The Private Equity Review

Fifth Edition

Editor
Stephen L Ritchie

Law Business Research

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

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Chapter 6

CHINA

James Yong Wang[1]

I GENERAL OVERVIEW

After seeing a record year for private equity (PE) and venture capital (VC)[2] in terms of both fundraising and investment activities in 2014, the PE/VC industry in China[3] kept the rapid growth momentum in 2015. It was the first year 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 private investment funds (PIFs) and private fund managers submit its answer sheet to the regulatory authorities. There are also many other important regulatory developments that are trying to solve some potential issues in the PE and VC industry in China.

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 a report of the Asset Management Association of China (AMAC), the self-regulatory organisation of the fund industry in China, by the end of December 2015,

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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.

a total of 25,005 private fund managers managing 24,054 PIFs have been registered with AMAC with total assets under management (AUM) of 5.07 trillion, comparing to 4,856 Chinese private fund managers with total assets under management (AUM) of 1.95979 trillion yuan registered with AMAC and 6,787 PIFs filed with AMAC as of the end of November 2014. 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 87 and 99, respectively, compared to 30 and 36 as of the end of November 2014. With the development of a unified national registration and record-filing system and the increased regulatory oversight, AMAC is looking to gain a more accurate overall picture of the PIF industry in China and keeps a much closer eye on the private fund managers and the PIFs. A recent key 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.[5] 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.[6] While domestic IPO was suspended for about four months in 2015, more and more PE/VC funds turn their attention to NTB. Among the over 5,000 NTB-listed companies, 954 companies are PE/VC sponsored and many fund managers raise PIPE (private investment in public equity) funds to invest in the NTB-listed companies.

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

5 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 http://www.hankunlaw.com/newsAndInsights/lawDetail.html?id=531de3894ff29fce014ff3f305ca0154 (Chinese).

6 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.

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 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, multi-layered 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.[7] 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),[8] historically the principal regulator for the VC industry, while PE funds were created by local (e.g., provincial and

7 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.

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

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,[9] minimum investor subscription amount, record-filing requirements, capitalisation for its management company (MC), preferential tax policies, subsidies and 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. 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 while a majority or wholly foreign-owned private fund manager may register with AMAC as a private PE/VC fund manager, such a manager cannot obtain the AMAC-registration to manage securities investments (i.e., hedge funds) as of this writing. A minority foreign ownership, on the other hand, would not prevent the private fund manager from obtaining the AMAC-registration.

Registration

AMAC released the Interim Measures on the Administration of Registration of Non-public Investment Fund Managers and Record-filing of Funds (Record-filing

9 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.

Measures), effective as of 7 February 2014. Pursuant to the Record-filing Measures, any private fund manager is required to register with AMAC 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 after the closing of such fund. 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.

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).

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. As more and more problems and regulatory issues surface with the rapid development of PE/VC fundraising activities in China, regulators have started to further strengthen their regulatory supervision since late 2015. As a result, registration and filing process for private fund managers and PIFs have slowed down, and AMAC published three rules in the first week of February 2016 to further regulate manager registration, disclosure requirements and internal control of the fund managers. Senior management of PIF managers is required to obtain fund professional qualification and PIF managers are required to submit legal opinions on a laundry of items at the time of their initial registration with AMAC or any subsequent material change (as discussed above). Many manager registrations and fund filings are delayed due to these new requirements.

ii Domestic sponsors and investors

General

PE funds raising capital exclusively from domestic investors may generally be structured as LLPs[10] under the Partnership Enterprise Law or LLCs under the Companies Law and other national and local regulations. While many Chinese LPs, especially state-owned

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

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 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 investor questionnaires to determine the qualification and risk tolerance of their investors, 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 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 filed with AMAC; and (3) other investors prescribed by the CSRC. PE, VC and hedge funds (whether structured as LLCs, LLPs or contractual funds), AMS's, 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 limitation 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.

As the type of financial institution holding the largest amount of client assets in China and the diminishing profitability of traditional banking business, Chinese commercial banks, with their huge network of branch offices across the nation and access to a vast amount of valuable corporate data, have been coveting the PE/VC market for a long time. However, their hands are tied by the PRC Law on Commercial Banks and the General Principles on Lending, which prohibit commercial banks from making equity investments using proprietary or deposits without special regulatory approval, and as a result, commercial banks have to work with other licensed asset managers such as trust companies, brokers or mutual fund manager subsidiaries in order to participate in the PE/VC market. Chinese commercial banks with offshore subsidiaries have managed to circumvent this prohibition by using their offshore holding company (typically in Hong

Kong) to set up private fund managers and obtain AMAC registration. In an aggressive effort to expand its membership to commercial banks, AMAC granted private fund manager licences to 17 commercial banks or their investment departments in the second half of 2015, which raised significant concerns of the banking regulators, and after the intervention by the China Banking Regulatory Commission (CBRC), such licences were revoked.

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. We are aware of approved IPO cases where an AMS is used somewhere up the shareholding chain but not officially disclosed in the IPO application materials. 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 toward 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.[11]

11 For a more in-depth discussion of AMS's, please refer to Han Kun Private Equity Commentary 'Legal Anatomy on Contractual Private Equity Funds' and 'Investment by AMS's in Pre-NTB and Pre-IPO Companies', available at http://www.hankunlaw.com/

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)[12]

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 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

newsAndInsights/lawDetail.html?id=531de3895050f7c001505f31756c0036 and http://www.hankunlaw.com/newsAndInsights/lawDetail.html?id=5f4aa842520f60380152111e61dc0009, respectively (Chinese).

12 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 http://www.hankunlaw.com/newsAndInsights/enLawDetail.html?id=531de3894fd952b5014fda0929cf0085 (English) and http://www.hankunlaw.com/newsAndInsights/lawDetail.html?id=531de3894fd952b5014fda0929cf0085 (Chinese).

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 unfortunately would 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,[13] 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)[14]

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.[15] The

13 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.

14 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, http://www.hankunlaw.com/newsAndInsights/enLawDetail.html?id=531de3894fd952b5014fda0bd063008d (English) and http://www.hankunlaw.com/newsAndInsights/lawDetail.html?id=531de3894fd952b5014fda0bd063008d (Chinese); for Beijing QFLP, http://www.hankunlaw.com/newsAndInsights/lawDetail.html?id=531de3894fd952b5014fda411d9200b9; for Tianjin QFLP (Chinese), http://www.hankunlaw.com/newsAndInsights/lawDetail.html?id=531de3894fd952b5014fda47b4d100bd; for Shenzhen QFLP (Chinese), http://www.hankunlaw.com/newsAndInsights/lawDetail.html?id=531de3894feb41fc014fedf667ce008d; for comparison of Beijing, Tianjin and Shenzhen QFLP programmes (Chinese), http://www.hankunlaw.com/newsAndInsights/lawDetail.html?id=531de3894fda4ae4014fda560df0000c; and for R-QFLP (Chinese), http://www.hankunlaw.com/newsAndInsights/lawDetail.html?id=531de3894fdaa704014fdf245493006e (Chinese).

15 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

pilot programme opens the door for foreign sponsors to set up onshore funds in China in the form of LLPs and brings clear advantages over the traditional FIVCE or offshore fund model. In particular, in contrast to 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 by 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, over 30 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.

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);[16] (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

cities with a QFLP pilot programme, the Shanghai programme is by far the most successful while the Tianjin programme is more time efficient.

16 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.

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.

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. 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.

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$230 billion (as at the end of 2014)) 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 1.24 trillion yuan of investible capital for PE funds. 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 248 billion yuan as of the end of 2015) 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 licenses' are expected to be issued by CIRC in 2016.[17]

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

17 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 http://www.hankunlaw.com/newsAndInsights/lawDetail.html?id=531de3894fda4ae4014fda7bea8f0042 (Chinese) and 'Deep into PE Terrain – Insurance Companies Licensed to Invest in VC Funds and Sponsor PE/VC Funds', available at http://www.hankunlaw.com/newsAndInsights/lawDetail.html?id=531de3894ff29fce014ff3ee0fc30132 (Chinese).

20 per cent with respect to investment returns from the fund.[18] 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.

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, which WHT 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 2015, China saw huge growth in outbound direct investment (ODI), with a total of over 735 billion yuan invested outside of China. Outbound mergers and acquisitions reach a new peak, with a large number of mergers in the TMT industry. The turbulence of the stock market in China in 2015 did not dampen people's passion for privatisation of listed China based company and re-listing in China (the so-called 'red-chip return').

18 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.

Following the wildly successful A share listing of Storm (Baofeng) Technology on China's Growth Enterprise Market in March 2015, dozens of red-chip companies such as Giant Network and Qihu 360 are on their way to return to China's stock market. 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. Individuals may also make outbound investments through specially approved channels such as Harvest Fund Foreign Exchange Fast Track (Waihuitong). However, after the stock market crash in the summer of 2015, 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.

III REGULATORY DEVELOPMENTS

i Measures for administration of fundraising activities for PIFs (draft for comments)

To keep pace with the rapid growth of fundraising activities, AMAC issued Measures for Administration of Fundraising Activities for PIFs (Draft for Public Comments) (Fundraising Draft) on December 16, 2015 which brought tremendous shock and impact on the PRC fundraising activities and PIF managers. Fund managers shall register with AMAC and obtain registration certificate before they begin to conduct fundraising activities. The PIF Interim Measure requires the PIF managers to use investor questionnaires to justify the qualification of each investor and prepare a written risk disclosure to be signed by the investor as confirmation, and the Fundraising Draft further provides specific topics or questions that shall be included in the questionnaires and the risk disclosure letter. The Fundraising Draft also requires that any person engaging in the fundraising business shall obtain fund industry qualification and attend relevant training sessions. The final regulation is expected to become effective soon.

ii Guide to fund agreements (draft for public comments)

AMAC also delivered the Guide to Fund Agreements (Draft for Comments) (Guide), including partnership agreement, contractual fund agreement and articles of association on 16 December 2015. The Guide provides that, in case the investors have executed more than one fund agreements (for example, a formal complicated limited partnership agreement and a simplified version filed with AIC), the fund agreement filed with

AMAC shall prevail over the other agreements. The fund agreements should also describe the investment decision process, investment risk prevention mechanism, continued supervision of the portfolios, etc., that were generally only seen in the manager's internal control documents previously.

IV OTHER NOTEWORTHY DEVELOPMENTS

i Qualified domestic individual investor (QDII2)

Unlike the QDII programme that allows Chinese institutional investors to invest in foreign securities markets, QDII2 programme released in late 2015 will allow certain high net worth Chinese individual investors to invest abroad, which may dramatically increase capital outflows. Residents of Shanghai, Tianjin, Chongqing, Wuhan, Shenzhen and Wenzhou will be the first batch of cities covered by the programme. The timetable for the actual implementation of the QDII2 programme, however, is less than certain.

ii IPO application reform: from approval to registration regime

In 2015, China's stock market took a rollercoaster ride with repercussions felt by the international financial market. The stock listing reform from the approval-based regime to a registration-based regime is expected to be launched in spring 2016 at the earliest. As a result of such reform, domestic IPOs are expected to become a more feasible exit for PE and VC-backed companies, at least in the long run.

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 lagged seriously 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 over 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 400 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 2015 Global Expert Guides for banking, finance and transactional law (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. He 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. He is a CFA and CAIA charterholder.

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