Debevoise is one of the world’s leading providers of legal services to private equity firms and their investment funds, portfolio companies and individual partners. The firm’s private equity funds practice is one of the largest in the world, whether measured by the number of funds, total committed capital or resources devoted to private equity fund formation. Debevoise is also a leader in private equity M&A and other transactions, renowned for crafting innovative solutions for some of the largest and most complex transactions in the industry.

In working with private equity clients, our lawyers take full advantage of the firm’s international experience, including unrivalled knowledge of fund structures across the globe, as well as significant experience with private equity portfolio investments and other minority investments characteristic of funds. This combination of in-depth knowledge and broad-based experience in the many different regions in which we operate enables Debevoise to provide “one-stop shopping” for fund structuring and formation, mergers and acquisitions, buy-side investments, financing, exits (either strategic sale or IPO) and all other investment considerations for our private equity clients.

With the experience of over 200 dedicated lawyers worldwide, our private equity practice has successfully developed a global market leading position.
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Introduction

Welcome to the BVCA *Guide to Private Equity & Venture Capital in Asia*, the latest in a series of guides produced by the BVCA designed to act as an introduction to international markets and business sectors.

The Asian private equity market is today recognised as being one of the most established outside of North America and Europe, with economic and demographic trends continuing to place the region high on the list of international investors. According to Preqin's latest Asian report, by the middle of 2013 Asia focused funds accounted for 75% of all capital raised for emerging markets funds between 2005 and 2013.

This appetite is only going to increase. Whilst there has been a slowdown in deal activity in recent years this is largely due to the impact of the global recession. Now the recovery is underway, most observers agree that Asian private equity will continue the extraordinary growth which has marked the last decade.

It is of course still an emerging market and this carries certain risks. And it is a rapidly maturing market, with domestic funds on the rise and business owners becoming much more accepting of the private equity model. Together these two make it a complex environment, even for the seasoned investor, meaning expert knowledge is essential.

This guide provides an entry-level briefing into some of the most important issues anyone investing in Asia must know, from taxation and marketing regulation, to due diligence and anti-corruption challenges. We hope you find it useful and we would sincerely like to thank our sponsor, Debevoise & Plimpton LLP, for their support.
The common narrative goes like this. Private equity first reared its head in Asia on the back of the Asian Financial Crisis. Governments went on a selling spree to raise much needed capital. Ever awake to an opportunity, in stepped the private equity managers.

Nearly 20 years on and it is safe to say it is an established, major player in the economic scene of the region. Last year, Asian private equity funds raised more than US$40 billion.\(^1\)

Optimism is the overwhelming feeling in the market today. The conclusions of a recent EY survey into the mood amongst private equity players in Asia says it all – growing economies are creating opportunities, a more ‘friendly’ view of private equity is emerging, and capital is becoming more accessible.\(^2\)

Against this rosy backdrop it is perhaps more important than ever for fund managers and investors to be up to speed on the key developments in some of Asia’s biggest and most attractive economies. Yes, the mood is positive and there are plenty of opportunities afoot, but dive in without a proper understanding of the local issues and those opportunities can pass you by.

It is true of any market of course, but given the current interest in Asia it is perhaps more important than ever to do your homework.

This guide does not aim to provide an exhaustive tour of the region. It does, however, aim to illuminate some of the issues any investor or any fund eyeing Asia should be aware of.

First, we team up with Indian law firm Khaitan & Co. to look to Singapore, and the growing role it has as a gateway for private equity to India. We look at what is driving this trend and how the most can be made of it.

In our second article we look at recent developments in Japan and Korea with regards to marketing fund interests – an important topic given the role of these two countries as significant sources of private equity investment.

We then turn our eye to China, focussing on two regulatory developments which could have a profound impact on the development of private equity in the region. The first promises to open up the possibility of Chinese insurers becoming key institutional investors in private equity. The second aims to bring some clarity and predictability around the regulation of domestic funds and managers in China.

Tax is the focus of our fourth article. In many Asian countries tax disputes are very common, and so we aim to shine a light on some of the main questions you should be asking when doing business in the region.

Lastly, we look at the significant operational impact of increased corporate governance standards and anti-corruption challenges. Battling corruption has of course become somewhat of a global focus, as regulators around the world continue to double their efforts in this direction, but the issue poses some specific challenges in Asia.

Together we hope these six short articles will serve as a spark for further enquiry and debate. Asia is a region of diverse economies, home to opportunities all along the spectrum. Keeping up to date with the big developments which drive and influence these opportunities should be a career long endeavour, to which we hope this guide will add some useful thoughts.

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1 “2013 Private Equity Fundraising” report from Prequin (https://www.preqin.com/docs/reports/Q4_2013_Private_Equity_Fundraising.pdf)

Recent data from the Indian Department of Industrial Policy and Promotion shows Singapore is poised to overtake Mauritius as the leading base for foreign direct investment (FDI) and private equity investment into India. The data indicates Singapore’s share of FDI inflows into India nearly doubled in the last ten months of 2013.

Spurred on by the enactment in India of the General Anti Avoidance Rules (GAAR) slated to come into force from 1 April 2015, more investors appear to be betting on Singapore for many reasons, including a favourable tax treaty and better remedies against expropriation of investments under the investment treaty between Singapore and India.

Undoubtedly, parties choosing to structure their investments via Singapore are primarily attracted by the potential to avoid paying Indian capital gains tax on their investments. Under Singapore’s tax treaty with India, the sale of shares in an Indian company by a Singapore company should generally be exempt from Indian capital gains tax. The capital gains exemption, however, can only be obtained upon the fulfillment of certain conditions specified in the tax treaty (essentially the conditions set out in the ‘limitation of benefits’ or LOB clause).

The LOB clause provides, among other things, that the benefits of the tax treaty cannot be claimed if such entity was set up primarily for the purpose of obtaining the capital gains exemption.
Singapore’s growing role as the gateway to India

(for e.g., a shell/conduit company). In order to not be classified as a shell or a conduit company, the Singapore entity must have incurred an annual expenditure of 200,000 Singapore dollars on operations in Singapore, in the 24 months prior to the date the capital gains arise.

GAAR provisions

Due to the LOB clause and pending GAAR provisions investors are increasingly concerned about demonstrating that the investing entity has commercial, legal and economic substance in Singapore. Under the GAAR provisions Indian tax authorities have been granted wide powers to tax ‘impermissible avoidance arrangements’, including the power to disregard entities in a structure, reallocate income and expenditure between parties to the arrangement, alter the tax residence of such entities and the legal situs of assets involved, treat debt as equity and vice versa.

The GAAR provisions are potentially applicable to any transaction or any part thereof. Thus in effect an investor could be denied the benefits of a tax treaty as a result of the application of the GAAR provisions (even if the tax payer has fulfilled the LOB requirements).

Clearly the Indian legislature is keen on shifting the focus of tax laws from the mere ‘form’ of an arrangement or transaction to the actual ‘substance’ of a transaction. Investors have found that it is easier to establish the necessary substance for a Singapore company (both in terms of fact and perception) for a variety of reasons including the fact that it has a large qualified workforce, relatively low personal income tax rates (which helps attract overseas talent), availability of quality infrastructure, relative proximity to India (which allows for ease of administration/greater control over Indian investments) and a reputation of being an economic hub in South East Asia.

In addition to the lower capital gains tax, Singapore residents are entitled to a lower rate of tax withholding in India of 15% on interest income which would otherwise vary from 20-40% under the regular domestic tax provisions. This saving has led to numerous India focused debt funds setting up base in Singapore.

National protection

Singapore also offers the added protection of national treatment and guarantees against expropriation under the India-Singapore investment treaty known as the Comprehensive Economic Cooperation Agreement.

The principle of national treatment is intended to ensure that foreign investors are treated on the same basis as domestic investors and are not subject to discrimination. Similarly the guarantee against expropriation limits the circumstances under which the state may expropriate foreign investments (with due compensation).

In addition, the cooperation agreement allows investors to directly initiate arbitral proceeding against a state without approaching its own government in case of a violation. Investors have an option of approaching ICSID or initiating arbitration under the UNCITRAL rules. This ability to sue the state directly has proved to be useful recently with a company invoking the Agreement’s protections after certain telecom licenses were canceled by the Indian Supreme Court due to corruption allegations against the Government resulting in huge losses.

One expects the Singapore story to become even more prominent in the Indian context in the years to come as Indian tax law becomes increasingly substance driven and investors seek the added protection of the investment treaty.

One expects the Singapore story to become even more prominent in the Indian context in the years to come as Indian tax law becomes increasingly substance driven and investors seek the added protection of the investment treaty. In turn Singapore’s growing role as the preferred holding company location for outbound investment into India will further strengthen Singapore’s role as a leading gateway to foreign investors in South East Asia’s other emerging markets.
Marketing fund interests in Japan and South Korea

Andrew M. Ostrognai, Partner, Debevoise & Plimpton LLP

For private equity funds looking to market to Asian investors two jurisdictions are increasingly important: Japan and South Korea. These jurisdictions stand out not only as increasingly important sources of capital, but they also deserve particular attention because they impose substantive requirements on the marketing of private equity funds that go beyond the traditional private placement regimes prevalent in many other jurisdictions.

Japan
Japan has a private placement regime for the marketing of fund Limited Partnership interests, which requires that (a) fewer than 500 investors in Japan acquire the interests and (b) investors be notified that the offer of the interests has not been and will not be registered, and that the offer of the interests will constitute an exempt small number private placement. This discussion will focus on funds organised as limited partnerships.

In addition to this, generally speaking a General Partner or placement agent that offers fund interests in Japan is required to register as a ‘Financial Instruments Business Operator’ that engages in the business of offering fund interests. An exemption from this registration requirement is granted to general partners that rely on the Qualified Institutional Investor (QII) business exemption. For the General Partner to rely on the QII business exemption the fund must have:

- at least one Limited Partner that it is a QII;
- no more than 49 Japanese Limited Partners that are not QIIs;
- no disqualified investors listed in the Financial Instruments and Exchange Act (such as certain special purpose companies and certain funds of funds in which non-QII invest), and
- certain transfer restrictions, in which a QII may not transfer its interests to a person other than a QII and a Japanese non-QII may not transfer its interests to more than one person.

Additionally, to rely on this exemption, a General Partner must file a Form 20 notification with the relevant office of the local financial bureau prior to any solicitation. The Form 20 must name at least one QII as well as the name of the fund. The General Partner must update the Form 20 if certain information changes.

South Korea
Under the Korean Financial Investment Services and Capital Markets Act (FSCMA) and related regulations, all offshore private equity funds marketed and sold to Korean investors are required to be registered with the Financial Supervisory Service of Korea (FSS). If the offering is solely to ‘qualified professional investors’ as defined under the FSCMA, the registration...
statement is simpler than would be required for marketing to retail investors, but other conditions still need to be met, including (a) a clear disclosure in the fund documents of the fees and expenses to be incurred by the investor, (b) formation of the fund in compliance with relevant laws, (c) persons and entities associated with the fund having not been sanctioned by Korean regulators or forced to suspend their business, and (d) the fund documents being in accordance with relevant law.

Separately, under the FSCMA, the marketing of offshore private equity funds to Korean investors (regardless of the status of the prospective investors) must be done through a locally licensed distributor, which generally would be a domestic financial institution that is licensed to market and sell fund products (a “local distributor”). There are no express exemptions under relevant regulations to the requirement to engage a local distributor. Therefore, in principle, representatives of the offshore fund that do not have a local fund distribution licence should not be engaged in the direct marketing of the funds to potential Korean investors.

If there are no marketing or solicitation activities in Korea in respect of an offshore private equity fund, and such a fund is offered to Korean investors on an unsolicited basis, then the requirements for fund registration and appointment of a local distributor described above would not apply. However, there is no clear regulatory guidance as to what constitutes marketing or solicitation, or offerings on an unsolicited basis, and accordingly these issues would need to be considered individually in light of all relevant circumstances.

The author wishes to thank Makoto Igarashi of Nishimura & Asahi in Tokyo and Pil-Kook Lee of Kim & Chang in Seoul for their extremely helpful advice on this topic. All errors, however, are those of the author alone.
Chinese insurance companies had total assets exceeding US$1.45 trillion at the end of the first quarter of 2014 and so represent a potentially significant source of institutional funds for sponsors of RMB funds and sponsors of offshore funds alike. The Chinese Insurance Regulatory Commission (CIRC) has recently taken encouraging steps towards creating a regulatory framework which would allow Chinese insurance companies to invest in both offshore funds and RMB funds.

In June 2012 the CIRC issued a new notice liberalising existing regulations regarding the ability of Chinese insurance companies to invest in RMB funds (the ‘Onshore Rules’). Soon after, the CIRC promulgated additional regulations permitting Chinese insurance companies to invest for the first time in certain qualified offshore private equity funds sponsored by qualified sponsors (the ‘Offshore Rules’).

Although the legal regime under which these investments will be permitted is a work in progress, with many details and uncertainties yet to be resolved, below is a high level summary of the substantive requirements of each regime (specific standards/thresholds differ between the Offshore Rules and the Onshore Rules):

- **Qualified fund sponsors** – sponsors must satisfy certain conditions including with respect to the amount of assets under management, paid-in capital, track record and maturity of the investment team.
- **Qualified Chinese insurance companies** – Chinese insurance companies seeking to invest in such funds must comply with certain requirements including having a minimum solvency adequacy ratio, and limiting the percentage of their assets allocated to private equity investments.
- **Reporting requirements** – Chinese insurance companies must provide certain information to the CIRC regarding their private equity investments.
- **CIRC endorsement** – Chinese insurance companies must obtain endorsement for their private equity investments from the CIRC, which can be time consuming.
Despite these encouraging developments there are still a number of important issues that remain to be clarified. While we have seen Chinese insurance companies successfully invest in RMB funds, we have yet to see an analogous investment in an offshore fund.

**Regulation of domestic Chinese funds and managers**

In June 2013 the China Securities Regulatory Commission (CSRC), regulator of the securities industry in China, emerged as the primary regulatory body for the domestic private equity industry in China. The CSRC is drafting a new set of rules to regulate private investment funds (including private equity funds) which are currently under review by the State Council of China. It is not clear when these rules will be finalised.

In the meantime the CSRC has authorised the Asset Management Association of China (AMAC), a national self-regulatory organisation for the fund industry, to administer a new regime requiring registration of domestic Chinese private equity fund managers and filings by domestic Chinese private equity funds (RMB funds). This new regime took effect in February 2014 and represents a significant change from the previous (and now inapplicable) regime for registration of domestic funds with the National Development and Reform Commission.

This regime only applies to domestic funds and managers. Foreign managers and foreign funds are not currently required to register or make filings with the AMAC.

Key aspects of the new regime include:

- Domestic managers (including managers with foreign investment) must register and apply for membership with the AMAC.
- Upon closing a RMB Fund, its manager must make a filing with the AMAC with details including its investment focus, legal name, size, investors, and fund agreements.
- Managers must update their AMAC filings on a quarterly and annual basis, and must promptly notify the AMAC if significant changes are made to information that has previously been filed.
- The AMAC has indicated that it will not conduct a substantive review of material submitted by managers. Certain basic information about managers and their RMB funds will be disclosed to the public on the AMAC website.
- The deadline for managers to register with the AMAC is 30 April 2014. No deadline has been set for RMB funds or managers to begin making filings with the AMAC.

“Despite these encouraging developments there are still a number of important issues that remain to be clarified. While we have seen Chinese insurance companies successfully invest in RMB funds, we have yet to see an analogous investment in an offshore fund.”
Tax issues for private equity in Asia

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As with any region, sponsors and investors investing in Asia need to be aware of the ways in which local tax issues can affect overall returns and manage those issues actively through proper diligence and structuring. Taxes payable in a target jurisdiction can meaningfully affect returns and be the determining factor in whether an investment is viable. For example, many Asian jurisdictions impose withholding taxes on dividends paid by resident companies, and capital gains taxes on sales of shares of resident companies by non-resident shareholders.

These taxes often represent pure ‘leakage’, since investors such as pension plans, governmental entities and other tax-exempt institutions pay no tax in their home country (so credits for local taxes are not usable). Even for taxable investors, the complexity of foreign tax credit systems will make it more efficient to avoid or reduce local country taxes wherever possible.

Clearly each country’s rules are different and the optimal structure will vary from jurisdiction to jurisdiction. Some countries have introduced favourable regimes under domestic law designed to facilitate fund management and private equity investment, such as Singapore’s
tax incentive schemes applicable to funds managed by fund managers in Singapore. This allows funds an exemption on certain specified income, including dividends and capital gains. Where available this will often represent the most efficient structuring option.

Compliance

In practice, however, qualifying for these regimes may be difficult and/or impractical for funds or investors, and such regimes in any event may have some uncertainties and risks. As a result, regardless of the availability of any special exemptions, funds and investors may need to manage their operations and governance to avoid creating a taxable business presence in a particular jurisdiction.

Some countries are parties to double tax treaties which reduce or eliminate dividend and capital gains taxes. Consequently a fund may make an acquisition using a vehicle formed in a country having a tax treaty with the target jurisdiction. Care must be taken on several fronts.

First and foremost, it is important to understand and comply with the rules of the treaty country as well as the target jurisdiction. For example, the acquisition vehicle may need to obtain a tax residency certificate (needed to claim treaty benefits). In addition, the target jurisdiction may have its own requirements in order to extend treaty benefits, such as demonstrating that the acquisition vehicle is formed for a valid business purpose or that board meetings of the acquisition vehicle occur in the country of the vehicle’s formation.

Some countries have passed laws that deny treaty benefits where there is insufficient substance or a tax avoidance motive, and tax authorities have been successfully challenging claims for treaty benefits. Thus, particular care must be taken to ensure that the acquisition vehicle meets all of the relevant requirements, even when using established routes, such as Mauritius into India or Hong Kong into the PRC.

Another option is to form an acquisition vehicle outside the target jurisdiction and to attempt to structure a future exit as a sale of shares of the acquisition vehicle that is outside the taxing jurisdiction of the target country. In this regard it should be noted that both China and India have enacted indirect transfer rules intended to subject such structures to capital gains taxes. Tax savings may also be achieved by forming an acquisition vehicle in the target jurisdiction that is partially capitalised with shareholder debt to generate interest deductions that can offset taxation on dividends and capital gains.

Although fund sponsors will generally concentrate their attention on the taxes payable by the fund with respect to an investment, it is also important to understand the tax position of the target. In many Asian countries, tax disputes are very common and it will be essential during the diligence process to place such disputes in the context of the overall tax history of the company, understand the likely as opposed to merely the nominal exposures involved, and in appropriate cases seek contractual protection through escrows and indemnities.

“Regardless of the availability of any special exemptions, funds and investors may need to manage their operations and governance to avoid creating a taxable business presence in a particular jurisdiction.”
Corporate governance and anti-corruption challenges

Philip Rohlik, International Counsel, Debevoise & Plimpton LLP

Asia contains an array of economies but many countries in the region share the unfortunate characteristic of endemic corruption, ranging from cash payments to kickbacks to nepotism. Corruption can also include ubiquitous demands for money that form part of many interactions with civil servants at every level. While it would be naïve to imagine any local target, especially a smaller company with high growth potential, is untouched by corruption, managing corruption risk can result in rewards for private equity firms at the time of exit.

Corruption-related legal risks in Asia

All investors need to assess corruption when investing in Asia. This is particularly true of funds subject to the US Foreign Corrupt Practices Act (the FCPA) and the UK Bribery Act.

All investors must be mindful of local anti-corruption efforts, including China’s recent crackdown in the pharmaceutical and consumer products sectors, and the increasingly aggressive enforcement efforts by local authorities in Indonesia, Malaysia and India. Significantly, investors also face the possibility of multiple enforcement actions, as scrutiny from one jurisdiction can bring scrutiny from others.

Corruption-related risks exist whenever the fund manager engages a third party to assist in sourcing a deal or obtaining regulatory approval. Additional risks arise when a fund manager raises capital from investors in the region. Fund managers must be especially mindful of benefits provided to representatives of Limited Partners whose employees, in the case of public pension funds and sovereign wealth funds, often qualify as ‘foreign officials’ under the FCPA - and of remuneration provided to non-US officials who serve on advisory and other boards.

Fund managers may also be exposed to liability for the actions of their portfolio companies – even, potentially, companies in which the private equity firm has only a minority stake. The fundamental measure by which potential liability should be judged is ‘control and direction’, determined by factual relationships rather than corporate formalities. Although possessing a small percentage of ownership is unlikely to incur liability, a minority position with significant control rights could be interpreted as giving an investor control.

Determining risk and value: due diligence

Knowledge of bribery includes actual knowledge and conscious avoidance or wilful blindness. To minimise the risk of an accusation of conscious avoidance or wilful blindness, a fund manager should undertake meaningful due diligence on the target. Under certain circumstances, investors in club deals might also consider whether due diligence of investment partners should be undertaken.

In the high-risk markets of Asia it is often impossible to eliminate all risk. Due diligence allows the investor to make a judgment about legal and reputational risks of entering the transaction. In making this judgment in the context of a minority investment, not all red flags are alike. Making a minority investment in a company while knowing that the provision of envelopes of cash to government officials is part of the company’s business plan presents significantly more legal and practical risk than does making such an investment while knowing merely that the company’s practices with regard to gifts, meals and entertainment fall short of FCPA best practices.

Adding value through anti-corruption controls

An investor can further protect itself by encouraging, if not requiring, the portfolio
Corporate governance and anti-corruption challenges

Even a minority investor can make the adoption of such controls a condition of the investment. If the deal dynamics do not permit an investor to require the adoption of such controls, encouraging their adoption adds value to a portfolio company, a primary goal of private equity firms.

Anti-corruption controls can be a significant benefit in a trade sale to an international corporation. Similarly, while anti-corruption might not be a topic of particular concern to listing committees on Asian exchanges, the types of accounting systems and compliance programmes needed for effective anti-corruption controls will assist with satisfying a listing committee or other relevant regulators if the exit from the investment is undertaken through a public stock or debt offering.

Conclusion
As with political or currency risk a realistic assessment of both the challenges and opportunities presented by anti-corruption compliance associated with investment in the region is necessary prior to investment. Such an assessment can allow private equity funds to determine the most appropriate regional balance in deploying funds as well as to realise increased value in an exit from a recently compliant company.

“All investors must be mindful of local anti-corruption efforts, including China’s recent crackdown in the pharmaceutical and consumer products sectors, and the increasingly aggressive enforcement efforts by local authorities in Indonesia, Malaysia and India.”
About the Sponsor

Debevoise & Plimpton LLP

Debevoise & Plimpton LLP is a leading international law firm, with eight offices around the world. The firm has been a pioneer in private equity for over 25 years and is a recognised leader in both fund formation and private equity transactional work. With over 200 lawyers serving private equity in the US, Europe and Asia, Debevoise is among a handful of firms with a truly global private equity practice.