



# Private Equity

in 32 jurisdictions worldwide

Contributing editor: Casey Cogut

# 2012



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# China

**Caroline Berube**

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## Formation and terms operation

### 1 Forms of vehicle

What legal form of vehicle is typically used for private equity funds formed in your jurisdiction? Does such a vehicle have a separate legal personality or existence under the law of your jurisdiction? In either case, what are the legal consequences for investors and the manager?

In the People's Republic of China (PRC or China), private funds are allowed to take the form of a limited liability company (LLC), partnership or joint venture. In practice, the vehicles used for private funds are limited partnerships or companies. LLCs are commonly used in the form of fund management companies, equity investment companies and equity investment management companies. An LLC has a separate legal personality and exists until the liquidation, bankruptcy or termination of its term as stated in the articles of association of the LLC, being dissolved by the resolution of the LLC's shareholders or due to governmental orders to close down. Investors bear liability up to the extent of their contributions to the registered capital of the LLC. The LLC pays tax in accordance with the Enterprise Income Tax Law and individual investors pay individual income tax in accordance with the Individual Income Tax Law. Equity investment enterprises and equity investment management enterprises can be described as new concepts in the PRC, and as a result, some local Chinese governments have enacted policies that allow them to benefit from preferential tax treatment in order to encourage their formation. For example, in Beijing, private equity management companies are not taxed until they start to make profit, and during such year they will obtain an ongoing five-year local tax 'holiday', in which no enterprise business tax (which varies depending on the type of business) is payable for the first two years, and in which a 50 per cent reduction applies for the remaining three years.

As for limited partnership, the private fund vehicle must register at the Administration of Industry and Commerce (the AIC) as a separate entity but without independent legal entity status. The general partners take unlimited joint and several liability of the partnership, but the limited partners only bear liability up to the extent of their financial contributions to the partnership. The individual partners pay tax but the partnership as a whole does not.

It is expected that a new investment programme by the Qualified Foreign Limited Partners (QFLP) will be introduced into the current Chinese foreign exchange administration system to encourage foreign investment in China-based private equity funds on a trial basis in some cities in China (for example, Shanghai). In the past, according to Hui Zong Fa [2008] No. 142 issued by the State Administration of Foreign Exchange (SAFE) on 29 August 2008, RMB-denominated capital of a foreign-invested enterprise that is converted from foreign currencies shall only be used for activities within its approved business scope and is not allowed for any onshore equity investment. The aforesaid circular has placed an obstacle for onshore equity investment by foreign-invested RMB funds. However, the QFLP programme was deemed as the opening of a gateway for foreign investors to get involved in the RMB private equity fund sector.

The QFLP programme allows foreign institutional investors to convert their overseas capital into RMB-denominated capital for investment in the domestic private equity or venture capital market once it is approved, which will increase the sources of capital for the foreign-invested RMB private equity funds.

The trial implementation was first launched in the Pudong New Area of Shanghai from March 2010 and then expanded into other districts of Shanghai. The official version of the Municipal Implementation Measures concerning the Trial Launch of Foreign Invested Equity Investment Enterprises Programme was released by the relevant Shanghai authorities on 24 December 2010. A quite high market access threshold is placed by the abovementioned implementation measures that, among others, the foreign equity institutions qualified for QFLP status must possess a self-owned asset of no less than US\$500 million or the investment fund it managed of no less than US\$1 billion.

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### 2 Forming a private equity fund vehicle

What is the process for forming a private equity fund vehicle in your jurisdiction?

If using an LLC as the private fund vehicle, and the LLC is set up by a Chinese legal entity or Chinese individual, the general process is as follows:

- reservation of the name of the LLC;
- opening of a basic bank account for the LLC;
- injection of the first portion of the required registered capital (the greater between 20 per cent of the total registered capital and 30,000 renminbi) must be injected within three months of the issuance of the business licence;
- preparation of the first 'round' of application documents for the LLC's incorporation and submission of such to the relevant AIC;
- obtainment of the LLC's business licence from the relevant AIC;
- application for the organisation code certificate with the local Bureau of Quality and Technical Supervision (BQTS);
- application for the state tax certificate with the State Tax Bureau;
- application for the local tax certificate with the local Tax Bureau; and
- application for the finance certificate with the local Finance Bureau.

Generally speaking, it takes about 30 working days (inclusive of the application processing times) to obtain a business licence and about 15 working days for the remaining steps (point six to point nine), subject to the local practice and timing of approval in different localities in China.

If an LLC is set up by a foreign investor or by a Chinese legal entity and a foreign investor, the major steps in the process are as follows:

- reservation of the name of the LLC;
- preparation and submission of the application documents to the local Foreign Economic and Trade Bureau or the national Ministry of Commerce (MOC) for the certificate of approval;
- preparation of the first 'round' of application documents for the LLC's incorporation and submission of such to the relevant AIC;
- injection of the first portion of the required registered capital (the greater between 20 per cent of the total registered capital and 30,000 renminbi) must be injected within three months of the issuance of the business licence;
- obtainment of the LLC's business licence from the AIC;
- application for the issuance of the organisation code certificate with the local BQTS;
- application for the state tax certificate with the State Tax Bureau;
- application for the local tax certificate with the Local Tax Bureau;
- application for the finance certificate with the local Finance Bureau; and
- application for the foreign exchange certificate with the provincial SAFE.

It takes approximately 95 working days (inclusive of the application processing times) to obtain the business licence and 15 working days for the remaining steps (point six to point 10), subject to the local practice and timing of approval in different localities in China.

The major official fee for the establishment of an LLC is the registration fee charged by the AIC, which is 0.08 per cent of up to and including the first 10 million renminbi of the LLC's registered capital, and 0.04 per cent of the LLC's registered capital that is between 10 million renminbi and up to and including 100 million renminbi. No fee is incurred for the portion above 100 million renminbi.

### 3 Requirements

Is a private equity fund vehicle formed in your jurisdiction required to maintain locally a custodian or administrator, a registered office, books and records or a corporate secretary, and how is that requirement typically satisfied?

An LLC must establish and maintain a registered office in China and appoint a legal representative who can act and bind the LLC to arrangements agreed on its behalf. Offices can only be registered in the commercial buildings designated to be used as office premises (it is forbidden to register an office in a residential building, although in practice some companies ignore this rule) (the Administrative Provisions on Company Registration; please also refer to the AIC website for detailed procedures: [www.sgs.gov.cn/sgs/1001/xzxc/djxx/djxx\\_02.htm](http://www.sgs.gov.cn/sgs/1001/xzxc/djxx/djxx_02.htm)).

Any subsequent amendments to the LLC (such as to its registered address, name or business scope) must be submitted to the authorities for approval and then registered or filed at the relevant government authorities. The company's financial records must be kept for the annual inspection procedure and must be submitted to various authorities.

### 4 Access to information

What access to information about a private equity fund formed in your jurisdiction is the public granted by law? How is it accessed? If applicable, what are the consequences of failing to make such information available?

Generally speaking, the LLC's basic information (for example, identities of the investors and the amount of the registered capital injected) is available to the general public at different levels of the AIC where the LLC was originally incorporated based on its investment scale

and the nature of its operation. The information can be obtained by submitting an application letter to such AIC office. Only lawyers or government clerks are permitted access to the LLC's more detailed information (such as information that was disclosed during annual government checks and information such as annual accounting, financial or registered capital verification reports, etc). However, some local AICs no longer allow lawyers access to such information unless otherwise authorised to do so via court orders.

### 5 Limited liability for third-party investors

In what circumstances would the limited liability of third-party investors in a private equity fund formed in your jurisdiction not be respected as a matter of local law?

There are currently no rules or regulations that might increase the liability of third-party investors, except of course where criminal activity is involved. Otherwise, the liability of third-party investors would only be affected by the agreement between the two relevant parties, with this agreement being subject to the more general Contract Law of the PRC.

### 6 Fund manager's fiduciary duties

What are the fiduciary duties owed to a private equity fund formed in your jurisdiction and its third-party investors by that fund's manager (or other similar control party or fiduciary) under the laws of your jurisdiction, and to what extent can those fiduciary duties be modified by agreement of the parties?

The 'fund manager' in this context is the LLC, and the directors of the LLC are under the standard directors' duties of loyalty, good faith and avoidance of conflict between duty and interest. An agreement between the parties can define the scope and extent of the fiduciary duties, provided that those terms are not against the general principles of the Company Law.

For a trust fund where the Trust Law of the PRC applies, the fund manager is required to discharge his or her duties with good faith, loyalty and diligence, and only in the best interest of the third-party investor rather than for the gains of any party other than the investor by using the capital under the trust funds. The fund manager is obliged to operate the funds from the third-party investor separately from the fund manager's own capital and may be held liable for the losses caused to the third-party investor arising from the misuse of capital from the trust fund in violation of the relevant regulations (article 16 of the Trust Law of the PRC).

### 7 Gross negligence

Does your jurisdiction recognise a 'gross negligence' (as opposed to 'ordinary negligence') standard of liability applicable to the management of a private equity fund?

Not strictly, but if the LLC (as the vehicle of the private fund) is in the form of a trust, the fund manager will operate the funds in accordance with the Trust Laws of the PRC. If the trustee, namely the LLC, causes losses to the funds due to violation of the management duties or improper handling of the fund's affairs, the third-party investor has the right to apply to the court or ask the LLC to refund their investment or give compensation for their loss. The investor can apply to the court for the aforesaid within a period of one year of the date after which he or she was made aware of (or has evidence of) the 'gross negligence'.

If it is proven that the trustee has committed a serious fault when managing or operating the fund, the investor has the right to remove the trustee according to the investment agreement between the investor and the trustee. Otherwise, the investor may also choose to file a lawsuit against the trustee in the court to remove the trustee.



**8 Other special issues or requirements**

Are there any other special issues or requirements particular to private equity fund vehicles formed in your jurisdiction? Is conversion or redomiciling to vehicles in your jurisdiction permitted? If so, in converting or redomiciling limited partnerships formed in other jurisdictions into limited partnerships in your jurisdiction, what are the most material terms that typically must be modified?

Some municipal governments in China (for example, Shanghai, Beijing and Tianjin) make reference to private fund vehicles in terms of their minimum registered capital requirements. For example, in Shanghai, when a foreign investor invests in an LLC that is acting as a private fund investment company, such foreign individual investor must inject a minimum capital amount of 5 million renminbi, as required by the Shanghai AIC. Further, the number of parties investing in the private equity fund shall be between two and 50, and such parties can be either natural persons or companies. Foreign private fund vehicles are expected to set up a wholly foreign-owned enterprise subsidiary or joint venture if they wish to actually manage a private fund in China. However, they may also acquire Chinese enterprises and subsequently convert them to wholly owned foreign enterprises.

**9 Fund sponsor bankruptcy or change of control**

With respect to institutional sponsors of private equity funds organised in your jurisdiction, what are some of the primary legal and regulatory consequences and other key issues for the private equity fund and its general partner and investment adviser arising out of a bankruptcy, insolvency, change of control, restructuring or similar transaction of the private equity fund's sponsor?

As there are no specific bankruptcy rules for private funds in China, we can refer to the Partnership Law and the Bankruptcy Law to answer this question. If the general partners of a private fund vehicle (in the form of a partnership) become insolvent or cannot repay their debts, they will be forced to withdraw from the initial partnership (article 24 of the Company Law). For private fund vehicles in the form of an LLC, the shares of an insolvent shareholder become part of the 'bankruptcy assets' that shall be distributed according to article 107 of the Bankruptcy Law. If an investment adviser to the LLC as the private fund vehicle becomes bankrupt, the LLC can terminate its relationship with the investment adviser and hire another.

**Regulation, licensing and registration****10 Principal regulatory bodies**

What are the principal regulatory bodies that would have authority over a private equity fund and its manager in your jurisdiction, and what are the regulators' audit and inspection rights and managers' regulatory reporting requirements to investors or regulators?

There is no specific regulatory body monitoring private funds in China nor are there any specific regulations requiring regulatory reports from fund managers. The formation process for private funds is governed by the AIC, like every business enterprise in China. A foreign-invested company (not a local invested company) is required to obtain approval from the MOC and the State Economic Technological Development Zone.

There are also regulations regarding the supervision and management of specific types of fund companies, whereas there is no one specific regulation for private equity fund enterprises. For example, securities investment companies are under the scrutiny of the Chinese Securities Regulatory Commission (CSRC), the Chinese securities industry watchdog. The CSRC has the right to check and supervise the corporate governance, business operations and risk management

policies of companies, and companies must submit their annual financial report, internal risk management evaluation report and auditing report to the CSRC. If any major or sudden change occurs to the fund management company, it shall be reported to the CSRC. If a Chinese commercial bank invests a cash contribution into the fund management company, the People's Bank of China and the Chinese Banking Regulatory Commission (the CBRC) must be also involved and approve the contribution – both are regulatory entities for commercial banks. Other regulatory bodies include the Development and Reform Committee and the China Insurance Regulatory Commission.

**11 Governmental requirements**

What are the governmental approval, licensing or registration requirements applicable to a private equity fund in your jurisdiction? Does it make a difference whether there are significant investment activities in your jurisdiction?

An equity investment company is considered an entity that is mainly engaged in equity investment activities and such enterprises are allowed to register as a limited liability partnership or LLC. The minimum registered capital for an LLC in Shanghai is 100 million renminbi for both domestic and foreign-invested equity companies, and all of the registered capital shall be injected as cash (as opposed to other capital, such as equipment). Equity management companies shall have a minimum registered capital of 5 million renminbi with a minimum 1 million renminbi injected as cash. In Beijing, private funds are also required to have more than two senior management staff. The amount of accumulated investment has not yet been considered as a qualification for incentive treatment.

According to the National Development and Reform Commission (NDRC), investment funds (EIF) with a registered capital of more than 500 million renminbi and locally set-up in the regions of Beijing, Tianjin, Shanghai, Zhejiang Province, Jiangsu Province and Hubei Province are required to apply for registration at the local NDRC office. EIFs managing social security funds are also required to register.

A higher market access threshold is imposed for securities investment funds. The establishment of a security investment fund requires a minimum registered capital is 100 million renminbi as the paid-up capital, which must be contributed in cash, and the registered capital of its major shareholders shall be not less than 300 million renminbi (article 13 of the Securities Investment Fund Law of the PRC).

**12 Registration of investment adviser**

Is a private equity fund's manager, or any of its officers, directors or control persons, required to register as an investment adviser in your jurisdiction?

There is no specific requirement for a private equity fund manager to register as an investment adviser, however a fund manager engaged in securities investment is required to register. The relevant regulations are the Provincial Regulations on the Administration of Qualification of Staff Engaged in Securities Investment Fund Transactions and the Code of Conduct for Sales Agents of Securities Investment Funds.

The first regulation prescribes that the fund's sales personnel and fund managers shall only be permitted to engage in sales activities of the securities investment funds only upon the passing of the qualification exam organised by the Securities Regulatory Commission of the PRC, the obtainment of relevant experience related to securities or fund transaction activities and the credentials for registration as a sales agent for securities investment funds.

The Code of Conduct for Sales Agents of Securities Investment Funds is a voluntary set of guidelines that outlines professional standards and behaviour of the fund managers and sales agents. As these are voluntary guidelines, they have no legal weight.

**13 Fund manager requirements**

Are there any specific qualifications or other requirements imposed on a private equity fund's manager, or any of its officers, directors or control persons, in your jurisdiction?

The general requirements imposed on an LLC's senior management and a securities investment fund manager, and their respective employees, are applicable here.

While not specific to a private fund's manager, the legal representative or senior manager (or managers) of an LLC must have a clean criminal record and must not have been directly involved in, or responsible for, a company's bankruptcy.

A fund investment company that deals in securities must be legally incorporated and accredited by the CSRC. The registered capital of the fund management company shall be more than 100 million renminbi in the form of paid-in cash capital. Regarding the personnel of such companies, there must be more than 15 qualified personnel in the fund management company who have obtained the relevant credentials outlined in question 12. In Shanghai, article 9 of Interim Measures on the Administration of Venture Capital Enterprises requires a venture capital enterprise to have at least three senior managerial personnel with more than two years' experience in venture capital investment or related areas.

Any change to the manager or other senior employees of the fund management company dealing in securities must be filed with the Securities Regulatory Commission. There is also a non-plurality requirement for senior managers of fund management companies in that the director, supervisor, manager or other employees are not allowed to hold a position in the fund's trustee company or other fund management companies or engage in any activities that infringe the benefits of the private fund's shareholder.

**14 Political contributions**

Describe any rules – or policies of public pension plans or other governmental entities – in your jurisdiction that restrict, or require disclosure of, political contributions by a private equity fund's manager or investment adviser or their employees.

In China, elections and political campaigns are conducted only at the expense of the state treasury. Individuals or social organisations are not allowed to contribute to a political party or to a partisan candidate. As a result, political contributions by a private equity fund's manager or investment adviser or their employees are not possible.

**15 Use of intermediaries and lobbyist registration**

Describe any rules – or policies of public pension plans or other governmental entities – in your jurisdiction that restrict, or require disclosure by a private equity fund's manager or investment adviser of, the engagement of placement agents, lobbyists or other intermediaries in the marketing of the fund to public pension plans and other governmental entities. Describe any rules that require a fund's investment adviser or its employees and agents to register as lobbyists in the marketing of the fund to public pension plans and governmental entities.

China's social security fund is a comprehensive fund composed of pension plans, medical insurance plans, unemployment plans, etc, and it is the most significant contributor to private equity funds. The social security fund is currently managed by an internal operations committee and several external asset managers. Currently, the use of intermediaries is not a usual practice for the social security fund. Private equity funds are actively seeking contributions from the social security fund, but disclosure of the use of intermediaries, instead of being regulated, is only required on a contractual level. There are currently no regulations requiring investment advisors or employees to register as lobbyists.

Entities of the Chinese government use their treasury funds to provide venture capital to small or medium-size enterprises, especially high-tech companies. Although start-up companies often turn to intermediaries for extra capital, it is rare that intermediaries are used when government-sourced venture capital is involved. Since the intermediaries are still rather inactive in this area, disclosure of use of intermediaries has not yet been regulated.

**16 Bank participation**

Describe any legal or regulatory developments emerging from the recent global financial crisis that specifically affect banks with respect to investing in or sponsoring private equity funds.

The slowdown in China's growth during the financial crisis was primarily attributable to its export-oriented economy. In response to the world recession, the Chinese government released a stimulus plan to invest in infrastructure spending and lower interest rates to free up capital and spur domestic demand in 2008. The outlook of private equity in China was weakened due to the uncertainty of the financial crisis, but in the long run, investors' confidence in the Chinese economy is still positive, as evidenced by a steady increase of fundraising in the private equity industry in 2009 and 2010.

With the development of the private equity market in China, the commercial banks have a stronger desire to expand their business scope and sources of income via their participation in the private equity industry. In practice, the majority of state-owned banks indirectly invest in the equity share of some pre-IPO companies and private equity funds through their HK subsidiaries established for operating the investment bank related business, such as CCB International (Holdings) Ltd, BOCOM International (Holdings) Ltd and BOC international (Holdings) Ltd. In addition, other banks, such as China Merchants Bank, Shanghai Pudong Development Bank and Minsheng Bank, provide private equity intermediary and advisory services.

In addition, since 2008, the CBRC has issued the Guidance on the Business Cooperation between Banks and Trust Fund Companies and the Notice concerning the Related Issues on Further Streamlining the Cooperation between Banks and Trust Fund Companies to regulate the banks' participation in the private equity industry.

**Taxation****17 Tax obligations**

Would a private equity fund vehicle formed in your jurisdiction be subject to taxation there with respect to its income or gains? Would the fund be required to withhold taxes with respect to distributions to investors? Please describe what conditions, if any, apply to a private equity fund to qualify for applicable tax exemptions.

If the fund is a standard private fund set up as an LLC and not subject to any of the specific guidelines and rules regarding local government incentives, its income or gains are subject to enterprise income tax of 25 per cent. If it is a limited partnership, it does not have to pay the enterprise tax, however, its individual partners' income and gains are subject to individual income tax at progressive rates ranging from 5 per cent to 35 per cent.

The fund is legally required to pay withholding tax, enterprise income tax (for LLCs) or individual income tax (for limited partnership) when distributing profits to its overseas investors, unless there are any tax treaties concluded between the PRC and the investor's home country. In these instances, the tax treaty will apply in the event of any inconsistencies.

If the funds were subject to any local government direction, tax incentives may apply. For example, in Beijing, if the private fund is in the form of a limited partnership with individual partners and a general partner, the fund shall be subject to individual tax but exempted from the local business tax normally payable if it satisfies any of the following conditions:

- it invests in a private equity fund with intangible or real estate assets and it bears its own risks in such investment; or
- it engages in a share transfer with the private equity fund.

In addition, the Beijing municipal government also exempts senior staff of the private fund from individual income tax.

In order to support and promote the development of high-tech industries, enterprises investing in unlisted small and medium high-tech enterprises by means of equity fund investment can enjoy a tax reduction of 70 per cent of the amount invested when the equity has been held by the enterprise for more than two years.

In addition, as an incentive policy towards equity investment enterprises with actual injected capital of more than 500 million renminbi, senior management staff employed for more than two years can benefit from tax rebates of up to 300,000 renminbi, when purchasing a condo or a car in Beijing, or participating in professional training.

#### 18 Local taxation of non-resident investors

Would non-resident investors in a private equity fund be subject to taxation or return-filing requirements in your jurisdiction?

The Enterprise Income Tax Law and Individual Income Tax Law provides the principle income tax regulations applicable to foreign investors of private equity fund investments. Non-resident enterprises and enterprises with an institution or establishment in China but with no actual relationship between the income obtained and the institution or establishment, shall pay enterprise income tax at a rate of 20 per cent (article 3 and article 4 of the Enterprise Income Tax Law). However, tax exemptions may apply to income from equity investment including any dividend and bonus obtained from resident enterprises by non-resident enterprises with institutions or establishments in China, but only where there is an actual relationship between such institution or establishment and the income (article 26 of the Enterprise Income Tax Law). For non-resident individual investors, equity investment income is subject to individual income tax at a rate of 20 per cent (Individual Income Tax Law).

As mentioned in question 17, a fund is legally required to withhold the income tax for its investors. The withholding tax rate in China is 20 per cent for non-resident investors and foreign individual investors respectively, in accordance with Enterprise Income Tax Law and Individual Income Tax Law. These taxation requirements are subject to any tax treaties between China and the non-resident investor's country of origin.

As China has implemented a strict foreign exchange control policy, the return of profits obtained from investment shall be reported by the fund company to the provincial SAFE and the fund company is required to purchase the desired foreign currency from designated commercial banks that are licensed to engage in foreign currency transactions.

#### 19 Local tax authority ruling

Is it necessary or desirable to obtain a ruling from local tax authorities with respect to the tax treatment of a private equity fund vehicle formed in your jurisdiction? Are there any special tax rules relating to investors that are residents of your jurisdiction?

Due to the multiple taxation layers (for example, local, provincial and national) in China, companies can often find themselves paying various taxes. For this reason, it is often desirable (though not necessary) for a private fund company to obtain a ruling from local tax authorities regarding special tax considerations. There are special tax rules available to private funds investing in small or medium-size enterprises, especially for high-tech enterprises. For example, in Beijing, employees of such private enterprises are exempt from income tax payable on their social charges.

#### 20 Organisational taxes

Must any significant organisational taxes be paid with respect to private equity funds organised in your jurisdiction?

As discussed in question 17, the organisational taxes to be paid differ according to the legal forms of both the private fund and its sponsors. If the private equity fund is in the form of an LLC, the private equity fund is required to pay enterprise tax at a rate of 25 per cent. Where a sponsor of the LLC is an individual person, he or she will be required to pay individual income tax at a rate of 20 per cent, and where a sponsor is an LLC, it shall be required to pay tax at a rate of 25 per cent. However, if the equity tax rate is higher than the enterprise income tax rate, the private equity fund investors are only required to pay the difference.

If the private equity fund is in the form of a limited partnership and the individual partner is itself a limited partner, the individual partner's income tax of the income and gains received from the limited partnership shall be taxed based on a progressive rate varying from 5 per cent to 35 per cent and the income tax from the equity investment shall be at a rate of 20 per cent.

If the individual partner is a LLC, business tax at a rate of 5 per cent shall be paid and any interests and equity transferred shall be taxed at a rate of 25 per cent.

#### 21 Special tax considerations

Please describe briefly what special tax considerations, if any, apply with respect to a private equity fund's sponsor.

Where the private fund is a Chinese-owned LLC, the income (for example, management fees) earned from investors is subject to enterprise income tax. Where the private fund is a limited partnership, its income will be distributed to the partners who are liable to pay individual income tax.

#### 22 Tax treaties

Please list any relevant tax treaties to which your jurisdiction is a party and how such treaties apply to the fund vehicle.

China has entered into bilateral tax treaties with more than 80 countries in order to avoid double taxation. Whatever the legal form used for the private fund, the tax treaties will usually affect foreign investors in private funds both formed within China's jurisdiction and outside of it. For example, a tax treaty was entered into between China and Singapore and dictates that profits earned by Singapore private funds, or Singaporean individual investors, from private transactions in China are only to be levied with Singaporean income tax, unless the Singaporean entity establishes a permanent office in China (article 7(1) of the Agreement between the government of the Republic of Singapore and the government of the PRC).

#### 23 Other significant tax issues

Are there any other significant tax issues relating to private equity funds organised in your jurisdiction?

In order to encourage the development of private equity transactions in China, some municipalities (for example, Beijing and Shanghai) have issued directions that contain preferential tax policies regarding such transactions (as mentioned in questions 17 and 19).



## Selling restrictions and investors generally

### 24 Legal and regulatory restrictions

Describe the principal legal and regulatory restrictions on offers and sales of interests in private equity funds formed in your jurisdiction, including the type of investors to whom such funds (or private equity funds formed in other jurisdictions) may be offered without registration under applicable securities laws in your jurisdiction.

There are no restrictions set forth on the type of investors under laws relating to securities. However, in accordance with the Guidelines on Risk Management of M&A Loans of Commercial Banks, issued by the CBRC, the principal legal and regulatory restrictions in question are set for institutions offering private fund loans.

First, institutions offering private fund loans must have been duly established commercial banks. Second, five conditions have to be satisfied in order for commercial banks to conduct private fund transactions:

- they must have a sound risk management system and an effective internal control system;
- the ratio of adequacy of the loan loss is at least 100 per cent;
- the ratio of capital adequacy is at least 10 per cent;
- the general reserve balance is at least 1 per cent of the loan balance during the same period; and
- the commercial bank has a team of experienced persons to conduct the private fund transaction loan's due diligence and risk assessment.

Even if the above conditions are satisfied, the commercial banks offering private funds shall be under the strict scrutiny of the CBRC during the process of the offering of the private funds.

*The Interim Measures on the Administration of Venture Capital Firm* (2006) provides a general guideline pertinent to practical issues of equity fund investment companies. According to articles 3, 14 and 16 a venture capital investment enterprise may use its assets for external investments. Investments in enterprises shall be limited only to those that have not been listed on the stock market. Venture capital investment enterprises may not engage in the mortgage and real estate business, except for the purchase of real estate for self-use. Investments of a venture capital investment enterprise in a single enterprise must not exceed 20 per cent of the total assets of the venture capital investment enterprise.

### 25 Types of investor

Describe any restrictions on the types of investors that may participate in private equity funds formed in your jurisdiction (other than those imposed by applicable securities laws described above).

The restrictions on the types of investors that may participate in private funds are not clear at the moment. The only laws and regulations applicable are the more general Company Law and the Partnership Law, which regulate the incorporation of companies and partnership enterprises respectively. In China, governmental investors make up a large portion of the private equity funds market. Taking into consideration the large amount of capital concerned and the complicated relationship with some institutional investors, certain regulations are in place to restrict, to a certain extent, Chinese institutional investors' participation in private equity funds. For example, the Chinese national social insurance fund is approved to invest in private equity funds which have been recorded by the Development and Reform Committee; however the invested amount shall be no more than 10 per cent of the total capital of the national social insurance fund.

Where foreign investors wish to acquire Chinese companies through private funds, they can either directly use private funds formed in other jurisdictions or they may participate in private funds formed within China's jurisdiction.

### Update and trends

According to the national industry policies emphasised by the central authorities in China, the environmental protection, new energy, energy-saving, telecommunication, biomedical, health care sectors and some advanced technology industries will become the key areas for foreign private equity investment in the near future, guided by China's view to shifting the development mode of the nation from export-oriented to consumer-oriented investment. Further, as the trial regulation to set up RMB funds has been underway and is expected to be introduced on a broader scale, there will be an increased interest in RMB funds from private equity companies as mentioned above.

Where foreign investors acquire Chinese companies through private funds (as well as through other forms), the *Catalogue for the Guidance of Foreign Investment Industries* (2011 amended edition) (GCFI) shall be observed. The GCFI encourages foreign investment in certain industries, for example the biotech and high-technology industries, while restricting the scale of foreign investment in certain industries such as the education industry and banning altogether foreign investment in industries such as the news or information media industry.

### 26 Identity of investors

Does your jurisdiction require any ongoing filings with, or notifications to, regulators regarding the identity of investors in private equity funds (including by virtue of transfers of fund interests) or regarding the change in the composition of ownership, management or control of the fund or the manager?

No matter what type of legal form is employed in a private fund (see question 1), the identity of the investors must be filed or registered with the relevant authorities (including, among others, the provincial AIC and the local Tax Bureau). Where any information related to the investors changes, such information shall be filed or registered with the relevant authorities. Further, every company shall be subject to an annual inspection, as mentioned in question 3 (usually from March to June every year) to ensure that all activities conducted by the company are in compliance with the relevant laws and regulations.

### 27 Licences and registrations

Does your jurisdiction require that the person offering interests in a private equity fund have any licences or registrations?

The requirements for entities offering interests in a private fund are covered in question 31. There are no extra licences or registrations required other than those usually required for the regular incorporation of an entity.

### 28 Money laundering

Describe any money laundering rules or other regulations applicable in your jurisdiction requiring due diligence, record keeping or disclosure of the identities of (or other related information about) the investors in a private equity fund or the individual members of the sponsor.

There are no specific rules relating to money laundering for private funds, and the general rules of the Law on Anti-money Laundering apply to private funds. These rules require confirmation and record-keeping of the identities of each investor (such as ID cards or passports for individuals, and business licences for entities). Moreover, deals involving a large sum of money or suspicious activity, or both, shall be reported to the relevant authorities for closer scrutiny.



What constitutes a 'large amount' differs, depending on the form of transaction; for example 200,000 renminbi or US\$100,000 for a daily total cash transaction constitutes a 'large amount', while 2 million renminbi or US\$200,000 constitutes a 'large amount' for online or credit card (and similar) transactions. Some examples of 'suspicious activity' include cancelling a bank account immediately after the completion of a large stock transaction and conducting banking transactions in a manner that is not in accordance with the entity's business operations.

### Exchange listing

#### 29 Listing

Are private equity funds able to list on a securities exchange in your jurisdiction and, if so, is this customary? What are the principal initial and ongoing requirements for listing? What are the advantages and disadvantages of a listing?

While technically possible, as private funds are quite new in China and the requirements for the incorporation of a stock company are fairly high, there is no listed fund management company in China as yet. The number of initial shareholders in a stock company must be between two and 200 (inclusive), and the registered capital (both initial and ongoing) must be at least 5 million renminbi.

In a private fund context, a potential advantage of listing may be liquidity and the relative 'permanence' of capital; however a disadvantage is that listing may be time-consuming and place limits on the transfers of interests (for more information, see question 30).

#### 30 Restriction on transfers of interests

To what extent can a listed fund restrict transfers of its interests?

As mentioned above, there is still, to date, no listed fund management companies in China. Moreover, the shares of the sponsors of a listed company cannot be transferred during the first year of the company's incorporation, and shares issued prior to the public listing may not be transferred during the first year from the date of public listing. The same rules applicable to the limitation of transfer of shares are also applicable to directors, supervisors and managers who own shares of the fund management company.

### Participation in private equity transactions

#### 31 Legal and regulatory restrictions

Are funds formed in your jurisdiction subject to any legal or regulatory restrictions that affect their participation in private equity transactions or otherwise affect the structuring of private equity transactions completed inside or outside your jurisdiction?

Investment by private funds is regulated in the same way as investment by a regular private company. Foreign-invested private funds are restricted or prohibited against investing in certain areas where foreign entities are not favoured, as provided in GCFI. The investors of private funds can provide restrictions in the private funds charter.

#### 32 Compensation and profit-sharing

Describe any legal or regulatory issues that would affect the structuring of the sponsor's compensation and profit-sharing arrangements with respect to the fund and, specifically, anything that could affect the sponsor's ability to take management fees, transaction fees and a carried interest (or other form of profit share) from the fund.

There are no direct restrictions on receiving profits from the fund, but rather, this is subject to the profit-sharing provisions under the Company Law of the PRC. Some of these general regulations may indirectly affect the compensation and profit-sharing arrangements. The remuneration of the fund management company is mainly sourced from management fees, which shall be collected by the fund management company on a daily basis based on the net value of the fund.

As the profit-sharing mechanism depends greatly on the net value of the fund instead of the profitability of the fund, the fund management company sometimes inflates the net value of the fund through their investment techniques, leading to an unusual phenomenon in the fund market, where even if the fund operates badly, the fund management company still earns profits. Such results will inevitably attract the attention of the Chinese authorities.



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