International
Comparative
Legal Guides

Private Equity 2021

A practical cross-border insight into private equity law

Seventh Edition

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China

Will Fung

Liu Naijin

Lu Hao

Grandall Law Firm

1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?

China's private equity ("PE") deal activity has seen a tremendous surge in 2020, in terms of both deal volume and value, despite the COVID-19 pandemic. At the onset of the COVID-19 outbreak in the first and second quarters of 2020, no country was spared, including China, and it had severely impacted the global economy as a whole. However, in the case of China, we witnessed the economy starting to regain its momentum post-Q2 of 2020, and PE deals have gradually recovered since then, against market predictions. PE transactions reached a record high in Q4 of 2020. Without the slightest doubt, a major contributing factor was a series of successful measures taken by the Chinese government to contain the COVID-19 pandemic. The rapid rebound of PE deals has been driven by strong demand and targeted investment in key sectors, in particular in the telecommunications, media and technology industries, backed by strong earnings.

In China, two broad PE transactional scenarios are usually considered: (i) PE transactions in a private or non-public listed company, which can either take the form of a limited liability company or a company limited by shares; and (ii) PE transactions involving a public or public-listed company as portfolio company, for instance, a private offering of shares by a public listed company.

According to the statistics reported by the Asset Management Association of China, PE investment funds have reached RMB10 trillion in assets as of the Q1 of 2021. With government reforms and issuance of favourable policies in healthcare especially, investment and financing in the biotechnology and healthcare sectors have seen a rapid increase. Overall, the PE investment industry in China is becoming more specialised, focused and targeted, giving rise to professional frontier areas and high-tech projects, such as unmanned aerial vehicles, artificial intelligence and mobile interactions.

With an ever-increasing number of PE investors shifting their focus on Environmental, Social and Governance ("ESG") investments over the last few years, ESG has become one of the significant criteria to guide investment in China, resulting in General Partners ("GP") gradually incorporating ESG principles into their investment strategies and consciously avoiding the risks associated with ESG.

1.2 What are the most significant factors currently encouraging or inhibiting private equity transactions in your jurisdiction?

In our view, three significant factors that we think that are driving and encouraging PE transactions in China in recent years are: firstly, supportive national economy policies backed by political administration stability; secondly, availability of world investment capital (be it from the government or from private sectors, domestic or international); and thirdly, less restrictive exit options for the players.

Since the launch of the Science and Technology Innovation Board ("STIB", also known as "SSE STAR MARKET" in China) at the Shanghai Stock Exchange in 2019, serving as Asia's Nasdaq-style tech board, the newly adopted registration-based listing system had replaced the filing and registration regime, which significantly sped up the approval and review process to take a company public.

Traditionally, IPOs in China are subject to a lengthy approval and review process by the China Securities Regulatory Commission ("CSRC"), and it could therefore often take months, if not years, to obtain the approval. With the introduction of the STIB, priority is given to high-tech companies involved in strategic sectors, such as the new generation of information technology, new and renewable energy, biotech and advanced equipment. The new exit channel has definitely created a booster effect for the PE and VC investors to seek for China deals.

The robust and highly dynamic stock exchanges in Shenzhen, Shanghai and Hong Kong provided a strong capital markets platform for IPO exits in China. Statistically, all the three China exchanges were ranked amongst the top five, producing IPO proceeds of US$118.7 billion, a 50% increase over the amount produced by the American exchanges. The China market is expected to generate significant IPO proceeds this year, with strong pipelines expected in 2021.

Further, from the regulatory regime, with the Foreign Investment Law and the Implementation Rules ("Foreign Investment Law") coming into effect on January 1, 2020, the

process for the establishment of a foreign-invested enterprise ("FIE") was simplified and streamlined. Recently, the setting-up of equity trading centres, such as the Beijing Equity Exchange Co., Ltd., had provided the market with a centralised platform for the facilitation and rendering services for private placements, transfers and related activities of securities for micro, small and medium-sized enterprises within the administrative region of Beijing: https://www.bjotc.cn/aboutus/build.html.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

The devasting effects of the pandemic have brought a huge challenge to all PE investors (including funding solutions); however, China is forecasted to be the only major economy to rebound and is expected to see a positive GDP growth rate in 2021. Some of these postponed PE transactions had resumed quickly and as soon as the COVID-19 pandemic started to be contained; however, cash flows at smaller, privately run businesses have stagnated and caused funding difficulties. With this backdrop, we believe that the Chinese government will continue to promote the reform of the National Equities Exchange and Quotations ("NEEQ"), and make it a main channel to serve small and medium-sized enterprises, science and innovation enterprises, and other private enterprises as a competitive platform for the players to raise new funds.

It is worth highlighting that, based on the recently released Q1 monetary policy report by the People's Bank of China ("PBOC") in May 2021, China remained cautious in formulating its stimulus policies, focusing on ways to address the issue of "*the foundation of our economic recovery is not yet solid*", a core issue that was raised in the Central Economic Work Conference attended by the nation's leaders in December 2020. Domestic consumption is still constrained and investment growth insufficient, in addition to ensuring employment remaining a great challenge. We do foresee that government-backed initiatives would be implemented, boosting larger capital-concentrated mega projects, which would inevitably lead to a corresponding increase in the consummation of PE deals across a wide array of sectors.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

Ultra-high-net-worth individuals and family offices are continuing to build their momentum and cultivating greater appetite towards the PE sphere, either by way of acting as GPs or LPs, or via a conventional approach in making direct investments into the portfolio companies. Apart from that, we are also seeing a greater allocation of funds by the non-traditional PE funds, e.g., sovereign wealth funds and pension funds increasing their portfolios in the China market, extending beyond the money markets/stock exchange, but increasingly acting as lead investors in increasingly PE transactions.

Asia private debt funds have more than doubled from US$28 billion in 2014 to US$64 billion in 2019. These private debt funds are set to accelerate throughout 2021, driven by funding needs for Asia businesses, especially targeting the China market. Due to the withdrawal of government liquidity programmes across the globe, coupled with the tightening in bank lending requirements, as a result, Asia is observing larger and more numerous private credit funds that provide financing solutions.

PE managers and institutional investors are actively increasing their role in providing debt and structured products to corporates, real estate projects and infrastructure developments in China. Private lending has traditionally been driven by banks. However, Asian banks are applying stricter lending standards, making lending more difficult. In addition, as they have been less focused on the small to medium market segments due to credit risk, regulatory concerns and group economics, alternative credit providers are expected to increasingly fill the financing needs of growing Chinese companies in 2021. Private debt solutions are offering China portfolio companies more flexibility, providing investors with higher yields. With a diverse product offering that includes direct lending, mezzanine financing, sponsor lending, and distressed and special situations, private debt is enabling greater and more flexible solutions with respect to traditional bank lending. This solution-based approach, along with the tightening supply, should help drive funds toward the asset class.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

The common types of PE transactions in China include mergers and acquisitions ("M&A"), share (equity) transfers and assets purchases. In the case of corporate debt situations, debt-to-equity swaps and debt-plus-equity can also be used for PE investors to convert the debt of the portfolio company that it owned into a certain number of equities based on the corresponding share price.

PE transactions had evolved substantially over the past two decades in China. Basically, there are two broad structures: namely the onshore and offshore investment models. The process of investing in PE in China differs depending on whether the PE fund is an onshore fund or an offshore fund.

Onshore funds

In this type of PE fund, the PE fund invests in an onshore domestic China entity through an offshore special purpose vehicle ("SPV"). The PE firm would then become a direct corporate shareholder in the concerned onshore domestic portfolio company. Subsequently, for an exit via IPO, the listing vehicle is incorporated as an onshore PRC joint-stock company if the PE investors intend to exit by listing the portfolio company on a China stock exchange.

Offshore funds

In this type of PE fund, an SPV acquires or invests in the stocks of the portfolio company's offshore holding company. Often, the holding company holds a 100% interest in a Hong Kong intermediary company, which in turn holds a 100% interest in a China subsidiary. In this type of PE structure, offshore holding companies are commonly called the "red-chip" companies because they hold Chinese assets, be it directly or indirectly.

The 100% interest in the China subsidiary would normally take the form of a "wholly foreign-owned enterprise" ("WFOE"). The offshore holding company is intended to be a listing vehicle if the PE fund intends to exit via IPO outside of China. The offshore investment vehicle is incorporated as a company in a jurisdiction that is offshore (such as the Cayman Islands).

Thereafter, the PE investors in an offshore company exit the holding company after the IPO exercise. However, if the portfolio company is a Chinese domestic entity that does not have an offshore holding company, as a closing condition, PE investors often require the portfolio company to restructure into an offshore structure so that the investors become shareholders of an offshore holding company. The offshore funds model seemed to be the preferred approach for many international PE funds wishing to enter into the Chinese market.

2.2 What are the main drivers for these acquisition structures?

The main drivers for such offshore funds approach would be based upon previous successful precedents, and a tested approach, albeit conventional, it gives the comfort of certainty and predictability. Some other considerations would include tax, speed of closing, flexibility in financing, other requirements and liability issues.

In the event of a share transfer, the need for Chinese authority approval would be minimised as opposed to onshore transaction. However, it is worth highlighting that, should a transfer involve a foreign investment in the equity interests or shares of a Chinese company, approval from the Chinese government would still be required, but as a matter of formality in adhering to the registration-filing requirements.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

In China, the equity structures commonly used in PE transactions are the share equity investment and mezzanine investment. Considering the regulatory environment for foreign investment in China, many PE transactions would still use the Variable Interest Entities ("VIE") structures to bypass certain regulatory restrictions or limitations for foreign investment in certain types of business, particularly the internet, telecommunications and media and education.

China is increasingly involving and connecting with the global world at large; a series of well thought-out plans to implement its reaching-out initiatives have been successfully implemented and carried out in stages, seeking to create win-win situations in all economic areas. With this backdrop, from its initial centrally planned economy approach, China is slowly and steadily opening its market access to foreign investors and, by allowing so, is learning to embrace and adapt to international practices/norms in PE transactions.

Under normal circumstances, depending on the ticket size, a PE investor will require a seat on the board of the portfolio company and may insist on certain veto rights over certain matters. However, such trends are now shifting; in line with international practices, the scope of exercising such a veto right (over major business decisions) had been limited and reduced substantially over the years, but PE investors are now generally aware of the need to give more freedom to the founding team of the portfolio company in order to allow for more rights to be reserved for the founding team/management.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Yes, the minority shareholder will need to have protective provisions clearly spelt out in the shareholders' agreements and the articles of association of the portfolio company. Among other considerations, the following are usually included, e.g.: (i) founders of portfolio companies shall be entitled to transfer the equity of the company directly or indirectly owned by them only upon obtaining the prior written consent from the minority shareholder; (ii) entitlement to a board seat (which depends on the negotiation outcome); (iii) veto rights over certain major matters that affect the rights or interests; and (iv) provisions on investor rights and privileges, including but not limited to rights to access to information and inspection, and pre-emptive, first refusal, tag/drag-along, dividend preferential, liquidation, redemption, anti-dilution and registration rights.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

There is no specific range; typically, this could range from 5–25% of equity allocated to the management, and it is often tied to the terms of the employment of the key personnel.

As for the vesting period, key founders are expected to stay for a further two to three years post-acquisition. Generally, 50% of the founders deal consideration would be offered, comprising a combination of stay bonuses, re-vesting, escrow provisions, earn-outs, revenue milestones, and giving out 'carrots' such as new equity grants, cash retention bonuses, etc.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Management equity holders are typically treated as bad leavers if their employment is terminated due to breach of contract, fraud, wilful misconduct, or engaging in other unethical activities, etc.

Good leavers, on the other hand, may generally refer to the management equity holders' resignation with valid and good reason after a specified period of time, thus not leaving the company in a bad shape and through early termination due to death or disability, or upon retirement.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

China's corporate governance rules are generally incorporated in the Company Law of the PRC ("Company Law"), with additional rules supplied by specific regulations governing the conduct of public listed companies and FIEs.

Unlike many other countries where the board of directors normally welds most power in corporate governance, the ultimate managing power in China is allocated differently according to the types of company. In domestic limited liability companies, companies limited by shares (either listed or unlisted) and WFOE, the general meeting of shareholders is entitled to make decisions on all matters of importance, leaving the board with daily management and execution of the shareholders' decision, in light of the highest authority of a company vesting with the shareholders.

Be that as it may, governance arrangements among PE investors and management will, in most cases, be spelt out in the form

of a shareholders' agreement or relevant transaction documents, which are not generally required to be made publicly available. However, in some situations, if such governance matters are reflected in the articles of association of the portfolio company, such constitutional document would then have to be lodged with the government authority, hence rendering it accessible to public.

If a PE investor only invests a minority stake but is substantial enough in the portfolio company, it is advisable for the PE investor to fight for a seat of at least a financial controller, which can be pushed further. A position as a VP in an operational role in the founder-controlled operating company would give the investor the monitoring/supervisory right to monitor the company's operations and, to a great extent, the right to a say in its expenditure. Again, it would still depend on what type of value-added contribution a PE investor may bring with them, apart from providing funding. With the massive market opportunity for scalability, the founding members of the operating company seem to have an increasing amount of bargaining power; in short, we are seeing a "seller's market" in China right now.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Yes, such veto rights will be vested in the form of either a shareholder's veto or director's veto (in the event a director seat is granted. Typically, such rights will be spelt out under reserved matters and usually include: amendments to articles of association; change of business scope; share transfers; capitalisation of the company; liquidation or dissolution of the portfolio company; indebtedness; and any other matters that may have any material impact on the company, from management operations to financial performance, etc.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

The veto rights to the shareholder or director are protected by the Company Law so long as such rights have been stipulated in the articles of association of the portfolio company upon the unanimous consent of the shareholders and are not in violation of the prohibitive provision of the laws and regulations.

It is worth mentioning that since the promulgation of the Foreign Investment Law, the highest authority of a company in China now vests with the shareholders, instead of the previous laws and regulations governing foreign investment, e.g., the Sino-Foreign Equity Joint Venture Law/Regulations (now repealed), which expressly stated that the highest authority of a company shall be the board of directors

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

Pursuant to the Company Law, shareholders of a company shall exercise shareholders' rights in accordance with the provisions of laws and administrative regulations, as well as the articles of association of the company. PE investors shall not abuse their shareholders' rights to cause damage to the portfolio company or the interests of other shareholders, including but not limited to the majority shareholders, or abuse its rights to prevent or interfere with dividends, resulting in losses to other shareholders

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Onshore transactions: PRC law shall be the governing law in the case of an onshore transaction, meaning that if a foreign PE investor invests into or acquires equity interests in a PRC portfolio company, it shall be subject to government approval and the share purchase agreement and shareholders' agreements shall be governed by PRC law.

Offshore transactions: In the case of an offshore transaction, shareholders' agreements are normally governed by the law of the jurisdiction of the offshore company, whilst a subscription agreement may be governed by a different law of choice to be agreed upon by the parties.

Arbitration clauses have been the norm, for both onshore or offshore transactions for the settlement of disputes. The seat of arbitration can be freely chosen by the parties, but it ought to be agreed upon and expressly provided in the agreements. It is not difficult to understand that, when given a choice, the founders of portfolio company would prefer to have a China-based arbitration tribunal, while a foreign PE investor may prefer a more neutral seat. Parties will often come to a compromise and accept to have such seat in either the Hong Kong International Arbitration Centre ("HKIAC") or Singapore International Arbitration Centre ("SIAC").

In the case of non-compete and non-solicitation provisions, there is no express provision under PRC law with regard to limitations or restrictions on the contents or enforceability of shareholders' agreements; however, these are always subject to the fundamental principles of not violating the national security interests of China.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

Article 146 of the Company Law provides the qualifications and duties of directors, supervisors and senior officers of a Chinese company. Nominees who fall under the following situations shall not be eligible to be appointed to the boards: (i) any person who does not have civil capacity or who has limited civil capacity; (ii) any person who has been convicted of any criminal offence in the nature of corruption, bribery, disseizing, misappropriation or disrupting the economic order of the socialist market, and five years have not elapsed since any penalty imposed has been completed; any person who has ever been deprived of his political rights due to any crime, and five years have not elapsed since the penalty imposed was completed; (iii) any former director, factory director or manager of a company or enterprise that has been declared bankrupt and liquidated, in circumstances where he was personally responsible for the bankruptcy of the company or enterprise, and three years have not elapsed since the bankruptcy and liquidation of the company

or enterprise was completed; (iv) any former legal representative of a company or enterprise that has had its business licence revoked and has been ordered to close its business operations due to a violation of law, in circumstances where the former legal representative was personally liable for the revocation of the business licence and three years have not elapsed since the date of revocation; or (v) any person who has significant unpaid due debts.

Under PRC law, the legal representative (normally, the chairman) has the obligations to act on behalf of the portfolio company, including, but not limited to, execution of legal documents, cooperating in administrative or civil/criminal investigations undertaken by government authorities, appearing in court, etc., and, in civil cases, the plaintiff may apply to the court for a restrictive order to prohibit the legal representative from leaving China pending completion of the litigation matter or debts being fully repaid. Therefore, PE investors shall be careful in nominating such a person to the board, and particularly, acting as the legal representative.

In addition, with the tightening and enhancing measures adopted by the CSRC, in the spirit of curbing corruption practices and governance aspects, a series of practice notes were issued. One recent added requirement is the imposition of a higher burden and the responsibility on the directors, supervisors and senior officers of the company to provide his/her personal banking statement for the last few years to the authority for IPO submission.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Generally, directors bear fiduciary duties toward the portfolio company in accordance with the Company Law. Without obtaining the consent of the board of shareholders or a shareholders' general meeting, directors shall not abuse his/her duties and powers to seize commercial opportunities of the company for himself/herself or others or engage in similar business as the companies on his/her own or with others.

Recusal or abstention in the boards are expected, especially in public listed companies, where a member of the board is deemed to be 'related to' a particular motion, resulting in potential direct or indirect conflict of interest. In other instances that may involve transactional conflict, full and frank disclosure to the board prior to entering into discussion would be a prudent exercise. Although there is no strict legal guidance *per se*, internal corporate governance would normally spell out the situation where a conflict of interest may take place, as well as the procedures to deal with such occurrences.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust, foreign direct investment and other regulatory approval requirements, disclosure obligations and financing issues?

The timeline of PE transactions is often impacted by the due diligence process, negotiation of definitive documentation, obtaining debt financing, third-party consents and regulatory approvals. Cultural differences would also sometimes materially impact the transaction process.

Onshore transactions: approvals from the Ministry of Commerce ("MOFCOM") are required prior to closing, followed by the registration-filing process with the State Administration for Market Regulation ("SAMR"). Materials including transaction documents, share purchase agreements, articles of association and other supporting documents also need to be submitted. The process for such approval process had arguably been made simpler with a shorter timeframe, after the implementation of the Foreign Investment Law. It is to be noted that although bilingual documents are quite often executed, for submission purposes, usually only the Chinese version is required to be lodged. Therefore, the drafting of the bilingual documents ought to be carried out by professionals instead of relying on outsourced translation companies, in order to prevent misunderstanding of the terms and conditions or the possibility of having a lost-in-translation scenario.

Although it is rare to see PE deals having to trigger merger-filing obligations under the Anti-Monopoly Law of the PRC ("AML"), in the event they are needed, the timeframe would indefinitely be prolonged substantially. In China, the test to determine whether a filing pursuant to the AML is required would consist of two factors: (i) the change of control test; and (ii) the turnover threshold.

Change of control: merger filing is required if: (i) one acquires control over the other; or (ii) there is a possibility of exercising decisive impact on other undertakings by virtue of acquiring their equities or assets, either by way of contractual arrangements or by other means. In most PE deals, however, minority interest may be acquired, although this does not necessarily mean the PE investor does not have control over the target under the AML.

Turnover threshold: this shall be met if: during the previous fiscal year, the total global turnover of all undertakings participating in the concentration exceeded RMB10 billion, and at least two of these undertakings each had a turnover of more than RMB400 million within China; or during the previous fiscal year, the total turnover within China of all the undertakings participating in the concentration had exceeded RMB2 billion, and at least two of these undertakings each had a turnover of more than RMB400 million that occurs within China. Great attention must be paid to the turnover threshold so that even if a concentration of undertakings does not trigger the turnover threshold, should the facts and evidence collected indicate that the concentration has or may have the effect of eliminating or restricting competition, the AML enforcement agency under the State Council may carry out investigations.

4.2 Have there been any discernible trends in transaction terms over recent years?

As mentioned earlier, with the availability of liquidity globally seeking to pump into the Asian region, especially in the midst of this pandemic with a lot of uncertainty, PE funds are chasing after deals in China in an ever more aggressive manner. This has created intense competition among PE investors, giving rise to founders of portfolio companies having more bargaining power in negotiating more favourable transaction terms with higher valuation with their potential prospective investor.

Due to over-expansion with high gearing and huge liabilities, and the inability to honour the repayment deadlines to their financial creditors, we are witnessing quite a number of such reputable and large market-capped Chinese companies seeking massive bailouts from white knight rescue missions, particularly so from deep-pocketed PE investors via restructuring processes to avoid liquidation leading to bankruptcy. These types of deals involve highly sophisticated negotiations, but 'beggars can't be

choosers' and PE investors tend to have an upper hand in such deals. Such distressed assets have the potential to be good if they can be strategised, with turnaround by professional players, and could be regarded as good bargain deals if the exit timeframe is set to be a mid- to long-term investment type.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

In China, insofar as PE transactions are concerned, leveraged buyouts and going-private transactions are not entirely common to date. Owing to China's examination and approval regime for IPO exercise (with the exception of the recently implemented STIB alternative), a company that has fulfilled the criteria and credentials in order to be approved for listing is itself a huge accomplishment.

However, in the past two to three years in particular, and with the escalation of geopolitical tension between China and the US, we are seeing more and more Chinese-controlled overseas listed companies' privatisation processes, where they are seeking going-private transactions and exploring relisting options either in the Shanghai or Shenzhen Stock Exchange, or the Hong Kong Stock Exchange.

With the recently public statement (July 30, 2021) issued by the Chairman of US Securities and Exchange Commission, additional disclosures are now required from Chinese companies seeking a listing on US stock exchanges. This may be viewed as a counter measure by the US side, following Beijing's recent crackdown on a few Chinese companies in their overseas IPO, citing cybersecurity concerns; against this backdrop, we do foresee there will be a mass exodus of China-based companies from the US stock exchanges.

Generally, barring political reasons, the main reason for an overseas public listed company to convert the public-to-private status in a particular stock exchange abroad, with the help of PE investors, is often the intention to seek for future listing in another stock exchange for higher valuation and to attract more liquidity. Such exercise would normally involve applicable takeover codes in which the said entity is listed, and overseas counsel would then need to play a leading role.

Among the challenges faced are compliance with the requirements of the particular stock exchange, uncertainty from the public shareholders, timeframe, and reputational risks at the public sphere.

A common way to deal with such challenges is by way of consulting with the local stock exchanges and the relevant regulatory authorities for a clearer timeframe, entering into an agreement with existing major/substantial shareholders who could help secure the required number of votes to support the proposed going-private exercise, and having in place a good investors-relations communication mechanism.

In the event that such going-private exercise is backed by the intent for listing exercise in the domestic market, the PRC counsel would need to play a significant role, as soon as practicable, in the restructuring process to convert the entity into an onshore company fitting the criteria for domestic IPO.

In China, such going-private exercise is undertaken pursuant to the Administrative Measures for the Takeover of Listed Companies (revised in 2020) ("Takeover Measures"), along with other securities-related laws and regulations and bylaws issued by the CSRC. Some of the key considerations are to examine the acquirer's qualification and suitability, creditworthiness, acquisition intent, and terms of offer, and the need to appoint an independent financial consultant for an expert opinion. The board then has a duty to make public on such an expert opinion, giving the shareholders the opportunity to decide whether or not to accept the offer. Certain *status quo* terms are expected during the period of the tender offer, e.g. the directors shall not resign, and without the approval of a shareholders' general meeting, the directors shall not dispose the company assets, make external investments, make adjustments to the principal business of the company, or provide guarantees or loans, etc, which will have a significant impact on the assets, liabilities, equities or business results of the company.

In the situation that a management buyout offer was made, the public listed company shall have a proper and well-functioning organisational structure and an effective internal control system, and the ratio of independent directors in the board of directors of the company shall attain or exceed 1:2.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

It is common for a PE investor to add an exclusivity clause to restrain the seller from looking for other buyers upon signing the definitive agreement. In addition, break-up fees are also acceptable under PRC law and can be seen in PE deals, e.g. legal and financial due diligence-related costs, which range between approximately 1–1.5% of the equity value.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

Apart from the normal provisions of a share purchase agreement in private acquisitions, certain provisions are specific to general PE transactions.

Buy-side

(i) Valuation and readjustment: it is advisable to take valuation and readjustment arrangement into consideration and for this to be reflected in the share purchase agreement, in order to minimise the loss suffered by the buyer due to the shortfall between the agreed purchase price and the actual market.

(ii) State Administration of Foreign Exchange ("SAFE"): specific representations related to compliance with the rules by SAFE ought to be expressly spelt out. As foreign exchange is heavily controlled in China, any transactions involving foreign currency cross-border remittances would require for SAFE approval to be obtained as a condition precedent prior to closing. This is important as it would impact the future repatriation of profits or dividends (if any) in the future.

(iii) Breaches and Indemnifications: PE investors may negotiate for special breach remedies and indemnifications in the event of a breach, taking into account commercial negotiation considerations. If such remedies or indemnifications are subject to PRC law, and are punitive in nature, the burden of proof shall vest on the claimant for such losses and hence requesting the court or arbitration to support such actual or foreseeable losses may not be easily recognised.

Sell-side

Representations and Warranties: PE investors may want to limit such representations and warranties in the agreements, to keep it to a bare minimum (see question 6.2 below).

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

Depending on the strength of negotiation, under normal circumstances, if a PE is on the seller-side, representations and warranties are expected to undertake post-closing indemnifications for breaches of such representations and warranties. Payment terms related to the transactions may also need to be extended (e.g., last escrow payment is not made until, possibly, 12–24 months after the initial closing) in order to cover any unexpected/contingency liabilities revealed post-closing. In addition to the covenants in the transaction documents, confirmation letters on some significant facts and key issues ought to be delivered to the sellers to reduce the risks that may arise out of the transactions.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Non-compete and non-solicitation undertakings are crucial and such provisions are typically used in venture capital investments for start-ups, although, to a great extent, they also apply to PE investments. The founders of the portfolio company, along with his/her team members, are the most valuable resource in any company, so as to ensure the continued survival and growth of the portfolio company, PE investors must secure full-time and exclusive services of the core team (key management) for an agreed period or a KPI to be installed, ensuring that they would collectively drive the company to achieve a specific milestone.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Representations and warranties insurance is not commonly used in China PE deals but has seen some in deals, particularly foreign investments in sophisticated, larger deals, with a premium ranging from 1.5–3% depending on the deal size, industry type and jurisdiction involved.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Representations and warranties would normally survive for a period of 12–24 months post-closing, although this again depends on the negotiation power of the parties; whilst a buyer would wish for it to extend for as long a period as possible, the seller, on the other hand, would want it to keep the R&W to the shortest possible term. Seller's counsel will often request to cap the amount for indemnification (typically between 5–15%), along with a survival period of the representations and warranties, such as six to 12 months post-closing.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

There is no actual statistical survey conducted in this aspect for China PE deals – it would vary on case-by-case basis and also depends on whether it is a buyer or seller's market.

A PE buyer may insist on opening an escrow account or for a joint management account to be set up, and request the seller to deposit a certain amount (usually between 10% and 15% of the total purchase price) as a recourse to cover indemnification for representations and warranties breaches to cover the losses and damages, whilst a PE seller would not provide any sort of additional security other than the mentioned escrow amount (if at all agreed to).

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

The PE seller will typically request a corporate guarantee delivered by the parent company of the buyer, under which it irrevocably and unconditionally guarantees to pay the PE seller all amounts so as to ensure that the seller ultimately receives the purchase price in full.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are not common in China PE deals. However, PE investors may request an exclusivity clause in the term sheet. In the event of breaching such an exclusivity clause, PE buyers can then assert claims for damages, normally capped at the professional fees and expenses incurred, such as legal and financial due diligence costs.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

One of the common exit strategies for PE firms is to seek for an IPO. As the approval process for a portfolio company via an IPO in the main board market is strict, time-consuming and arguably costly, coupled with rather a long queue in the pipeline, many PE firms now may opt for the NEEQ or the STIB, both of which are for small and medium-sized companies, with neither being limited to high-tech industries and there being no restriction on the nature of shareholders' ownership. Nevertheless, the frenzy and enthusiasm to float via the NEEQ has seen a significant drop in share prices in the past one to two years because of its low levels of trading and a move towards the STIB. According to Zero2IPO Research, in 2020, there were among 145 listed companies on the STIB, 114 of which have gained support from VC/PE investors, and the STIB has become the preferred exit channel for investment institutions.

Be that as it may, the government will continue to promote the reform of the NEEQ so that private enterprises, small and micro enterprises, and science and technology innovation enterprises can obtain more financing through the capital market and promote equity investment to have more exit channels.

The financial performance of the company, size and scalability, industrial sector and growth potential, compliance-related issues, the time required for the preparation, and approval for the IPO are amongst the important considerations.

It is worth noting that two mega IPOs were faced with setbacks: firstly, Ant group, which was supposed to be the world's largest IPO at the Shanghai Stock Exchange, expected to raise an estimated US$37 billion and boost Ant's market value in excess of US$300 billion (as of November 2020), but was halted at the very last minute. Secondly, although the ride-hailing app DiDi, which had its IPO at the New York Stock Exchange on June 30, 2021, successfully raised US$4.4 billion, giving it a market value of around US$68 billion, the shares have since plummeted over 40% below their IPO price as of July 26, 2021. DiDi has since been in trouble with the Chinese government authority, with a series of investigations and questioning over its compliance issues (allegedly, issues pertaining to national security interest), and the spill-over effect that had impacted DiDi-related/funded mobile apps (25 of it altogether), which had been requested to be removed in the China market. With this backdrop, it is worth noting that, apart from being able to fulfil the listing criteria in an overseas market, prior communications and approvals with the relevant Chinese government authorities ought to be treated with utmost case and seriousness in light of these precedents.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

Pursuant to the Company Law, shares issued by the company before the share offering shall not be transferred within one year from the date on which the shares of the company are listed on a stock exchange. The period can be shorter if the IPO takes places abroad; this depends on the rules by the different stock exchanges.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

It is not uncommon for PE sellers to adopt a dual-track strategy as this can turbocharge the exit and offer investors greater return. PE sellers may map out a wide variety of exit strategies based on the complexity and cost of two tracks, market conditions, and resources available, as well as sponsor motivations and other considerations.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

In China, PE transactions involving large-scale financing are funded by commercial banks. For other smaller deals, using bridging loans to provide short-term cash flow for the portfolio company during negotiation seems to be the norm.

The Company Law imposes restrictions on companies and management when granting security for debt financing. Specifically, where a company invests in other enterprises or provides guarantee for others, a resolution passed by the board of directors, board of shareholders or a general meeting in accordance with the articles of association of the company shall be required. Where the articles of association of the company provide a limit for the total amount of such investment or guarantee or the amount of each investment or guarantee, such limits shall not be exceeded. In the case of a company providing guarantee for a shareholder or the actual controlling party of the company, a resolution passed by the board of shareholders or a general meeting is required. Shareholders stipulated in the preceding paragraph or shareholders controlled by the actual controlling party stipulated in the preceding paragraph shall not participate in the resolution in respect of the matter stipulated in the preceding paragraph. Such a resolution shall be passed by a simple majority of votes cast by other shareholders attending the meeting.

A third-party guarantee will commonly need to be provided upon the occurrence of the large-scale debt financing. For offshore transactions, SAFE rules expressly prohibit an onshore guarantee to an offshore entity where the debt finance is used to acquire another offshore company's equity, and 50% or more of the assets of such portfolio company are located within China.

China still has a broader set of actors and structures dominating the PE space. In China, funding for PE deals could also come from a plethora of conglomerates and holding companies, as well as from the government, from big SOEs or directly from state-backed PE firms. Other channels for debt financing could also be provided by licensed trust investment companies, via raising unit trust plans/funds to the public, and licensed assets management companies could also raise funds from the public or utilise their own funds and, in turn, lend the funds raised to PE investors. In addition, investors who meet the condition can also use a Qualified Domestic Limited Partner ("QDLP"), a Qualified Foreign Limited Partner ("QFLP"), RMB investment and loan funds and other capital channels.

In view of the higher lending costs with significantly higher entry barriers, high-yield bonds are not a common source of debt financing for PE deals in China.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

There may have certain limitations on the amount and period of different types of debt financing, which need to be taken into consideration. For instance, with respect to the onshore debt financing, if a domestic acquirer applies for an M&A loan from the commercial bank, the amount of such loan shall not exceed 60% of the total transaction amount and the term shall not exceed seven years. As for offshore debt financing, such terms shall be subject to local law or jurisdiction given that the financial institutions are usually outside the territory of the PRC.

The CSRC released the Several Provisions on Strengthening the Regulation of Privately Offered Investment Funds in December 2020, which further regulate the business activities of privately offered investment funds. In particular, the administrator of a privately offered fund shall not directly or indirectly use the property of the privately offered fund in: borrowings (deposits) and loans; guarantees; equity in the nature of debts; and other non-privately offered fund investment activities, except where the privately offered fund provides loans and guarantees with a term of not more than one year for investee enterprises, pursuant to

the contractual agreement for the purpose of equity investment, and such loan or guarantee balance shall not exceed 20% of the paid-up amount of the said privately offered fund.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

At present, the market's view towards China's monetary policy in the second half of the year is generally to maintain neutral as the benchmark; although some participants expect policy easing, this has not become the mainstream view in the market. Recently, the executive meeting of the State Council decided to increase financial support for the real economy and introduce measures to further support carbon emissions reduction. The meeting called for timely use of monetary policy tools, such as reserve requirement reduction to further strengthen financial support for the real economy, especially for micro, small and medium-sized enterprises. In our opinion, lowering the reserve requirement ratio of commercial banks can release long-term liquidity, help strengthen the capital strength of banks, guide them to lend to enterprises at more favourable interest rates, especially micro, small and medium-sized enterprises, and help enterprises reduce financing costs.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Enterprise income tax ("EIT") is one of the key considerations for PE transactions in China. At present, EIT is set at 25% for all resident companies, with 20% being the capital gains tax for non-resident companies, based on the profit derived from disposing of equity in domestic companies or other assets, such as real estate or land-use rights as withholding income tax.

With regard to offshore transactions, according to a circular relating to EIT on the transfer of assets between non-resident enterprises issued by the State Administration of Taxation ("SAT") in February 2015, "where a non-resident enterprise makes indirect transfer of assets such as the equity of a Chinese resident enterprise through arrangements which do not have a reasonable commercial objective to circumvent the EIT payment obligation, the indirect transfer shall be redefined pursuant to the EIT as direct transfer of assets such as equity of Chinese resident enterprises". PE investors should pay attention to such requirements when designing investment and transaction structures as well as exit plans.

In respect of individuals, interests, dividends, bonuses received and income from the transfer of shares or other rights are subject to a 20% individual income tax ("IIT"), while income from wages and salary is subject to progressive tax rates ranging from 3% to 45%.

Stamp duty of 0.1% (based on the total consideration) is also applicable in PE transactions; such rate shall remain unchanged in the forthcoming Stamp Duty Law, which is set to take effect from July 2022.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Implementing an equity-based compensation scheme, such as growth shares and incentive shares for the management teams or, in some circumstances, employees of the portfolio companies in China is challenging, and can be deemed a costly undertaking. In respect of the use of such granting options, although not uncommon, the tax-efficient arrangements are yet to be seen, mainly because the laws and regulations, to the extent applicable, do not specifically address certain issues and/or are ambiguous and often incompatible with more mature markets such as in Europe or the US. Share options granted in China will be subject to tax upon exercise under PRC law. There is yet to be any sort of favourable tax treatment in China. To complicate the situation further, the CSRC has indicated that new regulations are forthcoming and has advised certain law firms to counsel their clients against implementing any type of stock options until the final rules are issued.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

The indirect transfer of assets, such as the transfer of equity of Chinese resident enterprises by non-resident enterprises, without a reasonable commercial purpose, shall be subject to EIT (see question 9.1).

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

At a macro level, PRC authority aims to improve tax mechanisms in accordance with the development of its domestic economy condition, with a certain flexibility on a provincial level for types of tax-preferential treatment given to specific industries or types of investments. The main aim is to continuously attract long-term capital investments in China.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

There is an overall tightening trend in regulation aspects in PE transactions, in which a series of regulatory policies have been released from December 2020 to June 2021, such as the Several Provisions on Strengthening the Regulation of Privately Offered Investment Funds, the Guidelines on the Application of Regulatory Rules – Disclosure of Information on Shareholders of Enterprises Applying for Initial Public Offering, etc., focusing on strengthening self-regulation administration and risk monitoring.

The Several Provisions on Strengthening the Regulation of Privately Offered Investment Funds stipulates 10 activities that privately offered fund administrators, privately offered fund trustees and other offered fund service providers and their employees are prohibited to conduct, such as engaging in affiliated transactions that harm the privately offered fund property or the interests of investors, directly or indirectly using the property of the privately offered fund in the investment activities with unlimited liability, or for other certain investment activities.

Guidelines on the Application of Regulatory Rules – Disclosure of Information on Shareholders of Enterprises Applying for Initial Public Offering further increase the

intermediary's responsibilities, reinforce the penetration inspection of shareholders, focus on verification of improper tunnelling, shareholding entrustment and other violation behaviours. Furthermore, where an issuer adds new shareholders within the 12-month period preceding submission of an application, the new shareholders shall undertake that the new shares held by them will not be transferred within 36 months from the date of acquisition.

Significant legislation and guidance adopted in the past two years relating to the security review on foreign investment and investment and financing for addressing climate change may have an impact on PE portfolios.

The Measures for the Security Review of Foreign Investments promulgated jointly by the National Development and Reform Commission ("NDRC") and MOFCOM started to take effect in January 2021. Foreign investments, either through new projects or acquiring equity or assets of domestic enterprises by way of M&A, that affect or may affect national security are now subject to security review by the working mechanism office of the NDRC.

In addition, increased attention must be paid to potential climate change concern, particularly as China has constantly promoted investment and financing actions in climate change in recent years. In October 2020, the Ministry of Ecology and Environment issued the Guidance on Promoting Investment and Financing in Addressing Climate Change, further emphasising the supporting role of investment and financing in addressing climate change and stating that standards for climate projects, climate information disclosure and climate performance evaluation will be developed in the future. PE investors should be aware that low-carbon transition might increase legal and compliance costs and risks for traditional high-carbon industries and special consideration should be given to this in due diligence.

Last but not least, in terms of improving exit channels, the CSRC has released the Special Provisions on Reduction in Shareholding by Venture Capital Fund Shareholders of Listed Companies in March 2020, further simplifying the criteria for applying the "reverse link" policy (which means that the lock-up period of the shares invested by venture capital funds is inversely proportional to the investment period; that is, the longer the investment time, the shorter the lock-up period). This requires that investors applying for the "reverse link" policy should meet the requirements of "early investment", "medium and small investment" or "high-tech investment". There are, however, no further restrictions on the proportion of total investment and the restriction on the reduction of venture capital funds of over five years will be cancelled.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

There is enhanced scrutiny of foreign investments that are deemed to be sensitive from a national security perspective. Pursuant to the Measures for the Security Review of Foreign Investments as stated in question 10.1, foreign investments within military industries or relating to the security of national defence, or in important agricultural products, important energy and resources, important equipment manufacturing, important infrastructure, important transport services, important cultural products and services, important information technology and internet products and services, important financial services, key technologies and other important fields relating to national security, and obtaining the actual controlling stake in the investee enterprise, are subject to pre-declaration to the office of the working mechanism prior to the implementation of the investments.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope, etc.)?

The timeline and scope of legal due diligence in connection with PE deal activity varies from case to case, in particular depending on the transaction size, the nature and operation status of the portfolio company, and other important factors. Generally, law firms will conduct legal due diligence through on-site investigation, reviewing documents provided by the portfolio company, as well as publicly available information and materials disclosed on government official platforms, and will then provide the legal due diligence report covering the following aspects: corporate; assets; material contracts; employment; intellectual property; litigation; and compliance status of the portfolio company. Beyond the general matters mentioned above, the scope of the legal due diligence generally also depends on the exact needs of the PE investors, combined with key concerns of specific industry involved.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

So far, there is no formal unified anti-bribery law or anti-corruption law or code in China. The relevant contents are mainly concentrated in the Criminal Law of the People's Republic of China, the Law of the People's Republic of China Against Unfair Competition, and administrative aspects laws and regulations. In recent years, the anti-corruption efforts have been intensified, which have a heavy effect on the PE investments activities. The inspections and investigations are geared towards corruption among government officials and leaders of SOEs in equity investments, to prohibit the aforementioned personnel from improper channelling or buying shares at low prices (insider's information), etc.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Not to our knowledge. PE investors will most commonly be LPs, which are only liable for the debts of the partnership enterprise up to their subscribed capital contribution. However, where a third party has reason to believe that an LP is a GP and enters into a transaction with the partner, such LP will be liable in the same manner as a GP in the transaction, which shall be jointly and severally liable without limit for the debts of the partnership enterprise, in accordance with the Partnership Enterprise Law of the PRC.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

China has been constantly enhancing the environment for foreign investment and deepening reform and opening up. It has

been over six years since the implementation of the Securities Investment Fund Law of the PRC in 2015, during which a series of supporting rules and measures have been carried out so as to further lay the institutional and regulatory foundations in PE transactions. There are tremendous long-term opportunities in PE deals within China in view of the continuing development of the Chinese PE market and the strong support and priority on growth by the Chinese government.

Open, transparent, flexible and legally protected financial and commercial markets would definitely help to drive PE transactions and expedite decision-making processes. We firmly believe that China will maintain an open door for PE transactions, especially for cross-border investment.

PE investors, particularly foreign investors, should be aware that there are still several fields, involving human stem cells and gene diagnosis and treatment technologies, pre-school education, ordinary high school and higher education institutions, internet news services, internet publishing services, etc., that are explicitly prohibited or have special requirements on foreign investment access, such as equity requirements and senior management personnel requirements. Attention must be given to these "investment negative list" concerns, particularly given the implementation of a national security review.

Will Fung, with his outstanding professional experience in the legal practice in China, has joined the first batch of foreign legal counsels duly registered with the Beijing Municipal Bureau of Justice. He is also a frequent guest and speaker for ASEAN "Belt & Road Initiative"-related investment forums. Specialising in cross-border M&A, PE/VC, and foreign direct investment in China, Mr. Fung is noted by sources for his good commercial awareness and being a skilled negotiator with a track record in delivering flexible and creative solutions for his clients.

Grandall Law Firm
9/F, Taikang Financial Tower
No. 38 North Road East Third Ring
Chaoyang District, Beijing 100026
China

Tel: +86 10 6589 0633
Email: willfung@grandall.com.cn
URL: www.grandall.com.cn

Liu Naijin concentrates on fund formation and PE and is a popular choice as legal counsel mandated by private and state-owned funds. He is noted as a solid practitioner with "good communication and coordination skills" by one client, who appreciates that "he is familiar with the business and regulations" in the PE sector. Mr. Liu focuses on providing comprehensive legal services for each component of the whole PE fund establishment, investment, management and exit processes. He has provided professional legal services for many government guiding funds, large state-owned funds and market-based funds. In addition, he has been appointed as the expert consultant by a number of the government guiding funds, as well as industry associations. Because of his continuous endeavours in the PE field, Mr. Liu has been voted as the National Outstanding Lawyer of the Year from 2011 to 2014 by the All-China Lawyers Association.

Grandall Law Firm
28/F, China Life Financial Center, No.38 Qufu Road
Heping District, Tianjin 300042
China

Tel: +86 22 8558 6677
Email: liunaijin@grandall.com.cn
URL: www.grandall.com.cn

Lu Hao graduated from the University of California, Davis with an LL.M. degree in 2017, and joined the International Practice Group of Grandall Law Firm as a legal assistant in the same year. Ms. Lu's portfolio focuses on foreign direct investments, cross-border M&A and PE transactions. She assists in advising Chinese companies with their outbound investment projects relating to compliance, corporate law and regulatory issues. In addition, Ms. Lu assists the ASEAN investment department of Grandall on regularly acting for international impact investors for their financing transactions (including revolving loans, equity financing, green financing), with various microfinance institutions in China.

Grandall Law Firm
9/F, Taikang Financial Tower
No. 38 North Road East Third Ring
Chaoyang District, Beijing 100026
China

Tel: +86 10 6589 0634
Email: luhao@grandall.com.cn
URL: www.grandall.com.cn

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