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Tianjin overhauls and heightens regulation for RMB PE fund industry

The municipal government of Tianjin has issued a set of new regulations which will affect RMB private equity investments funds[1] (**RMB PE Funds**) established in Tianjin by foreign and domestic managers. This briefing provides some background to Tianjin's regulatory overhaul and highlights some of the key provisions of the new measures.

Measures

The *Administrative Measures for Tianjin Equity Investment Enterprise and Equity Investment Management Entities* (**New Measures**) were issued in July 2011 and became effective as of 1 September 2011. They supersede the current provisional local regulation[2] which has been in effect since 2008 (**Provisional Measures**). This overhaul strengthens regulatory scrutiny for Tianjin's private fund industry and will affect both domestic and foreign-invested RMB PE Funds registered in Tianjin, whether registered before or after the effective date of the New Measures.

Background

Tianjin is an early starter among China's municipal governments in developing the local RMB PE Fund industry and is home to a large number of RMB PE Funds and their managers. It is viewed as a business-friendly jurisdiction for the RMB PE Fund industry; however, its bid to become the centre of China's nascent but rapidly developing RMB PE Fund industry has met with some growing pains lately. A number of Tianjin-registered domestic RMB PE Funds were involved in fund-raising scams. In the case of one particularly high-profile scam, the perpetrators reportedly marketed fake private equity interests in a Tianjin-registered fund with zero paid-in capital to the Chinese general public across the country through a pyramid selling scheme.[3] The regulatory overhaul is a direct response to such abuses.

Key Issues

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[1] Chinese national and municipal-level regulations use a number of terms, such as "Equity Investment Funds" or "Equity Investment Enterprises" to refer to private equity investment funds that are organized under Chinese laws. For ease of reference, such "Equity Investment Funds" or "Equity Investment Enterprises" are referred to as "RMB PE Funds" in this briefing.

[2] Provisional Measures on the Filing and Administration of Equity Investment Funds and Equity Investment Fund Management Companies (Enterprises) in Tianjin.

[3] The fund in question was boasted as having RMB 5 billion in subscriptions but in fact had no paid-in capital and the public bought into the scam, partly because the perpetrators were able to produce official registration papers.

In drafting the New Measures, the regulators have borrowed heavily from the *Circular on Further Standardizing the Development and Filing Administration of Equity Investment Enterprises in Pilot Areas* (**NDRC Circular**) issued by China's National Reform and Development Commission (**NDRC**) in January 2011. The NDRC has been administering a program of central registration of RMB PE Funds in the last three years. A filing with the NDRC makes a RMB PE Fund eligible for funding by China's National Social Security Fund and so has been sought after by fund managers. The NDRC Circular marks a watershed in the RMB PE Fund filing program: before its issuance, NDRC filings were voluntary and were accepted or rejected on an ad hoc basis. With the promulgation of the NDRC Circular, NDRC filings are, with a couple of exceptions, mandatory for RMB PE Funds that are registered in six pilot areas[4] (including Tianjin's Binhai New Area) having a subscribed capital of at least RMB 500 million or the equivalent in foreign currency[5].

The NDRC Circular also requires the local government in the place where the fund applicant is registered to receive the filing application and conduct a preliminary review. The New Measures implement Tianjin's obligation to facilitate NDRC filings.

Overall regulatory scheme

The New Measures appoint the Tianjin Municipal Development and Reform Commission (**Tianjin DRC**) as Tianjin's RMB PE Fund regulator. Tianjin DRC is tasked with forming a new office to take charge of the filing and administration of Tianjin's RMB PE Funds (**Filing Office**).

Tianjin-registered NDRC filing applicants (i.e. those having capital subscriptions of at least RMB 500 million or the equivalent in foreign currency referred to as **Large Funds**) must submit their filing applications to Tianjin DRC, which will conduct an initial review and if satisfied, pass the applications on to the NDRC. Tianjin-registered RMB PE Funds having capital subscriptions of at least RMB 100 million or the equivalent in foreign currency but less than RMB 500 million or the equivalent in foreign currency (**Smaller Funds**) must submit their filing application to the Filing Office.

Broad scope of application

The New Measures have a broad scope of application. They apply to both domestic RMB PE Funds and foreign-invested RMB PE Funds established in Tianjin. By contrast, equivalent regulations adopted in Beijing and Shanghai regulate foreign-invested RMB PE Funds and their domestic counterparts separately. While the non-discriminatory approach is generally welcome, in this instance, it has the effect of subjecting foreign-invested RMB PE Funds to provisions that are primarily intended to address the fund-raising scams mentioned at the beginning of this briefing.

The New Measures also apply to both Large Funds that are required to file with the NDRC and Smaller Funds that otherwise would not be subject to a filing. In addition, the New Measures incorporate many of the key provisions of the NDRC Circular, and further impose more stringent requirements on some of them. The implications are two-fold: (i) Tianjin is extending the NDRC's regulatory scheme (which used to be reserved to Large Funds) also to Smaller Funds, and (ii) Large Funds that are filed with the NDRC are also further subject to applicable Tianjin regulations, i.e. an NDRC filing does not exempt the Large Funds from local regulation.

The New Measures will apply both to new and existing RMB PE Funds that were registered in Tianjin before the New Measures came into effect.

Fund custodian and investor protection provisions

The New Measures contain a number of investor protection provisions which fall into two areas: those relating to the fund custodian, and those aimed at regulating the private placement offering process.

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[4] The six pilot areas are located in Tianjin municipality, Beijing municipality, Shanghai municipality , Jiangsu province, Zhejiang province and Hubei province.

[5] Please see our client briefing entitled "NDRC continues to spearhead the regulation of private equity funds in China" of March 2011 for more details. [English] [Chinese]

The need for a fund custodian is common in RMB PE Fund regulations. The NDRC Circular makes a fund custodian mandatory for RMB PE Funds managed by entities that are wholly or partly foreign-owned. Each of Beijing and Shanghai prescribe the same requirement for foreign-invested RMB PE Funds. The New Measures stress the fund custodian as an important protective measure against illegal fund-raising and impose greater responsibilities on the custodian. These include:

- requiring both domestic and foreign-invested RMB PE Funds to put fund assets into custody with a qualified onshore bank (**Custodian Bank**);

- requiring the Custodian Bank to be filed with the Filing Office and to send monthly written reports to the Filing Office regarding the RMB PE Funds under its custody;

- requiring the Custodian Bank to have (i) an infrastructure in place to combat illegal fund-raising, (ii) sufficient credentials for the custody of fund assets, and (iii) a separate unit to conduct its custody business with dedicated office space, among other things; and

- requiring the Custodian Bank to conduct detailed business due diligence on the RMB PE Funds and keep records of written due diligence reports. Such due diligence should be of a kind that is typically conducted by sophisticated institutional investors and includes, with respect to the RMB PE Fund manager, a review of its history of regulatory compliance, capitalization, investment experience and past investment projects, investment decision-making process, and information relating to key investment professionals.

The other type of investor-protection provisions focus on the private placement process because mass marketing to ordinary Chinese investors is at the core of the fund-raising scams that have come to light. Such provisions include:

- requiring investors who are natural persons to make a minimum investment of RMB 2 million (which is a significant increase compared to the RMB 1 million requirement under the Provisional Measures). In addition, an individual investor must provide a certificate from a financial institution indicating that the investor has financial assets of at least RMB 2 million;

- prohibiting nominee ownership and the pyramiding of investors, i.e. investors must invest with their own money; and

- requiring a minimum amount of paid-in capital at the RMB Fund's initial closing of RMB 20 million (in the case of corporate funds) and RMB 10 million (in the case of partnership funds). This is introduced to prevent fraudsters from using shell funds to deceive unsophisticated investors. As a result, the manager of a Tianjin RMB PE Fund would have to make capital calls at the initial closing.

The New Measures also call on other relevant governmental agencies, service providers (custodians, lawyers, accountants etc) and fund industry self-regulatory organizations to assist the Filing Office in policing the RMB PE Fund industry. Specifically:

- if an RMB PE Fund's custodian or relevant authorities discover any suspicion of illegal fund-raising by RMB PE Funds, they are required to report the case to a designated office for further handling;

- lawyers, accountants and other service providers of RMB PE Funds should file information relating to their organization, the relevant business unit, and the persons involved in servicing the fund clients (both persons-in-charge and rank-and-file employees) with the Filing Office. In addition, service providers should report any violation of laws and regulations by RMB PE Funds to the Filing Office on a timely basis; and

- RMB PE Funds and their managers are encouraged to become members of the China Private Equity Association which is subject to the direction and guidance of relevant fund industry regulators, and to file semi-annual reports with the regulators.

Concluding remarks

The New Measures introduce considerably more stringent requirements in the regulation of RMB PE Funds in Tianjin, which has often been seen as a place that is comparatively easy to set up new funds. The main catalyst for Tianjin's increased regulation – the fund raising scams – might occur in other places as well. It would be interesting to see if other regions and municipalities follow suit and introduce similar measures to tackle any potential fund-raising scams.