

China Corporate Alert - January 2011

New Foreign-Invested PE Rules Issued in Shanghai - A True Breakthrough or (Another) False Dawn?

Background

The recent *Circular Concerning the Publication and Circulation of the Implementing Measures for Carrying Out the Pilot Scheme for Foreign Invested Equity Investment Enterprises in Shanghai* ("**Shanghai PE Fund Rules**"), issued by the Shanghai municipal government's Financial Services Office, Commerce Commission and Administration for Industry and Commerce, was issued on 24 December 2010 and will take effect a month thereafter.

The Shanghai PE Fund Rules implement a prior circular issued in 2010 (Shanghai Government Office Circular No. 17), itself formulated in accordance with another circular issued in 2009 that was intended to implement the *State Council's Opinions on Promoting the Development of Modern Services Industry and Advanced Manufacturing Industry with a View Toward Establishing Shanghai as an International Financial Centre and Transport Hub*, thereby indicating that Shanghai appears to have the backing of the State Council to take the lead in this area.

It would be fair to say, however, that the nascent private equity industry in China has seen more than its fair share of false starts and false dawns.

In recent years, international and domestic media, as well as more than a few legal advisors hoping to turn the page on the global financial crisis, have fed rumours regarding "soon-to-be-issued" national Renminbi ("**RMB**") fund legislation, such as the National Development and Reform Commission's draft *Interim Measures on the Administration of Equity Investment Enterprises in Pilot Areas*, in eager anticipation of a new wave of foreign investment in China led by foreign venture capital and private equity firms and institutional equity investment funds. The draft still has not become law.

To the more sober-minded, however, and despite the promulgation of various local rules claiming to permit the establishment of equity investment funds ("**EIFs**"), foreign equity investment houses have been left to carry on without a solid national-level legal basis for establishing investment vehicles that mirror well-established and stable offshore fund and fund management structures. This means that there will still be, even after the Shanghai PE Fund Rules come into effect, issues around localities outside Shanghai recognising the Shanghai PE Fund Rules, particularly when it comes to investments by EIFs established in Shanghai seeking to invest in companies outside Shanghai.

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What the Shanghai PE Fund Rules Do (and Do Not) Achieve

The Shanghai PE Fund Rules allow foreign investors to establish:

- a foreign-invested EIF ("**Foreign Invested EIF**") as a partnership or similar entity; and
- a foreign invested fund management enterprise ("**Foreign Invested PE Fund Management Enterprise**") in the form of a corporation, partnership or similar type of entity.

The above may or may not be included in the pilot scheme.

What the Shanghai PE Funds Rules do achieve is that (assuming the foreign exchange issue discussed below can be overcome) they appear to offer many of the long-awaited benefits to foreign investors anticipated of RMB funds: these include the ability to conduct onshore fundraising, and the opportunity for Foreign Invested PE Fund Management Enterprises to manage domestic RMB funds without making them subject to foreign investment restrictions under the Catalogue¹. Foreign Invested EIFs or Foreign Invested PE Fund Management Enterprises organized as a partnership should also be able to achieve tax transparency pursuant to the *People's Republic of China Partnership Law*² and the *People's Republic of China Enterprise Income Tax Law*³. However it is notable that the Shanghai PE Fund Rules are silent on the tax treatment of Foreign Invested Fund Management Enterprises and Foreign Invested EIFs.

It remains to be seen whether the myriad of local tax benefits issued by local governments in China such as Shanghai, Beijing and Tianjin designed to attract private equity funds and fund managers to the various localities in question will survive once the national level rules in this area are promulgated.

What the Shanghai PE Funds Rules do not achieve is that they do not overcome the foreign exchange issues that have frustrated many of the foreign investors wishing to set up EIFs

¹ See the *Guidance Catalogue for Foreign Investment Industries* effective 1 December 2007 (the "**Catalogue**").

² First adopted by the 24th Session of the Standing Committee of the National People's Congress on 23 February 1997 and revised with effect from 1 June 2007.

³ Effective 1 January 2008.

in China, namely the requirement under State Administration of Foreign Exchange ("**SAFE**") Circular 142⁴ that unless there is a specific provision in the law that permits conversion (such as is the case with companies of an investment nature⁵, or with a foreign invested venture investment enterprise which is in the nature of an investment fund vehicle⁶), then a foreign investor is not permitted to apply to SAFE to have foreign exchange funds injected as registered capital into a foreign invested enterprise ("**FIE**") converted into RMB for the purpose of equity investment.

Rumours have been swirling about whether Shanghai will adopt a Qualified Foreign Limited Partner ("**QFLPs**") type scheme (modelled on the Qualified Foreign Institutional Investor) whereby a certain amount of quota fixed by SAFE would be allocated to qualifying QFLPs or something different. It is still unclear pending an official announcement as to who will be getting quota in the first batch of allocations made pursuant to the pilot scheme (see below), and the timing for issuing the second batch is not known at present.⁷

The obvious missing "party" to the Shanghai PE Fund Rules is Shanghai SAFE, despite the fact that it is mentioned in the text of the rules as one of the departments involved in the administrative side and is a participant in the Joint Council (see below). It is our understanding that central SAFE may have given its "internal" unofficial blessing to the Shanghai PE Fund Rules, but until Shanghai SAFE or central SAFE issue some regulations on this area, the mechanism for applying for and obtaining quota will remain opaque and unclear. What appears to be clear from the Shanghai PE Fund Rules is that only those who get approved under the pilot scheme will have any chance of getting quota in the first (and possibly second) batch, thereby leaving the others somewhat out in the cold, but investors in pilot enterprises will have the right to convert

⁴ State Administration of Foreign Exchange *Circular on Relevant Business Operation Issues concerning Improving the Administration of the Payment and Conversion of Foreign Exchange Capital of Foreign-invested Enterprises* dated and effective 29 August 2008 ("**SAFE Circular 142**").

⁵ "投资性公司" in Chinese, also known as holding companies.

⁶ *Foreign-invested Venture Investment Enterprises Administrative Provisions* promulgated by the Ministry of Foreign Trade and Economic Cooperation ("**MOFTEC**", the predecessor of MOFCOM), Ministry of Science and Technology, State Administration for Industry and Commerce ("**SAIC**"), State Administration of Taxation and SAFE on 30 January 2003 with effect as of 1 March 2003.

⁷ See PERE News 11 January 2011 which suggests that based on an article appearing in the China Securities Journal, an initial quota for Shanghai will be set at US\$3 billion separated into 3 stages of distribution with the Carlyle, Blackstone and Hong Kong-based First Eastern Investment Group funds likely to be in pole position for the first tranche of conversion quota of US\$300 million. The same article refers to Beijing having also obtained approval from the central Chinese government to launch a similar scheme in Beijing.

their foreign exchange to RMB within their given amount of quota.

QFII quota has historically been heavily oversubscribed and there is nothing to suggest that PE fund investment quota will be any different. Therefore for those without quota, the frustration is likely to continue, or they will have to switch vehicle to establish a vehicle like a FIVIE if they need to bring in foreign limited partners ("**LPs**"). For those willing to manage a pure domestic capital RMB fund, these issues simply do not arise and, as will be seen below, there may be opportunities for foreign-invested fund managers in China to invest foreign currency of up to 5% in a fund without changing its nature and "tainting" it with restrictions on underlying investments applicable to foreign invested enterprises and, by extension, foreign invested EIFs.

Procedural Aspects of the Shanghai PE Fund Rules

The procedures for establishing a Foreign Invested EIF or Foreign Invested Fund Management Enterprise take approximately one month to complete and involve a review by Shanghai's Financial Services Office. As foreign invested partnerships are not subject to examination and approval by the Shanghai Commerce Commission ("**Shanghai MOFCOM**")⁸, only a Foreign Invested PE Fund Management Enterprise organized *in the form of a company* must receive approval from Shanghai MOFCOM prior to applying for its business registration with the local branch of the SAIC, the Administration for Industry and Commerce ("**AIC**"). By contrast, a Foreign Invested PE Fund Management Enterprise organized *in the form of a partnership* and a Foreign Invested EIF (the latter is only permitted to take the form of a partnership (or similar entity)), may carry out business registration directly with the relevant AIC.

A Foreign Invested Fund Management Enterprise is permitted to establish and invest in EIFs as a promoter, manage EIFs and provide related investment consulting services. It must have at least one foreign investor which engages in equity investing or fund management internationally (or which has a similarly qualified affiliate) and which must appoint no less than two senior management personnel with experience with a China-related equity investor or a financial institution in China to a position of deputy general manager or above. The minimum subscribed capital for a Foreign Invested Fund Management Enterprise is US\$2 million. Lawfully generated RMB profits from the sale of existing equity interests or assets of an FIE or liquidation of an FIE may be reinvested to capitalize a Foreign Invested Fund Management Enterprise.

A Foreign Invested EIF is permitted to engage in equity investment activities and to provide management consulting

⁸ That is the local branch of the Ministry of Commerce, ("**MOFCOM**").

services to its investee enterprises. All of its capital must be used for investment purposes and it must entrust a qualified bank in China to act as a custodian for its funds. Its subscribed capital must be at least US\$ 15 million, all of which must be contributed in cash. Its partners must contribute capital in their own names (i.e., not as nominees or trustees), and each limited partner must contribute at least US\$ 1 million. Lawfully generated RMB profits also may be reinvested to capitalize a Foreign Invested EIF.

The Pilot Program

As noted above, getting accepted as a qualified pilot project participant appears to be key to getting quota, therefore this part of the rules is being heavily scrutinised by interested foreign investors. Ultimately the availability of foreign exchange quota will be the key to unlocking this sector to foreign investment: many international PE funds will likely meet the hard qualification criteria to the extent apparent on the face of the Shanghai PE Fund Rules, but query how many will actually receive quota (and when).

According to the Shanghai PE Fund Rules, the Shanghai Municipal People's Government will set up a Joint Council made up of representatives of all the main regulatory bodies and stakeholders to manage the review and qualification process for "pilot PE enterprises." The Joint Council will be led by the Financial Services Office in conjunction with most of the other municipal-level government departments in charge of the administration of foreign investment. The pilot participants will be Foreign Invested EIFs or Foreign Invested Fund Management Enterprises established in Shanghai primarily by recognized institutional equity investment funds such as foreign sovereign wealth funds, pension funds or fund of funds, but potentially also including other foreign institutional investors approved by the Joint Council.

To qualify, a foreign investor in a pilot PE enterprise must:

- hold assets worth no less than US\$ 500 million or manage assets valued at no less than US\$ 1 billion;
- have a sound governance structure and no record of regulatory sanctions in the last two years; and
- have or its affiliate (undefined) must have more than 5 years of investment-related experience.

Predictably, the Joint Council can impose other non-specified requirements and conditions under a "sweep-up" provision making it clear this is a discretionary process. Other disappointments include the guidance that pilot Foreign Invested EIFs with qualifying LPs will not be treated as domestic funds and will remain subject to the Catalogue and will need MOFCOM approval for investment projects. It is not clear whether this will involve approval for "restricted" category projects under the Catalogue and registration with

AIC for "permitted" or "encouraged" projects as per the *MOFTEC and SAIC Investment within China by Foreign Investment Enterprise Tentative Provisions*⁹ or some other case-by-case approval regime.

The Financial Services Office is charged with evaluating the qualification applications. Upon establishment, a pilot PE enterprise must carry out a record filing with its local district government and it must report its major investments activities and changes to existing portfolio investments to the relevant district-level department in charge on a bi-annual basis.

The most important sentence in the whole of the Shanghai PE Fund Rules is set out in Article 25:

"A Pilot PE FIE may conduct onshore equity investments using foreign exchange funds held by its custodian bank."

The term "Pilot PE FIE" refers to either a Foreign Invested Fund Management Enterprise or a Foreign Invested EIF. Such sentence is notably absent from the corresponding provision of the Shanghai PE Fund Rules relating to "ordinary" Foreign Invested EIFs, which simply says that these "must make onshore equity investments in accordance with PRC laws, administrative regulations and departmental rules relating to foreign investment, thereby implicitly meaning they are subject to SAFE Circular 142 restrictions, and deliberately side-stepping creating the "magic bullet" of a specific provision that would provide an exception to SAFE Circular 142.

Perhaps the most interesting provision of the whole Shanghai PE Fund Rules as far as foreign private equity investors are concerned is Article 24, which provides that a qualified pilot enterprise is permitted to contribute foreign currency as its equity investment in an enterprise which it has promoted, subject to a cap set at 5 percent of the total amount of the capital raised by the pilot enterprise.

This means that a Foreign Invested Fund Management Enterprise *that qualifies under the pilot scheme* could potentially manage a domestic capital EIF whilst investing up to 5% in foreign currency, as well as taking the market-standard 20% of the profits as General Partner without "tainting" the underlying EIF with the tag of "foreign investment". This right is notably not extended to non-pilot Foreign Invested Fund Management Enterprises under the Shanghai PE Fund Rules. This would allow a pure RMB EIF managed by it to be treated as "domestic" and hence operate with fewer restrictions on its underlying investments as compared to a Foreign Invested EIF with international LPs which would still be bound by the Catalogue in making its investments, not to mention MOFCOM approval for each

⁹ Effective 1 September 2000.

portfolio investment (one of the more disappointing features of the Shanghai PE Fund Rules, as noted above).

It is here where the advantages of the pure RMB domestic fund shine clearly through when compared to its foreign invested equivalent. No forex issues, no MOFCOM approval and fewer investment restrictions. It is not surprising that many Chinese companies seeking investors are therefore reaching out to domestic RMB funds and are more hesitant about taking on investment from Foreign Invested EIFs.

A pilot PE enterprise is subject to certain limits on its activities: it is not permitted to trade shares or corporate bonds on the secondary markets, except where one of its investee enterprises subsequently becomes listed, to trade futures or other derivatives, to invest in the real estate sector except for self-use (so it is not a vehicle for pure real estate investors), to invest using third party funds, or to provide loans or [loan] security.

Conclusion

While the Shanghai PE Fund Rules represent a step forward, the proof of the pudding is in the eating and it remains to be seen how other local governments will react to attempts by a Shanghai-based Foreign Invested EIF to invest in a portfolio company located outside Shanghai, or by a Shanghai-based Foreign Invested Fund Management Enterprise seeking to manage an EIF established outside Shanghai.

The new rules do not, by any measure, represent a true opening up of this area to foreign investors. For example, the issues and frustrations caused by China's rigid foreign exchange control restrictions remain. In particular, as noted above, SAFE Circular 142 remains a major issue. Having a limited pilot project based on discretionary admission criteria and quotas that fall way short of market demand does not really go far enough. The raft of local rules issued in Shanghai, Tianjin and Beijing and other places in China (none of which were backed up by national regulations or, more importantly, by foreign exchange rules approved by SAFE) demonstrates how China can sometimes get ahead of itself, create a market anticipation and expectation which then rapidly changes into frustration as a critical piece of the jigsaw is missing. Once the local rules were issued, foreign investors assumed the area was being opened up to foreign investment, but many ended up stuck and unable to get their foreign exchange registration for their EIFs.

Even when the Shanghai PE Fund Rules come into force, the tightly controlled pilot scheme will not meet market demand and satisfy the degree of expectation that has been created by the issuance of the previous local rules. As to when the national rules in the area of foreign exchange will be issued, it is anybody's guess. Our understanding of the workings behind the scenes is that the foreign exchange rules in this

area were near to being finalised until MOFCOM found out about them and was displeased that it had not been consulted (as this is an area related to foreign investment which is under MOFCOM's regulatory ambit), the net result being a further delay for all interested parties whilst the issues are ironed out as between MOFCOM and SAFE. It is also an open question as to how the various local departments in charge of foreign exchange controls located outside Shanghai will interpret and apply the Shanghai PE Fund Rules in practice.

In addition, foreign investors seeking to take advantage of the Shanghai PE Fund Rules to carry out equity investment activities in China, or even just in Shanghai, remain subject to China's rather inflexible corporate legal regime, which continues to prohibit or does not easily accommodate customary international fund structuring techniques, including the issuance of different classes of shares, such as preferred convertible redeemable shares, warrants and convertible debt instruments (though there are indications of pending changes in the latter area). Redemption, anti-dilution and call rights familiar to equity investors outside China cannot be implemented in the same way as in other more flexible jurisdictions: this is a major reason why China-related venture capital and private equity financings remain primarily an offshore industry. Above all, the missing "guest" at this table, SAFE, continues to cast a long shadow, and there is now a pressing need to issue local and indeed national foreign exchange rules in this area.

On the other hand, foreign investors may not want to wait for the national rules to be issued. These may trump or supersede the Shanghai rules which, it should not be forgotten, are part of a "pilot" scheme; in other words, an "experiment". These national rules are, we understand currently being prepared by central MOFCOM, but as our sources indicate they will likely be more restrictive than the Shanghai rules as far as foreign investors and LPs are concerned, it may be time for PE houses to try and get set up whilst there are relatively few restrictions in place, assuming, of course, that they can grab some of the highly prized available foreign exchange quota before then.

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