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Latest News: Pilot of QFLP System in Pudong New Area, Shanghai?

By David Yu and Nicholas Lou

The Result:

May foreign currency invested in RMB funds be converted into RMB within the given quota for the purpose of equity investment?

Is Shanghai likely to become the more attractive hotbed for equity investment by foreign private equity investors?

Background Information:

According to the latest news reports, after a series of discussions with the State Administration of Foreign Exchange ("SAFE") and other government departments, the relevant government authorities in Shanghai have recently passed a document regarding the Pilot Rules on Foreign Capital's Participation in RMB Equity Investment Fund ("Pilot"), which is expected to be promulgated in April, 2010. The Pilot will be first implemented in the Pudong New Area of Shanghai.

After promulgation of the Implementing Measures for Promoting the Development of Equity Investment Enterprises and Equity Investment Management Enterprises in Pudong New Area (浦东新区促进股权投资企业和股权投资管理企业发展的实施办法) in March, 2009 and Trial Measures for the Establishment of Foreign-invested Equity Investment Management Enterprise in Pudong New Area of Shanghai Municipality (上海市浦东新区设立外商投资股权投资管理企业试行办法) in June, 2009, the Pilot will become another important policy and measure for foreign-invested equity investment funds. Prior to its formal implementation, the specific terms and practical operations of the Pilot may still be subject to additional modification by SAFE, the Ministry of Commerce ("Mofcom") and other authorities. For the basic content of the latest version of the Pilot, please see below.

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In spite of all else, Shanghai Pudong New Area is likely to become a geographical focus for investors by drawing them to participate in RMB funds after the Pilot is formally implemented. But, the key question remains as to whether the Pilot will represent notable progress from current foreign-invested equity investment policies, particularly those governing equity investments of monies converted from foreign currency.

Obstacles Under Circular 142

On August 29, 2008, SAFE unveiled the Notice of the State Administration of Foreign Exchange on the Relevant Operating Issues concerning the Improvement of the Administration of Payment and Settlement of Foreign Currency Capital for Foreign-funded Investment Enterprises, Hui Zong Fa [2008] No.142 (国家外汇管理局综合司关于完善外商投资企业外汇资本金支付结汇管理有关业务操作问题的通知，汇综发[2008]142 号) ("Circular 142"). Circular 142 requires that "RMB of a foreign-invested enterprise which is converted from foreign currency shall only be used within the scope approved by the governmental approval authority, and, unless otherwise regulated, such RMB cannot be used for onshore equity investment." For obvious reasons, Circular 142 is widely considered an obstacle for onshore equity investment by foreign-invested RMB funds.

In November, 2009, the State Council officially promulgated the Measures for the Administration of the Establishment of Partnerships in China by Foreign Enterprises or Individuals ("Measures"). The Measures did not require for prior Mofcom approval when establishing foreign-invested partnership enterprises, instead, only requiring that registration be completed with the State Administration of Industry and Commerce ("SAIC"). While the Measures cleared some organizational impediments for foreign-investors looking to directly participate in RMB fund partnerships and simplified the formation process for those fund partnerships, it nevertheless overlooked the foreign exchange limitations set forth under Circular 142, which remains in place to inhibit onshore equity investments with RMB converted from foreign currency.

But, this Pilot may be the glimmer of hope that many foreign investment institutions had been praying for.

The Pilot – QFLP

It is currently known that Shanghai Pudong New Area Pilot may seek to create a Qualified Foreign Limited Partner (QFLP) system akin to that governing Qualified Foreign Institutional Investors ("QFII"). Under this new system, SAFE will approve a currency quota within which a foreign partner may invest into a RMB equity investment fund. However, the limitations include (i) such foreign-invested RMB fund must be founded in Shanghai Pudong New Area; and (ii) the fund manager (i.e. the equity investment management company) must be established in Shanghai.

According to the Pilot, the converted foreign-invested portion of a foreign-invested RMB fund cannot exceed 50% of the total capital size of the fund, within which the general partner ("GP") is limited to no more than 5% of the total capital size. Additional limitations may also be imposed in the preliminary stage of implementation, for instance, requiring that total foreign currency conversion not exceed USD 100,000,000.

Furthermore, domestic funds which acquire foreign currency from foreign investors via the QFLP system may nonetheless be deemed “foreign investment institutions”, which then are subject to relevant laws and regulations applicable to foreign-invested enterprises. This means, among other things, that the investment by the fund will be subject to the Foreign Investment Industrial Guidance Catalogue and Mofcom approval will be required when engaging in equity investment. From this perspective, this structure closely resembles that of foreign-invested venture capital enterprises, except whereas SAFE approval is still required whenever profits or invested capital (in RMB) of venture capital enterprises need to be converted to foreign currency for repatriation, the QFLP system allows an avenue to freely exchange currency under the granted quota.

However, the Pilot also mentions that, where the only converted foreign currency capital investment is by the fund manager, and all other capital is RMB raised from onshore entities, the fund may receive “domestic treatment”, and be considered an onshore investment institution. In that case, the fund will not be subject to foreign investment approval procedures and requirements.

Notwithstanding the above, foreign investors should take caution in applying for QFLP status. As is know at this stage, foreign equity investment institutions applying for QFLP qualifications must itself have a capital of no less than USD 500,000,000 or is managing investment funds of no less than USD 5,000,000,000. Also, any funds which were converted via QFLP qualifications may only invest in equity interest, and is prohibited from investing in the secondary market. Finally, to prevent foreign exchange arbitrage and short-term gain, RMB converted via QFLP qualification must remain onshore for no less than 12 months before being allowed for repatriation.

In any case, the Pilot has yet not been officially published or implemented and is subject to further consideration and revision by the relevant authorities. Of course, when instigating new investment and financial policies, governmental authorities will act with prudence and diligence.

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