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China's NDRC Adopts New Measures to Further Regulate Equity Investment Enterprises in Pilot Regions

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On January 31, 2011, China's National Development and Reform Commission (NDRC) issued a "Notice on Further Regulating the Development and Record-Filing Administration of Equity Investment Enterprises in Pilot Regions" (the Notice). The Notice provides a more specific operating and compliance guidance for equity investment enterprises (EIEs) established in four pilot regions (specified below). Generally speaking, a private equity (PE) firm, whether domestic or foreign-invested, is an EIE as defined in the Notice.

Before the issuance of the Notice, NDRC had proposed to issue jointly with other ministries and departments the "Interim Measures on the Administration of Equity Investment Enterprises" (the Interim Measures), which were supposed to regulate all EIEs established under Chinese law. The Interim Measures were not adopted. In contrast, the Notice is applicable only to EIEs established in four pilot regions, i.e., Tianjin Binhai New Area, Beijing Zhongguancun Science Park, Wuhan East Lake Hi-Tech Development Zone, and the Yangtze River Delta region (including Ningbo, Wuxi, and Shanghai Pudong District).

The Notice requires that an EIE be formed as a company or partnership. Fundraising for an EIE is to be handled through private placement, and all investors must be able to identify commercial risks and afford possible losses. The fundraisers should completely disclose the potential risks. Any promise of a fixed investment return is strictly forbidden. The investment scope of an EIE is limited to nonpublicly traded shares of a company, which distinguishes EIEs from securities investment funds, the latter being regulated under other laws and regulations, such as the Law on Securities Investment Funds.

An EIE must establish risk-control mechanisms, and constantly improve them. When an EIE has idle funds, such funds should be kept in its bank account or used to purchase government bonds or other financial products that provide a fixed investment return. Warranties can be provided only to the enterprises in which the EIE invests, and when the prospective investee is a related party to the EIE, a director, shareholder, or investment committee member that is related to such investee is not permitted to vote in the decision-making process.

In practice, EIEs sometimes engage outside management teams to manage their assets, and on many occasions such management teams are simultaneously in charge of the daily operations of more than one EIE. The Notice details the basic responsibilities of outside management teams, and requires that management teams should fully perform their fiduciary duties and be impartial when managing the assets of the multiple EIEs. The Notice also states several circumstances under which management teams must cease their service.

As the major supervising authority, NDRC will administer EIEs through an information disclosure and record-filing system. Each EIE is required to submit its annual business report and financial report within four months of the end of each accounting year, and to report any material changes (e.g., a revision to the EIE's articles of association or partnership agreement; any increase/decrease in capital; any debt financing; or any division, merger, acquisition, dissolution, or bankruptcy) within a 10-day period. Moreover, each EIE must file with NDRC unless one of the following criteria has been met: (a) the EIE has filed itself as a venture capital organization, (b) its total capital is less than RMB 500 million, (c) its capital is contributed by a single investor, or (d) all of its investors are the fully owned entities of the same parent. However, the Notice does not detail any legal consequences for failing to file with NDRC.

The issuance of the Notice indicates NDRC's desire to become a major regulating authority of the country's investment industries including the PE industry. As the PE industry is developing rapidly in China, we expect that the Chinese government will promulgate further laws and regulations to supervise PE-related activities in China.

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

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