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China

ALTERNATIVE INVESTMENT FUNDS

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

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CHINA ALTERNATIVE INVESTMENT FUNDS



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

Alternative Investment Funds (“AIFs” or an “AIF”) in China may be established as limited partnerships, contractual collective investment schemes, limited liability companies and companies limited by shares.

In accordance with the Limited Partnership Law, a fund sponsor may set up an investment fund in the form of a limited partnership as the general partner, and investors can subscribe to the fund’s interests as limited partners. Limited partnerships enjoy tax pass-through treatment and are not deemed to be a legal person under Chinese law. Most private equity funds are established as limited partnerships in China.

A contractual collective investment scheme (“contractual funds”) can be established by fund sponsors on a contractual basis with the investors through execution of an investment contract. Under such investment schemes, the investors and the fund sponsor form a trust relationship without establishing a legal entity. Most hedge funds (for the purposes of this Q&A, references to “hedge funds” primarily refer to “securities funds” in China, which are funds mainly operating in Chinese public markets) are established as contractual funds in China. Licensed financial institutions are required to use contractual funds to issue AIF products in accordance with their respective applicable laws and regulations.

AIFs can also be established as limited liability companies or companies limited by shares in accordance with the Company Law. The investors will subscribe to the AIF as shareholders. AIFs in the form of a limited liability company or a company limited by shares will be deemed to be a legal person and taxed at the fund level without the option of electing to be a pass-through entity. These two corporate forms of fund vehicle are generally not a common choice by fund managers and investors.

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

All structures (including limited partnerships, contractual funds, limited liability companies and companies limited by shares) provide investors limited liability protection to the extent of each of their capital commitment. However, in the case of AIFs in the form of limited partnerships, investors may lose such limited liability protection if they engage in management of the AIF’s business operations.

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

Limited partnership is the most preferred structure for private equity funds. Limited partnerships can accommodate most of the commercial arrangements in private equity transactions and enjoy tax pass-through treatment. In addition, under the QFLP regime, qualified foreign investors can participate in a Chinese onshore fund established in the form of a limited partnership. Therefore, AIFs with foreign investors should consider using limited partnerships as the preferred fund vehicle.

Contractual fund is the most preferred structure for hedge funds. Regulations applicable to financial institutions generally require that AIFs sponsored by licensed financial institutions and their subsidiaries use contractual funds.

Limited liability companies and companies limited by shares are not common choices of fund structures by AIF managers. However, when in some cases where investors require a higher degree of protection and rights in management in the fund, such structures may be chosen.

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?

Yes. Generally speaking, AIFs investing in private equities such as private equity and venture capital funds are required to be closed-ended, whereas AIFs investing in public assets such as public securities can be open-ended. However, if a private equity fund satisfies certain requirements such as being formed as a limited partnership, a limited liability company or a company limited by shares, and investing in a portfolio of investment targets, then such private equity fund can admit additional investors within certain period of time.

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?

For close-ended AIFs, redemption is not allowed. For open-ended AIFs, generally there is no such limitation.

The degree of liquidity that a fund manager can offer depends on the type of the fund, the investment targets and the liquidity in the secondary market.

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

Available tools to manage liquidity risks include lock-up periods, redemption frequency, redemption notices, redemption gates, side pockets, and suspension of redemption, etc. To make these mechanisms available, the fund organizational documents and agreements should expressly provide these provisions.

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

A Transferee of an investor's interests in an AIF must be a qualified investor that meets the investor suitability requirements. The fund's agreement or its constitutional documents may also provide certain transfer restrictions such as manager's consent on the transfer.

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

In China, the regulatory regime prohibits private equity (and venture capital) funds from engaging in any deposit or lending activities except for providing bridge financing for portfolio companies (provided that the total amount of such bridge financing or guarantee shall not exceed 20% of the fund's total capital commitment). Funds sponsored by licensed financial institutions must satisfy certain diversification requirements. Additionally, the regulatory regime also imposes restrictions on leverage ratios, investment scope and investment amount depending on the fund type and its target assets. For example, private equity funds should invest at least 80% of their capital into private equities.

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 are treated as tax look-through entities. However, for individual investors, Chinese tax authorities require that the fund withhold tax on the gain derived from the individual's investment in the fund. Foreign investors investing directly into AIFs are subject to a withholding tax regardless of whether it is a tax-exempt entity in its home jurisdiction.

AIFs organised as contractual funds do not have independent legal entities and therefore 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 distributions from funds.

AIFs organised as limited liability companies or companies limited by shares are subject to corporate income tax. Individual investors of such AIFs are additionally subject to individual income tax after receiving distributions from the AIFs. However, corporate entity investors are exempt from income tax after receiving after-tax distributions from the AIFs. For foreign investors, there will be withholding tax from any gain received from such AIFs.

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

Generally speaking, investors do not have any rights with respect to the management and operations of an AIF. However there are certain exceptions, including removal of the general partner or manager under certain extraordinary circumstances, advising on transactions involving conflicts of interest and investment restrictions (usually through an advisory committee). As mentioned above, involvement in regular management and operations would cause an investor to lose its limited liability protection if the AIF is formed as a limited partnership.

11. Where customization of Alternative Investment Funds is required by investors, what types of legal structures are most commonly used?

Limited Partnership.

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

Yes. Private fund managers that are non-licensed financial institutions are subject to regulation by Asset Management Association of China ("AMAC") and China Securities Regulatory Commission ("CSRC") and are required to register with AMAC. Licensed financial institutions as private fund sponsors are subject to regulation and registration requirements by their respective regulatory authorities.

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

Yes. AIFs not sponsored by licensed financial institution managers are regulated by the CSRC and AMAC and are required to be filed with the AMAC.

AIFs sponsored by licensed financial institutions are under regulations and registration requirements of their respective regulatory authorities.

14. Does the Alternative Investment Fund require a manager or advisor to be domiciled in the same jurisdiction as the Alternative Investment Fund itself?

For Chinese onshore AIFs, the fund manager must be established in China as well.

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

For Chinese onshore funds, the regulatory regime requires all relevant fund vehicles and management teams have an onshore presence. The managers of Chinese onshore funds should also meet AMAC's qualification requirements in order to obtain registration status.

16. What service providers are required?

A Chinese law firm must be engaged to issue a legal opinion to AMAC when the manager applies for registration with AMAC. AIFs must open a special settlement account ("Special Settlement Account") to hold funds raised from investors before the funds can be transferred to the fund's own account or the fund's custodian account. The Special Settlement Account must be opened with licensed financial institutions such as banks or securities firms to comply with the requirements of AMAC. Additionally, although AIFs without multiple closing mechanisms are not required to appoint a custodian bank, in practice most funds will engage a custodian bank.

17. Are local resident directors / trustees required?

The senior executives of a fund manager are not required to be a Chinese resident but a fund manager is required to have a number of senior management members who hold the requisite qualifications to engage in the fund management business.

18. 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 management business in China directly through their offshore establishments. To engage in fund management in China, foreign managers or advisors

must set up a Chinese domestic entity and register with AMAC.

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

A private AIF can only raise funds from qualified investors in private placements. The Chinese fund regulatory regime provides detailed laws and regulations in respect of the fundraising, sales and information disclosure by fund managers of AIFs. Fund managers must ensure full compliance with the regulations to avoid breach and enforcement risks.

In addition, managers should also familiarize themselves with securities and trading regulations in China in relation to AIFs' investment activities. Areas that require special attention include insider trading regulations and disclosure and reporting obligations.

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

Management fees for AIFs other than funds of funds generally range from 1.5% to 2.5% annually. For funds of funds the annual management fee usually ranges between 0.5%-2%.

21. 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. Hedge funds usually adopt a "high water mark" to calculate performance fees, while private equity funds often include the concept of a hurdle rate in calculating water-fall distributions.

"High water mark" ("HWM") means the highest net asset value the fund achieved previously. The fund manager will not receive a performance fee when the net asset value falls below the HWM until the net asset value has been raised again to a level above the previous HWM. Typically, the performance fees or "carried interest" for managers of private equity funds are 20% if the "hurdle rate" is exceeded. The "hurdle rate", a preferred return on each investor's investment, is often set at 6%-8%.

22. Are fee discounts / fee rebates or other economic benefits for initial investors typical in raising assets for new fund launches?

They are occasionally seen but not common.

23. Are management fee "break-points" offered based on investment size?

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

24. 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)?

Some structured AIFs divide investors into different classes reflecting their respective risk appetites and commercial objectives. In such an arrangement, loss will first be borne by certain classes of limited partners in return for a potential higher share of return on capital. It is not common for fund managers to use first loss programs as a source of capital.

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

The terms of seeding deals can vary widely. Typically, a seed investor may seek preferential terms such as a reduced management fee and incentive fee. 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 fund manager for a share of its future revenue. It should be noted that according to the applicable regulations, an AIF cannot invest in a fund management entity. Therefore, such seed investors may alternatively seek to hold equity interests in the general partner of the fund rather than the management company.

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

Although there have been no significant recent

developments, it is worth noting that the differences in management fees and incentive fees between small-scale VC funds and larger-scale VC funds appear to be less common (for example, the former used to have higher fees and no hurdle-rate/higher performance-based incentives than the latter, but that gap has closed).

We have also seen that secondary funds have started booming in recent years. Management fee and incentive fee arrangements in secondary funds are similar to those in the primary funds.

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

Managers of AIFs can only promote and market fund interests to specific qualified investors. No general solicitation or marketing to the general public is allowed. Marketing must be conducted by AIF managers that have registered with AMAC as managers of private funds, or placement agents that (i) hold a fund distribution license from the CSRC and (ii) are a member of AMAC. There are also restrictions on the number of direct and indirect investors allowed in a single AIF in accordance with applicable laws and regulations.

There are specific restrictions and prohibitions on what information can be provided in marketing materials or marketing activities. For example, the information disclosure documents provided by the managers to investors (such as a 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. Making public disclosures or disguised public disclosures;
2. Making false statements, misleading representations or material omissions;
3. Predicting investment performance;
4. Promising earnings or undertaking losses in violation of the laws and regulations;
5. Using disparaging language against competitors or other industry market participants;
6. Publishing endorsements, compliments or recommendations of any natural person, legal person or organization;
7. Comparing performance with the data and methods which are not comparable, fair, accurate or authoritative, and using such expressions as “best performance” or “largest scale”; or

8. Other practices prohibited by laws, administrative regulations, AMAC, and CSRC.

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

No. Pre-marketing is not a standalone concept from a regulatory point of view.

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

AIFs organized as private funds cannot be marketed to retail investors.

30. Does your jurisdiction have a particular form of Alternative Investment Fund be that can be marketed to retail investors (e.g. a Long-Term Investment Fund or Non-UCITS Retail Scheme)?

In general, AIFs cannot be marketed to retail investors unless they satisfy the public offering requirements of the CSRC and the listing requirements of an exchange market in China.

31. What are the minimum investor qualification requirements?

In accordance with the applicable regulations issued by CSRC, investors in an AIF in China must be a “qualified investor.” A “qualified investor” is any entity or individual that invests at least one million Renminbi in investment interests of a fund and has the capacity for risk assessment and risk tolerance, and must meet the following net worth or income requirements:

1. if the investor is a legal entity, it should have net assets of at least RMB 10 million; or
2. if the investor is an individual, he or she should hold at least RMB 3 million in financial assets, or have a personal average annual income of no less than RMB 500,000 for the last three years.

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

There are no additional restrictions on marketing to

government entities or pension funds, but the acceptance of government entities as fund investors will pose additional obligations in registration and disclosure of fund information.

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

Yes. A placement agent must (i) hold a fund distribution license from the CSRC and (ii) be a member of AMAC. Agencies which do not comply with the foregoing criteria are not allowed to engage in the fundraising of an AIF.

34. Is the use of "side letters" restricted?

No. It is common for AIF managers to enter into side letters with investors, provided that the preferential treatment given under the side letter is within the power

of the general partner and does not adversely affect the interests of other investors.

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

There are no regulatory or mandatory disclosure requirements with respect to side letters.

36. 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. In recent years investors tend to require more transparency on fund operations, and as such, the general partner may need to follow more detailed disclosure requirements.

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