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## NDRC's New Regulation on RMB Private Equity Fund in China

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### Background

The regulatory regime on private equity fund is developing at a fast pace, despite there is still no unified national-level law or regulation governing the business. After establishing its authority as a key regulator of China's venture capital funds, China's National Development and Reform Commission ("NDRC") takes the leadership in developing the regulatory regime and is determined to expand its regulatory power into the area.

In June 2008, NDRC designated six pilot regions, including Beijing, Tianjin, Shanghai, Jiangsu Province, Zhejiang Province and Hubei Province ("Pilot Regions"), to test the operation of private equity funds under the approval from the State Council. In these Pilot Regions, private equity investment enterprises ("EIE") and equity investment management enterprises ("EIME") are permitted to establish and operate under the supervision of NDRC. In January 2011, NDRC issued the *Circular on Further Regulating the Development and the Administration on Filings of Equity Investment Enterprises in Pilot Regions* ("Circular No.253"), which further improved and clarified the rules relating to establishment and operation of EIEs and EIMEs in the Pilot Regions. Circular No.253, in particular, introduced several basic rules, such as fund organizations, filing, fundraising and investment practices, function of fund managers, risk management, disclosing and reporting, etc.. On 23 November 2011, NDRC issued *Circular on Promoting Regulation and Development of Equity Investment Enterprises* ("Circular No.2864"). Circular No.2864 follows and develops the rules set out in Circular No. 253, and expands the application of the rules to the entire China. Like Circular No.253, Circular No.2864 continues to place emphasis on prevention of risks associated with operation of private equity funds and regulating fundraising activities.

Circular No.2864 came into effect upon its publication. However, the EIEs or EIMEs established before the effective date are given three months to file with the Filing Authority (as defined below) and six months to bring their investment fully in compliance with the new rules in the circular. Circular No.2864 shall have superseded Circular No.253.

Below are the key rules set out in Circular No.2864.

### Establishment of EIEs

Circular No.2864 provides that an EIE can be organized in the form of either a corporate entity or a partnership. The EIEs organized in the corporate form can entrust its management to another EIE or an EIME. Circular No.2864 requires that the number of investors to an EIE must be subject to the limits set in the PRC Company Law or the PRC Partnership Law, depending on the form of the EIE. Under the

PRC Company Law, a limited liability company must have no more than 50 shareholders, and the total number of shareholders in a company limited by shares must fall between 2 and 200. The number of partners in a limited partnership shall be between 2 and 50. In calculating the number of investors, Circular No. 2864 introduces a so-called “look-through” approach. It requires all the legal person investors and individual investors behind an unincorporated institutional investor in an EIE, such as a trust or a partnership investor, be counted as the investor, except that such an institutional investor is a fund of funds. This is a significant clarification on the basis of Circular No 253 and a measure intended to prevent funds from absorbing fund from unspecific members of public. More importantly, Circular No.2864 also requires each of such investors behind an unincorporated institutional investor meet the qualification to be such an investor to an EIE.

Investors to an EIE must contribute capital in cash, which can be paid into the EIE according to a plan set out in the articles of association or partnership agreement of the EIE. An EIE or EIME must have at least 3 members of senior management each with at least 2-year experience in the equity investment business or in a similar business. According to Circular No.2864, any individual being or being regarded as a member of the senior management must have no record of breaching any laws and is not involved in any outstanding material economic dispute during the past 5 years. Circular No.2864 defines respectively a number of positions within a corporate EIE, and a GP or other persons as may be stipulated in the relevant partnership agreement, as members of the EIE's senior management. In case that the GP of a partnership EIE is a legal person institution, all the members of senior management of the GP will be regarded as the senior management of the EIE.

### **Mandatory Filings**

Circular No.2864 mandates all EIEs (including fund of funds) to file with NDRC or a filing authority designated by a provincial government (“Filing Authority”). The filing is required to be made within one month after the business license of the EIE is issued, except where: (i) the EIE is a venture capital investment enterprise that should make filings in accordance with other applicable regulations, or (ii) all its capital is contributed by one institutional or individual investor, or by two or more investors that are wholly-owned subsidiaries of the same institutional investor. Unlike Circular No.253, which exempted the fund sized under RMB500 million or an equivalent amount in a foreign currency from the filing obligation, Circular No.2864 requires all the EIEs to file with a Filing Authority. Those exceeding or of the size of RMB500 million or the equivalent amount in a foreign currency must file with NDRC. The EIEs of smaller size must file with a Filing Authority designated by the provincial government. Moreover, an EIME or EIE engaged to manage the assets of an EIE (“Manager”) must also file with the Filing Authority together with the EIE under its management.

Circular No.2864 sets out details of the filing procedure including a list of documents required to be submitted and the basic procedures. The required documents must be submitted initially to a Filing Authority at provincial level. If the filing falls in the jurisdiction of NDRC, the Filing Authority at provincial level must transfer the filing application to NDRC after giving it a preliminary review together with its opinion. The required filing documents mainly include the incorporate documents , the registration of the EIE, fundraising proposals, capital verification and/or any document on capital commitment, information on the EIE's senior management, a formal legal opinion from a qualified PRC lawyer on the submission, etc. As a proof of successful completion of the filing procedure, the Filing Authority will publish some basic information of the filing EIE or EIME on their websites.

Under certain circumstances, such as an EIE or EIME dissolves or changes its main business from equity investment to other business, the EIE or EIME concerned must take initiative to cancel the filing. Since the filing is compulsory, Circular No.2864 provides for a penalty to punish those failed to comply with the requirement. According to Circular No.2864, if an EIE or EIME failed to file with the Filing Authority within 20 days after it is urged to do so by the Filing Authority, it will be named for the failure on the websites of the Filing Authority.

### **Fundraising and Investment Practices**

Another focus of Circular No.2864 is to regulate fundraising activities of EIEs. Like in the Circular No.253, an EIE is only permitted to raise fund from qualified private investors, i.e. the specific members of the public who are of sufficient ability to comprehend and bear the risks of their investment. Circular No.2864 prohibits offering fund units to unspecific members of the public or soliciting investors through public media, such as sending materials or SMS to the unsolicited public, organizing conferences or forums open to the public, placing fundraising materials at the publicly accessible counters of commercial banks, securities companies or investment trust companies, etc. In addition, EIEs must not guarantee in any form a fixed return to their investors. Private equity fund managers conducting fundraising activities in China must keep in mind that illegal fund raising from unspecific public members can constitute a serious crime under the PRC Criminal Law.

EIE's investment is limited to non-publicly-traded equities or fixed income financial products. The investment must be in compliance with China's industrial, investment and macroeconomic policies. EIE is not allowed to invest in publicly-traded securities or real property for purposes other than its own use. Circular No.2864 also clarifies that, when investing in fixed asset investment projects, both domestic and foreign-invested EIEs are required to seek and obtain specific project approval from NDRC or its local counterparts.

In addition to reiteration of the provision in Circular No.253, which requires engagement of an onshore custodian entity with legal person status to keep the assets, if the Manager is a wholly-foreign owned enterprise or a Sino-foreign JV, Circular No.2864 provides that EIE's assets must be entrusted to an independent custodian, except that its investors make a unanimous decision otherwise.

### **Reporting Requirements**

Circular No.2864 provides for a broad range of reporting obligations for EIEs and Managers. For example, all EIEs are required to report to the Filing Authority their audited annual financial statements and annual business report. In addition, during their operation period, EIEs or Managers are also required to report certain important matters to the Filing Authority within 10 days after occurrence of such matters. Such matters include change of the EIE's or Manager's capital, extending any external debt financing, amendments to the articles, management agreements and partnership agreements, change of fund Manager, custodian or the Manager's senior management personnel, corporate merger or split, dissolution, liquidation, etc.. Besides, a Manager or a custodian must also report timely to the Filing Authority annual asset management reports or annual assets custody reports.

## **Status of the EIEs with Foreign Investment**

Circular No.2864 in many aspects makes no distinction between a purely domestic EIE and an EIE with foreign investment. If Circular No.2864 is implemented to generally apply to all EIEs and EIMEs, foreign invested EIE and EIME can benefit from the filing. In practice, the filing is often regarded as a necessary proof of the legal status of the fund in China and is often required by local institutional LPs when raising funds. It has been a common wish of the foreign fund managers that certain qualified RMB funds with foreign investment can be treated as purely domestic funds in the downstream investment. Circular No.2864 makes no development to this direction. It is still unlikely to be realized in the near future, given the general legal environment in China, which distinguishes foreign investment funds from purely domestic investment funds. Ministry of Commerce and other regulators have all promulgated rules requiring downstream investment by an EIE with foreign investment be treated as “foreign” investment. However, some exceptions may apply in some locations if the foreign fund investor is qualified in a scheme called “qualified foreign limited partner”.

### **About the author:**

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