THE PRIVATE EQUITY REVIEW

Seventh Edition

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Stephen L Ritchie

THE LAWREVIEWS

THE PRIVATE EQUITY REVIEW

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PREFACE

The seventh edition of *The Private Equity Review* follows a turbulent and at times nerve-wracking 2017. It was also a year in which private equity demonstrated its strength as an asset class in spite – perhaps because – of that turbulence. Deal activity and fundraising were strong in almost every major market despite fierce competition from public strategic buyers and strong returns in other asset classes, demonstrating private equity's ability to adapt quickly to changing conditions to find profitable investment opportunities. As a result, we expect private equity will continue to play an important role in global financial markets, not only in North America and Western Europe, but also in developing and emerging markets in Asia, South America, the Middle East and Africa. In addition, we expect the trend of incumbent private equity firms and new players expanding into new and less-established geographical markets to continue, although recent protectionist trends remain a risk factor.

While no one can predict how 2018 will unfold, one can confidently say that private equity will continue to play an important role in the global economy, and will likely seek to expand its reach and influence. It remains to be seen how local markets and policymakers respond.

Private equity professionals need – now more than ever – guidance from local practitioners about how to raise money and close deals in multiple jurisdictions. This review has been prepared with this need in mind. It contains contributions from leading private equity practitioners in 27 different countries, with observations and advice on private equity deal-making and fundraising in their respective jurisdictions.

As private equity has grown, it has also faced increasing regulatory scrutiny throughout the world. Adding to this complexity, regulation of private equity is not uniform from country to country. As a result, the following chapters also include a brief discussion of these various regulatory regimes.

I want to thank everyone who contributed their time and labour to making this seventh edition of *The Private Equity Review* possible. Each of them is a leader in his or her respective market, so I appreciate that they have used their valuable and scarce time to share their expertise.

Stephen L Ritchie
Kirkland & Ellis LLP
Chicago, Illinois
March 2018

Part I

FUNDRAISING

Chapter 6

CHINA

James Yong Wang[1]

I GENERAL OVERVIEW

The concepts of venture capital (VC) and private equity (PE)[2] were first introduced to China[3] in the late 1980s. Ever since the 1990s, with the rapid growth of China's economy and the unprecedented expansion of start-ups, investments, and mergers and acquisitions, China's PE/VC industry has maintained a strong momentum, and the number of PE/VC firms has grown exponentially.

In the early 1990s, foreign PE/VC firms, such as IDG, entered into the Chinese market and dominated China's PE/VC industry from the late 1990s to 2006. During that period, the majority of foreign PE/VC firms invested via offshore foreign currency-denominated funds in overseas holding companies of enterprises within the territory of China with a 'red-chip' structure.[4] They reaped returns via exit in the United States or other overseas capital markets. However, with the growing familiarity with the PE/VC industry within China, the emergence of VC investments in China's Technology, Media and Telecom (TMT) industries, the development of multi-layered capital market domestically and promulgations or amendments of relevant laws and regulations such as the Law on Partnership Enterprises, China's domestic PE/VC firms have been developing rapidly since 2006.

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1 James Yong Wang is a senior investment funds expert at Han Kun Law Offices. The author acknowledges the assistance of his team members, including but not limited to Yao (Ally) Hu, Xiao (Shawn) Ding, Zhiwei (Charles) Liu and Chenchen (Cici) Jiang, in preparing this chapter, and the contribution of his former colleague Wei (Abby) Mei.

2 Opinions vary in respect of the relationship between 'VC' and 'PE'. Some argue that 'VC' refers to investments in start-ups or enterprises at their early stages while 'PE' refers to merger and acquisition investments in privately offered equities of non-listed enterprises and listed enterprises. Some argue that 'PE' covers all investments in non-publicly offered equities and thus VC is a branch of PE. However, regulatory rules differ in terms of the regulation of 'PE' and 'VC' and the regulatory authorities tend to make a distinction between the two. For instance, China Asset Management Association (AMAC), the self-regulatory organisation of the fund industry in China, divides private funds into 'securities investment funds', 'PE funds', 'VC funds', etc. Thus, in this chapter, unless otherwise mentioned, we distinguish 'VC' and 'PE' and use 'PE/VC' to describe investments in non-publicly offered equities.

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

4 'Red-chip structure' adopted by enterprises within the territory of China is a special transactional structure that is established for the purpose of overseas financing and IPOs. Usually, shareholders of enterprises within China establish overseas holding companies in offshore jurisdictions such as the Cayman Islands, and make such overseas holding companies acquire directly or indirectly equities of enterprises within China held by shareholders. In this way, ownerships of enterprises within China are transferred overseas.

Meanwhile, in view of the restrictions of foreign investments and foreign exchanges that put foreign currency denominated funds at a competitive disadvantage, as well as the chill over shares of Chinese companies listed overseas due to some fraud scandals, an increasing number of foreign PE/VC firms started to consider and explore schemes of forming yuan funds and exiting via domestic capital market.

Since 2010, China's domestic PE/VC firms and yuan funds have witnessed dramatic developments. Some media described it as a 'PE fever'. By the end of December 2017, a total of 22,446 private fund managers (PFM) managing 66,418 private investment funds (PIFs) have been registered with China Asset Management Association (AMAC), the self-regulatory organisation of the fund industry in China, with total assets under management of 11.1 trillion yuan.[5]

II LEGAL FRAMEWORK FOR FUNDRAISING

Inconsistent with China's burgeoning PE/VC industry, China's PE/VC laws and regulations remain lagged behind. Until the past few years, China began to adopt a series of significant rules and regulations over PE/VC industry and a basic legal framework takes its shape.

VC was first written into China's legal documents in 1996.[6] In 2003 and 2005, the Ministry of Foreign Trade and Economic Cooperation (now the Ministry of Commerce) and the National Development and Reform Commission (NDRC) promulgated the Regulations on Administration of Foreign-Invested Venture Capital Enterprises and the Tentative Procedures for the Administration of Venture Capital Investment Enterprises respectively, which established a legal regime for foreign-invested venture capital enterprise (FIVCE) and domestic venture capital enterprise. In August 2006, the Standing Committee of the National People's Congress adopted the newly amended Law of the People's Republic of China on Partnership Enterprises and introduced the concept of 'limited partnership', the most popular form of PIFs worldwide. With the growing awareness and acceptance among industrial insiders, limited partnership quickly emerged as the primary form of PE/VC funds in the markets.

In terms of PE, for a long period of time, there was no national law or regulation regarding PE's legal status or compliance requirements, and it is unclear who has the regulatory authority over the PE/VC industry.

In December 2012, the Standing Committee of National People's Congress amended the Law of the People's Republic of China on Securities Investment Funds (Funds Law), where 'non-public fundraising' is covered for the first time and the China Securities Regulatory Commission (CSRC) is authorised to enact relevant rules in practice. The amended Funds Law came into effect on 1 June 2013. Although the Funds Law specifies that CSRC oversees 'non-publicly offered' funds, Article 2 of the Funds Law also provides that the Funds Law shall apply to security investment activities by establishing security investment funds through public or non-public fundraising. Thus, controversies arose over whether the provisions of the Funds Law should apply to PE/VC funds that invest in non-publicly offered equities.

5 See Monthly Report of PIF Registration (December 2017) released by AMAC, available at http://www.amac.org.cn/tjsj/xysj/smdjbaqk/392717.shtml (last accessed on January 11 2018).

6 See Law of the People's Republic of China on Promoting the Transformation of Scientific and Technological Achievements (promulgated and came into effect in May 1996).

In June 2013, the State Commission Office for Public Sector Reform (SCOPSR) issued the Notice on the Respective Duties and Responsibilities over Private Equity Fund Administration that officially bestowed upon CSRC the authority for the supervision and administration of PE funds with the aim of protecting the rights and interests of investors.

As the regulator for the entire private investment fund industry including PE/VC funds, CSRC authorised AMAC to be responsible for the registration of PFMs and record filing of PIFs, and to perform the self-regulatory function over the entire PIF industry. In August 2014, CSRC promulgated the Interim Measures for the Supervision and Administration of Private Investment Funds (PIF Interim Measures), which established the system of registration of PFMs and record filing of PIFs, defined 'qualified investor' and clarified non-public fundraising and disclosure requirements for PFMs. Later, AMAC released a series of self-regulatory rules, including but not limited to the Guidance of Internal Control of Private Investment Fund Managers, the Administrative Measures for Disclosure of Private Investment Funds, the Administrative Measures for Fundraising of Private Investment Funds (Fundraising Administrative Measures), the Guidance on Private Investment Fund Contracts, the Administrative Measures for Service Business of Private Investment Funds (for Trial Implementation) (Service Business Measures), the Guidelines on the Administration of Investor Suitability for Fund Raising Institutions (for Trial Implementation) (Suitability Guidance).

Nonetheless, the level of legal authority of the existing supervisory and administrative rules remains relatively low as a whole. Against this background, in August 2017, the Interim Regulations for the Supervision and Administration of Private Investment Funds (Draft for Comments) was released by the Legislative Affairs Office of the State Council, and opinions were solicited from the industry. As of this writing, the Interim Regulations for the Supervision and Administration of Private Investment Funds is expected to be officially released soon. Once released, it will, as an administrative regulation from the State Council, mark a significant upgrade of China's private equity industry regulatory regime.

III GENERAL COMPLIANCE REQUIREMENTS

PIFs in the PRC are required to comply with various requirements in operation. Before engaging in any fundraising activity, PFMs established in the PRC (including PFMs with direct or indirect foreign shareholders) need to register with AMAC in accordance with the regulations formulated by AMAC. After the completion of fundraising, PFMs have to file the PIFs managed by them with AMAC under their names.

i PFM registration

Certain conditions need to be satisfied in order to complete the PFM registration. Since February 2016, AMAC requires that any PFM, when applying for registration, engage PRC lawyers to conduct due diligence investigation on such PFM, to confirm its compliance in all aspects and to issue a legal opinion. Only if the legal opinion and other application materials are accepted by AMAC will a PFM be qualified to be registered. In November 2017, for the first time, AMAC clearly defined 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), including illegal fundraising, false statement, engagement in conflicting business, being listed as enterprises with serious illegal and dishonest acts, or discredit of senior executives, etc. Basic information of registered PFMs will be publicised by AMAC.

ii Regulations on fundraising

With the rapid growth and development of the domestic PE/VC industry, irregularities in fundraising have emerged. Therefore, regulatory authorities issued a series of regulations over fundraising, among which the most important ones are the Measures for the Administration of the Fundraising of Privately Investment Funds (PIF Fundraising Measures) promulgated by AMAC on 15 April 2016, the Measures for the Administration of the Suitability of Securities and Futures Investors (Suitability Measures) promulgated by CSRC on 12 December 2016, and the Guidelines for the Implementation of the Appropriateness Management of the Fundraising Institutional Investors (Suitability Guidelines, together with Suitability Measures, collectively referred to as New Suitability Management regulations) promulgated by AMAC on 28 June 2017.

The PIF Fundraising Measures explicitly stipulates that only registered PFMs and entities that have obtained a fund distribution license from CSRC and a membership of AMAC are permitted to engage in private placement of fund interests. The PIF Fundraising Measures has also stipulated specific rules and restrictions in fundraising, such as the guidelines on advertisement and promotion, offline or via the internet. On the basis of PIF Interim Measures, the PIF Measures further requires due procedure of fundraising and fund industry qualification of personnel engaged in fundraising. On the other hand, the New Suitability Management Regulations requires the managers to formulate a uniform standard to classify investors, design a hierarchical risk-control mechanism, regulate the internal management of sales organisations of fund managers and elaborate specific procedures.

iii PIFs filing

Upon completion of fundraising, PFMs need to file the PIFs they manage with AMAC, which paves the way for further investment of such PIFs. AMAC addresses the importance of the principle of professional and specialised management for a PFM. When applying for registration, one PFM may only register in one business category (e.g., private equity/venture capital fund manager, private securities investment fund manager) and manage PIFs filed as a corresponding type. While filing a fund, AMAC will examine whether the PFM's fundraising activities are in compliance with relevant rules issued by AMAC, including whether the PFM has raised capital from qualified investors for such fund. If an investor is in the form of partnership or other unincorporated form and has not been filed with AMAC, AMAC will look through such investor to the ultimate investors to determine whether such ultimate investors are qualified investors.

IV DOMESTIC INVESTORS

i State-owned enterprises

State-owned enterprises (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 general partner (GP), either alone or in partnership with other parties.

The participation of SOEs as GP or LPs in a fund creates myriad issues. For example, SOEs are expressly prohibited from acting as GP under the PRC Law on Partnership Enterprises. It is unclear, however, what constitutes an SOE for the purposes of this prohibition, and different government authorities apply different standards. According to the definition by State Administration of Industry and Commerce (SAIC), SOEs only refer to wholly state-owned entities, while 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. According to Decree No. 32 of SASAC and Ministry of Finance which was released in June 2016, it mainly regulates 'state-owned enterprises, state holding enterprises, and state controlled enterprises', which generally requires that: (1) the enterprise contains over 50 per cent state capital as well as the largest investor be an SOE, or (2) the enterprise contains no more than 50 per cent state capital but is controlled by an SOE investor (through agreements or other arrangements), which is the largest investor of such enterprise. 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 National Social Security Fund Council (NSSFC) upon its IPO (Transfer of State-owned Shares). Before the end of 2017, a PE/VC fund with over 50 per cent state ownership may be classified as an SOS of a portfolio company seeking an IPO, and such fund would have to transfer a portion of its shares received in the IPO to NSSFC for free. In November 2017, with the promulgation of Circular Guo Fa No. 49 [2017] (Circular 49), the aforementioned Transfer of State-owned Shares regulation was repealed, which was a significant positive change for PE/VC funds.

It is worth noting that Circular 49 does not amend other existing regulations related to SOEs. Thus, a PE/VC fund with a significant state ownership should consider in advance whether assets held by them will be deemed state-owned assets subject to extra filing, asset evaluation and equity exchange procedures for the disposition of the fund's assets under relevant rules and regulations.[7]

The fast-growing fundraising activities recently also benefited from the active involvement of guidance funds and government-sponsored industry investment funds that provide a large amount of capital for PE/VC funds. Guidance funds have several unique features: (1) created for specific purposes, e.g., to support innovation and entrepreneurship, support the growth of small and medium-sized enterprises, support industrial transformation and upgrading, and support development of infrastructure and public services; (2) focusing on the goal of policy guidance with some guidance funds requiring a minimum non-state participation percentage; and (3) usually preferring a higher priority in the distribution waterfall to secure the return of its investment cost in exchange for the surrendering of certain upside interest.

ii Insurance companies and NSSFC

Chinese insurance companies have 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. 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 in VC funds. By the end of September 2017, more than 100 insurance companies have invested in more than 120 PE/VC fund management companies and more than 230 PE funds, with a total investment of over 500 billion yuan therein. PE and VC sponsors seeking insurance LPs are required to meet two sets of somewhat differing criteria.

7 These include, but are not limited to, the Law of the People's Republic of China on the State-Owned Assets of Enterprises, Interim Regulation on the Supervision and Administration of State-owned Assets of Enterprises, Measures for the Supervision and Administration of the Transactions of State-Owned Assets of Enterprises, Rules on the Evaluation and Management of State Assets and Interim Measures for the Administration of Assessment of State-owned Assets of Enterprises.

In addition to being permitted to invest as LPs into PE/VC funds, insurance companies are also permitted to sponsor PE funds as a GP. To date, 23 insurance asset management companies have been approved to be set up by the China Insurance Regulatory Commission (CIRC).

For first-tier PE/VC sponsors in China, another deep-pocketed LP to go after is the NSSFC. Since May 2008, the NSSFC has been permitted to allocate up to 10 per cent of its assets to domestic PE funds (investments in offshore PE funds are not yet permitted).

V FOREIGN INVESTORS

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

i Foreign-invested venture capital enterprise (FIVCE)[8]

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 but not limited to 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 renminbi equivalent (in the case of a corporate FIVCE) and US$10 million or the renminbi 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 renminbi 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,

8 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/downloadfile/newsAndInsights/621f96184cfa886935c765f471e3a88c.pdf (English) and http://www.hankunlaw.com/downloadfile/newsAndInsights/2ae32de1676104cb84c11bf378faa356.pdf (Chinese).

in which case the income of the FIVCE will not be taxed at the fund level but will be allocated and directly taxed in the hands of the investors. The tax pass-through treatment, however, was not well understood by many local tax authorities, causing many non-legal-person FIVCEs to not be able to enjoy the tax pass-through status in many local jurisdictions. As the LLP form was made available to foreign-invested PE funds in 2010, and the provision granting tax pass-through status to non-legal-person FIVCEs was officially repealed in 2011, the FIVCE became a much less desirable legal form for foreign-invested funds in China.

ii Qualified foreign limited partner (QFLP) and renminbi-QFLP (R-QFLP)[9]

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 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.[10] 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 Enterprise Income Tax (EIT), a QFLP fund as a partnership enjoys tax pass-through treatment at the fund level. In addition, 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 Hui Fa [2015] No. 19 (Circular 19) in March 2015 and Circular Hui Fa [2016]

9 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/downloadfile/newsAndInsights/c62418c065e436082cfb853a81b127cc.pdf (English) and http://www.hankunlaw.com/downloadfile/newsAndInsights/2ac6cbbabefd9fda11ede072f90a666e.pdf (Chinese); for Beijing QFLP, http://www.hankunlaw.com/downloadfile/newsAndInsights/7ed1b1ec937559e67827278d14602b6e.pdf; for Tianjin QFLP, http://www.hankunlaw.com/downloadfile/newsAndInsights/30061ab3916d999d0b77a781975b5d88.pdf (Chinese); for Shenzhen QFLP, https://www.hankunlaw.com/downloadfile/newsAndInsights/5224dd932a1355c635a00f6b5424b092.pdf (Chinese); for comparison of Beijing, Tianjin and Shanghai QFLP programmes (Chinese), http://www.hankunlaw.com/downloadfile/newsAndInsights/c01e5068177a72c0e4159faedb44e1c3.pdf; and for R-QFLP, http://www.hankunlaw.com/downloadfile/newsAndInsights/a853cc028c36ccbf1c346031b123260d.pdf (Chinese).

10 Beijing, Tianjin, Chongqing, Shenzhen, Qingdao and Guiyang (Guiyang Free Trade Zone) followed suit in adopting their own versions of the QFLP pilot programme, which were all modelled on the Shanghai version. Of all the cities with a QFLP pilot programme, the Shanghai programme is by far the most successful while the Tianjin programme is more time-efficient. It is worth noting that Shenzhen released Circular Shen Jin Gui [2017] No. 1 (New Shenzhen QFLP Rule) in September 2017, which improved the QFLP pilot programme it had formed in 2012. The implementation of the New Shenzhen QFLP Rule needs to be further observed in practice.

No. 16 (Circular 16) in June 2016 by SAFE, 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 renminbi. Circular 19 and Circular 16 are 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, dozens of 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 seven 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 renminbi (as exemplified by the Blackstone QFLP fund);[11] (2) the co-GP/joint venture foreign limited partnership (FLP) model, where the foreign fund sponsor partners up with a Chinese fund sponsor to set up a joint venture MC and raises capital from both domestic and offshore investors (as exemplified by the Carlyle–Fosun QFLP fund); and (3) the wholly foreign-owned FLP model (as exemplified by the Fidelity QFLP fund). For each model, there are different variations, and the QFLP pilot programme is quite flexible in accommodating such variations. QFLP funds and their MCs are required to include 'equity investment' and 'equity investment management' in their company names and business scope.

The nature of a QFLP fund as a domestic or foreign fund is also an important issue. Under PRC laws, 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. According to a written reply from 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 (e.g., TMT industry, culture and entertainment industry), 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). Furthermore, the New Shenzhen QFLP Pilot Programme Measures issued in September 2017 explicitly provides that the foreign-funded equity investment enterprises are required to directly invest in portfolio companies in accordance with the Foreign Investment Industries Guidance Catalogue.

It is very common for foreign sponsors to seek to raise renminbi capital exclusively from PRC investors, namely, under model (1) above. To avoid the time-consuming process of applying for a QFLP licence and foreign investment restrictions, foreign sponsors often

11 To learn more about the New Shenzhen QFLP Pilot programme Measures, please refer to the following Han Kun Private Equity Commentary: https://www.hankunlaw.com/downloadfile/newsAndInsights/5224dd932a1355c635a00f6b5424b092.pdf (Chinese).

choose to set up a pure DLP free from any foreign investment restrictions. To our knowledge, one approach used by certain market participants 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 is required to ensure that such contractual arrangements provide effective control over the GP and are enforceable under PRC laws, 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.

Another variation of the QFLP fund is the R-QFLP fund, where offshore renminbi 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 (PBOC) with respect to the use of offshore renminbi by the fund.

VI STRUCTURING OF OUTBOUND INVESTMENT FUNDS

In 2016, China witnessed huge growth (an increase of 44 per cent) in outbound direct investment (ODI), with a total of over US$170 billion invested outside of China even though the PRC government has significantly tightened the ODI and other outbound investment filing and approval channels due to significant concerns about capital flee and foreign exchange imbalance. The year of 2017 has seen a significant drop of ODI activities as the PRC government is determined to crack down on illegal transfer of domestic assets offshore via such activities. Since late 2017, however, with the gradual improvement of the foreign exchange imbalance, the PRC government appears to be cautiously reopening the door for ODI activities, but at the same time has also significantly raised the disclosure requirements for ODI approval and filing via a series of new rules from NDRC in late 2017 and early 2018, including Order No. 11 promulgated by NDRC on 26 December 2017 and effective on 1 March 2018, which will further strengthen the supervision on other channels for outbound investments (such as foreign loans backed by domestic guarantees), by expanding the definition of investment activities thereunder (e.g., controlling enterprises or assets overseas by agreements or trusts).

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 (QDII) programme provide alternative options for managers provided that they shall be qualified and get approvals under relevant programmes. Recent good news for global asset managers is that the Shanghai QDLP programme has been reported to be reopened with several QDLP licenses granted in early 2018.

VII TAXATION

Tax is critical to the fund structuring process in the PRC. As tax rules with respect to PE/VC funds and their partners are less settled, the room for tax planning and the downside for lack of or inappropriate tax planning may be significant.

Like in the United States, Hong Kong and a number of other jurisdictions, the tax status of carried interest received by the general partner remains less than clear. In the United

States, for example, legislative proposals have been raised from time to time to try to redefine carried interest from capital gain to ordinary income since 2006. The risk of carried interest being taxed as service income appeared fairly remote in China until early 2017 when a major New Third Board listed private equity firm was penalized by local tax authority to have failed to pay value added tax (VAT) on carried interest. Prudent advance tax structuring during the fund formation process thus became extremely important in this respect.

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/VC 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 significant 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/VC fund level or at the corporate investor level.

Individual investors, on the other hand, care deeply about the form of the fund. Individual investors are generally subject to individual income tax (IIT) at a rate of 20 per cent with respect to investment returns from the fund.[12] 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.

With the nationwide advancement of the VAT reform in the PRC since 2016, the financial industry has been included in the scope of the VAT reform. Subject to different types of investment targets, the VAT may be imposed on PE/VC funds on the basis of VAT taxable income (e.g., the bond interest income, income derived from trading of financial instruments, such as stocks and bonds). Considering that contractual funds have no legal entity and do not require any tax registration, there were uncertainties as to how the VAT scheme applies to contractual funds in practice. In 2017, a series of guidance regulations were issued by the Ministry of Finance (MOF) and the State Administration of Taxation (SAT), which clarified that asset managers are VAT taxpayers for the VAT imposed on asset management products, and a simplified VAT calculation method will apply to the VAT taxable income of such asset management products (including contractual funds) at a rate of 3 per cent, effectively as of 1 January 2018. However, for PE/VC funds in the form of LLP and LLC that were subject to clear VAT rules (i.e., 6 per cent) prior to the issuance of such documents, there is still uncertainty whether the simplified VAT calculation method at the rate of 3 per cent for asset management products applies.

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

12 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.

itself of such reduced WHT pursuant to a tax treaty between the PRC 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 advisers 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).

Venture capital investment enterprises (VCIEs) that are duly registered with NDRC or AMAC and angel investment individuals enjoy special preferential tax treatment in several pilot areas in the PRC, pursuant to Cai Shui [2017] No. 38, effectively as of 1 January 2017. If they hold investments in qualified seed or early stage technology enterprises for a period of at least two years, they are permitted to apply 70 per cent of their total investment amount in such qualified enterprises to offset their taxable income, with any excess carried forward to subsequent years. In the case of VCIEs formed as LLPs, the 70 per cent tax benefits could be passed along to their corporate or individual LPs.

VIII OUTLOOK

As a concept learned from the Western world, the PE/VC market in China has grown at a phenomenal rate over the past 20 years and helped create many of the leading Chinese companies and global technology giants such as Tencent and Baidu. At the same time, this phenomenal rate of growth has also caused myriad business and legal issues, some of which are unique to China. More and more PRC laws and regulations have been promulgated, while the whole regulation system still lagged seriously behind the development of the industry in many respects, and are also characteristically vague in many others. 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.

Appendix 1

ABOUT THE AUTHORS

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James Wang has 16 years of experience in the investment funds and asset and wealth management field. He has represented international and Chinese fund clients in the structuring of over 600 domestic and offshore PE, VC, hedge, real estate, mezzanine, film and media, energy and infrastructure funds, QFLP and R-QFLP funds, QDLP and QDIE funds, QFII and R-QFII funds, and QDII funds with total capital commitments in excess of US$40 billion equivalent. He also regularly represents trust companies, broker-dealers, mutual funds, insurance companies and wealth management companies in joint venture and partnership transactions, M&A transactions and the structuring and issuance of various asset and wealth management products. He has been consistently ranked as a 'Leader in Investment Funds, Private Equity and Venture Capital' for China by *Chambers*, *IFLR* and *Legalband*. He was also named as market leader for investment funds in China by the London-based Legal Media Group's *Global Expert Guides* for banking, finance and transactional law for 2015 and 2016 (the only lawyer with a PRC law firm named by the *Global Expert Guides* for the investment funds category in China). He is a member of the expert review committee of the QFLP and QDLP pilot programmes administered by Shanghai Financial Services Office, and also served as adviser to it on PE secondary market initiatives. James is also active in PE and VC investments, M&A and capital markets transactions. Prior to Han Kun, James worked at several major international law firms in the US and China including Clifford Chance, Kirkland & Ellis and Greenberg Traurig, and was a partner at Greenberg Traurig in New York. James is a CFA and CAIA charterholder.

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