

## Private Equity Markets in China: A Legal Puzzle

The market for private equity in China has undergone dramatic changes during the past decade. Full of risks and opportunities, the Chinese private equity market has been evolving since the late 1990s, when private equity funds were virtually nonexistent, to the present, where we have seen serious efforts from the Chinese government to promote this type of investment activity in China, despite the challenges involved.

Private equity initially became popular among Chinese enterprises that needed capital, western management skills and know-how, and access to the international capital markets. Due to China's vast size and rapid economic growth, major international private equity firms have formed funds targeting investments in China and have established a presence in the greater China region. Domestically, Chinese capital, inspired by the success stories of international private equity funds, has also been looking for its own private equity outlets through the formation of principally domestically-owned and -managed private equity funds in offshore jurisdictions targeting investments in China, the formation of RMB-denominated funds under China's experimental venture capital regulatory regime, and through the creation of the first few RMB-denominated private equity funds under China's Amended Partnership Law. Recently, we have seen additional efforts from the Chinese authorities to encourage the development of the private equity investment industry in China.

To fully understand the challenges and opportunities facing the Chinese private equity market, it is important to have a general understanding of the legal framework surrounding the RMB-denominated private equity investment industry in China.

Legislative development in the area of investment funds started in the late 1990s in tandem with the building and development of China's capital markets, which was marked by the re-opening of the Shanghai Stock Exchange for trading in December 1990, the establishment of the China Securities Regulatory Commission in 1992, and the enactment of the *Securities Law of the People's Republic of China* in 1998. The initial focus of legislative development in the area of investment funds was to provide a legal platform and a regulatory framework for the formation, management, investment and termination of funds investing in publicly-traded securities in China. Since the early 2000s, there have been legislative efforts to promulgate a legislation that would specifically authorize and regulate the formation, management and operation of private equity funds. Unfortunately, although there is still much anticipation for the passage of such legislation, no specific timetable has been set at the moment.

This delay in the enactment of a specific private equity regulation resulted in various PRC ministerial-level authorities and local governments issuing their own regulations authorizing and regulating the formation, management and operation of investment funds. The 2003 *Administrative Regulations on the Foreign Invested Venture Capital Enterprises* (the "Foreign VC Regulations") and the 2005 *Provisional Regulations on Venture Capital Enterprises* (the "Domestic VC Regulations") jointly published by several PRC ministerial-level authorities, provide the most commonly-used legal framework for the private equity industry, together with the amended *Company Law of the People's Republic of China* (the "Company Law").

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The China Banking Regulatory Commission, another PRC ministerial level authority, has also played a role in facilitating the creation and regulation of private equity funds. In early 2007, it issued the *Measures for the Administration of Trust Companies' Trust Plans of Raised Funds* and the complementary *Measures for the Administration for Trust Companies* (the "Trust Companies Measures"). The Trust Companies Measures, for the first time, authorized trust companies with the required license to raise funds from qualified investors and to make investments for the benefit of such qualified investors.

In addition to these and other initiatives of various PRC ministerial-level authorities, several local governments are also eager to attract private equity investment into their areas by providing local administrative measures. Most noticeably, the Administration for Industry and Commerce of Tianjin Municipality, China's private equity experimental hub, quickly issued its own opinion on the registration of private equity funds in Tianjin in November 2007. To maintain its competitive edge and to promote Shanghai as the financial center of China, Shanghai recently adopted the "Industry Catalogue Mainly Supported in Shanghai," in which the private equity investment industry was listed as one of the types of investments supported and encouraged by Shanghai. Shanghai is also considering the offering of tax and other incentives to attract venture capital, private equity and hedge funds to Shanghai.

The fragmented initiatives and regulations create a puzzle for private equity firms and potential investors. Yet, it epitomizes China's legislative process for handling an economic issue in which the Chinese government does not have significant experience. The implementation of the fragmented initiatives and regulations allows the Chinese government to accumulate necessary experience, which it will ultimately use to move toward the formation and enactment of a more comprehensive and higher-level legislation. One such move came on June 1, 2007 when the *Partnership Law of the People's Republic of China*, as amended, became effective (the "Amended Partnership Law"). The Amended Partnership Law has eliminated several features from the previous Partnership Law that were particularly discouraging to private equity funds and instead provides several fundamental principles that are pillars to the establishment, management and operation of domestic RMB-denominated private equity funds in China. The adoption of this law was a great encouragement for the creation of private equity funds in China, evidenced by the fact that, less than one month after the Amended Partnership Law became effective, the first limited partnership private equity fund was formed.

Another such move is to make the domestic stock market more accessible and attractive to private equity funds and to encourage the country's best businesses to remain in China. In addition, China's tax regime has just undergone a major overhaul. On January 1, 2008, the *Enterprise Income Tax Law of the People's Republic of China* (the "EIT Law") and the *Detailed Rules for the Implementations of Enterprise Income Tax Law* (the "EIT Regulations") became effective. The impact of the EIT Law and EIT Regulations is certainly felt by the private equity world.

Though the above initiative and regulations are fragmented and complex, they provide some legal framework for the formation, management and operation of private equity funds. Indeed, approximately 200 private equity firms reportedly formed in China are organized under the Foreign VC Regulations, the Domestic VC Regulations and/or the Company Law, and a good number of private equity firms have also been formed under the Amended Partnership Law.

It is also important to note that, due to the developing nature of the private equity markets in China, private equity funds typically behave more like venture capital funds rather than traditional private equity funds. This is generally attributed to the size, type and nature of the available investments in China, which cause private equity and venture capital firms to consider deals that they generally would not consider outside of China. One of the effects of this situation is that, in China, the terms venture capital and private equity seem to be used interchangeably.

Historically, an interesting characteristic of the Chinese investment community is that a large number of individual investors and privately-owned companies are active, on-stage players, while pension funds, social security funds, and other such institutional investors stay on the sidelines. This is not surprising, given that pen-

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sion, social security and the like are deposited with, and controlled and managed by, the government social security authority. There are signs that significant changes may be forthcoming that will make these funds available for investment. It is anticipated that RMB50 billion will be immediately available and that RMB100 billion will be available in three years. This source of funds will give RMB private equity industry a much needed boost. This authorization indicates that the Chinese government may also consider and evaluate allowing investment in RMB-denominated private equities by pension funds, social security funds, housing funds, and similar funds that are collected and managed by local social security bureaus across the nation and that, at present, are required to be deposited in state-controlled banks and to buy state treasury bonds. Given the short history of private equity industry in China, experienced fund managers are scarce. This may create opportunities for experienced international private equity industry players to play a role in China's growing private equity industry.

Aside from the development of the investment fund industry and legislation in China, in recent years, major international private equity firms have quickly formed funds targeting investment opportunities in China. Chinese capital has also flowed to offshore private equity funds, which then would find their way back into investments in China. Offshore private equity investments must follow the *Catalogue for the Guidance of Foreign Investment Industries, as amended* which classifies industries into categories in which foreign investment is encouraged, permitted, restricted or prohibited and that, in some cases, imposes a cap on foreign equity ownership. After two decades of welcoming and encouraging foreign capital, China is now beginning to scrutinize foreign investment. The amended *Regulations on the Acquisition of Domestic Enterprises by Foreign Investors* in 2006, and a series of foreign exchange control regulations enacted by the State Administration for Foreign Exchange, have created almost insurmountable obstacles to the offshore exit of private equity funds. The overhaul of the tax regime has also abolished the broad-based tax incentives that were previously available to companies in which offshore private equity funds invested.

Offshore private equity funds interested in investing in Chinese enterprises, and existing groups or funds with investments in China, need to take into consideration these on-going legal developments in China and carefully plan, structure, document and manage their projects.

### Conclusion

China presents both abundant opportunities and frustrating challenges for private equity investment. With 25 percent of the world's population and one of its fastest growing economies, China enjoys noticeable success and is poised to create more global superstars. Success, however, is far from automatic. The success of private equity funds in China requires the right team in terms of capabilities and language and culture skills, an over-investment in due diligence to identify the full breath of risks and opportunities, a crystal-clear understanding of and commitment to the Chinese market, as well as a thorough appreciation of China's legal regime. Although China seems to be moving into the creation of a more stable and predictable legal system, private equity practice in China remains a challenging legal puzzle that requires knowledgeable and experienced legal counsel for guidance through this process.

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