New Rules Pave the Way for Foreign-invested RMB PE Funds

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By Liang Tao

On March 1, 2010, the long-awaited Administrative Measures on Establishment of Partnership Enterprises by Foreign Enterprises or Individuals (hereinafter referred to as “Foreign-invested Partnership Measures”) will come into effect. The Foreign-invested Partnership Measures were promulgated by the State Council of China on November 25, 2009 and opened a new era of foreign investment legal framework in China. Once the Foreign-invested Partnership Measures become effective, the foreign investors will be entitled to conduct investment through the business form of partnership which could only be used by domestic investors in the past in China.

In addition, municipalities of Beijing, Shanghai and Tianjin also issued a series of local rules regarding foreign-invested funds to attract potential foreign investors. In consideration of the intense competition among the foregoing three cities to become the international financial centre, more rules to facilitate the development of the financial sector will be on the way. In respect of the foreign investors who are eager for the establishment of foreign-invested RMB-denominated private equity funds (hereinafter referred to as “Foreign-invested RMB PE Funds”), the foregoing new rules are of great significance and will encourage them greatly.

Introduction

In recent years, Foreign-invested RMB PE Funds have developed rapidly in the private equity market of China due to many reasons. Generally speaking, there are two main reasons, i.e., the economic situation of the world and China, and certain regulatory restraints on offshore funds via restricting round-trip investment and surrender of foreign exchange in China.

First, in consideration of the losses the investors suffered amid the global economic downturn, it becomes more and more difficult for the offshore private equity funds to raise capital. On the contrary, upon the launching of the ambitious stimulus plan by the central government of China, the investors in China still remain eager to invest in and provide sufficient capital for the Foreign-invested RMB PE Funds.

Second, the Circular of Huizongfa [2008] No. 142 (hereinafter referred to as “Circular 142”) was issued by the State Administration of Foreign Exchange (hereinafter referred to as “SAFE”) in 2008 to prohibit the RMB capital, which is converted from the paid-up capital in foreign exchange, from being invested in equity of domestic enterprises. Provisions on Mergers and Acquisitions of a Domestic Enterprise by Foreign Investors (hereinafter referred to as “M&A Provisions”) were issued in 2006 by the Ministry of Commerce of China (hereinafter referred to as “MOFCOM”) to block the round trip investment and further shut down the door leading to listing on the foreign stock exchanges.

The foregoing two rules finally blocked the inlet and the outlet of the capital of the offshore private equity funds and left little room for the offshore private equity funds to survive in China. Compared with the offshore private equity fund, the Foreign-invested RMB PE Fund becomes a more desirable choice. Especially upon the launch of the Growth Enterprise Market of China in 2009, more and more foreign investors propose to establish the Foreign-invested RMB PE Funds in China to enjoy the convenience of listing within the stock exchanges in China so as to realize their investment objectives.

Current way leading to the foreign-invested RMB PE Funds

At present, there is only one primary rule applicable to the establishment of the Foreign-invested RMB PE Funds. It is the Administrative Measures on Foreign-invested Venture Investment Enterprises (hereinafter referred to as "FIVCIE Measures") which was issued jointly by the Ministry of Foreign Trade and Economic Cooperation (the predecessor of the MOFCOM), and other relevant ministries in 2003. According to the FIVCIE Measures, foreign investors are entitled to establish Foreign-invested RMB PE Funds solely or jointly with domestic investors. The Foreign-invested RMB PE Fund can be set up in the form of either a company or a non-legal entity upon obtaining approval from the MOFCOM or its local counterparts. Pursuant to a notice issued by the MOFCOM in early 2009, the establishment of the Foreign-invested RMB PE Funds with the total capital no more than $100 million shall be approved by the provincial MOFCOM and establishment of such funds with the total capital above $100 million has to be still approved by the MOFCOM. It is worthy to note that the Foreign-invested RMB PE Funds are entitled to invest in the equity of domestic enterprises with all of their capitals according to the FIVCIE
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Measures. This obviously constitutes an exception to the 142 Circular which prohibits the reinvestment in equity of domestic enterprises by the foreign invested enterprises. Against the background that the foreign exchange regulation by the SAFE tends to be tighter, to date, FIVCIE Measures are the only exception to the 142 Circular.

The new issuance of the Foreign-invested Partnership Measures can facilitate the implementation of the FIVCIE Measures. Limited partnership is the most efficient form for the private equity funds and also is a globally accepted form by the private equity funds. Although it was stipulated that the Foreign-invested RMB PE Fund can be established in the form of non-legal entity according to the FIVCIE Measures, the Foreign-invested RMB PE Fund could not be founded in the form of partnership due to the lack of official permits regarding foreign invested partnership at that time. Today, the Foreign-invested Partnership Measures have changed the history. Therefore, the legislative development regarding foreign invested partnership will benefit the potential foreign investors who are planning to engage in the private equity business in China.

However, FIVCIE Measures also imposed certain limitations on the Foreign-invested RMB PE Funds. First of all, the Foreign-invested RMB PE Funds can only invest in the domestic enterprises with high and new technology. Enterprises in other sectors, such as real property development, exploitation of natural resources, public traded securities and such sectors with windfall profit can not be invested by the Foreign-invested RMB PE Funds. Second, as foreign invested enterprises, the Foreign-invested RMB PE Funds are also subject to the industry restrictions applicable to foreign investment. In the event that the Foreign-invested RMB PE Funds propose to invest in enterprises falling within "restricted" catalogue, they have to submit application materials to the local counterparts of the MOFCOM to seek for approvals. The competent department shall make a decision within 45 days upon the foregoing application. In a fast-changing market of private equity in China, it is obvious that the aforesaid approval process is too cumbersome to cater to the requirements of the founders of the promising start-up enterprises which are crying out for financing. Last but not least, since the issuance of the FIVCIE Measures in 2003, there have been few precedents of the Foreign-invested RMB PE Funds which have been set up under the FIVCIE Measures. Hence, in addition to few first-movers, such as IDG headed by Xiong Xiaoge, most of the foreign investors are hesitant about the feasibility of the Foreign-invested RMB PE Fund created under the FIVCIE Measures.

Alternative choice for foreign investors

Apart from the aforesaid way of directly setting up a Foreign-invested RMB PE Fund under the FIVCIE Measures, many foreign investors are also seeking for setting up Foreign-invested RMB PE Funds indirectly as an alternative choice to bypass the limitations imposed by the FIVCIE Measures. Although there are many legal uncertainties and risk on the road to bypass the FIVCIE Measures, many foreign investors are still attempting to find their ways through the maze of rules and regulations.

In 2006, Provisional Measures on Administration of Venture Investment Enterprises (hereinafter referred to as “VCIE Measures”) were issued by the National Development and Reform Commission (hereinafter referred to as “NDRC”) and other nine ministries. The establishment and operation of the domestic RMB PE Funds are currently governed by the VCIE Measures. According to the VCIE Measures, the domestic RMB PE Funds can be founded by the domestic investors instead of foreign investors. Compared with the Foreign-invested RMB PE Funds created under the FIVCIE Measures, the domestic RMB PE Funds set up under the VCIE Measures have various advantages.

First, the approval procedure for domestic RMB PE Funds is simple and streamlined. The applicants can conduct the registration with the department of the administration of the industry and commerce directly without the approval from the department of commerce. Only a record filling with the NDRC or its local counterparts is required upon the foregoing registration.

Second, the domestic RMB PE Funds are not subject to the restrictions on foreign investment and gain more flexibilities of investment than the Foreign-invested RMB PE Funds. It is feasible for the domestic RMB PE Funds to invest in the sectors falling within the "restricted" or "prohibited" catalogues even in absence of any approval from the government.

In principle, it is only the Chinese investors who are admitted to set up the domestic RMB PE Funds. However, many foreign investors are trying to invest in and set up the domestic RMB PE Funds indirectly via a multilayered investment structure. At first, the foreign investor sets up a foreign-invested enterprise in the territory of China as a special purpose vehicle (hereinafter referred to as "SPV"). Second, the foreign investor causes the SPV to set up a domestic RMB PE Fund in the form of limited partnership in which the SPV is the general partner. In order to solicit Chinese investors to invest in the fund as the limited partners, in general, the SPV will be responsible for administration and management of the fund and bear unlimited liabilities of the funds while other Chinese investors only undertake limited liabilities restricted to their investment in the funds. In this way, the foreign investors can establish domestic RMB PE Funds under the VCIE Measures and successfully bypass the FIVCIE Measures through the foregoing multilayered investment structure.

Recently, both Shanghai municipality and Beijing municipality have issued specific local rules on the establishment of the management enterprises of the Foreign-invested PE Funds. Tianjin municipality issued a general local rule regarding establishment of the management enterprises of the PE Funds in 2008. The so-called “management enterprises” can carry out the function of the SPV and can also be used as outsourcing service providers for the funds to manage the funds. Those local rules will further promote the application of the multilayered investment structure.
The indirect way of establishment of the Foreign-invested RMB PE Funds has both explicit advantages and obvious disadvantages. The other side of the coin of the indirect way is that this alternative choice undergoes many legal uncertainties. First, 42 Circular currently prohibits the reinvestment conducted by the foreign invested enterprises. Second, there is no applicable rule to clarify whether the domestic RMB PE Funds set up through the foregoing multilayered investment structure shall be subject to the restrictions on the foreign investment. Notwithstanding the existence of these legal uncertainties, many foreign investors have established SPV or management enterprises firstly according to the local rules in Beijing or Shanghai in order to gain the first-mover advantages.

Future outlook

New issuance of the Foreign-invested Partnership Measures and local rules of Beijing and Shanghai regarding foreign-invested private equity funds has paved the way for the Foreign-invested RMB PE Funds in China to some extent. However, it appears that there is no perfect way for the establishment of the Foreign-invested RMB PE Funds before the foreign exchange ban imposed by the 142 Circular has been removed and the ambiguity regarding the investment restrictions on the Foreign-invested RMB PE Funds has been clarified.

In the end of 2009, a heated internal discussion on how to bypass the 142 Circular was held in the Financial Services Office of Shanghai Municipal, according to a person familiar with the matter. It is said that the SAFE may agree to adopt measures to create certain exceptions to the 142 Circular and admit foreign investors to invest in the Foreign-invested RMB PE Funds. A breakthrough of the current foreign exchange regulation system may be made at the beginning of 2010.

In addition, according to the Opinions on Deepening Reform of the Economic Structure in 2009 circulated by the China's State Council and drafted by the NDRC in May 2009, the Administrative Measures on Private Equity Funds (hereinafter referred to as "PE Fund Measures") shall be drafted and promulgated by the NDRC as soon as possible to enhance the administration regarding the private equity funds. The PE Fund Measures will be the major applicable rules governing the private equity funds in China and will play an important role in the regulation system of the private equity market in the future.

A deep understanding of the current legal regulatory environment and keeping a close eye on the new legislative development in China will enable the foreign investors to gain both the present and potential advantages in the business of private equity funds in China. Therefore, for the foreign investors proposing to set up the Foreign-invested RMB PE Funds, it is advisable to conduct certain preparation, such as setting up a SPV or management enterprises to gain the first-movers advantages, and meanwhile pay close attention to the coming legislative changes and opportunities. As the famous proverb goes "chance favors the prepared mind".

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**Exploring New Measures for Sino-African Economic and Trade Cooperation**

On January 25, a seminar on New Measures for Promoting China-Africa Economic and Trade Cooperation was held in the great hall of CCPIT. This seminar was held to further explore the concrete new measures in promoting China-Africa economic and trade cooperation since the Fourth Ministerial Conference of China-Africa Cooperation Forum in November 2009. Premier Wen Jiabao declared eight new measures for pushing ahead the cooperation between China and African countries. The officials from the relevant department in Ministry of Foreign Affairs and Ministry of Commerce of China, high-levels from China National Development Bank, China Import and Export Bank and Sino-African Development Funds as well as other concerned enterprises, around 140 people attended the seminar. Mr. Yu Ping, Vice President of CCPIT, addressed the seminar on behalf of CCPIT and also clicked to jumpstart the operation of the website for China-African Joint Association of Industry and Commerce.

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**Mofcom: China Exempt Tariff for Africa’s Exported Products**

By Yan Mannman

At the Seminar on New Measures for Promoting China-Africa Economic and Trade Cooperation on January 25, Xie Yajing, Vice Director of Department of Western Asia and Africa gave detailed interpretation to the 8 measures declared by Premier Wen at the fourth Ministerial Conference of China-Africa Cooperation Forum.

According to her, China would take some concrete measures to help Africa export goods to China. First, in three years, China is to exempt tariff for 95% export of those African countries which have established diplomatic relationship. This year, i.e. in 2010, 60% export of Africa to China is to be free from tariff. In 2006, there were only 475 duty free taxable items and now the duty free items have already mounted up to more than 4700. Another measure is to set up Special Exhibition Center for African Goods, which is going to be located in Yiwu, the famous base of small commodity in Zhejiang China. In the Exhibition Center, the African goods can enjoy preferential treatment such as reduction of tax and fees. This center is sure to provide more facilitation for the African goods with African cultural characteristics. Besides, China also planned to set up 3 to 5 logistics center in Africa to help the smooth circulation of the African commodities.