

LEGAL UPDATE

Long & Field

The Role of Trust in Private Equity Investment

Abstract: Private equity funds have gradually become one of the most important investment vehicles in the capital market. A private equity fund may take the form of company, partnership or unit trust as its legal structure. The implementation of the new trust rules in 2007 will facilitate the establishment of private equity funds in the form of trust. However, due to the inadequacy of exit mechanism and the absence of preferential tax policies, there is still a long way to go before private equity funds in the form of trust become popular.

Private equity funds have become one of the most important investment vehicles in the capital market. Out of tax and regulatory considerations, a large number of international funds that operate in China are registered at offshore Cayman Islands or British Virgin Islands (BVI). Up to the present time, there are over 6000 funds registered in Cayman Islands, more than 3400 regulated funds in BVI since its opening of offshore fund market in 1998, and approximately 1600 collective investment schemes in Bermuda. It should be noted that the above-mentioned numbers do not include the large quantities of unregulated funds, which are exempted from regulations under local laws.

With respect to the legal structure of offshore funds, mutual funds established in BVI, according to the BVI Mutual Funds Acts, may take the form of company, partnership and unit trust. Back in China, as for company, the Company Law, which has undergone tremendous modifications, is becoming increasingly integrated; in addition, preferential tax policies encouraging venture capital firms have been promulgated. In terms of partnership, the recent revised Partnership Law has officially recognized limited partnership, which is widely employed by international private equity funds. When it comes to unit trust, the implementation of the new rules of the China Banking Regulatory Commission (CBRC) will facilitate the establishment of private equity funds in the form of trust; tax issues, however, will present as obstacles for the development of industrial investment trust scheme.

On March 3, 2007, the Administrative Measures regarding Trust Companies and the Administrative Measures regarding the Collective Capital Trust Scheme of Trust Companies, both issued by the CBRC, came into force, replacing the Administrative Measures regarding Trust Investment Companies and the Provisional Administrative Measures regarding the Capital Trust of Trust Investment Companies and other relevant regulations. With respect to the methods of fund raising, the new

regulations feature the following adjustments:

Firstly, the “200 upper limit” on the number of trust contracts in each capital trust scheme is eliminated. Pursuant to the stipulations in the Provisional Administrative Measures regarding the Capital Trust of Trust Investment Companies, trust investment companies, when managing, utilizing and disposing trust funds, may not accept more than 200 contracts from the clients, with the minimum amount of each contract being RMB50, 000. While in practice, the “200 upper limit” has significantly restricted the scale of capital to be raised in a single trust scheme; in order to circumvent this restriction, some trust companies resort to umbrella trust. The elimination of the “200 upper limit” may enable trust companies to raise more funds and invest in larger projects, thus realize the economies of scale. On the other hands, in order to control the risks due to the elimination, regulatory authorities try to strengthen regulations in certain aspects. For example, the new rules have specified requirements for the qualifications of investors and the upper limit on the number of natural persons engaged in the plan, making sure that the trust exclusively belongs to “The Game for the Riches”. In addition, trust companies are prohibited from investing different trust schemes under its management in the same project.

Secondly, the system of promotion beyond the place of registration is clarified. Under the original provisions, trust companies, prior to the launch of promotion in areas other than the place of registration, shall report to the CBRC at the provincial level at both the place of registration and the place of promotion; each collective trust scheme may only be promoted, simultaneously, at cities within the jurisdiction of the provincial CBRC at the place of registration, and at no more than two cities within the jurisdiction of another provincial CBRC; what’s

more, a trust company may only promote at most two collective trust schemes at places beyond the place of registration. The new rules stipulate that trust companies, when conducting promotion beyond the place of registration, shall report to the CBRC at the provincial level at both the place of registration and the place of promotion prior to the promotion. The clarification of the system of promotion beyond the place of registration will play a positive role in the promotion of trust products and the expansion of trust scale. As a matter of fact, along with the popularity of internet, the geographical boundaries of trust promotion have already been broken down.

Thirdly, the report-in-advance procedures regarding the establishment of collective capital trusts are cancelled. Under the Circular regarding the Further Regulation on the Collective Capital Trust Business, trust companies shall report to competent authorities prior to the promotion of collective capital trust scheme; the promotion may only be conducted after the consent of such authorities. The current rules, however, require no report-in-advance, which will simply the procedures for the establishment of collective trust scheme. Notwithstanding the exemption of report-in-advance liabilities, the regulatory authorities still have post-event regulatory power.

According to data provided by Use Trust Studio, trust in China still concentrates on the securities market, real estate and infrastructure, and most collective capital trust products are short term debt investment, few featuring the attributes of industrial investment funds. Compared with the typical trust products in China, the international private equity funds are mostly equity investment, with no definite targets, long period of investment return and high risks; on the other

hand, as high risks are always associated with high returns, a lot of international private equity funds manage to generate a 15%-20% annual rate of return. Currently, in China, certain collective capital trust schemes which closely resemble the international private equity funds are, among others, equity investment trust scheme in large and medium-sized enterprises launched by Anhui Guoyuan Trust and equity investment collective capital trust scheme launched by Hunan Trust. The major difference of the above-mentioned trust from the traditional collective capital trust scheme is that, despite its small scale and short term, such trust has no definite targets at the time of promotion and seeks investment return through equity investment.

Up to now, the time is not yet ripe for trust to become a form of industrial investment funds owing to the following factors: Firstly, the restrictions of investment concept. Most trust schemes engage in short term investment, so it takes time before trust schemes focusing on long term industrial investment become acceptable to investors. Secondly, the absence of preferential tax policies regarding trust, which leads to the failure to bring into full play the initiative of investors. Thirdly, the underdeveloped capital market, for example, the absence of growth enterprise market and the restrictions on loans for equity investment, result in the lack of exit alternatives. Therefore, the development of private equity investment trust scheme will take quite a long time; anyway, the revision of the new trust rules will facilitate the establishment of industrial investment trust scheme.

Legal Updates is published solely for the interests of friends and clients of Long & Field and should in no way be relied upon or construed as legal advice. For specific information on recent developments or particular factual situations, the opinions of legal counsel should be sought.

Copyright © 2006 Long & Field