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Chapter 5

CHINA

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I GENERAL OVERVIEW

After hitting a plateau for two years, China[2] saw a record year for private equity (PE) and venture capital (VC)[3] in terms of both fundraising and investment activities in 2014. It was also a year where the PE and VC industry in China embraced the long-awaited national regulation for private investment funds (PIFs), i.e., the Interim Measures for the Supervision and Administration of Private Investment Funds (PIF Interim Measures), promulgated by China Securities Regulatory Commission (CSRC) on 21 August 2014. There are also many other important regulatory developments that are starting to form a national regulatory framework for 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 November 2014, a total of 4,856 Chinese private fund managers with total assets under management (AUM) of 1.95979 trillion renminbi have been registered with AMAC, and 6,787 PIFs and schemes have been filed with AMAC, including 3,163 private securities investment

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2 For the purposes of this chapter, China does not include Hong Kong, Macao and Taiwan.

3 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.

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

funds, 2,544 PE funds, 665 VC funds and 415 funds of other types. With regard to the fund managers, the number of management companies with an AUM above 10 billion renminbi and between 5 and 10 billion renminbi is 30 and 36, respectively. With the development of a unified national registration and record-filing system, AMAC is looking to gain a more accurate overall picture of the PIF industry in China.

Prior to 2007, China's PE and VC market was dominated by offshore PE and VC funds organised in offshore jurisdictions (typically the Cayman Islands). During that period, most foreign PE and VC funds made their investments into offshore holding vehicles of Chinese companies (the restructuring of such Chinese companies to establish offshore holding vehicles for offshore financing and IPO is called the 'red-chip' model) and sought lucrative returns through the IPO of such companies on US or other foreign stock exchanges. The red-chip model was dealt a significant blow with the release of Circular 10 by the Ministry 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 the New Third Board 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, renminbi-denominated funds mushroomed. In recent years, renminbi funds have exceeded offshore China funds in terms of both the number of new funds formed and the total amount of capital raised. For example, in the first three quarters of 2014, a total of 150 disclosed renminbi funds raised US$23.389 billion, compared with 17 disclosed US dollar funds raising US$3.7 billion.

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 renminbi funds for domestic deals. Many foreign PE and VC sponsors have thus started to incorporate a renminbi fund strategy into their overall China strategy, as further described in Section II, *infra*. At the same time, a number of Chinese PE and VC sponsors with a successful track record managing renminbi 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.[5] 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),[6] historically the principal regulator for the VC industry, while PE funds were created by local (e.g., provincial and municipal) regulations (literally translated from Chinese as 'equity investment enterprise' or 'EIE', as opposed to 'venture capital enterprise' or VCE). PE and VC funds differ in many respects, including required minimum fund size,[7] 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

5 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.

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

7 Local AICs generally follow the minimum size requirement for VC funds of 30 million renminbi. 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 renminbi.

NDRC and apply for preferential tax treatment are still subject to the previous capital contribution requirements.

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.

Registration

AMAC released the Interim Measures on the Administration of Registration of Non-public Investment Fund Managers and Record-filing of Funds (Record-filing Measures), effective as of 7 February 2014. 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 on the private fund (such as the total amount of commitment and contribution, total number of investors and any change in the fund's investment focus) 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. In early 2015, local CSRC branches issued notices to a select group of large private funds requiring self-examination and self-certification of compliance. On-site examinations, which are practised under the National Examination Program in the United States, have also been conducted on certain funds that have been reported to AMAC for non-compliance and illegal activities. As a result, a number of registered fund managers have been subject to different types of penalty, such as public criticism of fund principals, blacklisting and revocation of their registration certificate.

ii Domestic sponsors and investors

PE funds raising capital exclusively from domestic investors may generally be structured as LLPs[8] under the Partnership Enterprise Law or LLCs under the Companies Law and other national and local regulations. While many Chinese LPs, especially state-owned enterprises (SOEs), were (and to some extent still are) more familiar and comfortable with LLCs, LLPs have gradually become the dominant form for PE funds in general in recent years.

Under the Partnership Enterprise Law, an LLP may have up to 50 partners, including at least one GP and one LP. The number of shareholders of an LLC likewise is limited to 50 under the Companies Law. In addition to LLPs and LLCs, PIFs are also allowed to be structured as 'contractual funds' that do not have legal personalities and are managed by fund managers through investment management agreements or other similar agreements. Contractual funds are allowed to have up to 200 investors, and are increasingly used by hedge funds and special asset management schemes.

A PIF may be offered through private placement in China to no more than 200 qualified investors, each of whom:

a shall make a minimum commitment of 1 million renminbi to the fund; and

b is an entity with net assets in excess of 10 million renminbi, or a natural person with individual financial assets in excess of 3 million renminbi or an average individual annual income in excess of 500,000 renminbi 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 schemes 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), asset management schemes, 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.

iii Foreign investors

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

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

Foreign-invested venture capital enterprise (FIVCE)

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 renminbi 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, in which case the income of the FIVCE will not be taxed at the fund level but will be allocated and directly taxed in the hands of the investors. The tax pass-through treatment, however, was not well understood by many local tax authorities, causing many non-legal-person FIVCEs to not be able to enjoy the tax pass-through status in many local jurisdictions. As the LLP form was made available to foreign-invested PE funds in 2010, and the provision granting tax pass-through status to non-legal-person FIVCEs was officially repealed in 2011, the FIVCE became a much less desirable legal form for foreign-invested funds in China. Certain foreign sponsors have decided to dissolve FIVCEs if such funds have not made substantial investments or their investments have not significantly appreciated in value. To the extent that such dissolution or restructuring requires the transfer of investments to an LLP established by the same group of investors, it 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,[9] 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 renminbi-QFLP (R-QFLP)

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.[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 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 renminbi 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 36 by SAFE and Circular 26 of the Shanghai Free Trade Zone in 2014, 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 within the 16 pilot areas prescribed by Circular 36 or the Shanghai Free Trade Zone where FIEs are allowed to convert foreign exchange-registered capital at their discretion and then make equity investments with renminbi.

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,

9 By comparison, certain local authorities (e.g., Shanghai Pudong District) have introduced local regulations permitting the restructuring of an LLC into an LLP. Due to the lack of implementing rules, however, such restructuring is only conducted on a case-by-case basis in practice.

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

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 renminbi (as exemplified by the Blackstone QFLP fund);[11] (2) the co-GP/joint venture FLP model, where the foreign fund sponsor partners up with a Chinese fund sponsor to set up a joint venture MC and raises capital from both domestic and offshore investors (as exemplified by the Carlyle–Fosun QFLP fund); and (3) the wholly foreign-owned FLP model (as exemplified by the Fidelity QFLP fund). For each model, there are different variations, and the QFLP pilot programme is quite flexible in accommodating such variations. QFLP funds and their MCs are required to include 'equity investment' and 'equity investment management' in their company names and business scope, and thus are PE funds. Sometimes, the foreign sponsor of a QFLP fund also intends to raise capital from capital pools administered by the NDRC or its local counterparts, which is an example of when the incompatibility between the two lines of regulations over PE and VC funds becomes particularly obvious and poses a significant structuring challenge to the fund sponsor and its counsel.

The nature of a QFLP fund as a domestic or foreign fund is also an important issue. Under Chinese 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 renminbi, 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 renminbi 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.

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11 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.

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 with respect to the use of offshore renminbi 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 renminbi, 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 of the team) 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 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 Chinese 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 considers SOEs to be all types of entities 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 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$200 billion (as at the end of 2013)) 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 since 2010, and up to 2 per cent of their total assets as at the end of the last quarter have been allowed to be invested in VC funds since December 2014, which translates into about 200 billion renminbi of investible capital for VC funds. In addition to being permitted to invest as LPs into VC funds, insurance companies have recently also been allowed to sponsor PE funds as a GP, and Everbright Yongming, Sunshine Insurance and a few other insurance companies have been approved by the China Insurance Regulatory Commission to set up PE funds as a GP.

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 funds or asset management 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 the China Banking Regulatory Commission, brokerage firms and mutual funds and asset management subsidiaries are regulated by CSRC, while third-party wealth management firms remain largely unregulated. Whether and to what extent such asset management schemes should be looked through for investor suitability and determination of the number of investors remains unsettled, and regulatory arbitrage is common in the structuring of some of such funds.

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

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

In the case of an FLP, withholding tax (WHT) at a rate of 10 per cent shall apply to dividend income from the FLP to an offshore partner, including carried interest to the offshore GP.[13] Such 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. Corporate FIVCEs 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. The high-tech qualification certificate, however, has proven fairly difficult to obtain in practice.

III REGULATORY DEVELOPMENTS

To keep pace with the rapid growth of internet fundraising activities, the Securities Association of China (SAC), the self-disciplinary organisation for the securities industry under the CSRC, issued Administrative Measures on Private Equity Crowdfunding (Draft for Comments) (Crowdfunding Draft) on 18 December 2014 to regulate crowdfunding internet platforms and related activities. Issuers may privately raise capital

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.

13 The 10 per cent WHT to the offshore GP assumes that such offshore GP is not deemed to have a 'permanent establishment' in China. If such offshore GP is deemed to have a 'permanent establishment' in China, then it will be subject to the 25 per cent EIT. Further, if carried interest is deemed service income rather than investment income by the relevant tax authority, it will be subject to business tax and ancillary tax at a rate of 5.6 per cent on the gross amount of the carried interest.

through PE crowdfunding platforms that have duly registered with the SAC and filed business financing plans with the Market Supervision Centre. As of 26 January 2015, nine crowdfunding platforms have been registered with the SAC and two PE crowdfunding plans have been approved. Responding to comments from the industry, the Crowdfunding Draft has recently been revised to lower the 'accredited investor' criteria: the investor shall make a minimum commitment of 100,000 renminbi to the fund; and the investor must be an entity or a natural person with individual financial assets in excess of 1 million renminbi or average individual annual income in excess of 300,000 renminbi for the past three years. Such accredited investor criteria are much lower than the 'qualified investor' criteria for PIFs under the PIF Interim Measure and provide a way for managers to raise money from investors with lower net assets.

IV OTHER NOTEWORTHY DEVELOPMENTS

i Outbound domestic investment (ODI) and qualified domestic investment enterprise (QDIE)

2014 also saw ODI surpassing foreign direct investments into China for the first time in history, with record-breaking deals such as the US$1.95 billion acquisition of the Waldorf-Astoria Hotel by Anbang Insurance Group from Hilton Group. In addition to cash-rich SOEs that are grabbing up global assets, Chinese non-SOE companies and wealthy individuals also have a rising need for ODI and international allocation of assets, including into overseas PE, VC, hedge and real estate funds, a new phenomenon with which the old ODI regulatory regime is ill-equipped to deal. In response thereto, both MOFCOM and the NDRC have promulgated new regulations to significantly loosen up the onerous ODI approval process. Local governments have also come out with different versions of pilot programmes to encourage ODI activities stemming from their local jurisdictions, of which Shenzhen and Shanghai are pioneers. On 8 December 2014, a long-overdue new pilot programme, nicknamed QDIE, was launched in Shenzhen. Compared with existing ODI programmes such as the qualified domestic institutional investor programme (which is only available to qualified financial institutions such as commercial banks, trust companies, securities companies, fund MCs, insurance companies and national social security funds for overseas securities investment) and the Shanghai Qualified Domestic Limited Partnership (QDLP) pilot programme (which allows global hedge fund managers to raise capital in China), the QDIE programme has a much broader scope of investable assets and is expected to make it much easier for Chinese investors to invest in overseas funds (including PE, VC, hedge and real estate funds), real assets and other asset classes. The first batch of US$1 billion in foreign exchange quota has been authorised by SAFE for QDIE, and several financial institutions have been approved for QDIE status. The Shanghai QDLP is also expected to be expanded to match the QDIE programme with respect to the scope of investable assets and applicants, albeit with a local presence requirement for the overseas manager. QDIE and similar pilot programmes are opening up new doors for overseas PE and VC fund managers to raise capital in China.

ii Other developments

Going into 2015, most of the funds raised during the 2006–2008 PE peak time are reaching the end of their terms, and GPs are under pressure to show returns to investors. It has been reported that PE firms still have 7,500 disclosed domestic portfolio companies in their portfolios as at the end of 2014. During the 14-month period between November 2012 and January 2014, when the CSRC placed a moratorium on IPOs, sales to other PE funds and strategic buyers emerged as a more attractive option for PE and VC funds. However, this trend changed fast with the success of the first IPO after the end of the moratorium on 17 January 2014. By the end of 2014, there were 125 IPOs raising US$13.1 billion in China and 647 companies are on the CSRC's IPO waiting list. Ninety-six Chinese companies, including Alibaba, went public on overseas stock exchanges and raised a total of US$49.26 billion in 2014. Among these companies that went public in 2014, 126 were backed by PEs and VCs.

Major regulatory changes on the domestic IPO market are also making headway. In the middle of 2014, the CSRC announced support to internet and high-tech companies without a record of profitability to go public at the Growth Enterprise Board after a one-year listing at the New Third Board. The 'Nine New Guiding Opinions' promulgated by the State Council on 9 May 2014 restates that the reform of the registration (rather than approval) based IPO system will be actively and steadily pushed forward. The PRC Securities Law is expected to be amended to reflect the 'registration system' and reduce or loosen up related administrative verification and approval procedures. As a result of such reform, domestic IPOs may become a more attractive and 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. Chinese 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.

Appendix 1

ABOUT THE AUTHORS

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James Wang has over a decade 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 200 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$35 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* and *IFLR*, as well as one of the Top-15 Rising Lawyers in China by *Asian Legal Business*. 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, he worked at several major international law firms in the US and China, and was a partner at a major international law firm in New York. He is a CFA and CAIA charterholder.

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