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Modes of RMB PE Funds in China

By David Yu and Nicholas Lou

The RMB private equity funds in China have become more and more active and attractive. Subject to China's foreign exchange regulations and foreign investment threshold in restricted and prohibited sectors, fund managers are seeking suitable RMB fund structures under which they can have more flexibility of fund raising, management and operation.

Under the current Chinese legal regime, fund managers may use various structures to establish RMB PE funds including company mode, contractual mode, partnership mode and trust mode.

Company Mode

Under the company mode, the fund manager and investors can invest in a target company through a limited liability company in China (**Project Company**) as an investment vehicle. The fund manager, as one of the shareholders, will contribute capital into the Project Company, including registered capital, shareholder's loan and other funds, and will also have the right to hold and manage the target company by controlling the Project Company in accordance with the shareholders' agreement and the articles of association.

However, there are several disadvantages in using the Project Company as the investment vehicle, mainly:

- Allocation of statutory reserve funds and other operational funds to the Project Company may reduce the fund investors' ROI;

- The Project Company may need a large amount of registered capital to make investment while it will be difficult to reduce the registered capital due to complicated procedures for capital decrease, which will increase the investor's risks. In addition, the less flexibility of capital increase and reduction may cause obstacle and difficulty in fund manager and investors' capital injection and withdrawal as well as distribution of profit;

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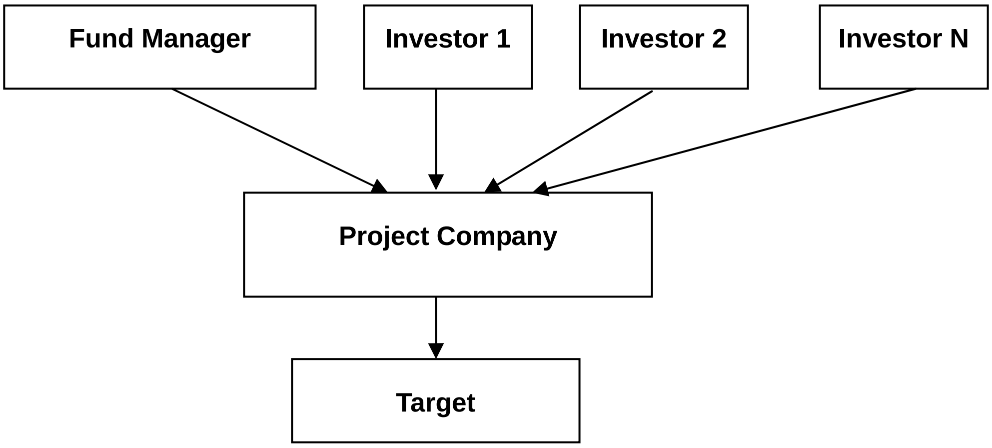
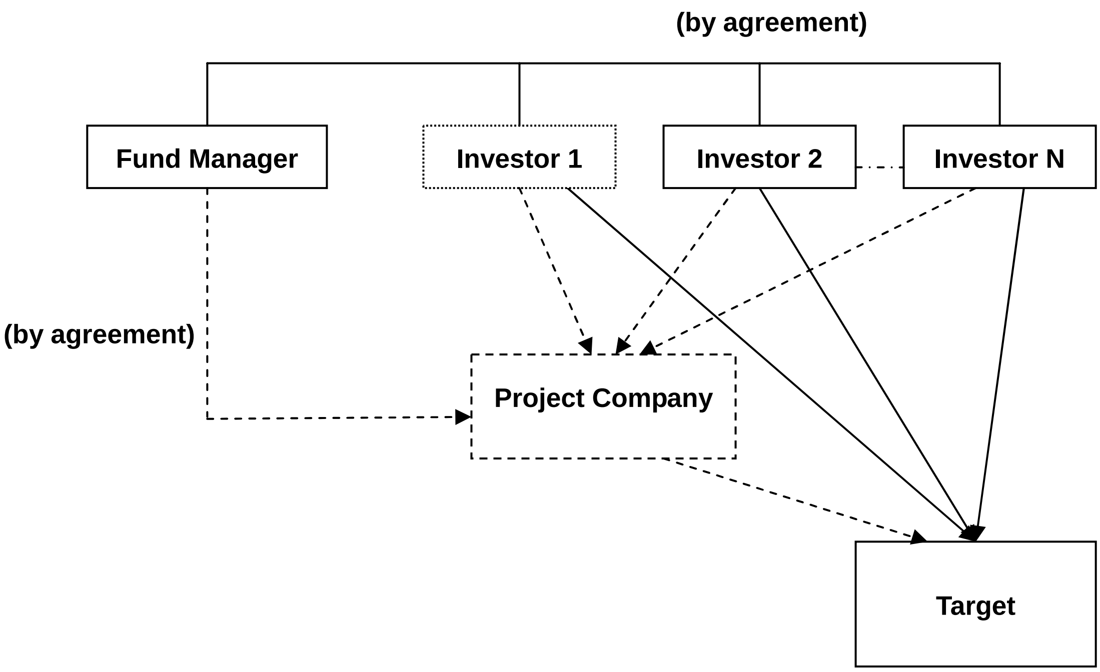
- The fund manager of the target company, if concurrently being a minority shareholder of the Project Company, may not be able to fully control the Project Company as well as the target company; and

- Where there is a foreign shareholder, the Project Company will be subject to registration and approval formalities in terms of changing the shareholding structure, registered capital, etc., and the registered capital subscribed by such foreign shareholder cannot be converted for equity investment purpose. Accordingly, in such case, the Project Company will become less flexible.



Contractual Mode

For the purpose of avoiding being a shareholder of a company, a fund manager may enter into a consultancy agreement with investors, under which the investors will invest directly into the target company in their own name or through the Project Company, which is similar to the company mode.

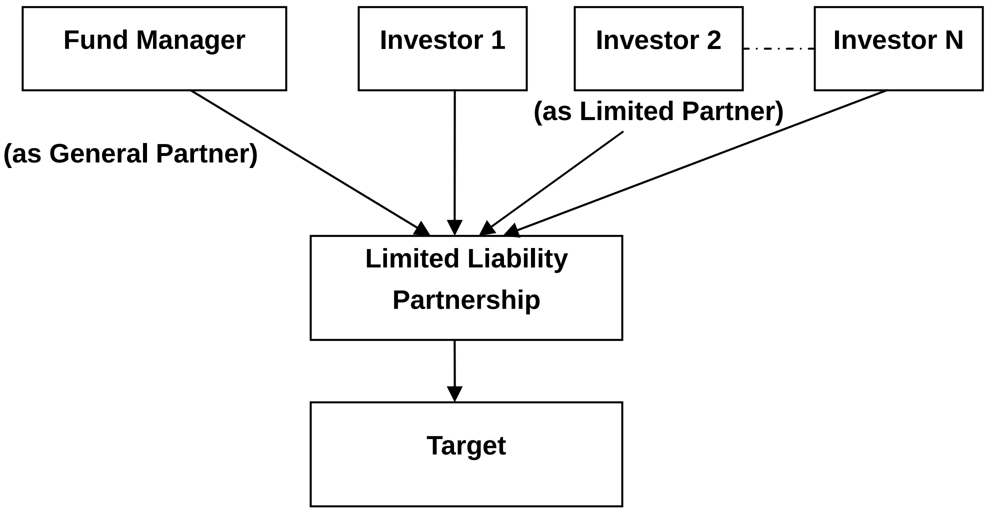


The investors will obtain ROI from the target company while the fund manager may receive management fees from the investors or the Project Company.

However, such arrangement may impair the controlling power of the fund manager over the target company. In addition, the fund manager is unable to participate in direct capital investment and can only provide investment consulting services to the target company or the Project Company. Thus, the fund manager's interests may not be well secured.

Partnership Mode

The amended the PRC Partnership Law effective as of 1 June 2007 has paved the way for domestic individuals and institutions to set up a limited partnership, which is deemed as a new form of PE fund vehicle in China. However, no laws regarding foreign invested partnerships have been promulgated. Accordingly, the feasibility of foreign invested partnership in practice is uncertain.



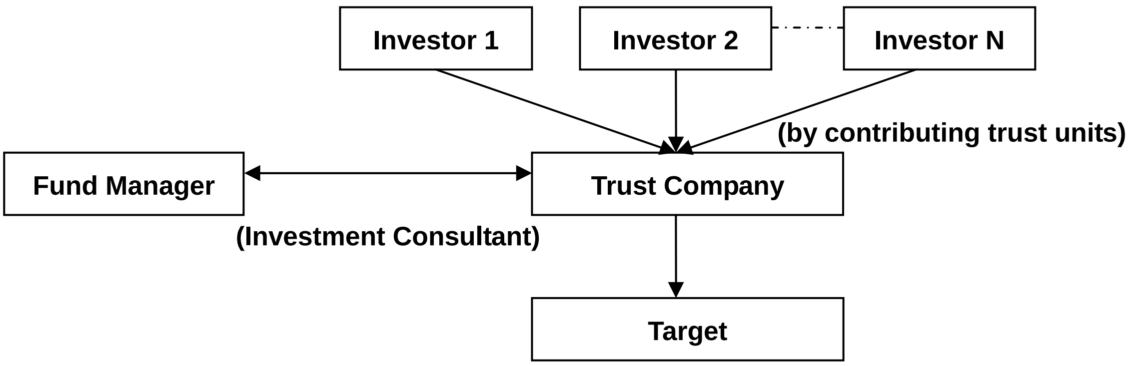
In the partnership mode, the general partner can act as both fund manager and investor. Compared with the company mode, the partnership is not required to reserve statutory reserve funds and pay enterprise income tax, and thus the partnership mode has lower operational cost. In addition, the general partner may enjoy benefit from the flexible mechanism of capital injection and withdrawal as well as distribution system according to the partnership agreement. In practice in recent years, several RMB funds have been established in the form of domestic partnerships.

However, the law and practice in China applicable to partnerships is still immature, especially in respect of foreign invested partnerships, the feasibility of which is still uncertain due to lack of laws.

In practice in China for a company's initial public offering of its shares and the listing thereof, it appears that current obstacles still exist for a partnership to hold the shares of a listed company, although no such obstacles are provided by laws, which means a partnership, as the shareholder, may encounter restrictions in listing the target company on A share market.

Trust Mode

Formation of a RMB fund through trust is not new. In practice in recent years, some trust companies issued trust plans for equity investments in and providing loans to various target companies. However, only providing loan facilities through a trust plan does not characterize the trust plan as a PE fund.



On 25 June 2008, the China Banking Regulatory Commission (**CBRC**) issued the Guidelines for Trust Companies to Operate Private Equity Investment Trust (**Guidelines**) which allows the establishment of RMB PE funds by means of issuing trust products. Under the trust structure pursuant to the Guidelines, the trust company may create a trust plan with the funds focusing on PE investments in various target companies, including the equity interests of unlisted companies, tradable shares under trading restrictions of listed companies and other investible equity interests approved by CBRC.

In the PE fund under trust plan, the trust company may entrust an investment consultant (**Consultant**) other than itself to provide consulting services for PE investments. There is no limitation on management fees charged by the fund manager.

Notwithstanding the foregoing, there are still some key requirements for the trust structure according to the Guidelines, including but not limited to:

- The trust company shall comply with certain requirements, including having five or more qualified professionals for equity investment trust;
- In case of investment in the trust plan for private equity investment by using the trust company's funds, the contribution for the trust unit under the trust plan shall not exceed 20% of the assets under the trust plan and the used fund shall not exceed 20% of the net assets of the trust company;
- The trust company shall report to CBRC within 10 days after the establishment of the trust plan; and
- The Consultant's minimum paid-in registered capital shall be RMB 20 million and the Consultant shall hold at least 10% of the trust units.

Modes of RMB PE Funds in China

In current practice, there exist the precedents for each of the above-mentioned four modes, of which, the partnership mode and the trust mode are preferred. Moreover, it is foreseeable that, once the relevant laws on foreign invested partnership are promulgated, Sino-foreign invested partnerships and wholly foreign owned partnerships will become an ideal option for both offshore fund managers and offshore investors.

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