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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 investors? If so, how is this achieved?

Managers owe investors an obligation of honesty, trustworthiness, prudence, diligence and obligations stipulated in the fund contract, and there is no limited liability for such obligations and liabilities arising from the breach of such obligations. However, rigid redemption is prohibited under any structure. The notion of limited liability is typically with respect to the debts of the fund. In the case of a limited partnership, as a general partner, the sponsor or the manager shall bear unlimited liability for the debts of the fund; in the case of a corporation, as a shareholder of the company, the sponsor or the manager shall, in principle, bear limited liability for the debts of the fund to the extent of the amount of capital subscribed for the company; however, Chinese law provides for specific circumstances where a shareholder may lose protection of limited liability. In the case of a contractual fund, the liabilities usually shall be borne with the property of the fund itself. However, if the fund property and the property of the manager fail to be effectively separated, the manager may still be required to bear liabilities with its own property.

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

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 appointing a custodian bank and still within investment period stipulated by the fund contract, then such private equity fund can be open for subscription.

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

In general, 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, suspension of redemption and extension of fund term, etc. To make these mechanisms available, the fund organizational documents and agreements should expressly provide these provisions.

In recent years, with the increasing demand for overall liquidity of funds, the trend of private equity secondary market trading has been continuously emerging, providing alternative solutions for illiquidity management of funds.

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 and term of such bridge financing or guarantee shall 'satisfy certain restrictions). 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.

9. What is the local tax treatment of (a) resident, (b) non-resident, (c) pension fund and (d) sovereign wealth fund investors (or any other common investor type) in Alternative Investment Funds? Does the tax status or preference of investors or the tax treatment of the target investments primarily 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 and what restrictions are investors typically subject to 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). 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.

Some specific types of fund investors may have special requirements for operation of fund investment. Investors subject to industry regulations, such as insurance companies, may require not to participate in specific portfolio of the fund due to their own regulatory factors. Some government guide fund investors may require more participation and information rights for fund investments, and correspondingly require seats as members or observers of the investment committee.

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

Limited partnership is most commonly used. Limited partnerships can accommodate most of the commercial arrangements in private equity transactions and enjoy tax pass-through treatment.

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?

Yes. For Chinese onshore funds, the regulatory regime requires the fund manager be established in China.

15. Are there local residence or other local qualification or substance requirements for the Alternative Investment Fund and/or the manager and/or the advisor to the fund?

For Chinese onshore funds, the regulatory regime requires the fund manager be established in China and 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 by applicable law and regulation?

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 that do not use special investment vehicles for investment and do not have 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.

Under the provisions of the CSRC's 'Interim Provisions on Administration of Recognised Hong Kong Funds' (effective on 1 July 2015), public funds established in Hong Kong in accordance with Hong Kong laws that satisfy the conditions stipulated by the CSRC can be registered with the CSRC by Hong Kong fund managers. These fund managers can engage mainland institutions as agents to sell the funds in mainland China (known as 'Recognised Hong Kong Funds'). Hong Kong fund managers can also engage mainland service providers to handle matters such as product registration, information disclosure, sales arrangements, data exchange, fund clearing, regulatory reporting, communication, customer service and monitoring on their behalf. However, Hong Kong managers are still legally responsible to the mainland investors who subscribe to the Recognised Hong Kong Funds.

On 19 April 2024, the CSRC announced five measures for capital market cooperation with Hong Kong. One of the measures proposes allowing Recognised Hong Kong Funds to delegate investment management functions to overseas asset management institutions within the same group as the Hong Kong manager.

19. What are the 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% to 2% annually. For funds of funds the annual management fee usually ranges between 0.5%-2%.

21. Is a performance fee or carried interest typical? If so, does it commonly include a "high water mark", "hurdle", "water-fall", "preferred return" 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 are 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.

26. What industry trends have recently developed regarding management fees and incentive/performance fees or carried interest? In particular, are there industry norms between primary funds and secondary funds?

Based on the requirements of limited partners, there is a downward trend in the standards for management fees and incentive fees. It is also 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).

An increasing number of fund investors tend to require that funds shall calculate management fees based on actual capital contribution or investment costs, rather than on subscribed capital.

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 organized as private funds cannot be marketed to retail investors. A private AIF can only raise funds from qualified investors in private placements.

31. What are the minimum investor qualification requirements for an Alternative Investment Fund? Does this vary by asset class (e.g. hedge vs. private equity)?

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 similar investors (e.g. sovereign wealth funds) or pension funds or insurance company investors?

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.

In early 2025, the General Office of the State Council released Guiding Opinions on Promoting the High-quality Development of Government Investment Funds, providing further guidance for the operation of government investment funds, and attention should be paid to how the government investment funds investors to propose corresponding operational requirements to their target fund.

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. In addition, according to the relevant rules issued by the CSRC taking effect from October 2020, agencies that are specialized in the sales of public funds and private securities investment funds are prohibited from the sales of private equity investment funds.

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.

Recently, various government guide funds are relatively active in the fundraising market, and their side letters usually include provisions related to their own operational goals, such as requirements of investing in specific regions or industries.

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