Find the Way out of the Forest - An Update on PE Regulation in China

Tao Liang, Sidley Austin LLP

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— An Update on PE Regulation in China

By Liang Tao

Since foreign private equity ("PE") firms first came to China in mid-1990s, they have not slowed down. As rainmakers, they have been participating in big deals changing the landscape of various industries in China. The high rate of return of foreign PE funds in China attracts more and more foreign PE firms to enter into China's PE market. However, as China's domestic PE firms are growing rapidly, foreign PE firms find that they are lost in a forest of rules and regulations which are not friendly towards them.

What is PE?

In North America and Europe, PE firms are important intermediaries in the whole financial system. PE firms recruit private pools of capital from wealthy individual investors and institutional investors, e.g., pension funds, university education funds, hedge funds and sovereign wealthy funds. Upon successfully soliciting enough investors with sufficient capital, PE firms will establish PE funds to invest in portfolio companies, with a view to earning high returns by selling shares of these portfolio companies in future IPOs or M&A transactions. There are a number of structures which can be used to carry on the business of PE funds, such as corporations, limited liability partnerships, and trusts. The limited liability partnership is the most popular one. Under the structure of limited liability partnership, PE firms serve as the general partners in charge of the operation of the PE funds, while other investors of the PE funds are limited partners.

PE funds have bridged a gap in China's financial system. At present, China's state-owned banks tend to provide cheap loans to state-owned companies. Many small and medium companies, especially certain high-tech and high growth companies without substantial fixed assets, are keen to seek for capital support from resources other than the bank system. PE funds become an important alternative financing channel.

China's PE industry is currently still in its adolescence stage. Under China's current regulatory regime, PE firms or PE funds have not been explicitly defined. However, China's regulator has promulgated a set of regulations and rules governing the business activities PE firms and PE funds engage in.

Overview of China's PE regulation

According to China’s laws, PE funds may be divided into three types by nationalities of their ultimate investors, i.e., domestic PE funds, foreign PE funds, and foreign invested PE funds. Domestic PE funds refer to PE funds which are established outside mainland China by "pure" foreign investors. Foreign PE funds mean PE funds which are established outside mainland China by "pure" foreign investors or by both foreign investors and Chinese investors. When investing in portfolio companies in China, legal requirements on the three kinds of PE funds vary dramatically.

Domestic PE funds can freely invest in portfolio companies in any industry which is open for private sector investors, without any foreign exchange issues. On the contrary, foreign PE funds are subject to both the industry restrictions and the foreign exchange limitations, when carrying on equity investments in China. According to the Foreign Investment Industrial Guidance Catalogue which was updated in December 2011 and came into force on January 30, 2012, foreign investors, including foreign PE funds, are restricted or prohibited from engaging in many sensitive industries. In certain key industries, foreign investors are also subject to certain shareholding ratio restrictions. For example, foreign investors are prohibited from holding over 50% shares of PRC value-added telecommunication companies. Therefore, theoretically, foreign PE funds shall keep away from certain industries which have not been open for foreign investors. Though foreign PE funds can bypass some of the industry restrictions by adopting VIE structure or other arrangements, when competing with domestic PE funds to invest in potential portfolio companies, foreign PE funds are less attractive than domestic PE funds.

Except for industry restrictions, foreign PE funds also face foreign exchange hurdles. As China imposes rigid foreign exchange regulation with respect to cross border investment activities, in order to convert foreign currencies into RMB, foreign PE funds are required to apply with the State Administration of Foreign Exchange or its local counterparts.
("SAFE") for each deal. In addition, such application is reviewed and approved on a case-by-case basis, making such application procedure prolonged and uncertain. When the potential portfolio companies are in urgent need of capital injection, they will be reluctant to receive foreign PE funds’ money due to the complex and delayed procedures.

Taking advantage of the restrictions on foreign PE funds, domestic PE firms and PE funds become more flexible and efficient. To reverse worsening situation, foreign PE firms step up their lobbying activities in China. As China’s local governments also have incentives to attract foreign investments and stimulate local economies, foreign PE firms and China’s local governments have tried many times to explore a feasible way to address the aforesaid two problems. At present, foreign invested PE funds are deemed as the most possible investment vehicles which can address concerns on industry limitation and foreign exchange procedures.

**Foreign invested PE funds**

In August 2008, SAFE issued the Notice of the General Affairs Department 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 of Foreign Invested Enterprises ("Circular 142"). The Circular 142 was to regulate conversion of the registered capital of foreign invested enterprises ("FIEs") into RMB in China, preventing “hot money” from flowing into China. The Circular 142 is a serious threat to the foreign invested PE funds, by prohibiting FIEs from using RMB capitals converted from foreign capital to invest in PRC companies, unless such investment is within the approved business scope of the FIEs and has been approved by SAFE. Under the Circular 142, foreign PE firms cannot simply establish FIEs serving as the investment vehicles any longer. How to pour foreign currency into China’s companies becomes a critical issue for foreign invested PE funds.

At central government level, China has adopted two kinds of investment vehicles, which can use the RMB converted from their registered capital to invest in PRC companies, i.e. foreign-invested holding companies and foreign-invested venture capital enterprises. They are the two major foreign invested vehicles explicitly exempted from the restriction set forth in the Circular 142. Both foreign-invested holding companies and foreign-invested venture capital enterprises are allowed to use their RMB funds converted from their registered capital, to engage in equity investments in China. Many foreign PE firms have adopted the foregoing two vehicles when establishing foreign invested PE funds. However, both of the investment vehicles are currently suffering the foregoing two problems, notwithstanding that foreign invested PE funds are established within mainland China instead of offshore venues. Against such a repressive backdrop, foreign PE firms have strong incentives to further explore other alternative solution to circumvent the two restrictions.

**QFLP**

Among many investment vehicles which may fix the problems of industry limitations and foreign exchange restrictions, qualified foreign limited partners ("QFLP") is the most high profile one. Though central government has not issued any policy regarding the QFLP, several local governments have issued provisional regulations to launch pilot schemes. Among them, Shanghai Municipality adopts very aggressive policies on developing QFLP regime. According to rules promulgated by Shanghai Municipality, if a foreign PE firm is approved to form a qualified foreign invested PE management firms in Shanghai, such management firm, as the sponsor and general partner, can establish a qualified foreign invested PE fund in Shanghai which can directly apply with banks for converting its registered capital into RMB, without going through SAFE’s approval procedures for each investment. That means the qualified foreign invested PE fund will not suffer the restriction under the Circular 142 and the painful foreign exchange approval process, and can wire RMB capital into portfolio companies as fast as domestic PE funds. Moreover, the qualified foreign invested PE fund can be exempted from industry limitations imposed on foreign investors, provided that all other investors, serving as limited partners of such fund, are Chinese entities or individuals; and the qualified foreign invested PE management firm accounts for no more than 5% “total size” of the qualified foreign invested PE fund.

Obviously, if the industry limitation and foreign exchange restriction can be removed, qualified foreign invested PE funds under the QFLP regime will become the most promising and popular investment vehicle for foreign PE firms. Nevertheless, in practice, Shanghai’s QFLP regime is far from perfect. SAFE, China’s national foreign exchange regulator, has not explicitly supported the QFLP regime, creating a doubt whether qualified foreign invested PE funds can practically avoid foreign exchange verification for each deal. Additionally, some foreign PE firms have complained that some other local governments did not endorse Shanghai’s QFLP regime and declined to remove the industry limitations on the qualified foreign invested PE funds which have met the foregoing 5% shareholding ratio requirement. It appears that there is a long way for foreign PE firms to benefit from the QFLP regime in practice.

**Future**

Before China has developed a unified regime governing PE industry and clarified policies applicable to the foreign invested PE firms and PE funds, foreign investors proposing to establish and operate PE funds in China still need to “grope” their way through the forest at night, and closely monitor the evolution of the legal regime and market practice.

(Author: from an international law firm in Beijing)