

PE in China: A Growth Spurt

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On 24 December 2010, the *Implementing Measures for the Launch of Pilot Foreign-invested Equity Investment Enterprises in the Municipality* (上海市关于本市开展外商投资股权投资企业试点工作的实施办法) (Pilot Measures) was jointly issued by the Shanghai Financial Service Office (Shanghai FSO), the Shanghai Municipal Commission of Commerce (Shanghai Mofcom) and the Shanghai Administration for Industry and Commerce (Shanghai AIC). Effective as of 23 January 2011, the Pilot Measures marks another breakthrough in the development of *renminbi*-denominated funds (Rmb funds) as it further clarifies how the involvement of foreign investors and foreign-invested fund management enterprises will affect the legal treatment of such Rmb funds. Specifically, it provides additional guidance for the establishment of and investments by foreign-invested equity investment enterprises (Investment Enterprises), and adds a new concept for foreign-invested equity investment enterprises, the “Pilot Enterprise for Foreign-invested Equity Investment Enterprise” (Pilot Enterprise) scheme. The Pilot Measures also stipulate more detailed rules on how foreign-invested equity investment management enterprises (Management Enterprises) may participate in Rmb funds.

Background on Fund Investment in China

- *FIVCIE as the major vehicle for foreign-invested equity investment funds prior to the Pilot Measures*

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Since 2003 and with the effectiveness of the *Administration of Foreign-invested Venture Capital Investment Enterprise Provisions* (外商投资创业投资企业管理规定) (FIVCIE Provisions), foreign investors have had the option of making equity investments via a foreign-invested venture capital investment enterprise (FIVCIE). An FIVCIE could be formed as a non-legal and tax-friendly investment entity that is similar to limited partnerships in other jurisdictions. The FIVCIE Provisions and relevant regulations also provided clear guidance

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with respect to application, approval and filing procedures as well as to relevant tax and foreign exchange matters. However, it also had key limitations. As made obvious by its name, FIVCIEs were limited to venture capital investments in privately-owned hi-tech industry sectors. Further, an FIVCIE could only invest with its foreign currency and is not allowed to convert it into Rmb for equity investment directly. Its investments must also comply with foreign investment laws and regulations, including the *Foreign Investment Industrial Guidance Catalogue (Amended in 2007)* (外商投资产业指导目录(2007年修订)) (Foreign Investment Catalogue).

Thus, while creating an investor-friendly vehicle, the FIVCIE Provisions was not an open door through which foreign investors could freely engage in equity investments in China. Additionally, due to its foreign exchange conversion treatment and restrictions under the foreign investment laws and regulations, an FIVCIE is essentially treated as a foreign investor, and is not congruent with an Rmb fund.

➤ *The advent of Rmb Funds in the form of limited partnerships*

The limited partnership, as used to establish Rmb funds, is a relatively nascent vehicle for pooling investment capital in China. In 2007, the revised *Partnership Enterprise Law* (合伙企业法) provided for limited partnerships for the first time. This allowed investors to pool investment capital in private equity funds (PE funds) structured similarly to those in jurisdictions such as the United States, jump starting the development of Rmb funds in China. However, the Partnership Enterprise Law did not provide for foreign investment in Rmb Funds. Specifically, it was silent on the procedures and requirements for the establishment and administration of Rmb funds with foreign limited partners (LPs), as well as foreign exchange and other matters crucial to foreign investment.

However, foreign investors were optimistic in March 2010, when the State Council released the *Measures for the Administration of the Establishment of Partnerships in China by Foreign Enterprises or Individuals* (外国企业或个人在中国境内设立合伙企业管理办法) (FIEPs Measures) and the State Administration of Industry and Commerce (SAIC) promulgated the *Provisions for the Administration of the Registration of Foreign-invested Partnerships* (外商投资合伙企业登记管理办法) (FIEPs Registration Provisions). The FIEPs Measures officially and expressly permit foreign-invested partnership enterprises (FIEPs) while the FIEPs Registration Provisions delineate the detailed procedural rules of registration. With the FIEPs Measures and the FIEPs Registration Provisions, foreign investors theoretically could utilise the limited partnership form to conduct equity investment in China. Unfortunately, both the FIEPs Measures and the FIEPs Registration Provisions do not clarify the establishment and operation of a foreign-invested partnership engaging in equity investment as its principal business.

In practice, foreign investors also encountered a major hurdle when investing through a foreign-invested partnership: restrictions on foreign currency conversion as administered by the State Administration of Foreign Exchange (SAFE). The *Circular on Relevant Operating Issues Concerning the Improvement of the Administration of Payment and Settlement of Foreign Currency Capital by Foreign-invested Enterprises* (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), issued by SAFE in 2008 (Circular 142) effectively limits the use by a foreign-invested enterprise (FIE) of its converted Rmb for equity investment, which is seen as the major hurdle of foreign currency conversion of FIEPs. Thus, foreign investors looking to make an equity investment through Rmb funds in the form of a foreign-invested partnership in China are handcuffed by foreign exchange obstacles.

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As a result, some foreign investors have been active in the Chinese PE fund market by forming Management Enterprises, acting as general partners (GPs), and sponsoring funds in the form of limited partnerships with domestic (non-foreign-invested) investors as limited partners (LPs). However, detailed and bright line rules regarding foreign exchange settlement and equity involvement by these Management Enterprises and fund GPs were still lacking.

The Pilot Measures resolves some of the aforementioned issues by providing added clarity for Management Enterprises. It also sets forth a new framework for the Pilot Enterprise with qualified foreign investors to invest as LPs in Rmb funds established as limited partnerships.

Resolving Some Uncertainties Regarding Management Enterprises and Investment Enterprises

Prior to the Pilot Measures, the most relevant were local rules governing Management Enterprises in places such as Shanghai, Beijing, and Tianjin. In the Pudong new area of Shanghai, the *Trial Measures for the Establishment of Foreign-invested Equity Investment Management Enterprises* (《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》) (Pudong Trial Rules) set in place detailed provisions regarding the establishment of Management Enterprises (the Pudong Trial Rules expired on 30 June 2010). These local rules attracted the establishment of Management Enterprises by global fund management companies such as Blackstone, Carlyle, TPG, and Sequoia Capital in Shanghai, Beijing and Tianjin. However, these rules were limited to Management Enterprises only and did not provide for Investment Enterprises. Guidance with respect to Investment Enterprises remained insufficient.

The Pilot Measures, applicable to Shanghai, fill the regulatory void left by the expiration of the Pudong Trial Rules and add further detailed provisions to the regulatory landscape by setting forth requirement thresholds for the establishment of Management Enterprises and Investment Enterprises, while also creating an additional category of the “Pilot Enterprise”.

➤ Requirements for Management Enterprises

The Pilot Measures impose requirements regarding the name, form, minimum capital investment (or registered capital), business scope, and provide for the application procedures for establishing Management Enterprises. Such enterprises should have “equity investment fund management” in its title. It can take the form of either a limited liability company or a partnership. Its minimum investment or registered capital must be no less than US\$2 million, all of which must be contributed in cash. No less than 20% must be contributed within three months of obtaining the business licence and the remainder within two years. The permitted business scope includes the development and establishment of equity Investment Enterprises, management of the equity investment business of equity Investment Enterprises and related services, equity investment consulting, and other services expressly permitted by the relevant approval and registration authorities. A Management Enterprise must have at least one investor (partner or shareholder) who is, or is an affiliate of, an entity whose business scope includes equity investment or equity investment management. Furthermore, the Management Enterprise must have at least two senior management personnel who have no less than five years of experience in equity investment or equity investment management, no less than two years of experience in senior management, prior experience working with equity investment and/or financial institutions in China, and good personal credit and no records of prior violations or financial disputes within the previous five years.

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➤ *Requirements for Investment Enterprises*

Under the Pilot Measures, Investment Enterprises are expressly permitted to be formed as partnerships. It should have “equity investment fund” as part of its title. The permitted business scope includes investment by using self-owned capital as permitted under PRC laws and regulations via forming new enterprises, investing in existing enterprises, or equity transfer. Investment Enterprises are also permitted to provide consulting services to its invested enterprises.

The total capital commitment must be no less than US\$ 15 million, all of which must be contributed by the partners themselves. Excluding the GP, each remaining LP must contribute no less than US\$ 1 million. All contributions must be made in cash. It should be noted, however, that there is no mandatory contribution schedule under the Pilot Measures. The permitted time to pay up the contribution amount is subject instead to the partnership agreement.

➤ *Newly-introduced Pilot Enterprise concept*

Aside from the abovementioned Management Enterprise and Investment Enterprise provisions, the Pilot Measures introduce for the first time a “Pilot Enterprise” classification, under which both Management Enterprises and Investment Enterprises may qualify. Those qualifying as Pilot Enterprises (Pilot Management Enterprises and Pilot Investment Enterprises) may benefit from certain safe harbour (details available later on) and foreign currency settlement provisions. Consequently, a Pilot Enterprise is subject to particular rules under the Pilot Measures and the administration by the “pilot foreign-invested equity investment enterprise program joint working committee” (Joint Working Committee). The Joint Working Committee is a new body consisting of members from various local government agencies, including the Shanghai FSO, Shanghai Mofcom, and the Shanghai AIC. It decides and implements various policies with respect to Pilot Enterprises. Additionally, the Pilot Measures involve the Shanghai FSO in the application and approval process.

More specifically, the Joint Working Committee is responsible for examining and approving Pilot Enterprises. The scope of permitted foreign investors is relatively broad and mainly includes institutional investors, such as foreign sovereign funds, pension funds, endowment funds, charitable foundations, fund of funds, insurance companies, banks, securities companies and other foreign institutional investors recognised by the Joint Working Committee. Capital contribution to the Pilot Enterprise is subject to dedicated fund custody, and the fund account and its use are managed by a qualified custodian bank.

The partners in a Pilot Investment Enterprise in the form of partnership must meet high qualification requirements. The managing partner, or an affiliate of the managing partner, must have no less than three years of positive direct or indirect experience in equity investment in China. Foreign partners must own assets of no less than US\$ 500 million or have no less than US\$ 1 billion under management in the year prior to the date of application. The foreign partner must have sound and adequate internal controls, and has not been subject to administrative sanctions by any relevant regulatory authority. It, or an affiliate entity, must have no less than five years in relevant investment experience.

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With regards to application and reporting obligations, Pilot Enterprises are required to file with the Shanghai FSO within 10 days after registration with the Shanghai AIC. In addition, Pilot Enterprises must make periodic reports regarding certain material matters on a semi-annual basis.

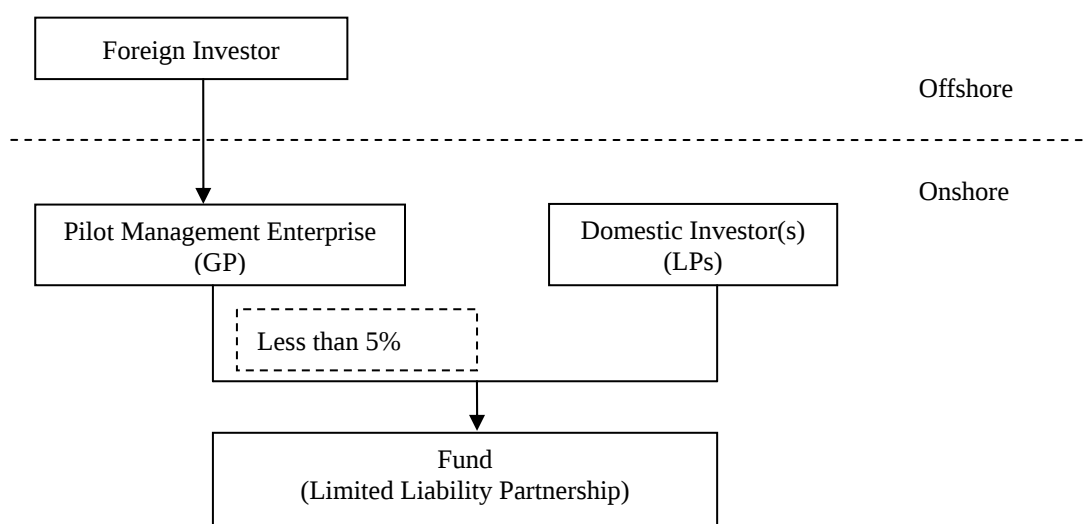
Although the Pilot Measures do not provide so expressly, it is implied that a Pilot Investment Enterprise may convert foreign currency for equity investment via a designated custodian bank, subject to a quota and only those Management Enterprises and Investment Enterprises that qualify for Pilot Enterprises status may settle foreign currency for equity investment. Those not qualifying as Pilot Enterprises might still encounter foreign exchange obstacles when engaging in equity investment.

It is also worth noting that the Management Enterprises qualifying as Pilot Enterprises may convert foreign currency to invest up to 5% of the total commitment amount of an Investment Enterprise promoted by that Management Enterprise. Furthermore, if the Pilot Management Enterprise contributes no more than 5% of the total fund commitment amount to a limited partnership Investment Enterprise and all LPs are domestic partners, the Investment Enterprise can be treated as a domestic limited partnership. Then, foreign investment regulations and rules do not apply. This creates a “5% safe harbour” rule under the Pilot Measures.

Analysis of Fund Structures under the Pilot Measures

When and how an Investment Enterprise formed as a limited partnership will be deemed a “domestic” partnership has been a major issue of discussion. Investment Enterprises deemed “domestic”, “foreign-invested” or “with foreign-investment” are each subject to varying regulatory schemes. Based on the Pilot Measures provisions, three major investment structures are presented for analysis: i) a fund composed of a GP which is a Pilot Management Enterprise and only domestic LPs; ii) a fund composed of a GP which is a Pilot Management Enterprise or a domestic entity and at least one foreign LP; and iii) a fund composed of a GP which is a Pilot Management Enterprise or a domestic entity and at least one FIE LP but no foreign LPs.

Structure 1: Funds composed of a Pilot Management Enterprise as GP and Only Domestic LPs



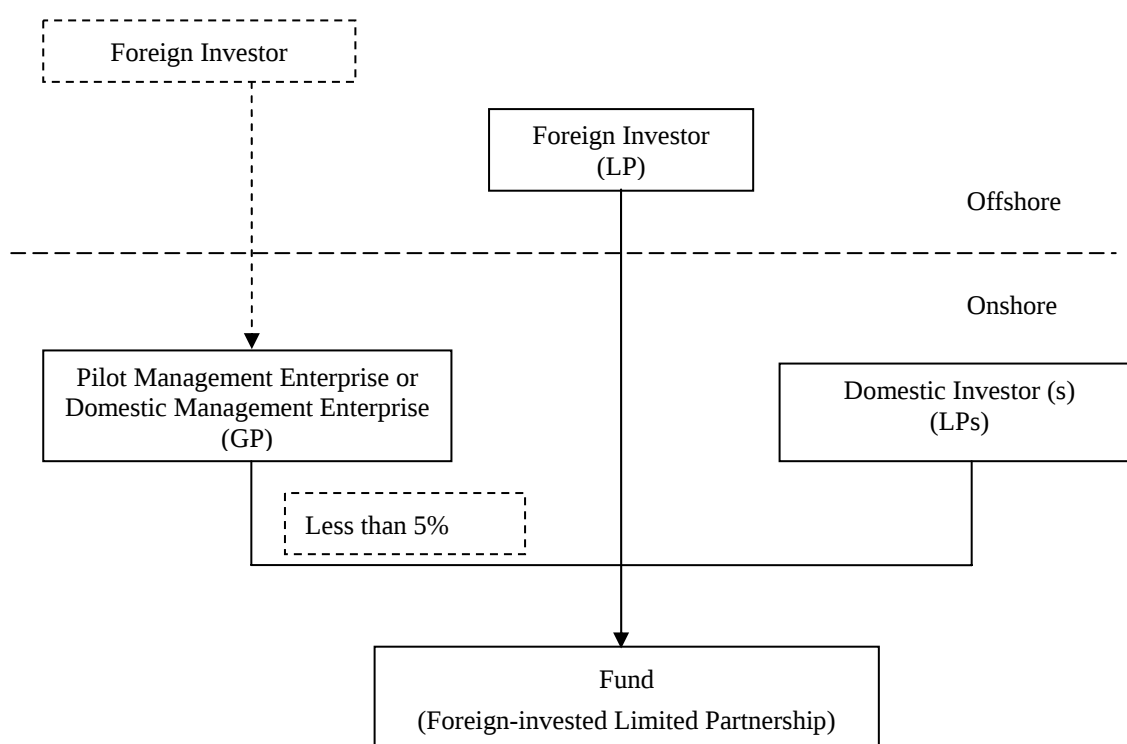
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Prior to the Pilot Measures, it was unclear whether the GP being a foreign-invested management enterprise would cause the fund to be deemed a “foreign-invested” fund or a fund “with foreign investment”. This regulatory risk was a constant concern in structuring Rmb Funds. Also, the restrictions imposed by Circular 142 against foreign currency settlement for equity investment acted as an additional regulatory hurdle.

However, the Pilot Measures expressly provide a bright line “5% safe harbour” rule, whereby a Pilot Management Enterprise as GP contributing no more than 5% of the total capital contributions of the fund will not affect the “domestic” status of the fund. In this structure, such fund can then enjoy legal treatment as a domestic Rmb fund, subject to fewer regulatory restrictions than FIEs and foreign investors.

The local officials of Shanghai further indicated that although the Pilot Measures did not expressly mention a foreign exchange quota, in practice, it allows such Pilot Management Enterprise GPs to convert up to 5% of the total capital contribution amount of the fund. However, it should be noted that Safe has not released any details regarding how such settlement will be regulated and carried out by the relevant custodian bank.

Structure 2: Funds Composed of a Pilot Management Enterprise or a Domestic Entity as GP and at Least One Foreign LP

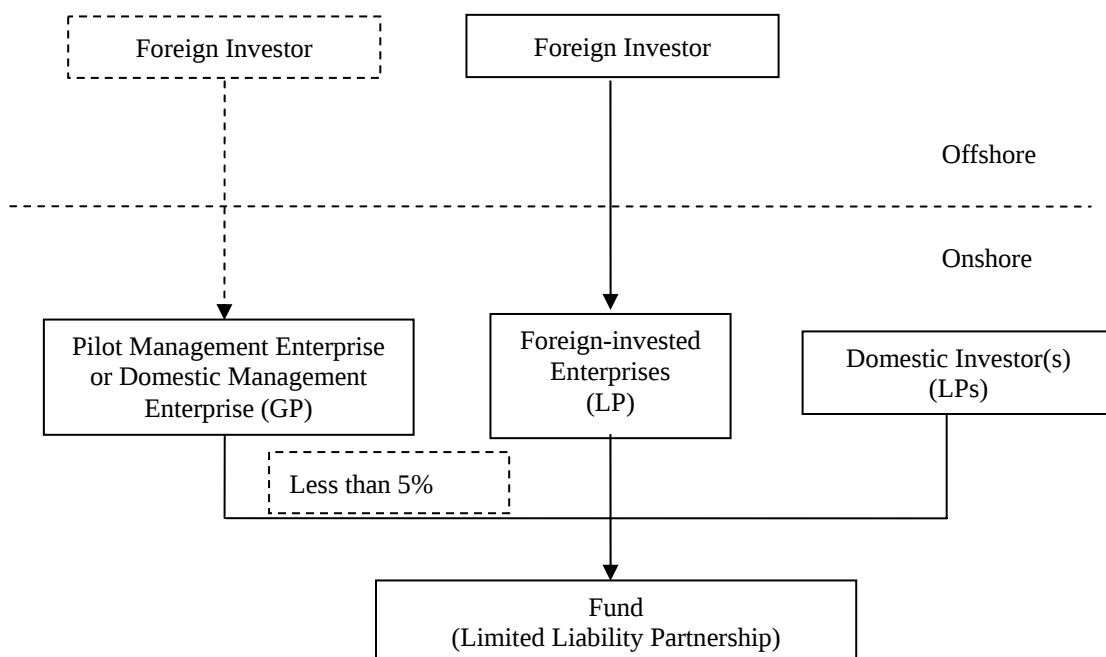


This is the typical FIPE structure contemplated under the Foreign-invested Partnership Measures and the corresponding Registration Procedures. The Foreign-invested Partnership Measures expressly stipulate that such FIPEs engaged in onshore equity investment are subject to the applicable laws, regulations and rules on foreign investment. This stipulation is echoed in the Pilot Measures.

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However, regarding the nature of such FIEs, regardless of whether the fund qualifies as a Pilot Investment Enterprise, members of the SAIC in charge of foreign investment matters had unofficially taken the view that Investment Enterprises formed as FIEs are deemed “foreign investors”. This means they should be subject to foreign investment laws and regulations, and should undergo application and registration procedures according to rules applicable to foreign investors directly investing in the PRC. Under this interpretation, the portfolio companies of such Investment Enterprises are deemed FIEs and must obtain the relevant FIE approval certificate prior. However, it is nebulous under this interpretation how the Ministry of Commerce (Mofcom) and its local branches, which are responsible for such FIE administrative procedures, would conduct approval or filing.

Structure 3: Funds composed of a Pilot Management Enterprise or a Domestic Entity as GP and at Least One FIE LP, but no foreign LPs



Regarding FIEs investing in a Management Enterprise or Investment Enterprise, the Pilot Measures only provide guidance for investments in limited liability companies (see Article 36 of the Pilot Measures). Such FIE investors need Shanghai Mofcom approval and such investment is subject to the *Tentative Provisions on Investment Within China by Foreign Investment Enterprises* (关于外商投资企业境内投资的暂行规定). However, the Pilot Measures are silent on the treatment of investments in limited partnerships (where there are no foreign LPs). Thus, if the default applicable partnership rules are to be applied, Mofcom approval would not be needed.

It remains unclear whether, irrespective of the GP being a domestic enterprise or a Pilot Management Enterprise falling under 5% safe harbor rule, an FIE participating as an LP in the Investment Enterprise might nonetheless cause the partnership to be deemed “with foreign investment”, which causes the partnership’s equity investment to be subject to foreign investment laws and regulations. Conversely, it is understood that, treating such an Investment Enterprise as a domestic limited partnership would effectively allow foreign LPs to circumvent

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applicable foreign investment and reinvestment laws and regulations (particularly the Foreign Investment Catalogue). Compounded with the fact that Mofcom assumes a prudent regulatory attitude towards foreign investment, it is unlikely that regulators will allow such Investment Enterprise to be deemed a domestic limited partnership where it substantively allows FIE LPs to evade applicable laws and regulations.

Furthermore, it has been unofficially implied by the representatives of both the Shanghai Mofcom and Shanghai AIC during a recently held conference that it would be inadvisable for investors to test this investment structure for the purpose of evading foreign investment regulation, as there may be risk of legal impediments both during the inflow of foreign capital during contribution and investment, and the outflow of foreign capital during profit distribution. Thus, investors would be wise to strictly comply with all foreign investment-related laws and regulations when conducting equity investment via this fund structure.

Furthermore, it should be noted that the Pilot Measures are promulgated and passed by the Shanghai local government. Thus, it is unclear whether local regulations and rules of a target portfolio enterprise will apply when making portfolio investments. Given there is no guidance on the national level in this regard, there exists the risk that the fund will still have to clear the local regulatory hurdles where the portfolio company is located.

New NDRC Notice Regarding Equity Investment

On 31 January 2011, the National Development and Reform Commission (NDRC) issued the *Circular on Further Regulating the Development and Record Filing of Equity Investment Enterprises in Pilot Areas* (关于进一步规范试点地区股权投资企业发展和备案管理工作的通知) (Notice 253). Notice 253 stipulates additional rules regarding the development and filing procedures for equity investment enterprises in pilot areas (Beijing, Shanghai, Tianjin, Suzhou, Zhejiang and Hebei), including:

- **Investment scope and projects:** investment is limited to the equity of privately-held enterprises. Capital not used for such investment may only be used to invest in fixed-return investment products, such as national debt. Otherwise, it must be deposited in a bank. Furthermore, the investor must comply with national industry policies, investment policies, and macro-economic policies, and undertake any applicable fixed-asset investment approval and filing procedures. Investments by foreign-invested equity investment enterprises are subject to investment approval procedures according to relevant laws and regulations.
- **Custodian requirements:** where the manager of an equity investment enterprise is a wholly foreign-owned enterprise or foreign-invested joint venture, the assets of the equity investment enterprise shall be held by an onshore custodian institution with legal entity status.
- **Informational disclosure requirements:** aside from disclosing investment information to its investors as required under the company's articles of association or partnership agreement, an equity investment enterprise shall also submit to the NDRC or the local competent agency responsible for filing procedures, annual operational reports and audited annual financial reports within four months following the end of each fiscal year.

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- **Scope of filing:** in principle, all equity investment enterprises that (i) have completed their registration with the Administration of Industry and Commerce; (ii) predominantly invest in the equity of privately-held enterprises; and (iii) have total capital amount of more than Rmb500 million (including both subscribed but unpaid-up and fully paid-up capital) are required to file with the NDRC. However, investment enterprises filed as venture capital investment enterprises according to the *Interim Measures for the Administration of Venture Capital Investment Enterprises*, or have less than Rmb500 million (or foreign currency equivalent) in total assets, or which are wholly-owned subsidiaries (and do not raise funds from multiple investors) are exempted from the filing obligations under Notice 253.
- **Party to file:** if an equity investment enterprise is self-managed, it shall undertake the filing procedures. If an equity investment enterprise entrusts its management to a management enterprise, the management enterprise shall undertake the filing procedures.
- **Filing procedures:** the applicant shall first submit the filing materials to the competent filing agency at the provincial level. Then, the competent filing agency shall examine whether the materials are complete and submit its preliminary examination opinion to the NDRC within 20 business days. The NDRC will then examine the materials during the following 20 business days. Approved enterprises will be listed publicly on the NDRC website.

Also, the National People's Congress's Financial and Economic Committee is actively pushing to revise the *PRC Securities Investment Fund Law* (Fund Law) and has released draft revisions to securities regulators and members of the industry for comments. Notable aspects of the proposed revision are that private funds will be included within the definitional scope of "funds" subject to regulation and that the China Securities Regulatory Commission (CSRC) will be designated as the agency responsible for the filing process. Ultimately, which agency will be responsible for the filing process (whether it be the NDRC or the CSRC) will be decided by the finalised Fund Law revisions. Hence, these expected revisions will be the subject of close attention and concern by the market.

Final Thoughts

The foreign-invested Rmb PE fund formed as FIPEs is still at the stage of inception in China. Significant matters such as transfer of partnership interests, subsequent round fund-raising, mergers and acquisitions, tax liability (particularly regarding when and how a foreign LP will be considered to have a permanent establishment in China), profit distribution, and exit remain in need of additional guidance from Mofcom, the SAIC, Safe, the State Administration of Taxation and other competent regulators. Irrespective of the still-existing regulatory uncertainties, it is foreseeable that various local governments, such as those of Beijing and Tianjin, will follow Shanghai's lead in pushing their own policies and guidance in an effort to attract foreign investors and advance their Rmb PE industry. On the national level, the power to regulate equity investment funds will be determined by the revisions to be made to the Fund law, but the NDRC currently appears most active in participating in the filing process for equity investment funds.

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