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A Brief Overview of the Pilot Program for Foreign-funded Equity Investment Enterprises

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On September 22, 2017, the Shenzhen Municipal Finance Office, Shenzhen Municipal Government Financial Services Office, Market and Quality Supervision Commission of Shenzhen Municipality and Qianhai Administration Bureau jointly issued the *Pilot Program for Foreign-funded Equity Investment Enterprises in Shenzhen* (“**New QFLP Measures**”), based upon the *Interim Measures for the Launching of a Pilot Program for Foreign-funded Equity Investment Enterprises in Shenzhen* (Shen Fu Jin Fa [2012] No.12) (the “**Interim Measures**”) and *Operating Procedures for the Pilot Program for Foreign-funded Equity Investment Enterprises in Shenzhen* (Shen Fu Jin Fa [2012] No.13) (“**Operating Procedures**”). The New QFLP Measures reflect improvements to the pilot program for qualified foreign limited partner (“**QFLP**”) system in Shenzhen.

Foreign-invested equity investment pilot enterprises established under the QFLP system serve as an important channel for foreign investors to participate in investments in China. On December 24, 2010, the Shenzhen Municipal Finance Office, Shanghai Municipal Commerce Commission and Municipal Administration of Industry and Commerce jointly promulgated the *Implementing Measures for the Pilot Program for Foreign-funded Equity Investment Enterprises in Shanghai*, which marked the initial launch of the QFLP pilot program in Shanghai. Subsequently, the QFLP pilot program was also introduced successively in Beijing, Tianjin, Shenzhen, Chongqing and Qingdao. In 2012, Shenzhen officially launched the QFLP pilot program by promulgating the Interim Measures and Operating Procedures. Compared to these two earlier regulations, the New QFLP Measures see modifications mainly in the following aspects:

I. Expanded pilot enterprises and scope

According to the Interim Measures, foreign-funded equity investment management enterprises (“**FEIMEs**”) may be established with investments from foreign enterprises or individuals (it is not expressly provided whether a FEIME can be established in the form of a Sino-foreign joint venture; in practice, however, we have found a small number of FEIMEs that exist in the form of Sino-foreign joint ventures), and are only permitted “foreign investor management of foreign capital,” meaning that FEIMEs are only permitted to manage foreign-funded equity investment funds. However, according to Article 8 of the New QFLP Measures, a FEIME may be established either in the form of a wholly foreign-owned enterprise or in the form of a Sino-foreign joint venture. The New QFLP Measures also clearly specify the conditions to be met by domestic and foreign shareholders and partners:

- Foreign investors should meet either of the following conditions: (1) in the fiscal year prior to applying, hold proprietary assets (net assets) of not less than USD 100 million or its equivalent or hold assets under management of not less than USD 200 million or its equivalent; (2) hold an asset management license issued by the Hong Kong Securities and Futures Commission (or other offshore financial regulatory authority).
- Domestic investors should meet either of the following conditions: (1) be a licensed financial institution approved by the state financial regulatory department, such as a commercial bank, a securities exchange, an insurance company, a trust company, a financial leasing company or a public fund management company, or be a direct 50% or greater held subsidiary thereof; (2) be a large-sized enterprise that was introduced by the municipal government, which in the year prior to applying held proprietary assets (net assets) of not less than RMB 500 million or assets under management of not less than RMB 1 billion yuan, have achieved profits for the most recent three consecutive years with total net profit not exceeding RMB 60 million and a cumulative total taxes paid of less than RMB 18 million.

The New QFLP Measures allow for “foreign investor management of domestic capital” on the basis of “foreign investor management of foreign capital,” which means that FEIMEs are permitted to initiate the establishment of, or be entrusted to manage, domestic private equity and venture capital funds.

In addition, in accordance with the principle of “uniform standards for domestic-funded enterprises and foreign-funded enterprises,” the New QFLP Measures also permit “domestic investor management of foreign capital,” which means that qualified domestic private equity and venture capital fund management companies are permitted to initiate the establishment of, or be entrusted to manage, FEIMEs.

- A domestic private equity or venture capital fund management company must satisfy the

following conditions to initiate the establishment of, or be entrusted to manage, a FEIME: (1) be a domestic enterprise incorporated in accordance with the laws of China; (2) be a domestic private equity or venture capital fund management company that has been registered with the Asset Management Association of China (“**AMAC**”) for more than six months; (3) in the year prior to applying, hold proprietary assets (net assets) of not less than RMB 500 million yuan or assets under management of not less than RMB 1 billion; (4) have a sound governance structure and solid internal control systems and not have received punishment from judiciary or relevant regulatory authorities in the last three years; (5) have a management company registered in Shenzhen.

Through the implementation of these three policies, “foreign investor management of foreign capital,” “foreign investor management of domestic capital” and “domestic investor management of foreign capital,” the Shenzhen QFLP pilot program further expands its targets and scope of application, which will help to encourage more domestic and foreign fund managers and investors to participate in the pilot program.

II. Clearly specifying the conditions for domestic and foreign FEIME investors

Based upon the criteria and conditions for qualified investors provided by AMAC, the New QFLP Measures specify appropriate entry thresholds for different types of investors in order to encourage various kinds of funds to participate in the pilot program:

- A domestic or foreign-funded enterprise must satisfy the following conditions to become a limited partner of a FEIME: (1) be an institution or individual which has corresponding risk identification ability and risk - taking ability; (2) in the case of an institutional investor, have a sound governance structure and solid internal control systems, and have not received punishment from judiciary or relevant regulatory authorities in its place of residence for last three years; if a foreign institutional investor, possess net assets of not less than USD 5 million or its equivalent, with a single investment of not less than USD 1 million or its equivalent; if a domestic institutional investor, hold net assets of not less than RMB 10 million, with a single investment of not less than RMB 1 million; (3) in case of individual investors, sign an equity investment enterprise (fund) risk disclosure letter; for both the domestic and foreign individual investors, hold financial assets of not less than RMB 3 million or achieve an average annual income of not less than RMB 500,000 for last three years, with a single investment of not less than RMB 1 million.

III. Clarifying FEIME investment limitations, and restricting the proportion of investments from the same controller

Consistent with the principle upheld by the central government of promoting investment in industry sectors and discouraging virtual investments, the New QFLP Methods require FEIMES

to be guided by the Catalogue for Foreign Investment Industries to invest directly in industry sectors and prohibit the establishment of FEIMs in the form of fund of funds (in our understanding, this means that it is not possible to establish an FEIME for fund of funds management purposes, even though an investment made by the fund of funds through its ultimate equity investment and venture capital funds could also be directed to industry sectors. In addition, it remains to be confirmed in practice whether QFLP funds making portfolio investments through a subordinate SPV is subject to this restriction). Besides this restriction, if the general partner and the limited partner of a FEIME are controlled by the same controller, the total capital contribution ratio of that controller cannot exceed 50%.

IV. Clearly specifying requirements for fund manager registrations and fund filings; FEIMs failing to complete such registrations and filings are disqualified from participating in the pilot program

In order to eliminate the existence of so-called “empty shell FEIMs,” which refers to FEIMs that have not issued products for several years and which have not exited from the pilot program due to the absence of an exit mechanism, the New QFLP Measures require FEIMs to complete registration with AMAC within 12 months of obtaining approval to conduct FEIME operations and to establish an initial FEIME and the first domestic private equity or venture capital fund within this 12-month period. FEIMs and domestic private equity or venture capital funds so established should be filed with AMAC within 6 months from their establishment (it remains to be confirmed how to determine the time of establishment, whether by the date of establishment, the time of initial closing or the time of final closing; we understand that it may be the time of initial closing or final closing). A FEIME failing to complete fund manager registrations and fund filings in a timely manner will be disqualified from participating in the pilot program and be publicly notified.

V. Clearly specifying procedures for amending FEIME registration items

Because the Interim Measures are ambiguous about the procedures for amending FEIME registration items, in practice some FEIME directly conduct relevant AIC registration amendments without approval. According to the New QFLP Measures, if a FEIME applies to amend its registration items (including the change of company name, business scope, shareholders or partners, to increase or decrease subscribed or paid-in contributions, to change the contributions payment schedule, change company form, senior officers, or the division or merger, dissolution, liquidation or bankruptcy of the company), the Market and Quality Supervision Commission of Shenzhen Municipality will seek the opinion of the Shenzhen Municipal Finance Office. Where an FEIME intends to amend its registration items, the FEIME should submit application materials to the Shenzhen Municipal Finance Office,

which should make a decision within 15 business days after initially reviewing the materials and consulting the opinion of the pilot program leading group.

VI. Specifying post-supervision responsibilities of trust banks

The New QFLP Measures clearly specify the responsibilities of custodial banks. Specifically, FEIMs should entrust a commercial banking institution authorized by the state financial supervision department, above the branch level, which has the capital escrow capacity and qualifications to take custody of principal funds. The FEIME and FEIME-managed domestic RMB funds should entrust a commercial banking institution authorized by the state financial supervision department, above the branch level, which has the capital trust capacity and qualifications to take custody of project funds.

Banks in charge of both principal capital and project capital escrow accounts will supervise the use of capital within such accounts to ensure the authenticity and compliance of the use of such funds. The banks will supervise the FEIMs to use the funds within the escrow accounts within their business scopes, in accordance with the law and in a legitimate manner, shall conduct anti-fraud and anti-money laundering inspections upon project settlement, and will urge the FEIMs to pay the relevant taxes and fees. Specifically, the bank in charge of the principal capital escrow accounts is responsible for supervising the income or profit of all the projects managed by the FEIMs, while the banks in charge of the project capital escrow accounts are responsible for supervising the movement of capital for specific projects.

● **Important Announcement**

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