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Expecting Clarification on the Legal Nature of Foreign-invested RMB Funds

By David Yu, Nicholas Lou and Lawrence An

A recent document released by the National Development and Reform Commission (the "**NDRC**") has again highlighted the issue of the legal nature of foreign-managed RMB funds.

According to this NDRC document: **Under the "Provisions on Guiding Foreign Investment Directions" (Order No.346 of the State Council) and the "Measures on the Administration of the Establishment of Partnerships by Foreign Enterprises or Individuals Within China" (Order No.567 of the State Council), equity investment enterprises in the form of a limited partnership, with enterprises of "foreign investment" as general partners and domestic enterprises as limited partners, should be governed by the policies and regulations on foreign enterprises and their investment projects should be bound by the "Catalogue for the Guidance of Foreign Investment Industries".**

What is the meaning and scope of "foreign investment"?

The document does not clarify whether the term "foreign investment" only refers to "foreign investors" or "foreign-invested enterprises (including foreign-invested partnership enterprises)" in addition to "foreign investors".

If the term "foreign investment" refers only to "foreign investors", then limited partnerships established by foreign investors as general partners within China should be subject to the "Measures on the Administration of the Establishment of Partnerships by Foreign Enterprises or Individuals in China" and their nature should be "foreign-invested partnerships".

However, if the term "foreign investment" refers also to "foreign-invested enterprises" established by "foreign investors" within China, then limited partnerships established by such foreign-invested enterprises as general partners should be subject to the "Partnership Enterprise Law" and their nature should be partnerships re-invested by foreign-invested enterprises within China.

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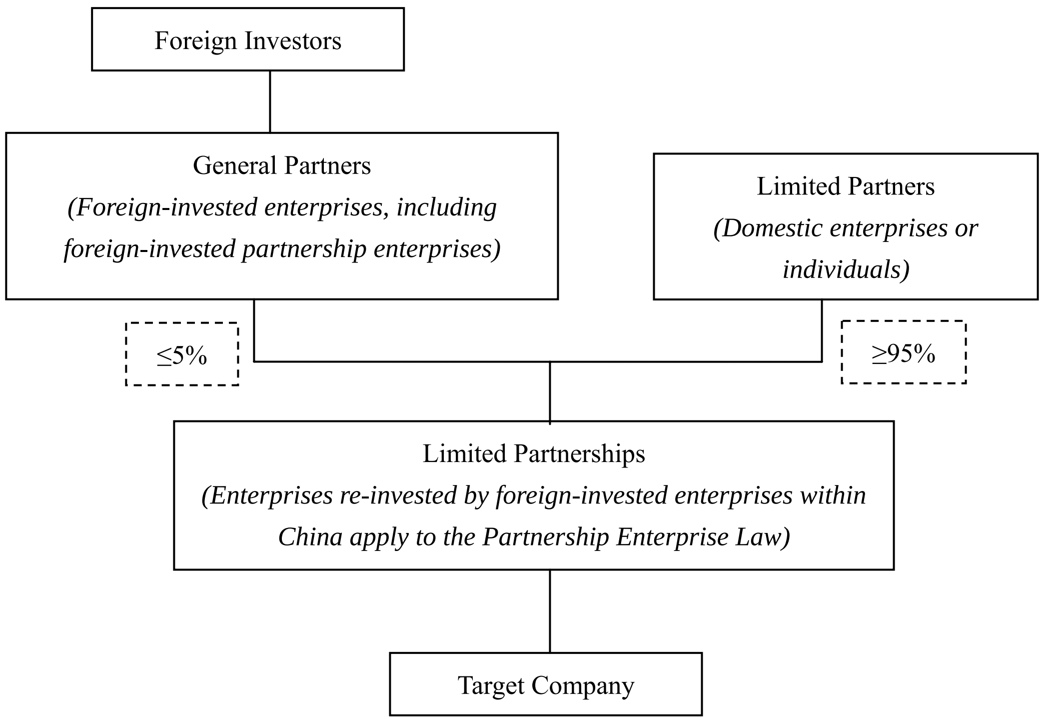
Similar issues are seen in the pilot rules regarding foreign-invested equity investment enterprises of some cities in China including Shanghai and Beijing.

For instance, the Shanghai Municipal Finance Bureau released the “Measures on Implementing the Pilot Work of Foreign-invested Equity Investment Enterprises in Shanghai” (Hu Jin Rong Ban Tong [2010] No. 38) (the “**Pilot Measures**”) in December 2010. Under Article 24 of the Pilot Measures, approved foreign-invested equity investment management enterprises may make capital contributions to equity investment enterprises established by them using foreign currencies, the amount of which shall not exceed 5% of the total funds raised, and the capital contribution made in this way shall not affect the original nature of the equity investment enterprise.

Despite the fact that the Pilot Measures does not expressly confirm whether the legal nature of the equity investment enterprises under its Article 24 shall be “domestic enterprise” or “enterprises re-invested by foreign-invested enterprises” but requires the inheritance of their “original nature”, thus, there are still plenty of uncertainties in determining the legal nature of the Article 24 equity investment enterprises. Nevertheless, a majority view in the market presumes that an Article 24 equity investment enterprise will probably be deemed as a “domestic enterprise”, resulting in relevant funds to be commonly structured as follows:



Under the above structure, the “Limited Partnership” that has foreign-invested equity investment management enterprise acting as its general partner shall legally be deemed as “foreign-invested enterprise”, and when all of its limited partners are domestic investors, deeming such “Limited Partnership” as a “partnership re-invested by foreign-invested enterprises” seems more appropriate.

As such, the Pilot Measures remains silent on stating whether the Section 24 equity investment enterprises are of "domestic enterprise" nature, even for funds strictly complying with the structure provided under Section 24. However, if such Section 24 equity investment enterprise is deemed as "enterprise re-invested by foreign-invested enterprises", according to current laws, regulations and administrative policies governing foreign investments, any of its re-investments in China will also be subject to all restrictive and prohibitive requirements in the "Catalogue of Industries Guiding Foreign Investment", with no avoidance of such allowed by structuring multiple layers of re-investments.

The description of "foreign investment" in the NDRC document in this sense is consistent with the current foreign investment management system of the State, i.e. no matter how the meaning and scope of foreign investment are determined, such equity investment enterprises need to follow the "Catalogue for the Guidance of Foreign Investment Industries".

What Is the Meaning of "administered in accordance with regulations and policies governing foreign investments"?

Upon closer reading of the NDRC document, the meaning of "administered in accordance with regulations and policies governing foreign investments" will also require further clarification.

By "administered", if the NDRC means the administration on the re-investment by the equity investment enterprise in its target, then all restrictive and prohibitive requirements in the "Catalogue of Industries Guiding Foreign Investment" shall be followed by such equity investment enterprises due to their "foreign" element, which, as explained above, conforms with the current laws, regulations and administrative policies governing foreign investments in China.

However, if such administration should extend as to require the relevant equity investment company to, when re-investing in the target, undergo the approval procedures of foreign direct investment (like those required for foreign investors to make investments in China), relevant practices may in addition be subject to the understanding of the Ministry of Commerce. Further, if approval procedures of foreign direct investment are applied, the relevant fund will then look much like a foreign-invested venture capital investment enterprise. As a foreign-invested venture capital investment enterprise uses primarily foreign capital, its strict approval requirements do conform to the administrative policies regarding foreign investments. However, the reasonableness of a policy that requires strict compliance with the approval procedures (like those for a foreign-invested venture capital investment enterprise) on a fund consisting only domestically raised RMB may be put to questions.

Other available structures

Some uncertainty still remains as to whether an equity investment enterprise with foreign-invested enterprises as general partners needs to be regulated by the examination and approval procedures for foreign direct investment, and therefore other available fund structures are being discussed in the market currently. For instance, whether a domestic re-investment enterprise can be set up under the level of general partners and this domestic re-investment enterprise can act as the general partner in an equity investment enterprise. This structure, on one hand, is subject the requirement that the registered capital of foreign-invested enterprises may not be used directly for equity investment after the settlement of foreign currencies, and on the other, may cause additional tax burdens and more importantly, faces compliance issues as being deemed as established with the purpose of avoiding the requirements on foreign investment examination and approval.

Expecting all the departments to unify requirements

Since foreign investment management involves departments other than the NDRC, and some examination and approval functions are performed by the Ministry of Commerce and other departments, the absence of the approval requirement and approval procedures for foreign-invested equity investment enterprises may so explained. Therefore, as NDRC alone may not be able to provide definitive answers regarding whether equity investment enterprises with foreign elements will be required to undergo approval procedures and comply with standards applicable to foreign investors when making investments in China, we expect a unification of such rules by all relevant authorities including the Ministry of Commerce, the State Administration for Industry and Commerce, and the State Administration of Foreign Exchange.

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