



GETTING STARTED IN VENTURE PHILANTHROPY IN ASIA

LEGAL FRAMEWORK PROFILE
for CHINA

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Compiled with the pro bono support of

**C L I F F O R D
C H A N C E**

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LEGAL FRAMEWORK AND
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LEGAL FRAMEWORK PROFILE
for CHINA

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About Business Families Institute @ Singapore Management University (BFI @ SMU):



SMU established BFI @ SMU to be Southeast Asia's first business family centric institute focused on addressing the needs of business families in the region through its vision to facilitate business families to think generations, think growth and think giving. BFI @ SMU intends to serve as an educational, engagement and research platform to bring together business families, drawing on the university's experience to offer insights on issues such as business succession and family ownership. Its mission is to engage and enable business family members to be active, committed and involved stewards, stakeholders and partners through learning and education.

More information at <http://bfi.smu.edu.sg/>

Where amounts in the reports have been converted from local currency to US dollars the following exchange rate have been used for reference: US\$1= CNY6.20 (source oanda.com average rate for CY 2013, midpoint interbank rate). The amounts will change based on actual exchange rates and changes to the underlying costs, fees and charges from the date of this report.

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INTRODUCTION TO THE LEGAL FRAMEWORK AND COUNTRY PROFILES

The country legal framework profiles are companion booklets to AVPN's "Getting Started in Venture Philanthropy in Asia - a practical guide to establishing and operating a venture philanthropy or social investment organisation". The guide explains the key operational issues and the separate country legal frameworks focus on legal issues to supplement the main guide. The guide and each country profile are available to download from www.avpn.asia/startVPO.

1. Overview of the Legal Framework

There are corporate law, charities law, tax law and possibly financial regulatory fund raising and fund management issues, arising at different levels of the venture philanthropy (VP) eco-system. Some venture philanthropy organisations (VPOs) want to attract foreign as well as domestic funds and so factors affecting the cross-border flow of funds in the VP eco-system are critical considerations to these VPOs. As VP investments cover the spectrum from charities to social enterprises, the analysis of funds flows from top level funders to VPOs as intermediaries, and to social purpose organisations (SPOs), needs to consider both donations and a range of other financial instruments. The flow in the return direction of social impact (monitoring and reporting) and financial return (in the case of social investment) is equally important.

Some Asian countries (e.g. Singapore and Hong Kong) are already major financial centres and want to attract regional or offshore philanthropic and social investment funds. They have well developed cross-border fund management laws and regulations and skilled investment practitioners that apply to these activities.

This introduction describes the framework used for each of the five country profiles that have been prepared with the pro bono support of leading law firms. These profiles are available for download in softcopy - see the end of the introduction.

2. The Three Level Perspective of the VP Eco-system

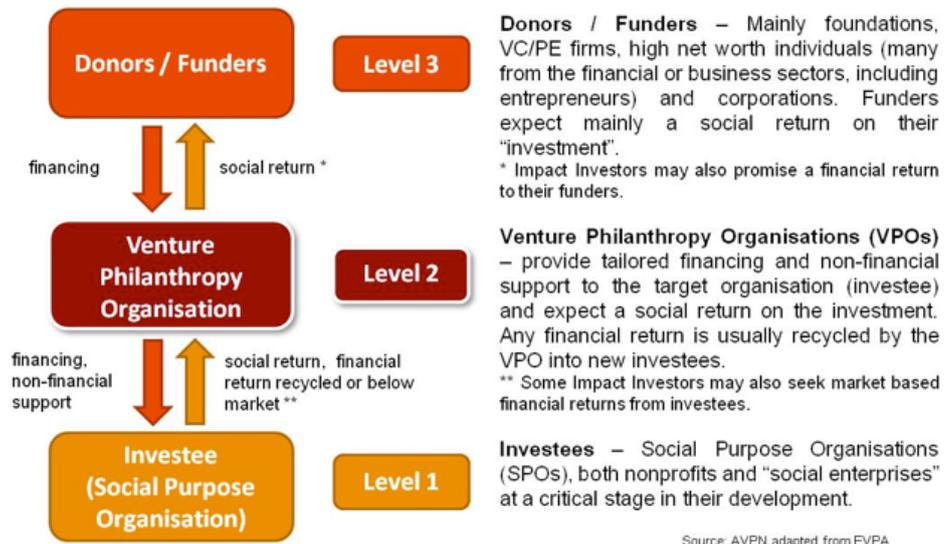
For this legal framework section and the stand alone country profiles our approach is to consider the venture philanthropy eco-system as operating on three same three levels in the main section of the AVPN report "Getting Started in Venture Philanthropy in Asia". The top level (Level 3) comprises the funders seeking social returns, the middle level (Level 2) comprises the VPO intermediaries that raise funds and deploy the funds through various VP strategies and the bottom level (Level 1) comprises SPOs seeking resources (financial, human and intellectual capital) to grow their activities.

These three levels represent a flow from end suppliers (level 3), through specialist intermediary suppliers (level 2) to the demand side (level 1) which serves a range of beneficiaries / customers / service users.

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This is shown in Diagram 1 as follows:

VPO funding model – three levels



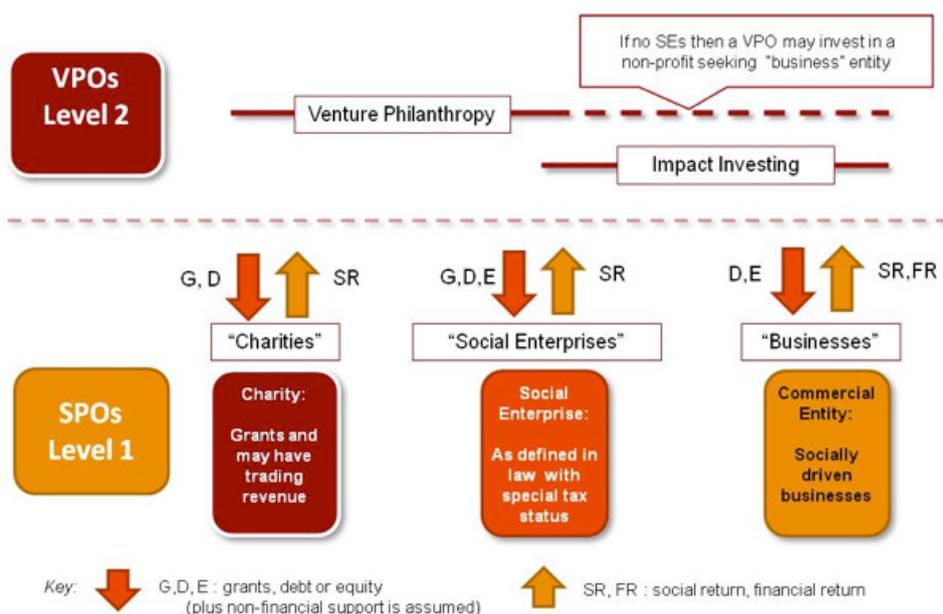
As the primary social impact is generated at the base of the eco-system and flows up, we start the analysis of legal entities at Level 1 which is the investee Social Purpose Organisations (SPOs) that are commonly available in each country. The choices of entity for VPOs at Level 2 of the eco-system are often similar to the entities used by SPOs at Level 1. The sources of funding flowing down from Level 3 may be donations/grants or, depending on the VPO strategy, other financial instruments such as debt and equity. Some VPOs at Level 2 may have a hybrid investment strategy in SPOs (i.e. grants, debt and equity) and so receive hybrid funding. VPOs decide whether they want to re-cycle financial return from their investee SPOs to fund their own costs and make new investments, and/or make distributions to their funders. A related choice is whether the VPO is a limited life organisation, raises new rounds of funding from time-to-time, or is intended as an evergreen vehicle that is self sustaining.

3.Choice of Entities for Social Purpose Organisations at Level 1

There are a wide range of legal entities that may be available for SPOs at Level 1 but these can be broadly grouped as Charities, Social Enterprises and Commercial Entities (or Businesses). In the five countries considered by this framework there are no separately defined legal entities that are “Social Enterprises” -that is entities that they have special tax status and are effectively a hybrid between a business entity and a charity.

A list and description of the main types of SPO in a country is a basic building block of the legal framework profiles in the country profile reports.

For each country profile, the simplified investee SPO choices and available financing instruments are shown in Diagram 2 below:



In some countries social businesses (and social entrepreneurs) may be attracting investment for only social return, or for a mix of social and financial returns. These entities are often commercial entities which have a social mission and may adapt their governing documents to prohibit distributions and/or restrict transfers of ownership so that they become social "impact first" or "impact only" organisations.

4. Choice of Entities for Venture Philanthropy Organisations at Level 2

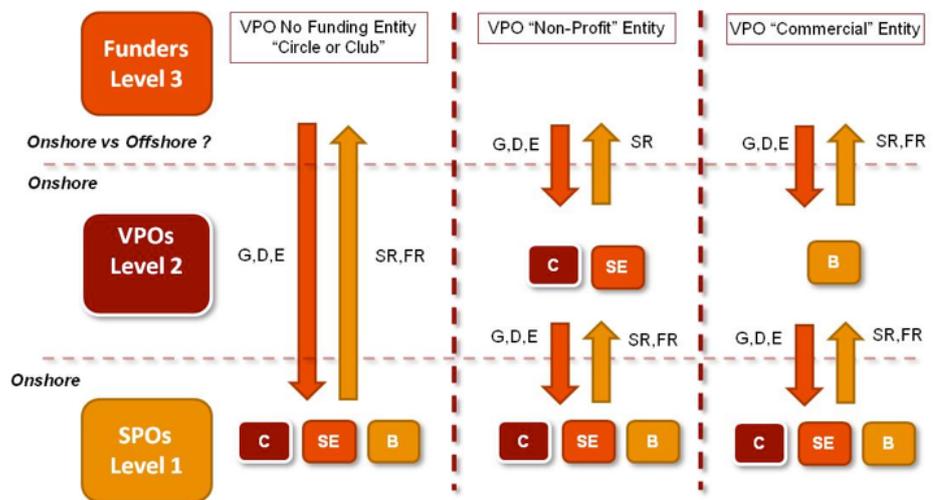
A VPO consists of a management team and a source of funding. These are often contained in a single legal entity but may be separated into a "fund" entity and an advisory (or consulting) entity.

Building on the SPO entity types and financial instruments that can be used to fund them, the legal framework country profiles consider three generic VPO operating models that are adapted and commonly used in Asia. The sponsors of a new VPO will likely choose a variation of one of these three models depending on the resources available to the VPO, its investment strategy and country of operation. The most important decision factor is whether the VPO wants to follow a grant approach, a social investment approach or a hybrid, i.e. whether the VPO will seek investee SPOs that provide both social and financial returns, and whether the VPO offer its funders both social and financial returns.

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The generic flows of funding and target social and/or financial returns are shown for the three models in Diagram 3 below:

Three basic VPO legal models for analysis



The three operating models (above from left to right) are:

- (1) A “virtual fund” where the fund itself is not a legal entity and the VPO operates as a consulting company. This model may be called a “social impact circle” or “social investor club” or simply a “venture philanthropy advisor). Examples include Dasra (India) and Asia Philanthropic Ventures (Singapore).
- (2) A VPO entity which only offers social return to its funders. This model may be called a “venture philanthropy fund” or a “venture philanthropy foundation” and is often a charity and/or foundation.
- (3) A VPO entity which offers both social and financial return to its funders and operates as an “investment fund” in the form of limited partnership or investment holding company, or other commercial entity, that can tax efficiently receive financial returns from SPOs and provide financial returns to its funders.

One of the main differences between more traditional venture philanthropy “investing” using grants and social investment is the promise and ability of the VPO to transmit a financial return from Level 1 to Level 3 through its activities at Level 2.

5.Executive Summary of the Five Countries Profiled

Given the depth and breadth of information provided by the various law firms for the five jurisdictions, it is useful to provide a high-level observation of some of the key highlights of each country’s legal landscape insofar as it relates to establishing a venture philanthropy organisation (VPO) in Asia.

Singapore

While there is no legal entity that is a hybrid between a charity and a traditional commercial entity in Singapore, the majority of charities and non-profit organisations in Singapore are established in the form of a company limited by guarantee (CLG) i.e. the liability of its members is limited by its constitutional documents to such amount as the members undertake to guarantee. While a CLG can accept donations and grants, it is unable to receive funding in the form of equity as it does not have share capital. Conversely, a CLG may accept debt funding insofar as it does not contravene the provisions of its constitutional documents although the receipt of debt funding may have implications under the Securities and Futures Act (SFA).

A CLG may be, in turn, registered and regulated as an approved charity in Singapore in order to enjoy full income tax exemption on income and receipts. In relation to the use of charities as a vehicle for venture philanthropy, the guidelines issued by the Office of the Commissioner for Charities (OCC) is relevant as it discourages charities from engaging in activities which exposes the charity's assets to significant risk. As such, although the investment of charity funds is not strictly prohibited, the OCC advises such charities to set up a separate business subsidiary for business activities where such business activities are not related to the primary purpose of the charity.

In relation to Level 2 VPOs in the form of CLGs or otherwise, the restriction is that they cannot distribute profits to its stakeholders (be they founders or members) if the VPO is a registered charity or entities that have special charitable status. Although a VPO may be able to pay interest on loans taken from its members, this is subject to any restrictions provided in its constitutional documents. Further, as a non-profit VPO is supposed to carry out wholly charitable purposes, it is unlikely to be able to make either an offer of securities or carry on business as a regulated activity, both of which will trigger the relevant financial regulatory restrictions or the Moneylenders Act. For these reasons, it is also unlikely to be able to give loans to Level 1 SPOs and expect returns thereon.

Hong Kong

The legal position in Hong Kong is very similar to that of Singapore in that most charitable organisations are CGLs. As a general observation, most charities in Hong Kong are funded by donations and grants. Debt funding is uncommon (and will depend on any restrictions contained in the constitutional documents) and equity funding is generally inapplicable given that most charities are CGLs, societies or set up as a trust. Similar tax exemptions apply to both Singapore and Hong Kong for Approved Charities that continue to have a charitable purpose. In the context of the proposed VPO models which imply a flow of funds to and/or from a profit-driven commercial entity, this may breach the on-going charitable purpose compliance requirement.

In relation to the "No Funding" Entity Model, this is often the simplest model as there is no intermediate VPO entity and the funding will flow directly from the funder to the SPO. However, funders providing funding to the Level 1 SPO through debt may trigger the requirements of the Money Lenders Ordinance (MLO). Another complication is that the constitutional documents of the Level 1 SPO (assuming that it is an Approved Charity for tax reasons) may and probably should prohibit the distribution of income. Therefore, financial returns to a funder may not be permissible. In relation to the Level 2 VPO "Non-Profit" Model, there are additional twin complications of (a) whether a Level 2 VPO that is an Approved Charity would be permitted to provide funding to a Level 1 SPO, and (b) whether a Level 2 VPO that is an Approved Charity can provide a financial return to the Level 3 Funders. In order to overcome these impediments, the Level 2 VPO "Commercial" Entity Model may be the most viable structure if the flow of financial returns is imperative although such an entity would not have the tax benefits accorded to the an Approved Charity.

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China

In China, entities that are able to carry on charitable activities usually take on one of these three structures: social organisations, foundations and private non-enterprise entities. Briefly, a social organisation is membership-driven, whereas foundations are not-for-profit organisations funded by assets donated for public welfare purposes and, lastly, private non-enterprise entities are social institutions established with private capital for the purpose of providing social services. Not-for-profit organisations in these three forms are prohibited from distributing financial returns to their members and sponsors. Further, for these three types of organisations, the key issues center on the legality of the source of funding as well as the use of funds.

As with Singapore and Hong Kong, these not-for-profit organisations in China are usually funded by donations and grants. Further, as these charitable structures do not have share capital, equity funding is not an option. As for debt funding, even where there is no explicit prohibition in the constitutional documents, they do not typically borrow as a matter of practice to fund their charitable activities. To understand this situation further, if these organisations attempted to be a Level 2 VPO “Non-Profit” Entity, the major impediment would be that in China, only banks and qualified financial institutions are able to extend loans. As such, if the Level 2 VPO wanted to extend a loan to a Level 3 SPO, it could only do so through the entrusted loan model where the Level 2 VPO provides funds to a financial institution that is qualified to conduct lending, and that financial institution would extend the loan to the Level 3 SPO as the lender.

Japan

Charities in Japan are broadly categorized as (a) non-profits, (b) associations (2 types) and (c) foundations (2 types), all of whom enjoy varying tax benefits on their charitable or authorised activities subject to compliance with applicable requirements. However, these entities are not permitted to distribute profits to their members and/or they are not permitted to return funds to their members or contributors. That said, the legal profile suggests that these entities are permitted to accept debt funding except that for non-profits, they cannot facilitate the profit of a particular person (in this case, it would presumably be the lender). Interestingly, only associations and foundations may accept equity funding although for foundations, equity funding can only be done at incorporation and not subsequently.

The analysis for Level 2 VPO “Non-Profit” Entities is relatively simple as it is generally accepted that charitable organisations in Japan are prohibited from distributing profits and the legal profile implies, by extension, that such charitable entities are not permitted to provide funds to Level 1 SPOs. Further, as with the other jurisdictions, the potential triggering of the Money Lending Business Act is such that it would not be practicable for charitable organisations to apply for the licenses in order to extend loans to the relevant Level SPOs. Further, the legal profile suggests that any return of funds (whether debt or otherwise) by the Level 2 VPO “Non-Profit” Entity would be fraught with obstacles which is understandable as the establishment of VPOs is still a relatively new development in Japan.

India

Various forms of social entrepreneurship models are used in India depending on their areas of operation and business requirements. Thus, social enterprises may opt for the revenue model, hybrid model or the venture capital model depending on the relevant financial viability and desired social outcomes. Interestingly, in India, a Level 1 SPO may be set up pursuant to Section 8 of the Companies Act (2013) as a not-for-profit company or pursuant to the Alternative Investment Fund Regulation (AIF Regulation) where an alternative investment fund (or a social venture fund) can be established or incorporated in India in the form of a trust, a company or a limited liability partnership.

However, these structures have inherent restrictions. For example, the aforementioned not-for-profit company is prohibited from distributing dividends to its shareholders. In comparison, the legal profile suggests that the aforementioned social venture fund may enjoy a “pass through” benefit under the relevant sections of the Income Tax Act such that income accruing to the social venture fund would be deductible in the hands of the investor. In comparing the various structures available to establish a VPO in the various countries, it appears that India’s albeit nascent development in this area is probably gaining the most traction at this point in time.

6. The Country Legal Framework Profiles (available for download)

Five country profiles covering the legal frameworks for China, Hong Kong, India, Japan and Singapore are available for download in PDF format. These were prepared on a pro bono basis by leading law firms based on a questionnaire designed by AVPN that addresses the key legal issues when establishing a VPO. The questionnaire uses the ecosystem framework and terminology described above that is consistent with the main section of the AVPN report “Getting Started in Venture Philanthropy in Asia”.

Each country profile is an overview and does not seek to address all the relevant legal, tax and regulatory issues in detail. New sponsors of a VPO should seek specific legal, tax and regulatory advice on the basis of their own circumstances before setting up their operating entity.

The reports are available for download from www.avpn.asia/startVPO .

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LEGAL FRAMEWORK PROFILE for CHINA

AVPN Report - "Getting Started in Venture Philanthropy in Asia"

Legal Framework Section

China Country Profile

This briefing paper for the People's Republic of China ("**China**" or "**PRC**") has been prepared for AVPN by TieCheng Yang and YuXing Huang of Clifford Chance LLP, Beijing Office. For more information please contact TieCheng.Yang@cliffordchance.com or YuXing.Huang@cliffordchance.com, telephone 86-10-6535 2288. Descriptions and references to tax are for reference only. Each recipient of this paper should seek their own independent tax and legal advice from their appointed advisors.

In China, three types of entities could conduct charity business as their primary business: social organisations, foundation and private non-enterprise entities. On the contrary, companies and some partnerships are established for commercial purposes, although they may make charity donations. "Public institutions", as a hybrid concept, exists in China as quasi-government agencies funded by State-owned assets to assume public welfare, administrative as well as commercial functions.

Practically speaking, all foundations and most social organisations and private non-enterprise entities are non-governmental organisations or not-for-profit organisations. Public institutions engaging in public welfare activities may enjoy a similar treatment as non-for-profit organisations in certain aspects such as tax incentives. Companies and partnerships pursuing a business are regulated separately and differently.

As both Chinese and foreign funders may be involved in setting up the Venture Philanthropy Organisations ("**VPOs**"), we would like to bring to your attention China's foreign investment restriction and foreign exchange control regime, which we will discuss in detail below.

We set out below our advice on the considerations when seeking to establish a VPO and social purpose organisations ("**SPOs**") and responses to your questions. Please note that the advice is prepared on a high-level basis aiming at flagging out major issues. Should you need more detailed advice in certain aspects, please let us know.

1 Country Scoping Questions

1.1 *Do "Social Enterprises" exist as a legal entity in your country, as opposed to charities (or their equivalent, e.g. NGOs) and traditional commercial entities (e.g. companies and]*

Since the unified charity law is still under discussion, currently there is no explicit distinction of "charity entities", "social enterprises" and "commercial entities" under PRC law.

Generally speaking, there are three types of entities that could conduct charity related activities as their primary business, namely, social organisations, foundations and private non-enterprise entities. On the contrary, companies and some partnerships are established for commercial purposes, although they may make charity donations.

While "social enterprise" is not a recognised concept under the PRC law, Chinese law does create a hybrid concept between the charity entities and commercial entities, namely the "public institution". Public institutions, as a whole, are quasi-government agencies staffed with government employees, although their functions could be quite flexible - some undertaking administrative functions, some engaging in operations and business activities and others providing public welfare related services. On one hand, as opposed to charity entities or not-for-profit organisations, public institutions are not generally prohibited from engaging in profit making activities. On the other hand, as compared to companies who own their assets independently, public institutions are dependent on the State who may grant subsidies and have control over the governance or operation of the public institutions. Kindly note that Chinese government is now contemplating a reform of public institutions. No new business and administration oriented public institutions will be approved to be established and existing public institutions with similar functions will be merged. Public institutions engaging in public welfare activities, such as schools, hospitals, public health institutions and science and technology research institutions will prevail.

1.2 Is the relevant legislation and regulation of SPOs at the national government (i.e. federal) level or are there substantial State or other lower-tier laws and regulations (including tax) that apply?

In China, central authorities have the legislative power to promulgate laws and regulations that apply nationwide, while regional authorities may be authorised to make regulations and rules that could be enforced within the region (i.e. province, city, district, etc). Typically local rules are tailored rules specific to the locality for effective implementation of the central regulations or supplements wherever the central rules are inadequate. In most cases, local rules must not contradict the principle of the relevant central legislation.

Currently, the law governing all types of charity organisations is under preparation and consideration. Laws and regulations of each type of the potential SPO are separately made at the national level, covering aspects such as eligibility requirements of the investors, process of incorporation, permitted activities, ongoing compliance requirements and tax incentives of each type of SPO. Local rules also exist in these areas in order to guide the practice of local authorities. In this regard, we will base our advice below mainly on the national laws and regulations.

2 Level One Questions

2.1 List in the following table the relevant entities/structures of SPOs that exist in your country:

 Relevant Charity Entities	 Relevant SE Entities [If applicable]	 Relevant Commercial Entities
1. Social organisation	1. Public institution	1. Company
2. Foundation		2. Partnership
3. Private non-enterprise entity		

2.2 For each of the entities in 2.1 (or the most relevant if the list is extensive) please provide:

1. Brief description (definition) of the general legal nature of the entity/structure

(1) Social Organisation

Social organisation is essentially a membership association. It is defined as an organisation founded by Chinese residents and entities for the purpose of realising the common will of their members. All social organisations are legal person entities who are capable of assuming civil liabilities independently. While social organisation is a typical choice for a charity entity, it could also serve other not-for-profit functions as agreed by its members.

(2) Foundation

Foundation is a not-for-profit organisation founded with the assets donated by individuals or other legal person entities for public welfare purposes. Like social organisations, foundations are independent legal entities. Foundations can be divided into public fundraising foundations (who can raise funds from the public) and non-public fundraising foundations.

(3) Private Non-enterprise Entity

Private non-enterprise entity is a social institution established by individuals, enterprises, institutions, social organisations or other social forces with private capital (as opposed to State-owned assets) for purpose of providing social services. A private non-enterprise entity could be in the form of either an independent legal person entity, a partnership or an individual unit.

(4) Public Institution

Public institutions are social service organisations established by the State or by other organisations by using State-owned assets to conduct activities including without limitation education, technology, culture, healthcare, sports and media.

(5) Company

Companies have a legal person status and are independent from their investors. Companies in China have property right over the assets contributed by their investors and generated by the companies and assume civil liabilities with its own assets.

(6) Partnership

Partnerships are unincorporated business organisations where individual or institutional partners make contributions and operate and work together. The assets and liabilities of a partnership cannot be segregated from its partners who shall assume unlimited liabilities of the partnership. As an exception, a limited partnership could be established where one or more general partners assume unlimited liability and have management control over the partnership and limited partners are only liable to the debts incurred by the partnership to the extent of their investment. Limited partnership is commonly used as the vehicle for private equity funds and fund managers. While most partnerships pursue a business and financial return, some private non-enterprise entities established in the form of partnership could engage in charity business.

2. *The main considerations when seeking to establishing such an entity (e.g. time taken, regulatory approvals or filings needed, complexity of documentation, etc)*

Please see below a comparison chart setting out the major regulatory issues (including minimum capital requirements, approval and registration process and timeline, major documentation required for the establishment) that one may consider in establishing a certain type of SPO.

	Minimum Capital	Approval and Registration Process and Timeline	Major documentation
Social organisation	RMB100,000 (US\$16,000) for national social organisation and RMB30,000 (US\$4,800) for regional social organisation.	Application shall be made to the relevant industry regulator for approval (i.e. the Ministry of Health, Ministry of Education, the Ministry of Culture or their local counterparts) – approval timeline depending on different regulators. Application shall be made to the	Articles of association

		Ministry of Civil Affairs or its local counterpart for registration – up to 60 days.	
Foundation	RMB8 million (US\$1.3m) for national public fundraising foundation; RMB4 million (US\$645,000) for regional public fundraising foundation and RMB2 million (US\$322,000) for non-public fundraising foundation.	Application shall be made to the relevant industry regulator – approval timeline depending on different regulators. Application shall be made to the Ministry of Civil Affairs or its local counterpart for registration – up to 60 days.	Articles of association
Private non-enterprise entity	Different thresholds apply depending on the sector where a private non-enterprise entity is established (i.e. RMB300,000 (US\$48,000) for a cultural private non-enterprise entity while RMB50,000 (US\$8,000) for a legal person science and technology private non-enterprise entity).	Application shall be made to the relevant industry regulator – approval timeline depending on different regulators (i.e. it may take up to 60 days for the Ministry of Culture to grant the approval while only a maximum of 20 days for the Ministry of Science and Technology). Application shall be made to the Ministry of Civil Affairs or its local counterpart for registration – up to 60 days.	Articles of association
Public institution	N/A	Application shall be made to the State or its authorised regulators - approval timeline depending on different regulators. Application shall be made to the State Administrative Bureau of the Registration of Public Institutions for registration - up to 30 days.	Articles of association
Company	N/A Higher thresholds may be applicable depending on the business of the company.	Prior approval may be needed in special cases - approval timeline depending on different regulators. Application shall be made to the State Administration for Industry	Shareholders' agreement Articles of association

		and Commerce ("SAIC") or its local counterpart for registration – up to 15 days upon acceptance.	
Partnership	N/A	<p>Prior approval may be needed in special cases - approval timeline depending on different regulators.</p> <p>Application shall be made to SAIC for registration – up to 20 days upon acceptance.</p>	Partnership agreement

3. *Main ongoing compliance requirements once established*

(1) Social Organisation, Foundation and Private Non-Enterprise Entity

For these three types of organisations, the major ongoing compliance requirements lie in the legality of source of funding and the use of funds. It is explicitly provided that these organisations shall utilise the funds in a manner that complies with the articles of association, applicable regulations and the agreement with the funders who donate money to such organisations (if any). No misappropriation of funds is allowed.

Among these organisations, stricter scrutiny is imposed on foundations. For public fundraising foundation, the amount of money used for charity business shall not be lower than 70% of the funds received last year. For non-public fundraising foundation, such threshold is 8% of the remaining funds of the foundation last year. Money spent on employee salaries and benefits and administrative payments shall not exceed 10% of the total expenditure of the current year.

If there is any change to the name, domicile, purpose, scope of business, legal representative and amount of initial funding, application shall be made to the relevant industrial regulator for approval, and filing shall be made with the Ministry of Civil Affairs or its local counterpart for change of registration.

All these three types of organisations shall submit annual working report to the relevant authorities reporting the activities, the financial status, staff movement and financial management status in the last fiscal year. Annual inspection will be made by the Ministry of Civil Affairs or its local counterpart against these organisations.

(2) Public Institution

During the existence of a public institution, the legality of its activities and use of funds will be monitored. Funds invested in the public institutions cannot be withdrawn illegally. In addition, the revenue a public institution generates shall be used in the activities that meet its purpose and business scope and donations granted to a public institution shall be utilised according to the agreement with the donors.

Where a public institution changes its name, domicile, purpose, business scope, legal representative, or the source or amount of its initial funding is changed, the public institution shall file with the State Administrative Bureau of the Registration of Public Institutions. Certain changes such as change of name requires approval from the State or its authorised regulator.

Annual filing shall be made with the State Administrative Bureau of the Registration of Public Institutions to demonstrate the business, profit and loss and efforts to comply with the regulations applicable to the public institutions.

(3) Company

Main ongoing compliance requirements applicable to companies would involve the following aspects:

- (i) companies shall operate within its permitted business scope. Operating beyond the business scope will result in penalties from the State Administration for Industry and Commerce;
- (ii) the capital contribution of the company cannot be withdrawn unless otherwise permitted by law;
- (iii) companies could not harm the creditors' rights and have to inform them of certain events such as decrease in registered capital or bankruptcy; and
- (iv) companies are obliged to pay for the social welfare of its employees and taxes.

Where any of the name, place of business, legal representative, registered capital, business scope, type of company (i.e. limited liability company or joint stock company) and term of the company is changed, the company shall file with SAIC or its local counterpart of such change. Where the establishment of the company has been approved by an industrial regulator, approval from such industrial regulatory is also required for any of the change to the items above.

Annual filing shall be made with SAIC by submitting an annual report to demonstrate the company information such as capital contribution of the shareholders and company assets, which may be available to the public for company search.

(4) Partnership

The partners shall not misappropriate the funds of the partnership or abuse their management power.

Where any of the name, place of business, managing partner, business scope, type of partnership (i.e. general partnership or limited partnership), information of the partner (i.e. his/her/its name, domicile, contribution amount, form of liability, etc) and term of the partnership is changed, the partnership shall file with SAIC or its local counterpart of such change. Where the establishment of the partnership has been approved by an industrial regulator, approval from such industrial regulatory is also required for any of the change to the items above.

Partnerships shall submit report to and be inspected by SAIC or its local counterpart on an annually basis.

4. *Benefits / considerations for choosing such an SPO (including tax)*

(1) Social Organisation, Foundation and Private Non-enterprise Entity

(i) Permitted activities

These not-for-profit organisations are good options if a VPO expects social return since they are eligible entities to conduct charity activities as their primary business. Among the three types, foundations may only conduct public welfare related activities while social organisations and private non-enterprise entities may serve other purposes. All of them may not engage in for-profit business, but they may make investment in commercial entities if such investment complies with their purpose of establishment unless the State Council provides otherwise.

The management council of the foundations is responsible for the investment of the foundation in accordance with the articles of association of the foundations and the relevant PRC law. As a general principle, foundations shall maintain and increase the value of the donated assets in a legal, safe and effective manner. There are no explicit requirements under PRC law that restricts the investment scope of the foundations. However, the management council would be held accountable for any loss of the foundations' assets if it violates the articles of association of the foundations and the relevant PRC law during the decision making process of the investment.

(ii) Government support

Under the *PRC Public Donation Law* promulgated by the Standing Committee of the National People's Congress in 1999, it is explicitly provided that the State will encourage the development of the charity business and may provide support and preferential treatment to not-for-profit organisations. The *Public Donation Law* defines the not-for-profit organisations as foundations, charity entities and other social organisations with a purpose of devoting to the public welfare. It appears that all foundations, most of the private non-enterprise entities and social organisations will fall into the definition of the not-for-profit organisations. The central government not only provides preferential treatment (such as tax treatment which we will discuss in detail below) but also grants subsidies to certain not-for-profit organisations.

(iii) Tax incentives

Under the newly amended *PRC Enterprise Income Law*, certain income of qualified legal not-for-profit institutions (i.e. donations from third parties, subsidies from the government, etc) are exempted from enterprise income tax ("EIT") provided that they meet certain eligibility requirements, including without limitation, that all of their income shall be used in the public welfare business except reasonable expenses on the organisations and could not be distributed. Also, not-for-profit organisations engaging in nursing, medical, educational and cultural etc business could be exempted from business tax (which generally applies to entities providing services). Certain imported goods for charity purposes are exempted from value-added tax ("VAT", which generally applies to the sales of goods, we will discuss in details in question 2 of the level three question).

(iv) Control

For social organisations, only Chinese residents and legal person entities could be the founders or members. Foreign individuals or entities, Chinese governmental agencies or public institutions with an administrative function could not set up a social organisation.

There is no explicit limit on the founders of a foundation or a private non-enterprise entity.

(2) Public Institutions

(i) Permitted activities

Public institutions are capable of engaging in both not-for-profit and for-profit activities while providing social services such as education,

medical service, scientific research would be the main purpose and the activities of public institutions shall strictly stick to their purposes.

(ii) Government support and tax incentives

The government support and tax incentives mentioned under items 4.(1)(ii) and 4.(1)(iii) above are available to public welfare-oriented public institutions.

(iii) Control

Since public institutions are quasi-government agencies mainly funded with State-owned assets, it is impossible for a private entity, no matter onshore or offshore, to establish or have control over public institutions.

(3) Company and Partnership

(i) Permitted activities

A company or partnership which engages in income generating activities provides the VPO with potential financial return. They may also get a social reputation if the company/partnership undertakes certain social responsibilities (i.e. making donations). Companies are encouraged to involve in the charity business, however the funds and efforts devoted in the charity business shall be reasonable and shall not adversely impact the primary business of such company. A partnership may involve in charity activities as long as such activities are in accordance with partnership agreement.

(ii) Government support and tax incentives

Companies are generally subject to the EIT, business tax and/or VAT and other taxes such as real estate tax. A portion of the donation made by a company (i.e. no more than 12% of the profits of the year) to qualified charities could be deducted from the taxable income when calculating the EIT.

(iii) Control

Companies may be invested and established by social enterprises, foundations and private non-enterprise entities with a legal person status, public institutions, companies and partnerships.

PRC private companies (not State-owned or listed) may invest in and have control over the partnerships. Foreign investors may invest in and have control over the partnerships, but will be subject to foreign investment restrictions. Social enterprises, foundations and private

non-enterprise entities and public welfare oriented public institutions cannot become general partners of a partnership.

5. *Can the entity accept funding in the form of (i) donations/grants, (ii) debt, and (iii) equity?*

(1) Social Organisation, Foundation and Private Non-enterprise Entity

Funds contributed to these organisations is called "initial funding". The main source of the initial funding would be donations/grants and these organisations will not provide any financial returns to the funders. These organisations do not issue any shares, therefore individuals or institutions do not provide funding by acquiring shares. In terms of debt, while there is no explicit prohibition on borrowing by not-for-profit organisations, they do not typically borrow since they are not permitted to provide guarantee or mortgage their public welfare related assets.

In China, only banks and other qualified financial institutions could extend loans to individuals and entities. While lending and borrowing between individuals are permitted as long as the interest rate does not exceed the statutory cap, lending and borrowing directly between two entities is not allowed.

However, if an entity wants to provide funding to another entity in the form of debt, it could only do so through the entrusted loan model where an entity provides funds to a financial institution who is qualified to conduct lending business and the financial institution will extend the loan as the lender in accordance with the terms and conditions as determined by the funding entity. The lender receives only a commission but does not bear the loan risk. If a VPO intends to grant loans to a SPO which is a not-for-profit organisation, it could only adopt the entrusted loan model and provide funding through banks or qualified financial institutions in China.

(2) Public Institution

Funding of public institutions mainly sourced by the State subsidies. Donations and grants from third party individuals and entities are also possible. Public institutions are not permitted to provide guarantee or mortgage their public welfare related assets either.

(3) Company and Partnership

Companies may accept funding in debt and equity. Partnerships may accept funding in contribution (capital contribution, contribution in kind or labour services) and debt.

3 Level Two Questions

3.1 For the three VPO operating models please list the most relevant option choices for entities:

No Fund Entity "circle" or "club" [In this case an entity is only for the VPO consulting function]	VPO "non-profit" entity   Relevant SE and/or C Entities	VPO "commercial" entity  Relevant Commercial Entities
1. Company (private equity investment management company)	1. Social Organisation	1. Company
2. Partnership (private equity investment management enterprise)	2. Foundation	2. Partnership
	3. Private Non-enterprise Entity	

3.2 Outline the benefits or considerations for each option as a choice for a VPO

As a general comment, it shall be noted that public institution is not an available option for each business model since public institutions are quasi-government institutions and are not open for private capital (unless in the form of third party grant/donation, and even in this case, individuals and private organisations cannot have control over a public institution). In addition, if the funders are foreign individuals or institutions, social organisation cannot be chosen as a VPO as only Chinese residents or organisations may participate in social organisations as members.

Specifically for each VPO business model and entity:

1. Can the entity distribute financial returns to its stakeholders in the form of grant/donation refunds, debt principal repayment and interest payments, equity dividends and buy-backs.

- (1) Social Organisation, Foundation and Private Non-enterprise Entity

Not-for-profit organisations in these three forms cannot distribute financial returns to its members or sponsors. All funds of the social organisations, foundations and private non-enterprise entities shall be used to serve their own purpose and maintain their existence. It is also unlikely that a donor could ask for refund or revoke the donation/grant, although conditional grant is possible.

One exception to the general rule is that funders of a private school are permitted to receive "reasonable return" from the balance of the private school after deducting the cost and sparing fees such as development funds.

Repayment of debt principal and interests would be fine.

(2) Company and Partnership

Companies and partnerships can repay debt principal and interests to the lenders and distribute dividends to the shareholders/partners.

Companies are typically required to distribute the dividends according to the shareholding ratio of each shareholder, while the profit sharing arrangement among partners in a partnership could be more flexible.

2. *If a commercial entity is used, do financial regulatory restrictions apply (e.g. for fund raising or fund management)? How can these be avoided? (e.g. private entity, limited solicitation).*

Currently, private equity fund raising and management activities do not require a financial license, while activities such as securities brokerage and underwriting, launching and managing securities investment funds, providing securities and futures related consulting services are regulated activities which require licenses. In order to avoid any financial regulatory restrictions or licensing requirements, the fund raising activities should be limited to targeted investors who have risk identification and risk tolerance capacity. In China, offering or marketing funds or securities to unidentified investors or more than 200 identified investors would constitute public offering which requires approval/verification from the China Securities Regulatory Commission. Having said that, 200 is not a threshold number as to constitute a "safe harbor" for private placement. Generally the fewer Chinese investors that are involved or targeted, the better. In addition, private equity fund raising must not take the form of offering to the public by advertisement, public announcement, broadcasting, telephone, fax, mail, promotional conference, briefing conference, internet, short messages or other public solicitation.

Please note that currently, only several regions in China (i.e. Beijing, Tianjin, Shanghai, Chongqing, etc.) have promulgated local rules to regulate private equity investment enterprises (i.e. private equity funds) and private equity investment management enterprises (i.e. private equity fund managers). If a private equity fund investment enterprise or management enterprise is established in these regions, registrations shall be made with local authorities such as the local counterparts of SAIC. Any private equity fund with the asset scale of RMB5 billion (US\$800m) or more shall be filed with the National Development Regulatory Commission ("NDRC"), unless such fund is sponsored by one individual or institution (or several institutions that are wholly owned by the same entity). The manager of such fund shall also be filed with the NDRC.

4 Level Three Questions

These questions relate mainly to the cross-border implications of fundraising by the VPO.

4.1 Considering the three VPO business models and entities listed in 3.1 above:

1. *Are there any restrictions on fundraising from onshore funders (as grants/donations, equity or debt)? If so describe the key restrictions if not already covered in 2.2.*

In addition to the public offering restriction as mentioned in section 2.2 above, the following restrictions are also noteworthy.

The major restriction on raising grants/donations is that grants/donations shall be voluntary. The VPO could not force any individual or entity to make donations or raise donation for profit-making purposes.

If funds are provided in the form of debt, it shall be noted that loans could only be granted through licensed commercial banks or other financial institutions. Inter-company loan is prohibited in China.!

2. *Are there any restrictions on fundraising from offshore funders (e.g. foreign ownership laws, foreign exchange control, different tax treatment, withholdings)*

- (1) Cross-border Fundraising

Fundraising on a completely offshore basis will not trigger any PRC law issues as long as such activities are permitted by the local law. Fundraising on a cross-border basis (i.e. onshore VPO market funds from offshore funders) would also be okay if such activities are within the purpose or business scope of the VPO as approved by relevant PRC authority.

- (2) Foreign Ownership Restrictions

China has long managed and directed foreign investment on the industry basis through the *Foreign Investment Industrial Guiding Catalogue* ("**Catalogue**"). The current version of the Catalogue divides industries into three basic categories: encouraged, restricted, and prohibited and lists out the industries under each category. Industries that do not appear in the Catalogue are deemed as the permitted categories. All foreign investment in China shall observe the Catalogue. Offshore funders may not contribute their funds to, and a VPO may not be established in, a sector which is prohibited from foreign investment. For the restricted categories, ownership restrictions may apply (i.e. limited to joint venture, controlled by Chinese partners, foreign ownership cap, etc.).

- (3) Foreign Exchange Control

China is maintaining a foreign exchange control system where foreign investment (as grant/donation, debt or equity) is to be exchanged for renminbi and the cross-border fund flow is supervised and regulated by the State Administration of Foreign Exchange ("SAFE"). Foreign exchange related transactions are classified into two categories: capital account items and current account items. Current account items are transactions of an ordinary recurrent nature, including payments for foreign trades and services and interest payments for foreign exchange debts. Capital account items are those capital inflow or outflow transactions which serve either to increase or decrease an onshore entity's debt or equity, including foreign direct investment, all types of loans, loan-related security transactions, securities investments as well as grants/donations from offshore. The capital account transactions are subject to SAFE approval or registration.

This means that foreign equity, debt and donations/grants are all subject to the SAFE approval. In addition, while foreign debt may be available to a foreign-invested enterprise within its difference of total investment and registered capital, it is difficult for a pure domestic company to borrow foreign debt.

(4) Tax Treatment

Certain grants/donations from foreign individuals and entities may enjoy exemption or deduction of customs duties and import VAT. Specifically, the following goods are exempted from VAT:

- equipment and instruments which are imported from offshore to China for scientific research, experiment and education;
- equipment, goods and materials donated by foreign governments and international organisations; and
- necessities for the disabled imported into China by the organisation of the disabled.

Goods and materials donated by foreign governments and international organisations are exempted from the customs duties.

Interests of foreign debts and dividends paid to foreign investors are subject to the EIT at a rate of 10%, subject to the bilateral tax arrangements, pursuant to which such EIT may be deducted.

3. *Are there any foreign control or sponsor/promoter issues for the entities (e.g. limit on foreign directors or trustees)*

(1) Social Organisation, Foundation and Private Non-enterprise Entity

Foreigners are not eligible for members in social enterprises. There is no explicit limit on the foreign directors in a social organisation.

Foreign individuals and entities may set up foundations in China and foreigners are eligible for acting as the president or officers of a foundation as long as they reside in China for no less than three months a year. However, since PRC law does not provide clear guidance on how to set up a foreign-funded charity in China and foreign-funded charities are rare in practice, the approving procedures need to be tested.

We are not aware of any explicit limit on the foreign sponsors or directors or in a private non-enterprise entity. Similar to that of foreign-funded foundations, the approving regime for foreign-funded private non-enterprise entities is unclear at the current stage.

(2) Company and Partnership

The PRC law does not impose restrictions on the number of foreign directors/shareholders of a company or partners of a partnership.

Other Comments and Explanation:

Please note that the sector where an SPO/VPO is established does matter. Even for the same type of entity, different industry regulators may have their own eligibility requirements on funders and different approving procedures and timeline may apply. In addition, foreign investment is restricted or prohibited in certain sectors. Since the sector where an SPO/VPO will be involved is not specified, we can only give our advice on a general analysis without referring to specific requirements from each industry regulator.

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The advice above is based on our experience as international counsel representing clients in their business activities in China. As is the case for all international law firms licensed in China, we are authorized to provide information concerning the effect of the Chinese legal environment, however we are not permitted to engage in Chinese legal affairs in the capacity of a domestic law firm. Should the services of such a firm be required, we would be glad to recommend one.

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