certain functions and operations in PIFs, thereby safeguarding the assets and the marketing and distribution interests of the fund.

### 3.8 Local Substance Requirements

To qualify as a PFM registered with AMAC, an investment manager must have economic substance, including but not limited to: (i) having at least five full-time qualified staff members; and (ii) having an independent office site. However, there is no requirement regarding the local director, employee or local general partner under PRC laws.

### 3.9 Change of Control

When a PFM applies for AMAC registration, it must disclose its controlling person. After completion of AMAC registration, such controlling person will be disclosed to the public on AMAC's website. Pursuant to relevant guidelines issued by AMAC, the controlling person refers to the controlling shareholder (the shareholder who has the power to designate the majority of directors of the PFM or the shareholders who are in agreement on concerted action) and the natural person, legal person or other organisation that can control the activities of the PFM. The "look-through" rule will apply to track the ultimate natural person, SOE, collective enterprise, listed company or overseas institution under the supervision of foreign financial regulatory authorities, for the purpose of identifying whether any of them is a controlling person.

When a change-of-control event occurs, a private fund manager must complete the relevant procedures required for such change with AMAC within 30 business days from the date of such change and submit a legal opinion on such change to AMAC. The controlling shareholder

and/or the actual controlling person after such change must satisfy all the relevant requirements under the applicable laws and rules issued by AMAC. In the event that any change of actual control of a private fund manager occurs, the assets under its management may be no less than CNY30 million consecutively in the 12 months prior to the date of such change.

### 3.10 Anticipated Changes

As the New PIF Regulations only took effect on 1 September 2023, it is anticipated that the updated rules may be further promulgated by the relevant administrative authorities and AMAC at a later stage.

## 4. Investors

### 4.1 Types of Investors in Alternative Funds

The primary investors in alternative funds in the Chinese market include institutional investors and individual investors. The following types of investors have recently been active in the market:

- SGFs and GGFs;
- listed companies (including SOEs);
- non-listed corporate investors (including SOEs);
- insurance companies;
- financial institutions managing asset management products (such as a trust plan);
- social security funds;
- charity funds;
- campus funds;
- family offices and family funds; and
- high net worth individuals.

Among such investors, social security funds and insurance firms are the most challenging, since

there is a relatively high bar for PIFs accepting such investors.

In addition, SGFs, GGFs and insurance companies may have certain specific requests on the fund terms of PIFs and information disclosure, due to their respective risk tolerance and internal policies, which PFM will usually make efforts to satisfy for fundraising purposes. For example, the European-style distribution waterfall might be preferred by SGFs and GGFs when they invest in a PIF in the form of a limited partnership, to ensure that all the invested capital of the investors and the agreed preferred return will be returned in full to be distributed to the investors prior to any generation and distribution of carried interests to general partners.

### 4.2 Side Letters

Side letters are permitted and commonly used in the fundraising process, and there is no special approval or disclosure requirement in the Chinese market. Institutional investors, in particular, will usually request to have a side letter to satisfy their own specific requests on commercial terms and compliance matters, such as:

- a most-favoured nation (MFN) clause;
- an information right and confidentiality request;
- an advisory committee member seat;
- reduction on the management fee or carried interest;
- co-investment preferences and arrangements;
- an LP interest transfer right to affiliate; and
- other special compliance requirements and tax provisions.

## 4.3 Marketing of Alternative Funds to Investors

Under PRC law, PFMs or their qualified agents may only offer PIF interests to investors classified as “qualified investors”, which is determined based on the supporting materials and risk-tolerance questionnaires that the investors provide. A “qualified investor” refers to any investor who satisfies each of the following requirements:

- the investor’s identified risk and tolerance ability matches the PIF product in which the investor intends to invest;
- the investor makes a commitment to the PIF product in an amount of no less than CNY1 million; and
- if the investor is an entity, such investor has net assets in an amount of no less than CNY10 million; or
- if the investor is a natural person, such investor has individual financial assets in an amount of no less than CNY3 million (including bank deposits, securities, bonds, trusts, etc), or has an average individual annual income in an amount of no less than CNY500,000 in each of the past three years.

An exception to the above requirements is where an investor is a “deemed qualified investor”. Deemed qualified investors may be any of the following:

- social security funds, enterprise annuity schemes and other pension funds, charitable funds and other commonwealth funds;
- PIFs registered with AMAC;
- financial products supervised by financial regulatory authorities;
- a PIF’s fund manager and/or its employees; and
- other investors prescribed by the CSRC and AMAC.

In this regard, if the PIF intends to admit any PRC investors, the investors to be admitted must either be “deemed qualified investors” or satisfy the “qualified investor” requirements as described above, and such PRC investors must also provide the relevant supporting materials to prove their qualification and status accordingly.

## 4.4 Rules Concerning Marketing of Alternative Funds

There are specific rules and restrictions on fundraising activities in the Chinese market.

### Fundraising Practitioner Qualifications

Persons who intend to undertake fundraising activities are required to have AMAC-recognised PIF professional qualifications.

### Qualified Investor Verification Procedure

The PFM and/or its agent is generally required to collect from prospective investors supporting materials and risk-tolerance questionnaires to determine whether such investors satisfy the “qualified investor” requirements or “deemed qualified investor” status before they undertake marketing or advertising of PIF interests to such investors. In addition, the number of investors in a single PIF must not exceed 200 persons, pursuant to PRC regulations.

### Marketing Method

After completing qualified investor verification procedures, a PFM and/or its agent may only offer PIF interests and circulate offering documents and fund contracts to qualified investors on a non-public basis. Any kind of public offering – such as placements through published materials; outdoor advertisements; posters; newspaper, radio, TV or internet promotional materials; and such other public media or speeches, seminars and similar meetings – is expressly prohibited.

## Marketing Materials

AMAC Rules provide certain key words which cannot be used in the offering document, such as “estimated return” and “expected yield”. Meanwhile, specific information is required to be disclosed in the offering document under PRC laws, such as the registration number of the fund manager, the custodian engaged for the PIF, etc.

## No Guarantees

Investment managers and alternative funds are prohibited to directly or indirectly promise investors a fixed return or no loss in any situation.

## Record-Filing

After the investors execute the fund contracts and the closing of a PIF is announced, the PFM must submit the record-filing of such PIF to AMAC under the PFM’s name, before the PFM undertakes any investment on behalf of such PIF.

## 4.5 Compensation and Placement Agents

Placement agents are commonly used in the fundraising process in the Chinese market. There are two kinds of placement agents – financial institutions holding the licence to distribute the interest of PIFs and agents without qualifications. For financial institutions holding the relevant licence, such institutions can undertake offering activities directly; for agents without qualifications, such agents can only refer potential investors to, and connect such investors with, the relevant PFMs, and all fundraising activities must be undertaken by the PFM itself.

## 4.6 Tax Regime for Investors

For taxation at investor level, refer to **2.5 Tax Regime for Funds**.

## 4.7 Double Tax Treaties

Whether an alternative fund established in China may generally qualify for benefits under double tax treaties depends on the legal form of the funds, tax rules in the jurisdiction in which the funds may invest, and the applicable double tax treaty. Generally speaking, as a large percentage of PRC PIFs conduct overseas investment through offshore SPVs, tax treaty benefits, if triggered, may not be relevant to the PRC tax regime.

## 4.8 Foreign Account Tax Compliance Act (FATCA)/Common Reporting Standard (CRS) Compliance Regime

China is a member of the CRS compliance regime and information exchange is carried out every year. However, there are very few reported tax avoidance matters through such exchange mechanism. How this actually functions in China remains to be seen.

## 4.9 Anti-Money Laundering (AML) and Know Your Customer (KYC) Regime

There is no specific anti-money laundering (AML) requirement imposed on PIFs or PFMs under PRC laws, as AML requirements are mostly conducted by financial institutions such as commercial banks and security companies. The know your customer (KYC) process is usually completed by PFMs during the verification procedure to identify “qualified investors” based on the supporting materials and questionnaires provided by such investors.

## 4.10 Data Security and Privacy for Investors

There are three pillar laws under China’s data law legal framework, namely, the Cybersecurity Law (CSL), the Data Security Law (DSL), and the Personal Information Protection Law (PIPL). The PIPL and the DSL are more relevant and

respectively stipulate compliance requirements, including cross-border data transfer restrictions, on personal information and more sensitive information (aka, “Important Data”). Both the PIPL and the DSL set forth extra-territorial effects that apply to managers and funds dealing with China-based investors. Notably, local investors need to enter into data transfer agreements with overseas recipients and seek approval from regulators when exporting personal information or Important Data.

In addition, in the event that sensitive data may constitute state secrets or otherwise endanger national security, managers and funds need to act cautiously and avoid requiring and/or exporting such data. The Anti-Espionage Law will apply if funds and managers do require or export such sensitive data and there will be administrative penalties or even criminal liabilities arising from such violations.

## 4.11 Anticipated Changes

As the New PIF Regulations only took effect on 1 September 2023, it is anticipated that the updated rules may be further promulgated by the relevant administrative authorities and AMAC at a later stage.



## Trends and Developments

### Contributed by:

Lu Ran, Pei Zhao, Shiye Yuan and Zhichao Duan  
Han Kun Law Offices

**Han Kun Law Offices** is a leading full-service law firm in China widely recognised for advising on complex cross-border and domestic transactions, and for providing tailored legal services and effective solutions to clients. Han Kun has more than 800 professionals located in seven offices in Beijing, Shanghai, Shenzhen, Hainan, Wuhan, Hong Kong and Singapore. Most of Han Kun's practices have been consistently

recognised as top PRC law firms by authoritative international legal ranking organisations such as Chambers and Partners. In particular, Han Kun's investment funds practice is known for its wide and deep involvement in private equity business and for its activity in frontier business areas. It has received recognition from the private equity market for the innovative and pragmatic legal services it provides to clients.

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**Lu Ran** of Han Kun Law Offices advises local and overseas clients in a variety of private equity-related transactions. Her comprehensive legal services include the formation and

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**Pei Zhao** has over 15 years of experience in investment fund and private equity fields. At Han Kun Law Offices, she represents a wide range of fund sponsors in China and throughout Asia in

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# CHINA TRENDS AND DEVELOPMENTS

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**Shiye Yuan** joined Han Kun Law Offices in early 2020 and leads the firm's tax practice. Prior to this, Mr Yuan was an M&A tax partner with KPMG and worked for two of the Big 4 accounting firms for over 15 years. Mr Yuan implements tax optimisations throughout the whole PE/VC life cycle, in particular, offering stable and predicted tax resolutions in ever-evolving tax regimes. He also provides M&A arrangements and transaction structures which balance tax savings and compliance, and which can withstand challenges from investors and listing authorities. Mr Yuan also has wide expertise in designing focused tax arrangements for high net worth individuals and families.



**Zhichao Duan** heads the data compliance practice of Han Kun Law Offices and is widely recognised as a leading expert in the market. With a specific focus on tech-related legal matters, Mr Duan has abundant experience in representing industry-leading tech companies in the internet, automobile, AI, pharmaceutical, and medical device sectors. Mr Duan is particularly known for providing practical data compliance solutions by factoring in the commercial and technical needs of clients.

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## Introduction

With the rapid development of the Chinese private equity/venture capital (PE/VC) market in the past decade, China has attracted the interest of both domestic and international investors and other market participants, and the capital under management in the Chinese market has greatly increased. This tremendous growth in the PE industry in China has also helped many Chinese companies involved in technology and other sectors to start and expand their businesses in both China and the overseas market.

## Market Overview

As PE/VC funds play a critical role in promoting scientific and technological innovation, and supporting the development of the real economy, PE/VC funds boost high-quality economic development. High-quality economic development requires PE funds in order to play a greater role in building a modern industrial system, maintaining and increasing residents' wealth, and accelerating the growth of a modern capital market. However, due to the geopolitical volatilities and disruptions caused by the COVID-19 pandemic, the PE/VC market in China has had ups and downs in the past three years. Fundraising periods have become relatively longer and only certain "top-quartile performance" funds have successfully launched with smooth fundraising. Many PE/VC firms are under great pressure in their fundraising activities.

## Regulatory Development

In the face of the rapid development of the PE and asset management industries in China, PRC regulators have promulgated numerous laws and regulations in recent years with the aim of mitigating financial risk and providing more protection for investors. It is expected that PRC regulators will also increase their scrutiny of fund managers and other market participants. Laws

and regulations governing the investment fund sector have been tightened, with the publication of the Regulations on the Supervision and Administration of Private Investment Funds on 9 July 2023, which came into effect on 1 September 2023 (the "New PIF Regulations"). These will contribute to the robust and standardised development of the PE/VC industry.

## Several Hot Topics

### *Cross-border structure*

The investment fund sector will enter a new era of cross-border capital allocation with the liberalisation of the qualified foreign institutional investor (QFII), qualified foreign limited partnership (QFLP), qualified domestic limited partnership (QDLP), qualified domestic investment entity (QDIE) and qualified domestic institutional investor (QDII) policies and quotas, with the growing importance of allocating capital to the Chinese market.

### *QDLP pilot programme*

Current PRC laws and regulations are silent on the regulation of fundraising activities within China or towards Chinese investors by foreign PE/VC firms. As such, there could be legal and compliance concerns if an offshore PE/VC fund directly admits PRC investors.

Furthermore, even if marketing and fundraising activities are carried out strictly in compliance with the applicable PRC laws and regulations, outbound investment restrictions on the prospective PRC investors may lead to burdensome procedures and increase uncertainty regarding the admission of PRC investors.

As an alternative, offshore PE/VC fund managers are increasingly considering an approach expressly permitted under PRC laws and regu-

lations, which is the qualified domestic limited partner (QDLP) fund.

A QDLP fund is a type of renminbi-denominated fund established pursuant to special pilot programmes promulgated in certain provinces or cities in China, which pool PRC qualified investors with the investment objective of targeting offshore financial products. QDLP pilot programmes usually differ from place to place with respect to specific access and regulatory requirements, with pilot programmes in certain places permitting QDLP funds to invest in offshore PE/VC funds.

In order to set up a QDLP fund to pool investors in China, the foreign fund manager or any of its affiliates must first set up a QDLP fund manager, which should be registered with the Asset Management Association of China (AMAC) as a Type 3 fund manager, and obtain a QDLP quota with the local government in the intended registration place of the QDLP fund. Then, the QDLP fund manager may raise one or more QDLP funds within its QDLP quota as approved by the local government. After completing record-filing for private investment funds (PIFs) with AMAC and outbound investment registration (which is completed at the level of the QDLP funds, instead of by each of the PRC investors separately), QDLP funds may then legitimately invest capital from PRC qualified investors in offshore PE/VC funds and/or other financial products. QDLP fund investment has already been considered and taken up by many well-known institutions, including Black Rock, Oaktree Capital, Morgan Stanley and KKR.

### *QFLP pilot programme*

In addition to the QDLP pilot programme, the State Administration of Industry and Commerce (SAIC) promulgated the Administrative Regula-

tions on the Registration of Foreign-Invested Partnership Enterprises in 2010 and Shanghai released trial regulations on its qualified foreign limited partner (QFLP) pilot programme in January 2011. This opened the door for foreign sponsors to set up onshore funds in China in the form of limited partnerships.

For any fund focusing on making onshore investments in China, the QFLP fund is a convenient channel with three main advantages:

- it simplifies the investment procedure, as within the QFLP fund's quota the QFLP fund's investment procedure is almost the same as for an onshore fund;
- it helps to hedge the fluctuation of the renminbi exchange rate, as within the QFLP fund's quota, the fund manager has the power to determine the amount of capital to be injected into the portfolio companies and the timing of the conversion of foreign currency to renminbi; and
- a QFLP fund's loss can be used to offset profit to decrease taxable income.

The QFLP pilot programme operates as a foreign exchange exception. An offshore fund usually has to go through a time-consuming approval process with the State Administration of Foreign Exchange (SAFE) for each of its investments in China, and each portfolio company that will receive capital in foreign currency from the offshore fund must seek approval from SAFE for the foreign exchange settlement on each occasion that it needs to use such capital. In contrast, once SAFE approval for a QFLP fund is obtained at the time of the fund formation, the capital in foreign currency may be converted into renminbi directly in a prompt manner (typically close to one week) by the fund manager, thus avoiding the lengthy SAFE approval process for each

investment and saving the portfolio company the trouble of having to seek SAFE approval on foreign exchange settlements.

As the QFLP pilot programme is a city-level programme, different cities may issue different requirements, but most of them follow Shanghai's programme with the intention of attracting world-famous PE firms and getting them to set up QFLP funds in their location. In general, the following requirements have to be satisfied by the applicant for a QFLP licence in different cities:

- requirement of a local fund manager – the foreign applicant needs to incorporate a local company in the target city, which then applies for a licence to launch the QFLP fund; and
- requirements of foreign investors – most of the QFLP pilot programmes require the assets of foreign investors or the assets under such foreign investors' management to meet certain minimum amount requirements, and each individual foreign investor needs to invest a minimum amount in the QFLP fund, consistent with the applicable laws and regulations.

### *Exit strategy*

China's PE fund industry entered a golden development stage around 2010, and a large number of local managers emerged. Due to the typical ten-year term of the PE/VC fund, a large group of PE/VC funds have gradually entered into the exit period since 2020, and the exit pressure has become increasingly prominent. Whether the portfolio investments of the PE/VC funds can be successfully disposed of and exited may be affected by many factors, such as the macro-economic environment and changes in the capital market policy.

There are many exit strategies that PE funds can use to offload their investments. The main options include:

- an initial public offering (IPO) – in an IPO, the shares of the portfolio companies invested in by PE funds may be sold to the public as part of the IPO and this might prove to be the most lucrative exit strategy for PE funds to provide the highest return on investments;
- a strategic acquisition or trade sale – the companies invested in by PE funds are sold to a strategic acquirer or a larger company operating in the same or a related industry, to provide synergy benefits to the acquirer and an exit opportunity for the PE investors;
- a secondary sale – this may be initiated by the PE investors or the managers, and involves another PE firm or financial buyer acquiring the interest of the existing PE investor in a PE fund, to allow the initial investor to exit their position; and
- a management buyout (MBO) – in an MBO, the management team of the portfolio company buys out the PE fund's interest in such company, to enable the management team to gain a larger stake in the company and to provide an exit opportunity for the PE funds.

As portfolio companies with asset valuation in high growth may not always be able to maximise value due to the cyclical fluctuation of the economy, the significance of secondary funds and secondary transactions to the liquidity and continuity of the PE/VC market becomes more noteworthy.

### *Transfer of LP interest*

PE investors tend to go for an early exit to achieve a higher internal rate of return (IRR) and reuse their funds, while some investors with specific maturity and return requirements have

stronger exit pressure and motivation, including financial institutions with their own exiting requirements (such as fund of fund), and government-guided funds (GGFs) that have achieved or failed their purpose. Since the COVID-19 epidemic, an increasing number of corporate investors have had cash-flow pressure in their main business and the need to draw back cash from their investments in PE funds. Compared with waiting for the disposal or exit of the fund portfolios, the direct transfer of the PE investor's interest in a PE fund is more straightforward and efficient. As a result, "LP interest transfer" has gradually become a common exit method used by PE investors, as investors can take into account their own financial conditions to make a transfer decision before the PE fund fully disposes of its portfolio investments.

### *Transfer of asset package*

Secondary transactions may also be initiated by the fund manager. In such cases, the reorganisation of a private fund or establishment of a successor fund will occur, and then the underlying assets of a PE fund will be transferred to a new reorganised fund or a new successor fund. Compared to LP interest transfer, assets transfer solves the exit and liquidity problem of the entire fund, so that the investors of the transferor fund will get the return as a whole. In general, the manager will continue its management of the assets through the new reorganised fund or new successor fund to provide new strength in the subsequent value improvement. In these secondary transactions, conflict of interest, affiliated transactions, valuation of underlying assets and transfer pricing might be major obstacles to be considered by the managers and other involved parties.

### *Taxation regime*

The PRC tax regime in PE/VC funds has been quite stable from a regulatory perspective. A few new rules have been introduced in the past two years, with most of the regulatory updates aimed at extending or moderating the existing rules, in response to the significant economic uncertainty after the COVID-19 epidemic.

In terms of tax practice, however, there have been substantial and continuously evolving changes in the Chinese PE/VC market. From a domestic transaction point of view, the PRC tax authorities have strengthened the administration of partnership taxation. Due to various historical reasons, there were a few loopholes in this area. For example, the tax rule clearly states that LPs of a partnership must also recognise taxable income and file tax returns on income attributable to in-kind distribution, in addition to cash distribution. However, over the past decade, only a few taxpayers have filed tax returns in this way, while most taxpayers have filed tax returns on a cash settlement basis. This practice has caused a delay in tax reporting and even under-reporting of final tax. Since 2022, the PRC tax authority has targeted this wrongful behaviour and several major relevant cases have been identified and disclosed to the public. From a cross-border transaction point of view, indirect share transfer (such as the indirect transfer of underlying assets in China) has been a key focus for the PRC tax authority. If there is any taxable income, the overseas company (eg, SPVs set up by offshore funds) will be charged 10% PRC withholding tax, even though there is no direct shareholding between the offshore funds and underlying onshore portfolio companies.

In terms of ongoing trends, no major changes in the PRC tax regime for PE/VC funds is anticipated in the near future, as:

- there might be other primary matters that the PRC tax legislators have to attend to and solve, eg, VAT law, real estate tax law, etc;
- new favourable tax rules may make the existing unbalanced taxation of PE/VC funds even more fragile; and
- stricter tax rules on the PE/VC market (eg, a 25% tax rate for QFLPs) might be a concern when overseas investors consider whether to invest in Chinese PE/VC funds.

From this perspective, it is expected that, at least at the regulatory level, PRC taxation of PE/VC funds might remain substantially the same for the next three to five years.

## *Data protection*

Data laws in China have been rapidly evolving in the past few years. A comprehensive legal framework comprising three pillar laws, namely, the Cybersecurity Law (CSL), the Data Security Law (DSL), and the Personal Information Protection Law (PIPL), has been established. Such development has profound implications for operating funds in China. Data-related implications include enhanced protection of personal information and sensitive data, as well as cross-border data transfer restrictions.

Regulatory enforcements relating to the PRC data laws have been on the rise since the onset of the legislation. Various companies in different sectors have adopted stronger compliance measures in line with the legislation and regulation requirements, for example, by introducing internal data governance mechanisms and relevant data-handling protocols. There is no exception for investment funds, and a growing number of funds have launched PRC data compliance projects.

There are two data-related topics that are of particular concern for funds operating in China, that is, cross-border data transfer (CBDT) restrictions and sensitive data processing. With respect to CBDT, China has stringent regulation requirements. For cross-border data transfer of personal information, local data exporters need to enter into data transfer agreements with overseas recipients and either complete a filing or obtain prior approval from the regulators to legitimise their data exports. For sensitive data handling, companies need to establish a data classification system to identify more sensitive data and adopt respective data security/cybersecurity measures to safeguard the integrity of such data. Failure to do so may elicit administrative penalties or, in extreme cases, criminal liability (eg, for misconduct relating to state secrets). Funds operating in China are actively working on such topics to control risks arising from the PRC data laws.

## **Outlook**

The Chinese PE industry has developed at a fast pace in the last decade, and with it, the scale of PE funds has rapidly expanded and deal valuation has largely improved. From a long-term perspective, facing various challenges in the PE/VC market, such as economic fluctuation, pressure to exit and DPI concern, this might be a good opportunity for the Chinese PE/VC market to focus on stability and rationality and for investors to navigate the market more carefully and identify quality assets and value-creating opportunities.

Looking forward to 2024, with the end of the COVID-19 pandemic and the full reopening of China, plus the Chinese authorities' plans to expand domestic demand, further recovery and positive developments in the PE industry, as well as in overall economic activities, are expected.

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