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# Private Equity 2023

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## **China: Trends & Developments**

Steven Yu and Jia Guo  
Global Law Office



## Trends and Developments

### Contributed by:

Steven Yu and Jia Guo

Global Law Office

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have vast experience in representing investors, but it has also extensively represented financing enterprises and founders. With a deep understanding of the best legal practices and development trends of each investment term, the team at GLO knows how to find the most effective balance of interests in terms of negotiation so as to realise all-win results. Vast practical experience and industrial background knowledge enable GLO to enhance value in every process of the client investment cycle.

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### US-China Tensions Will Reshape the US Outbound Investment Regime

On 9 August 2023, President Biden issued an Executive Order (EO) to address US investment in certain national security technologies and products in the PRC including Hong Kong SAR and Macau SAR. The EO requires the US Department of Treasury to work with the US Department of Commerce and other agencies to put into place an array of implementation regulations to establish a mechanism that could identify and differentiate “notifiable” vs “prohibited” outbound transactions in terms of extent of the threat that may be posed to the country’s national security. The EO will come into effect following the issuance of implementing regulations by the US Department of Treasury and does not set a deadline for these regulations to be issued. Given the 45-day comment period and the time it will take to develop implementing regulations, the new outbound investment regime will likely not come into effect until 2024.

The EO echoed the long-anticipated moves expanding the current US governmental control from the areas of inbound investment into the US and technology and commodity export to sanc-

tioned persons and countries, to the area of outbound investment by US persons into countries of concern, mostly notably, China. Since this is similar to the current Committee on Foreign Investment in the United States (CFIUS) review regime aiming at protecting national security, but in an opposite direction, it is therefore colloquially known as “Reverse CFIUS”. Such “Reverse CFIUS” can be dated back to 6 June 2022, when seven US Congress members led bipartisan effort to propose an amendment to the Innovation Act aimed at reviewing and limiting US investment into countries of concern or those considered “foreign adversaries” like China in certain industries on national security grounds. This was followed by the release of a new draft of the National Critical Capabilities Defense Act on 13 June 2022, a revised version of the originally proposed legislation that was circulated in 2021, aiming to address national security risk by establishing an expansive outbound investment review regime. The EO was issued after the US Senate approved adding a measure to the 2024 National Defense Authorization Act in July 2023 that would require mandatory notifications of certain investments in China, Russia, Iran and North Korea.

The EO targets the following three categories of “covered national security technologies and products”: (1) semiconductors and microelectronics, (2) quantum information technologies and (3) artificial intelligence. The EO is anticipated to target only certain types of investment transactions such as equity transactions (eg, via mergers and acquisitions, private equity, venture capital and other arrangements), greenfield investments, joint ventures and certain debt financing transactions that are convertible to equity, however, target transactions entered into to evade the prohibitions under the EO are also regulated. For example, a US person will not be able to knowingly invest in a third-country entity that will use the investment to participate in a transaction with a covered foreign person in a country of concern.

The above-described US regulatory development occurring more than a year ago appears to have had a significant impact on the Chinese private equity and venture capital market, both for fundraising and for investment. According to statistics released by Zero2IPO Research, RMB investment is still the dominant force in the market in the first half of 2023 and the concentration has further increased. Specifically, the number of RMB investment cases and the investment amount were 3,320 and RMB234.071 billion, respectively, reflecting a year-on-year drop of 35.6% and 39.9%. At the same time, the number of foreign currency (primarily USD) investment cases totaled 155, reflecting a year-on-year drop of 76.2%, and the disclosed investment amount was CNY58.894 billion, reflecting a year-on-year drop of 49%, which was 2.1 times and 1.2 times of the decline rate of RMB investment respectively. The focused industry areas of investment in the first half of 2023 include semiconductor and electronic equipment, biotechnology/medical and IT industries, with a total of 2,271 invest-

ment events in the three areas, accounting for 62.4%.

Regardless of what the regulations issued by US Department of Treasury will ultimately look like, the “Reverse CFIUS” is on the way. In anticipation of these regulations, US persons should carefully evaluate their investment strategies in foreign countries, especially China. From China’s perspective, a continuous and stable utilisation of foreign capital in innovative and high-end tech areas could face some challenges to be overcome in the next decade.

## Measures for Registration and Filing of Private Funds Substantially Raised the Threshold for the Registration of Fund Managers

In mainland China, fund managers are required to complete registration procedures, which do not amount to a permission or approval from a legal perspective, in the Asset Management Association of China (AMAC) before raising a private fund. On 1 May 1 2023, the Measures for Registration and Filing of Private Funds (the “Registration Measures”) promulgated by AMAC came into effect. The Registration Measures raise the threshold for the registration of fund managers and introduce a strengthened supervision by the AMAC compared with the previous rules.

The Registration Measures impose higher standards for the required experience and professional ability of senior management personnel of fund managers and also require applicants to provide evidence of their experience in the submitted materials. Meanwhile, the controlling shareholder, actual controller or general partner of fund managers (if any) are required to have more than five years of relevant practice experience in the fund management or related area.

All the requirements mentioned above and other related restrictions in the Registration Measures are meant to exclude applicants without sufficient experience in equity investment and private fund management from entering into the business of private funds management.

In response to the licence-selling behavior of fund managers found in the past, AMAC has also taken new precautionary measures which require that the change of control of a fund manager shall not be done within three years after the registration, while the management scale of the target fund manager in the last year shall not be less than RMB30 million.

### **Regulations on the Supervision and Management of Private Investment Funds Further Strengthened Private Fund Supervision**

On 9 July 2023, the State Council of the People's Republic of China promulgated the Regulations on the Supervision and Management of Private Investment Funds (the "Private Funds Regulations"). The Private Funds Regulations, which came into force on 1 September 2023, are the first administrative regulations in the field of private investment funds. Its promulgation marks a further improvement of the private funds regulatory system.

The Private Funds Regulations strengthen the supervision of fund managers. Under the Private Funds Regulations, the qualification of a fund manager would be canceled by the AMAC if a fund manager has been found conducting illegal fundraising for illegal business operations. The regulations also strengthen the penalties for senior management personnel of fund managers. Employees of a fund manager, fund custodian, securities or futures exchange, securities company, securities depository and clearing institu-

tion, futures company or any other institution or functionary of a state body, who have been discharged due to any violation of laws are not allowed to serve as senior management personnel in a fund manager after the discharge.

The Private Funds Regulations also set up a series of administrative penalties for the illegal behavior of fund managers and responsible personnel. In the event that a private fund manager fails to fulfill the investigation obligation of qualified investors, fails to complete record-filing formalities for a privately-offered fund, engages in illegal related-party transactions without disclosure in accordance with applicable law and regulations, the China Securities Regulatory Commission (CSRC) is entitled to impose a warning, notification and criticism as well as fines upon such fund managers and/or directly responsible supervisors and personnel. Under the Private Funds Regulations, the fine imposed by the CSRC could be up to five times the illegal income. If there is no illegal income or if the illegal income is less than RMB1 million, the maximum fine would be RMB1 million.

### **The Registration-based IPO System, Revised Issuance Conditions and Registration Procedures Further Facilitated and Expanded Investment Exit Channels for Investors**

In November 2018, the Science and Technology Innovation Board Market (STAR) was initiated in the Shanghai Stock Exchange and piloted the registration-based IPO system. In August 2020, the Growth Enterprise Market (GEM) of the Shenzhen Stock Exchange piloted the registration-based IPO system. In November 2021, the Beijing Stock Exchange was set up and implemented the registration-based IPO system. The registration-based IPO system has empowered finance and the development of the real econo-

my, especially for technology-based and innovative enterprises.

In February 2023, the registration-based IPO system for stock issuance was formally expanded to the whole capital market. The CSRC issued the Administrative Measures for the Registration of Initial Public Offerings of Stocks and other related implementation rules. The stock exchanges, National Equities Exchange and Quotations Limited Liability Company, China Securities Depository and Clearing Limited Liability Company, China Securities Finance Corporation Limited and the China Securities Association also issued and implemented related rules, involving a total of 165 rules, which marks a significant development of the regulatory system for the capital market of mainland China.

In terms of issuance conditions, a new market value indicator is introduced according to the listing rules of the Shenzhen Stock Exchange and the Shanghai Stock Exchange. For applicants, they need to comply with all of the following conditions including, (a) the estimated market value is not less than RMB5 billion, (b) the net profit for the most recent year is positive, (c) the business revenue for the most recent year is not less than RMB600 million and (d) the cumulative net cash flow generated from the operating activities for the most recent three years is not less than RMB150 million, or, alternatively, all of the following conditions must be met, (a) the estimated market value is not less than RMB8 billion, (b) the net profit for the most recent year is positive and (c) the operating income for the most recent year is not less than RMB800 million. Compared with the previous Administrative Measures for Initial Public Offerings and Listings (expired), the new rules have removed the restrictive conditions such as the absence of uncompensated losses at the end of the most recent period and

the limitation on the ratio of intangible assets to net assets. The revised issuance conditions provide new options for applicants and aim to support the issuance and listing of high-quality enterprises with mature business models, stable operating performances and large business scales.

In terms of registration procedures, according to the Administrative Measures for the Registration of Initial Public Offerings of Stocks, the stock exchange will review the registration documents and forward the application to the CSRC for registration. The Issue Review and Approval Committee of CSRC is formally cancelled after the full implementation of the registration-based IPO system. Upon receipt of the stock exchange's review comments and relevant registration documents, the CSRC will proceed registration procedures and issue the decision on whether to register within 20 working days. Under the registration-based IPO system, the time needed from application to listing has been greatly shortened for applicants.

Under the full implementation of the registration-based IPO system, the issuance conditions and review procedures have been optimised, which further facilitates the listing for issuers and expands the exit channels for investors.

## **Trial Administrative Measures of Overseas Securities Offering and Listing by Domestic Companies Reshaped the Regulatory Framework for Overseas Listing of Domestic Enterprises**

On 17 February 2023, the CSRC issued the Trial Administrative Measures of Overseas Securities Offering and Listing by Domestic Companies (the "Trial Administrative Measures"), which came into force on 1 March 1 2023. The Trial Administrative Measures substantially changed

the regulatory framework for the offshore listing of domestic companies.

Offshore listing of domestic enterprises is an important way to exit for investors, especially for offshore investors. Traditionally, there are three types of offshore listing structures for domestic enterprises: H-share structure, grand red-chip structure and small red-chip structure. The small red-chip structure could be further divided into equity control structure and variable interest entity (VIE) structure. H-share structure, which can be understood to be a company incorporated in the PRC directly applying for listing and fundraising at offshore stock exchanges, requires the approval of the CSRC. The grand red-chip structure could be understood to be an offshore holding entity or entities with domestic assets or interests as the listing applicant which is ultimately controlled by a PRC incorporated enterprise. Before the implementation of the Trial Administrative Measures, the Notice of the State Council on Further Strengthening the Administration of Share Issues and Listings Overseas or the “1997 Red-Chip Guideline” (expired) was the applicable regulation. This regulation required the approval of the CSRC and of the provincial government for the overseas listing of grand red-chip structure companies. For the small red-chip structure, it can be understood as a domestic natural person holding interests in a domestic company through offshore companies and, as such, a round-trip investment into China. The offshore company, usually a Cayman company, is used as the listing company for the financing purpose under the small red-chip structure. After the abolition of the no-objection letter system as stipulated in the Circular of China Securities Regulatory Commission on Issues Concerning Stock Issuance and Public Offering Abroad of Overseas Corporations which Involve Domestic Equity in 2003, the small red-chip struc-

ture of overseas listing required no approval or registration with the CSRC, which worked for almost 20 years. After the implementation of the Trial Administrative Measures, the regulation of above-mentioned structures has changed fundamentally, as CSRC filings are required under all three structures.

Article 2 of the Trial Administrative Measures explicitly provides that “indirect overseas issuance and listing of domestic enterprises refers to the issuance and listing of securities by an enterprise with its main business activities in the territory, under the name of the enterprise registered abroad, overseas issuance and listing based on the equity, assets, income or other similar rights and interests of domestic enterprises.” While under Article 15 of the Trial Administrative Measures, if a target company fulfill the conditions that the operating revenue, total profit, total assets or net assets of the domestic enterprise in the latest fiscal year account for more than 50% of the issuer’s audited consolidated financial statements for the same period, as well as that the major parts of the operating activities are carried out in the PRC territory or the main premises are located in the PRC territory, or that the majority of the senior management in charge of the operation and management are Chinese citizens or the place of habitual residence is located in the PRC territory, it will be recognized as an indirect overseas listing of a domestic enterprise and subject to the filing requirements under the Trial Administrative Measures.

Before the implementation of the Trial Administrative Measures no filing or registration to the CSRC was required for a proposed listing of a company with the small red-chip structure and its listing could usually be completed within six to twelve months. After the implementation of the Trial Administrative Measures, it will take

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more time due to the filing procedures. But from another perspective, the Trial Administrative Measures provide more flexibility for companies with an H-share structure. Under the current regulatory regime, proposed listed companies with an H-share structure no longer need the approval of CSRC as in the past. They could also avoid complex and tax-costly cross-border reorganisations as in the case of small red-chip structures.

The implementation of the Trial Administrative Measures also brings uncertainty to companies with VIE structure, which is traditionally used by companies engaged in industries in the prohibited or restricted catalogue for foreign investment. There is still some uncertainty as to whether these companies will be able to pass the NDRC filing in practice. In the Trial Administrative Measures and the related replies to the reporters' questions, the CSRC indicated that it would not completely reject the filing of VIE structure companies engaged in industries in the prohibited catalogue for foreign investment, but that it would consult with other central government-level industry regulators on this matter. However, up to now, as far as it is known, no VIE structure companies engaged in industries in the prohibited catalogue for foreign investment have completed the filing with CSRC.

## China Pilots Giving Private Equity and Venture Capital Funds a New Exit Option

According to a notice published by the CSRC on 8 July 2022 (the "Notice"), the CSRC launched a new pilot program that enables stock (in-kind) distributions by private equity funds and venture capital funds (collectively, "PE Funds"), adding a much-needed alternative exit option for them.

It was reported that, in October 2022, the SCRC consented in principle to Shanghai Linli Invest-

ment Partnership (Limited Partnership)'s pilot application for in-kind distribution by stock. The applicant should fulfill the corresponding procedures and information disclosure obligations in accordance with the relevant laws and regulations and the requirements of the CSRC on the pilot program of in-kind distribution by stock by PE Funds and distribute stock to their investors in a timely manner. Other pilot applications by qualified PE Funds for in-kind distribution by stock were also processed in an orderly manner.

According to the Notice, an in-kind distribution by stock by PE Funds to investors means an arrangement whereby the PE Fund's manager and investors (including shareholders or limited partners, as applicable) agree to distribute the stock of listed companies that are tradable on the secondary market held by PE Funds to investors (share/interest holders) through a "non-transaction" ownership transfer. This type of non-cash payment to investors, known as a distribution-in-kind, is commonly employed in overseas markets, but is a brand-new approach in China.

Many PE Funds traditionally have a five to ten year duration, but it usually takes quite a few years for their early-stage projects to go public. As such, they have a strong exit demand and face pressure from their limited partner investors. Apparently, as opposed to the traditional exit channel (PE Funds typically liquidate their stock in a portfolio company after it is tradable on a stock exchange and distribute the cash proceeds to their investors), the CSRC's pilot program aims to create a straightforward and more flexible way for investors to cash out upon their own judgment of the timing and pricing.

On the other hand, some restrictive requirements apply to applications under the pilot



program according to the CSRC. Only a listed company's pre-IPO shares held by PE Funds can be distributed. PE Funds or their investors who are the controlling shareholder, the largest shareholder or the actual controller of a listed company are not eligible for the program. and lastly, PE Funds who hold a listed company's stock that is subject to a lock-up period, commitment or other sale restrictions are not allowed to participate. Moreover, the current enterprise registration system and the securities registration and settlement system lack corresponding supporting mechanisms, resulting in difficulties in implementing such non-cash distribution.

In sum, the CSRC's pilot program takes into account the differentiated needs of investors, broadens PE Funds' exit channels, promotes the long-term sound development of China's private equity and venture capital industry and and boosts the role of private equity and venture capital in supporting the nation's real economy, innovation and entrepreneurship.

## China's First Regulation Governing Generative AI Services

Generative AI is a ground-breaking technology that will have a profound influence on production efficiency and further reshape the whole world. China has embraced the opportunities and challenges that this new technology may bring to the nation, and hence is prepared to react in all respects including improving its regulatory efforts.

On 10 July 2023, China promulgated the Interim Measures for the Management of Generative Artificial Intelligence Services (the "Interim Measures"), a cabinet-level regulation governing the provision of generative AI services, in the name of the Cyberspace Administration of China (CAC) and six other central government regula-

tors. The Interim Measures have taken effect on 15 August 2023 and aim to ensure the national security and social interest as well as promote the development and application of technologies in this fast developing area. The Interim Measures have followed principles and rules in the upper-level legislative framework including the PRC's Cyber Security Law, Data Security Law, Personal Information Protection Law and the Law on the Progress of Science and Technology (collectively, "Upper-level Laws").

The application scope of the Interim Measures is limited in two dimensions. First, the Interim Measures only apply to service providers of generative AI services and such services. Second, such generative AI services are only those that are available to the public in the territory of PRC. Therefore, the activities of internal research, development and application of generative AI technologies conducted by institutions do not fall within the regulatory scope of the Interim Measures. Cross-border provision of generative AI services from China to overseas users is also excluded from the coverage by the Interim Measures.

A key compliance requirement under the Interim Measures is that generative AI service providers must conduct security self-assessment and register their algorithms in accordance with the Administrative Provisions on Algorithmic Recommendation in Internet Information Service which took effect on 1 March 2022 if their services involve functions or elements that may solicit or influence public opinion or are capable of social mobilisation. Another notable compliance requirement is that generative AI service providers need to perform labeling obligations for their generated images and videos as required in the Administrative Provisions on Deep Synthesis in Internet Information Services which took effect

on 10 January 2023, in order to prevent deep fake and virtual reality technologies from being abused. Only companies planning to provide services to the Chinese domestic users are required to comply with the foregoing provisions in the Interim Measures and such companies include overseas service providers who intend to operate their business for Chinese domestic users from abroad.

Besides some specific compliance requirements, the Interim Measures reiterate and echo the significant principles and rules already raised in the Upper-level Laws, including without limitation: (a) safeguarding national security and social interests, maintaining social stability and upholding core socialist values; (b) preventing discrimination in all stages from algorithm design, data selection and training, model generation and improvement through to the provision of the AI services, (c) respecting others' intellectual property rights and trade secrets, and refraining from conducting monopoly and unfair competition practices; (d) respecting others' legitimate rights, including among others, protection of personal information and (e) enhancing the transparency of generative AI services and the accuracy and reliability of their output.

The Interim Measures impose daily monitoring responsibilities on the AI service providers to ensure that their output is in accordance with the law. In particular, where such service providers discover illegal content, they must take prompt action to stop generation or transmission, remove content, correct their training model and report to the relevant authorities. Where service providers discover that users are using generative AI services for illegal activities, they also have the duty to take measures, such as issuing warnings, restricting functionality, suspending, or terminating the provision of services

to the users, keeping the relevant records and reporting such activities to the relevant authorities.

At present, foreign generative AI platforms such as ChatGPT and Bard are not available in China. Chinese domestic companies are racing to develop homemade systems including Baidu's Wenxin Yiyao, Alibaba's Tongyi Qianwen and JD.com's ChatRhino. Beyond the Interim Measures, further introduction of comprehensive and implementation legislation is expected in this regard, including a draft Artificial Intelligence Law that is reportedly in its deliberation stage. This shows China's great endeavors to offer a sound legal and regulatory environment to develop technologies in this frontier area. Furthermore, the Interim Measures explicitly encourage platforms to carry out international exchanges and to participate in the formulation of international rules relating to generative AI. Against this backdrop, it is expected that more financial and strategic investors (both international and domestic) will enter the Chinese market and bring capital to fund innovations of startups in generative AI related areas. However, whether or not there will be over-regulation of this industry and the relevant market in the future remains to be seen.

## **China Continues to Support Venture Capital Firms and Individual Angel Investors with Tax Policies**

Soon following the promulgation of the Private Funds Regulations in which the nation is supporting the development of venture capital funds from their fundraising through exiting stages, the Ministry of Finance and State Taxation Administration (STA) jointly released the Circular on Extending the Implementation of Relevant Tax Policies for Venture Capital Enterprises and Individual Angel Investors ("Circular 17") on 1

August 1 2023, to further support entrepreneurship and innovation.

According to Circular 17, venture capital firms and individual angel investors that either start to invest or have invested in technology start-ups for more than two years can continue to enjoy the tax incentives in accordance with the Notice Regarding Tax Policies for Venture Capital Enterprises and Individual Angel Investors (“Circular 55”) until 31 December 2027. Circular 17 has further clarified that the following criteria that “qualified technology start-ups” should meet for accepting tax incentives remain unchanged: (a) the number of their employees should not exceed 300 persons, and (b) the total assets and annual turnover should not exceed RMB50 million respectively.

The major tax incentives set forth in Circular 55 include:

- a venture capital firm of a corporate nature which has made a direct equity investment (in the way of capital increase) in a tech company in seed stage or early stage (“tech start-up”) for at least two full years (24 months), may deduct 70% of the investment cost from its taxable corporate income in the second full year of holding equity shares of the tech startup, and the amount of excess investment cost which is not deducted may be carried forward to the subsequent taxation years for deduction purposes if its taxable income of that year is not high enough for deduction;
- in case of a venture capital firm in a limited partnership who has made a direct equity investment in a tech startup for at least two full years, both its corporate partner(s) and individual partner(s) may deduct 70% of their investment cost from their respective corporate income (for corporate partner(s)) and

business income (for individual partner(s)) distributed from such partnership enterprise and such deduction may be carried forward to the subsequent taxation years if the said taxable income of that year is not high enough for deduction; and

- an individual angel investor who has made a direct equity investment in a tech startup for at least two full years is allowed to deduct 70% of their investment cost from the taxable individual income derived from transfer of the equity shares in the tech startup, and such deduction may be carried forward to the future when obtaining the taxable income from their transfer of such tech startup’s equity shares.

Circular 55 also establishes the following criteria for tech startups, venture capital firms and individual angel investors to which the relevant tax incentives are applicable:

- for a tech startup: (a) it is subject to audit-based tax collection and is registered in mainland China; (b) at the time of accepting the investment, the number of its employees shall be no more than 200 which is replaced by 300 by subsequent tax regulations promulgated by STA, among which there shall be no less than 30% of employees with a bachelor’s degree or higher, and each of its total assets and the annual turnover shall be no more than RMB30 million, which is replaced by RMB50 million by subsequent tax regulations promulgated by STA; (c) at the time of accepting the investment, it shall have been established for no more than five years (60 months); (d) its shares have not been listed in any stock exchanges in China and abroad at the time of and within two years of acceptance of the investment; and (e) in the year of acceptance of the investment and the next tax year, its

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- total costs for R&D shall be no less than 20% of the entire cost expenditures;
- for a venture capital firm: (a) it is subject to audit-based tax collection, registered and not an initiator of the tech startup; (b) it has completed filing with the National Development and Reform Commission (NDRC) or the AMAC under the CSRC; and (c) the total equity held by such venture capital firm and its affiliates in the tech startup within two years after its investment shall be less than 50%; and
  - for an individual angel investor: (a) they or their relatives are not the initiators or employees of the tech startup; (b) the total equity held by the individual angel investor and their relatives in the tech startup within two years after the investment shall be less than 50%.

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