



The Legal 500 Country Comparative Guides

China: Alternative Investment Funds

This country-specific Q&A provides an overview of alternative investment funds laws and regulations applicable in China.

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1. What are the principal legal structures used for Alternative Investment Funds?

On April 27, 2018, the Guiding Opinions on Regulating the Asset Management Business of Financial Institutions (the “New Regulations on Asset Management”) jointly issued by the People’s Bank of China, the China Banking and Insurance Regulatory Commission, the China Securities Regulatory Commission (the “CSRC”), and the State Administration of Foreign Exchange. The New Regulations on Asset Management harmonize the supervision standards of the asset management industry. Although it mainly applies to the asset management business of licensed financial institutions, Alternative Investment Fund managers who are not licensed financial institutions also fall under the New Regulations on Asset Management unless they are subject to certain other specific laws and regulations in this regard. Alternative Investment Funds (“AIFs”) in this article refer to funds managed by Alternative Investment Fund managers and do not include private equity collective investment products managed by licensed financial institutions.

The principal legal structures of AIFs include limited partnership, contract-based collective investment product, limited liability company and joint-stock company.

2. Does a structure provide limited liability to the sponsor and/or manager vis-a-vis investors?

AIFs organised as limited partnership: sponsors and/or managers shall serve as general partners and assume unlimited liability for the debt of the AIFs.

AIFs in the form of contractual fund (established by the Alternative Investment Fund managers on a contractual basis with the investors through execution of an investment contract): sponsors and/or managers may or may not hold a unit in a fund, and in the case they do, it can be stipulated in fund contracts that sponsor and/or manager may not assume unlimited liability.

AIFs organised as limited liability company/joint-stock company: sponsors and/or managers may or may not hold shares in the AIFs, and in the case they do, their liability is limited to the amount of their subscribed capital.

3. Is there a market preference and/or most preferred structure? Does it depend on asset class?

There are two types of AIFs that account for the overwhelming majority in the market: according to the definition of Asset Management Association of China (the “AMAC”), (i) funds mainly focusing on investments of private equity: private equity funds (“PE Funds”), and (ii) funds mainly focusing on investments of publicly trading products: security investment funds (“Securities Funds”).

PE Funds are usually organised as limited partnerships, and Securities Funds are usually organized as contractual funds. Securities Funds can be further subdivided into stock funds, bond funds, hedge funds and other categories.

The main considerations of the preferences of types of fund structure include: 1) tax treatment of investors and managers; 2) the impact of exit of investment when choosing different structures; 3) the flexibility of subscription and redemption of investors, contributions of investors to AIFs and AIFs' distribution strategies to investors under different investment strategies.

4. Does the regulatory regime distinguish between open-ended and closed-ended Alternative Investment Funds (or otherwise differentiate between different types of funds or strategies (e.g. private equity vs. hedge)) and, if so, how?

The regulatory regime distinguishes between different types of funds like Securities Funds, PE Funds (including venture capital funds, buyout funds), asset-allocation funds and other funds (investing in areas other than the aforementioned ones). The regulatory authorities have been gradually exploring and emphasizing differentiated supervision standards for venture capital funds and other types of PE Funds.

The New Regulations on Asset Management have different regulatory requirements for open-end products and closed-end products in terms of operations of funds.

5. Are there any limits on the manager's ability to restrict redemptions? What factors determine the degree of liquidity that a manager offers investor of an Alternative Investment Fund?

There is no general limitation. However, investors subject to special supervisions such as government-guided funds and insurance companies may need to follow special redemption requirements.

The degree of liquidity that a manager offers investor of an AIF is mainly affected by the liquidity of investment targets and the degree of activity of private equity secondary market. Currently the market is developing rapidly, and the environment of secondary market is becoming more and more active.

6. What are potential tools that a manager may use to manage illiquidity risks regarding the portfolio of its Alternative Investment Fund?

Compared with Securities Funds, PE Funds have poor liquidity. Managers may set up SPVs to hold portfolio companies in order to indirectly dispose of the investments if permitted by the regulations. Although the shares of listed companies held by funds shall be subject to the lock-up period requirement, there are certain arrangements that can be used to achieve

substantially similar effects of realizing benefits from shares transfer, for example, assignment of rights in dividends or proceeds, or pledging the shares for credit facilities. However, the use of such arrangements is not frequent in China's market.

7. Are there any restrictions on transfers of investors' interests?

The fundamental requirement is that the transferee must be a qualified investor.

Considering the possible impact of different types of investors on the exit of investment or investment of the PE Fund, investors are usually required to make certain representations and warranties in the fund agreement, and the transferee shall also comply with those representations and warranties.

8. Are there any other limitations on a manager's ability to manage its funds (e.g., diversification requirements)?

The main limitations at the regulatory level: 1) funds shall not engage in deposit and loan activities; 2) there are limitations of leverage ratio and debt ratio of certain types of funds; 3) funds have minimum investment ratio of certain types of investment targets. For example, PE Funds shall invest 80% of their assets into private equities; 4) The real estate market regulations provide that certain investments involving real estate are restricted; 5) investors under special supervision usually require the funds they invest in not engage in certain types of investment target.

Usually, the fund's formation agreement will stipulate the limitation of leverage ratio and diversification requirements.

9. What is the local tax treatment of (a) resident, (b) non-resident, and (c) pension fund investors (or any other common investor type) in Alternative Investment Funds? Does the tax treatment of the target investment dictate the structure of the Alternative Investment Fund?

AIFs organised as limited partnerships: limited partnership is treated as a tax look-through entity for the purposes of income taxes; investors shall bear their own income tax (pension fund does not bear income tax). If a non-resident enterprise establishes an institution or substance within China, it shall pay enterprise income tax for the income derived from the institution and substance, and the income that occurs outside China but is actually linked to the institution or substance it established; a non-resident enterprise does not establish an institution or substance within China, or the income is not actually linked to the institution or substance it established, it shall pay enterprise income tax on its income derived from China.

The AIFs organised as contractual funds: Since contractual funds do not have independent legal entities, they are not regarded as taxpayers in China. From the perspective of tax collection and management, as a collective property, contractual funds are not subject to tax

registration and do not need to pay income tax at the fund level. Investors need to declare and pay income tax by themselves after they receive the distribution from funds. However, the investments of contractual funds need to be made in the name of managers, if managers are limited companies/joint-stock companies, in practice the tax department may require managers pay for corporate income tax. In that case, investors may face a situation of double taxation.

The AIFs organised as limited liability companies/joint-stock companies: funds are subject to Chinese corporate income tax, and individual investors subject to individual income tax after receive the profit from the AIFs, enterprise taxpayer are exempt from income tax after receive the after-tax profit from the AIFs. For tax-exempt organization like pension funds, corporate income tax that has already occurred at the fund level increases the actual tax burden of such investors.

For the VAT, different structure subjects apply different rate of VAT, for example, the AIFs organised as contractual funds are applicable to 3% VAT rate, are lower than other common legal structures. The differences mainly reflected in the different VAT tax rates for the sale of financial assets, which will affect the fund structure to a certain extent.

Overall, the tax situations of different investment targets under different fund structures are complicated, and some tax treatment issues are not clear at regulatory level, therefore typically before an Alternative Investment Fund set up, it requires careful planning.

10. What rights do investors typically have with respect to the management or operations of the Alternative Investment Fund?

There are some common rights that investors typically have with respect to the management or operations of AIFs, including participation in removal of the general partner or selection of managers, advising on related transactions, conflicts of interest, and investment restrictions (usually through advisory committee), and receiving information of operations of funds.

11. Are managers or advisers to Alternative Investment Funds required to be licensed, authorised or regulated by a regulatory body?

Yes. Managers to AIFs are required to be registered with the AMAC.

12. Are Alternative Investment Funds themselves required to be licensed, authorised or regulated by a regulatory body?

Yes. AIFs are required to be filed with the AMAC by their managers.

13. Are there local residence or other local qualification or substance requirements?

Yes. Managers engaged in fundraising and investment management activities within the territory of China shall be registered with the Chinese enterprise registration authority and shall also apply to the AMAC for registration with respect to the existence validity, business registration, professional operations, ownership structure, actual controller(s), affiliated parties and branches, basic operating facilities and conditions, risk management and internal control system, outsourcing, compliance and qualifications of senior executives of the applicant, etc.

14. What service providers are required?

A Chinese law firm must be engaged to issue a legal opinion to the AMAC when the manager applies for registration with AMAC. AIFs must open a special account¹ for private fund-raising settlement funds with banks or other capital supervisory institutions to comply with the requirements of the AMAC, and would usually appoint (but not obliged) banks or institutions to keep custody of the funds and manage the fund account. It is not required for AIFs or their managers to engage agencies or institutions to provide services for fund sales, investment advisory, unit registration, valuation and accounting, and information technology systems. The qualification requirements for investment consultants to AIFs have not yet been issued.

15. Are local resident directors / trustees required?

Before forming an AIF in China, a domestic entity must be established as the manager, which shall be registered with the Chinese enterprise registration authority as well as the AMAC. According to the rules of the AMAC, there shall be a principal office of business in China for the operation of the AIF by the manager and a certain number of qualified management team members are also required. The senior executives of a manager are not required to be a Chinese resident but they shall obtain and maintain the qualification to engage in the fund business by passing the examination for qualification to engage in fund business or through qualification determination by the AMAC if certain conditions are met.

16. What rules apply to foreign managers or advisers wishing to manage, advise, or otherwise operate funds domiciled in your jurisdiction?

Foreign managers or advisers are prohibited from engaging in fund business in China. They can do so by setting up a domestic entity owned by the foreign managers and register the entity with the Chinese enterprise registration authority as well as the AMAC. Once the registration completes, such entity can engage in fund business according to the relevant rules and regulations.

17. What are common enforcement risks that managers face with respect to the management of their Alternative Investment Funds?

An AIF shall only raise funds from qualified investors in a non-public manner, and the fund

manager shall be responsible for the compliance of fundraising regardless of whether a fund sales agency is involved.

In the process of fundraising and operation of an AIF, the fund manager shall perform the obligations of information disclosure to investors, and filing and reporting to the supervisory authorities in accordance with the regulatory requirements and the fund contract.

An AIF shall register with the enterprise registration authority regarding its acquisition of any equity in a portfolio through any investment. If an AIF is established in the form of limited partnership or limited liability company, it shall promptly register with the enterprise registration authority for any change of its investors.

When engaged in investment activities, an AIF shall comply with certain regulatory rules (for example, investment transactions of securities investment funds shall comply with the laws and regulations and the securities trading rules of exchanges, and equity investment funds shall also comply with the above-mentioned securities trading rules when realizing investment through the securities market).

Any violation of the above-mentioned regulations may trigger enforcement risks to the managers of the AIF.

18. What is the typical level of management fee paid? Does it vary by asset type?

The management fee generally ranges from 1.5% to 2.5% annually. The annual rate and the calculation basis vary from different types of asset. For example, the management fee for Securities Fund is usually calculated based on the net asset value, the management fee for private equity fund is usually calculated based on the capital commitment during the investment period and unrealized cost net of write-offs afterwards, and while for fund of fund, the annual rate of management fee is sometimes half of that (or even lower) of its portfolios.

19. Is a performance fee typical? If so, does it commonly include a “high water mark”, “hurdle”, “water-fall” or other condition? If so, please explain.

Yes. Securities Fund usually adopts “high water mark” to calculate performance fee, and private equity fund always includes the concepts of hurdle and water-fall.

“High water mark” (“HWM”) means the highest net asset value the Securities Fund achieves. The fund manager will not receive performance fee when the net asset value falls below the HWM until the asset value have been raised again to a level above the previous HWM.

A private equity fund will usually arrange water-fall as “fund-as-a-whole” structure or deal-by-deal structure. Fund-as-a-whole arrangement requires that limited partners shall receive investment returns which equal their contributions before any payment of carried interest to

the general partner, while deal-by-deal structure permits payment of carried interest to general partner before limited partners receive investment returns which equal the amount of capital that has been drawn on an aggregate basis. In both structures, hurdle rate may be included, which requires meeting the agreed hurdle rate as a precondition for payment of carried interest.

20. Are founder shares (which offer a reduce fee structure for initial investors) typical in raising assets for new fund launches?

They are occasionally seen but not common.

21. Are management fee “break-points” offered based on investment size?

Investors who commit an amount significantly higher than other investors may negotiate a reduce fee structure as an incentive but there are no generally agreed break-points for the market.

22. Are first loss programs used as a source of capital (i.e., a managed account into which the manager contributes approximately 10-20% of the account balance and the remainder is furnished by the investor)?

There are structured funds in the market dividing investors into preferred and inferior limited partners, which reflects different risk appetite and commercial objectives of the limited partners. Loss will be first borne by inferior limited partners. Despite these structured arrangements, it is not common for the fund manager to use first loss programs as a source of capital.

23. What is the typical terms of a seeding / acceleration program?

The terms of seeding deals can vary widely and they depend on the commercial logic and purpose of seed investors. Typically, a seed investor may seek preferential terms such as a reduced management fee and incentive fee than other investors. Moreover, there is a trend that more seed investors, particularly those who are already in the fund management business, tend to seek an equity stake in the manager for a share of its future revenue. It should be noted that according to the regulation rules, it is not allowed for any investment product such as private funds to hold the equity in a private fund manager, and for this reason, such seed investors may alternatively seek to hold a share in general partner other than the manager.

24. What industry trends have recently developed regarding management fees and incentive fees?

No significant change in the trend is observed in recent years, but it is worth noting that in the previous years small-scale VC funds might choose not to include a hurdle rate and their

management fee is relatively higher, and in recent years, the difference in the management fees and incentive fees is gradually narrowed down.

25. What restrictions are there on marketing Alternative Investment Funds?

Marketing must be conducted by institutions that have been registered with the AMAC as managers of private funds, or agencies that (i) have been registered with the CSRC, (ii) have obtained the fund sales business qualification and (iii) have become member of the AMAC (“fund sales agencies”) under the engagement of a manager of an AIF.

AIFs shall solicit funds from qualified investors in a non-public manner. The total number of investors of a single fund may not exceed the specific number set by the Securities Investment Fund Law, the Company Law, the Partnership Enterprise Law, or any other law.

The information disclosure documents provided by the managers to investors (such as private placement memorandum) shall comply with the regulatory requirements, including disclosure of certain essential information. When disclosing fund information, the following practices are strictly prohibited:

1. Make public disclosure or disguised public disclosure;
2. Make false recording, misleading representations or material omissions;
3. Predict investment performance;
4. Promise earnings or undertake losses in violation of the rules;
5. Slander other fund managers, fund custodians or fund sales agencies;
6. Publish content of endorsement, compliment or recommendation of any natural person, legal person or organization;
7. Compare performance with the data and methods which are not comparable, fair, accurate or authoritative, and use such expressions as “best performance” or “largest scale”; or
8. Other practices prohibited by the laws, administrative regulations, the AMAC, and the CSRC

26. Is the concept of “pre-marketing” (or equivalent) recognised in your jurisdiction? If so, how has it been defined (by law and/or practice)?

Pre-marketing is not a standalone concept in terms of marketing at regulatory level (relevant requirements are specified in Section 4.1). In practice, it is common that managers of AIFs may communicate with certain potential investors before formal commencement of the fundraising.

27. Can Alternative Investment Funds be marketed to retail investors?

AIFs shall solicit funds from qualified investors and the total number of investors of a single fund may not exceed the specific number set by the Securities Investment Fund Law, the

Company Law, the Partnership Enterprise Law, or any other applicable laws.

28. What are the minimum investor qualification requirements?

According to the Interim Measures for the Supervision and Administration of Privately Offered Investment Funds issued by the CSRC on August 21, 2014, a qualified investor of an AIF shall be an entity or individual that (i) has the appropriate risk identification ability and risk tolerance, (ii) invests not less than 1 million yuan in a single AIF, and (iii) meets the following relevant criteria:

1. An entity with net assets of not less than 10 million yuan.
2. An individual with financial assets of not less than 3 million yuan or with an average annual income in the last three years of not less than 500,000 yuan.

The term “financial assets” includes but is not limited to bank deposits, stocks, bonds, fund shares, asset management plans, financial products of banks, trust plans, insurance products, and futures equity.

The following investors shall be deemed as qualified investors:

1. The Social Security Fund, enterprise annuities, and other pension funds; and charity funds and other social welfare funds.
2. Investment plans legally created and filed with the AMAC.
3. Private fund managers and their employees that invest in private funds under their management.
4. Other investors as specified by the CSRC.

Where investment is made directly or indirectly in a private fund by pooling the funds of multiple investors in a non-corporate form such as a partnership or contract, the private fund manager or fund sales agency shall, in a look-through manner, check whether the ultimate investors are qualified investors, and include them in the total number of investors, except investment in private funds by investors as mentioned in subparagraphs (1), (2) and (4) of this section.

29. Are there additional restrictions on marketing to government entities or pensions?

There are no additional restrictions on marketing towards government entities or pensions, but the acceptance of government entities as fund investors will pose additional obligations in registration and disclosure of information of the fund.

30. Are there any restrictions on the use of intermediaries to assist in the fundraising process?

Agencies that (i) have been registered with the CSRC, (ii) have obtained the fund sales

business qualification, and (iii) have become member of the AMAC may be engaged by the manager of an AIF to raise private funds . Agencies which do not comply with the foregoing criteria are restricted from engaging in fundraising activities, and they can only assist in certain aspects of the fundraising process as instructed by the manager of the AIF.

31. Is the use of “side letters” restricted?

It is common for private equity fund managers to enter into side letters with investors provided that the preferential treatments, mainly including commercial arrangement and the application of Limited Partnership Agreement terms, provided to the investors through the side letters should be within the powers of general partner and the provisions of the side letters must not adversely affect the interests of other investors.

32. Are there any disclosure requirements with respect to side letters?

There are no regulatory or mandatory requirements for the disclosure of side letters.

33. What are the most common side letter terms? What industry trends have recently developed regarding side letter terms?

The common terms of side letters include specific disclosure rights, co-investment rights, exclusion rights and most favoured nation treatment. As to the industry trends, it is worth noting that in recent years investors have been calling for more transparent fund operation, and as such, general partner may need to follow more detailed disclosure requirements. In the meantime, more investors are negotiating for a seat in Limited Partner Advisory Committee, and more attention has to be given to the details of arrangements concerning the economic interest, for example, more restrictions on recycling of distributions and limited partner’s giveback of distributions.