

NDRC continues to spearhead the regulation of private equity funds in China

In order to further regulate China's private equity industry, the National Development and Reform Commission (NDRC) promulgated the *Circular on Further Improving Administration of Developing and Filing of Equity Investment Enterprises in Pilot Areas* (关于进一步规范试点地区股权投资企业发展和备案管理工作的通知) (PE Fund Filing Circular) on 31 January 2011, which came into effect on the same day. The PE Fund Filing Circular requires private equity funds of no less than RMB 500 million that are established in any of the six specified locations to be filed with the NDRC and subject to its supervision and a series of ongoing disclosure requirements.

Evolution of NDRC's fund filing regime

NDRC has taken the lead in supervising private equity funds through filing and administration of venture capital enterprises (DVC Enterprises) since 1 March 2006. That was the time when the *Interim Measures on Administration of Venture Capital Enterprise* (创业投资企业管理暂行办法) (Domestic Venture Capital Enterprises Measures), jointly promulgated by NDRC and nine other ministries, came into effect. The Domestic Venture Capital Enterprises Measures mandate the formation of DVC Enterprises to be filed with NDRC or its local branches. Upon filing, they may enjoy preferential treatment including (but not limited to) tax incentives available in the *Notice regarding Tax Policies Promoting Venture Capital Enterprises* (关于促进创业投资企业发展有关税收政策的通知, 财税[2007] 31), which allowed a tax rebate of 70% of the private equity investment of qualified DVC Enterprises in non-listed high-tech small and medium enterprises. DVC Enterprises that have not filed with NDRC or its local branches are not entitled to such benefits.

Since the filing regime came into place, its application has been expanded to an unexpected scale for a rather different reason. In August 2008, the National Social Security Fund (NSSF) announced that it has been approved by the State Council to allocate up to 10% of its national fund size to invest in private equity funds and industrial investment funds, on condition that such funds have been filed with or approved by the NDRC respectively. When Hony Capital and CDH Funds announced that NSSF has committed RMB 1 billion in each of them based on their filings with the NDRC, the market was convinced that in practice NDRC filing is important to attract high profile state-owned limited partner investors. This prompted a considerable number of private equity fund managers to voluntarily file themselves with NDRC. According to statistics released on the official website of NDRC, 22 private equity fund managers have filed with NDRC, in addition to a longer list of venture capital managers and venture capital enterprises¹ as at October 2010.

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¹ See <http://cjs.ndrc.gov.cn/qytzycyjj/cytzbaql/ybactgyjbx/ndrc/>

Since June 2010, however, NDRC has specifically suspended the review of filing applications of private equity managers to avoid abuse by them as an endorsement to attract limited partner investors. While this suspension is still valid as at the date of writing, the PE Fund Circular comes in timely to specifically impose a filing requirement on certain private equity funds, in line with NDRC's reported intention to establish a better regime to "properly supervise" China's private equity industry.

Relationship with relevant law and regulations

The promulgation of the PE Fund Filing Circular raises questions on its impact on the industry, its relationship with relevant local rules and the PRC Securities Investment Funds Law (Securities Investment Funds Law) which is currently being revised and likely to be approved by the National People's Congress (the highest legislative body of China) by the end of 2011.

Currently, the PE Fund Filing Circular is applicable to six pilot areas including Beijing, Tianjin, Shanghai, Jiangsu, Zhejiang and Hubei (Pilot Areas). Within each Pilot Area, the local government has formulated its respective rules to promote the private equity industry under its own administration. Although apparently no inconsistency between the local rules and the PE Fund Filing Circular has been raised so far, it should be noted that if it were to exist, the PE Fund Filing Circular issued by NDRC, a central level authority, should prevail. On a separate question, it remains unclear whether a private equity manager may double dip the benefits of filing with NDRC and launching private equity funds pursuant to local rules (e.g., *Shanghai Implementing Measures on the Launch of the Pilot Program for Foreign-Invested Equity Investment Enterprises in Shanghai* promulgated by the Shanghai municipal government and effective in Shanghai as from 23 January 2011).

The ongoing revision to the Securities Investment Funds Law has also caused uncertainty to the status of the PE Fund Filing Circular. Reportedly, a new chapter may be inserted into the Securities Investment Funds Law to address various types of private funds including private equity funds which would, to a certain extent, be regulated by the China Securities Regulatory Commission (CSRC). If that happens, questions may arise as to whether the Securities Investment Funds Law or the PE Fund Filing Circular would prevail in case of inconsistency, and how any overlapping powers and duties of NDRC and CSRC would be addressed and tackled.

Against this background, the following sets out the salient points under the PE Fund Filing Circular:

Establishment, fund-raising and investment scope

Establishment

An equity investment enterprise (i.e. a private equity fund or PE Fund) must be established pursuant to the Companies Law or the Partnership Law of the PRC. A PE Fund in the form of company limited by equities or shares may set up an internal management unit or outsource the management to another PE Fund or PE Fund manager.

Fund-raising

Fund-raising must only be conducted through private placement, targeting specific clients who are capable of identifying risks and bearing losses. Information must not be circulated via the mass media (including commercial websites) in the form of public notices, community posts, brochures to the public, massive mobile phone short messages to non-specific recipients, forums, seminars and any other public or disguised public distribution (including leaving placement memorandum at the counters of commercial banks, securities companies and trust companies).

Risk Disclosure

The PE Fund must sufficiently disclose investment risks and possible investment losses, and may not commit to the payback of investment principal or any fixed investment return to investors.

Capital Commitment

All investors must make capital contribution with their legitimately sourced self-owned cash. Investors may commit to making capital contribution and it may be drawn down as needed in accordance with the Articles of Association or the Partnership Agreement of the PE Fund.

Investment Scope

The PE Fund may only invest in an enterprise's private equities, and all its idle cash must only be deposited in banks or used to subscribe for fixed income investment products such as national bonds. The investment must comply with industry policies, investment policies, and macro-economic control policies on a national level. The invested project must observe all legal requirements relating to approval, verification, and filing for a fixed assets investment project. A PE Fund with foreign capital must also comply with relevant regulations on foreign investment.

Risk management mechanism

No Guarantee

The PE Fund must establish its own risk management mechanism in accordance with its Articles of Association or Partnership Agreement. It must not provide guarantee to any entity other than the portfolio company in which it invests.

Compulsory Custody

If the manager of the PE Fund is a wholly foreign-owned enterprise or Sino-foreign joint venture enterprise, the PE Fund must put its assets under the custody of a legal person custodian in China.

Information disclosure obligation

Annual Report

In addition to disclosing required information to investors in accordance with the Articles of Association or Partnership Agreement of the PE Fund, the PE Fund must also submit its annual operation report and audited annual financial report to NDRC or its local branch within four months after the end of each financial year. The manager and assets custodian of the PE Fund shall submit their respective annual assets management report and annual assets custody report to NDRC or its local branch within four months after the end of each financial year.

Filing of Material Changes

The PE Fund must make a filing with NDRC or its local branch within 10 working days of the occurrence of certain material events to the PE Fund or its manager. These events include (i) amendment to the Articles of Association, Partnership Agreement or Management Agreement etc.; (ii) increase or reduction of its capital commitment or debt financing positions; (iii) merger or spin-off; (iv) change the fund manager or custodian, including change to the senior management of the PE fund manager; or (v) dissolution, bankruptcy, or receivership.

Filing procedure

Application

Any PE Fund which (i) has been registered with the administration for industry and commerce; (ii) has investment in equities of private companies or other PE Funds (i.e., fund of funds) as its main business scope; and (iii) is within the Pilot Areas must file with NDRC through its local branches and abide by the administration of NDRC. In the event that a PE Fund outsources its management to an external PE manager, it must make a filing of both itself and its manager, whether by itself or via its manager. If the PE Fund is self-managed, it must make the filing itself.

Exemptions

A PE Fund that satisfies any of the following conditions are exempted from the filing requirement: (i) it is already filed as a Venture Capital Investment Enterprise pursuant to the Domestic Venture Capital Enterprises Measures; (ii) it has a capital commitment (i.e. the fund size) of less than RMB500 million or the equivalent in a foreign currency; or (iii) it is set up by one entity or one individual, or by several entities but wholly-owned by a common parent.

Required documents

The PE Fund must submit the following documents for filing: (i) filing application form; (ii) photocopy of business license; (iii) private placement memorandum; (iv) Articles of Association or Partnership Agreement; (v) capital commitment executed by each investor; (vi) capital verification report issued by a competent organization regarding the actual capital contribution made; (vii) general partner's affidavit that the PE Fund has been legally placed and launched; (viii) CVs and supporting documents of senior management; (ix) a legal opinion regarding the filing documents and materials; and (x) the management agreement and custodian agreement, if any.

If the manager of a PE Fund also makes a filing, the manager must submit the following documents: (i) a photocopy of its business license; (ii) its Articles of Association or Partnership Agreement; (iii) a name list of its shareholders or partners and an introduction of their background; (iv) CVs and supporting documents of its senior management; and (v) its track records and prior performance of its PE management.

Senior management referred to above must include: (i) where in a company, director, supervisor, manager, deputy manager, chief financial officer, board secretary, and other personnel as provided in the Articles of Association; and (ii) where in a partnership, general partner and other personnel as provided in the Partnership Agreement. If the general partner of the partnership is a legal person or a non-legal person entity, the senior management of the general partner will also be considered as the senior management of the PE Fund.

Penalties – public denouncement

NDRC and its local branch must notify and procure the relevant PE Fund or its manager to make a filing within 20 working days if it considers such PE Fund or manager to be subject to filing obligation under the PE Fund Filing Circular. In case a PE Fund and/or its manager fails to comply with such filing notification, NDRC shall disclose its name to the public as a "PE Fund / manager in circumvention of filing regulation" through NDRC's official website.

For PE Funds and managers who have filed, NDRC and its local branch shall conduct an annual inspection within five months after the end of each financial year. Where necessary, NDRC may choose to conduct an on-site or off-site inspection, or an investigation by mail and telephone inquiries. If any non-compliance is identified during such inspections, NDRC or its local branch shall require the PE Fund or its manager to rectify within six months, failing which it may disclose its name to the public as "the PE Fund / manager improperly operated and managed" on NDRC's official website.

Conclusion

The industry generally considers the promulgation of the PE Fund Filing Circular as a positive move of NDRC. This is because it has formally introduced a filing regime for PE Funds/managers, resumed filing work, and set out non-discriminatory filing requirements for PE Funds with foreign capital.

We will continue to closely monitor and alert you on the impact of the implementation of the PE Fund Filing Circular, particularly in the context of its interaction with local rules issued by the Pilot Areas, and the forthcoming amended Securities Investment Funds Law.

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