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PRIVATE CAPITAL MARKETS UPDATE FROM CHINA

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China

With its increasingly consumption- and technology-focused economy, China provides ample opportunity for private equity and venture capital investments for both general partners (GPs) and limited partners (LPs). However, China's private capital market continues to be defined by foreign exchange controls and foreign direct investment restrictions. Capital cannot freely enter or leave China other than through regulated channels and, in addition, foreign investment in China is subject to controls and conditions.

Despite the capital controls and the subsequent limited availability of international capital, the China-focused private equity and venture capital investment industry has developed significantly over the last few years. Chinese GPs are increasingly successful in raising USD funds offshore to invest alongside domestically raised RMB funds. The Sino-US trade tensions and the pandemic have since 2019 caused a drop in fundraising and deal activity, although the market should be sitting on relatively high levels of dry powder and therefore capacity for deal-making.

The internationalization of China's private capital market remains limited. The breadth of the channels for capital to enter or leave China continue to evolve over time but conditions remain complex. Over the last 12 months, the Chinese government has, however, relaxed and simplified some of the rules regarding foreign investment in China through the "Relevant Measures Concerning Further Expansion of External Opening of the Financial Sector" (known as the "11 measures") and the introduction of a new Foreign Investment Law.

Specific programs for investment into private equity funds have existed for some time and continue to evolve. These programs are generally in the form of pilot programs and established separately by individual cities. Such programs have been established in places such as Beijing, Shanghai, Tianjin, and Shenzhen. By way of example, in Shenzhen's Qianhai Free Trade Zone, a revised qualified foreign limited partner (QFLP) scheme was established in 2017 that allows foreign-owned private equity fund management enterprises and Chinese domestic private equity fund management enterprises to establish and manage QFLP partnerships. QFLP partnerships are Mainland Chinese partnerships through which foreign investors are allowed to invest in Mainland Chinese private equity assets. Since earlier this year, QFLP partnerships in Shenzhen are permitted to invest in non-performing loans as well.

In addition, there are similar local pilot programs through which foreign asset managers can raise capital from Chinese domestic investors by establishing a Mainland Chinese fund vehicle for investment in overseas funds and assets, such as Qualified

Domestic Limited Partnerships (QDLPs) in Shanghai and Qualified Domestic Investment Entities (QDIEs) in Shenzhen. To establish a QDLP or QDIE, foreign asset managers are required to establish a Mainland China-domiciled management entity in addition to the fund vehicle.

Each of these pilot programs comes with different requirements and, for international GPs, assessing Chinese capital or investing international investors' money in China in this way is a complex undertaking.

Effective on 1 November 2020, the current two parallel regimes of Qualified Foreign Institutional Investors (QFII) and RMB Qualified Foreign Institutional Investors (RQFII) have been consolidated into one so that foreign institutions can make a one-time application for the new "Qualified Foreign Investor" (QFI) status. Under the new regime, in addition to listed securities, QFIs are allowed to invest into private securities investment funds under the permitted investment scope and are being launched by affiliates or private fund manager that are duly registered with the Asset Management Association of China, which was not possible under the previously QFII and RQFII regimes. This represents China's latest step to open up key areas of the onshore financial markets to international investors.

Regardless of the outcome of the US and China trade tensions, Hong Kong, with its freely convertible USD-pegged currency, will remain uniquely positioned and continues to serve as a vital gateway to China for international GPs and LPs. Its geographical position in the Greater Bay Area (GBA) and inclusion in the GBA policy initiative (which we look at in this article) adds to its role as an access route to the Mainland Chinese market for international investors.

For international investors, in addition to making direct investments into Mainland Chinese onshore funds established under one of the pilot programs and investment with international or Mainland Chinese GPs through offshore USD funds, we will see in this article that the GBA policy initiative and recent legislative developments in Hong Kong may offer additional access routes to the Mainland Chinese private capital markets.

Greater Bay Area

The GBA is an area in which opportunities for private capital both in terms of investment in portfolio companies and capital raising can potentially grow significantly over the coming years. The GBA policy initiative is a development policy for the Pearl River Delta region aiming at greater economic integration of various cities in the southern Guangdong province, including Guangzhou, Shenzhen, Hong Kong, and Macao. A framework agreement for the development of the GBA and an outline development were issued in 2017 and 2019 respectively.

The GBA is economically significant for China. It covers an area of roughly56,000 square kilometers, which is about three times the size of the San Francisco bay area. The GBA has a combined population of over 72 million people and a GDP of around USD1,679.5b. Within the GBA, Hong Kong is China's only truly international finance center, Shenzhen is a technology hub which hosts the headquarters of some major Chinese technology firms, and Guangzhou remains a significant manufacturing center. In recent years, Shenzhen Qianhai Free Trade Zone has been focused on connecting with Hong Kong and Macao.

Given the size of the economy, the enhancement of the financial infrastructure of Hong Kong and increasingly Shenzhen and the Pearl River Delta region is key. To integrate and develop the economy of the GBA, policy makers have started to put an emphasis on the role of private equity and venture capital. It is a stated objective of the GBA policy initiative to "support the engagement of Hong Kong's private equity funds in the financing of

innovation and technology enterprises in the Greater Bay Area" and to "support Hong Kong's institutional investors in raising RMB funds […] for investment in the capital markets of Hong Kong, and in participating in the investment of domestic private equity and venture capital funds".

Tangible legal arrangements to achieve the stated policy goals are emerging. A recent example of a scheme to implement the GBA policy initiative is the Wealth Management Connect Pilot Scheme which was announced on 29 June 2020. Under this scheme, residents of the Mainland cities in the GBA can invest in eligible investment products distributed by banks in Hong Kong and Macao by opening designated investment accounts with these banks. Likewise, residents of Hong Kong and Macao can invest in eligible wealth management products distributed by Mainland banks in the GBA by opening designated investment accounts with these banks. The Wealth Management Connect Pilot Scheme is an example of a broadening channel for capital flows between Mainland China and Hong Kong and we expect that other channels will gradually be developed in the coming years.

President Xi announced in October 2020 additional reforms aimed at internationalizing and liberalizing the business environment in Shenzhen. This is an extension of China's experimentation with different economic models in the Shenzhen Special Economic Zone and a further indication of China's plans for the GBA.

Hong Kong

The Hong Kong government has recently shown a two-pronged approach to developing private equity and venture capital markets. First, it accepted recommendations to set aside part of the fund that is primarily established to provide the means to maintain the peg of the Hong Kong dollar to the US dollar, namely the Exchange Fund, to form a "Growth Portfolio" for investment in "strategic investments in projects with a Hong Kong nexus" where "two or three mandates should be structured to cover investments in private equity and venture capital". Providing Hong Kong government money to Hong Kong early-stage investments is intended to boost the Hong Kong venture capital ecosystem. This may assist Hong Kong's private capital investment scene to catch up with the arguably more dynamic scene in Mainland China.

Second, the Hong Kong government is about to complete a longer-term project of legislative changes to promote Hong Kong as a center for asset management for private funds. The Hong Kong government focused on three elements: (1) legislating for tax concessions that make the operation of private funds in Hong Kong feasible from that perspective, (2) reform of the limited partnership laws and (3) clarification of the regulatory and licensing requirements for private funds and sponsors in Hong Kong.

Hong Kong introduced a tax exemption for offshore funds several years ago which allowed more fund management activities to be carried out in Hong Kong without subjecting the offshore funds to profits tax on profits from qualifying transactions. In 2019, the tax exemption was broadened to capture all funds. This meant that the exemption from profits tax on profits from qualifying transactions can now also be claimed by funds established in Hong Kong, irrespective of where the management is conducted.

To complement the tax exemption for profits of the fund and encourage management activities in Hong Kong, the Hong Kong government plans to legislate for a tax concession for carried interest. A consultation paper was published on the proposals and industry stakeholders have submitted their responses to the proposals.

Following the introduction of the Hong Kong open-ended fund company regime (which was recently further enhanced by the Securities and Futures Commission), on 31 August 2020, Hong Kong's Limited Partnership Fund

Ordinance (LPFO) came into force. The LPFO removes what was perceived to be a barrier to establishing a private fund using a Hong Kong vehicle – the lack of a viable "fit-for-purpose" modern limited partnership vehicle. Previously, Hong Kong's limited partnership law was based solely on the United Kingdom's Limited Partnerships Act 1907 and had not seen any major reforms since its enactment. The LPFO creates a new type of limited partnership with statutory features that are commensurate to those seen in limited partnerships in typical fund domiciles. For example, the legislation provides for a "white list" of activities that limited partners may engage in without being deemed to have become involved in the management of the limited partnership (as a result of which their limited liability status would otherwise be lost). The LPFO is arguably more prescriptive than legislation elsewhere in that it requires, among other things, the appointment of an investment manager, which can be the same person as the general partner, and a suitably qualified responsible person, which can be the general partner or the manager.

Finally, to support these efforts, the Hong Kong Securities and Futures Commission (SFC) issued a circular that explained its approach to the licensing requirements of a GP of a limited partnership that conducts fund management business in Hong Kong. The Securities and Futures Ordinance is not clear on this point, although arguably the SFC's prior approach to enforcement suggested that a general partner that provides asset management services in Hong Kong would have to be licensed. The circular states that the SFC's approach is not to require the GP to be licensed provided that the GP delegates all of the asset management functions to a duly licensed investment manager.

The limited partnership and tax legislation and the regulatory approach to private limited partnership funds in Hong Kong is nuanced and GPs will want to navigate the environment with care. That said, the recent legislative developments have generally made it feasible for private funds to be established in Hong Kong. While there still remain good reasons for establishing China-focused private funds in traditional offshore jurisdictions, mainly in the Cayman Islands, Hong Kong now offers an alternative choice that will be attractive for some GPs and LPs to tap into the potential offered by the dynamic Chinese private equity and venture capital market and the future opportunities offered through the GBA project.

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