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# CHINA RISING Investor Newsletter

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The Shanghai Stock Exchange Composite Index (SSE) continued its winning streak rising 10.3% in the last month through April 2, 2009. Year-to-date the index outperformed all global markets with a 33.2% gain. Still, U.S.-listed Chinese equities lagged this benchmark over the same period....

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## CHINA RISING INVESTMENT CONFERENCE



May 18, 2009 • Yale Club • New York City

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Reg D exemption and simultaneous Reg S offering to overseas investors

- Positioned for rapid upgrade to NASDAQ or NYSE after initial listing due to broad shareholder base and capitalization structured to produce \$1 plus in EPS, thus increasing likelihood of meeting \$4 bid requirement

By reforming the process through which Chinese companies access the U.S. capital markets, via structures such as registered directs for public companies and IPX or other similar structures for private companies, it should be possible to rehabilitate the reputation both for Chinese growth stocks and for the alternative going public industry. While this task is not going to be an easy one, the potential rewards for those who are willing to make a long term commitment to China will be enormous.

According to recent data published by the Federal Reserve, China ranked number 13 in terms of investment by U.S. investors in overseas equities - with only \$96 billion in equities of PRC-based

companies held by American investors in 2008, as compared to \$734 billion invested in UK equities. The world's fastest growing major economy ranked behind such economic flyspecks as Spain (\$107 billion), Australia (\$138 billion) and the Netherlands (\$154 billion) in attracting American investor dollars. Clearly if Americans want to enjoy any kind of retirement they are going to have to leverage up their exposure to the fastest growing companies in world's biggest growth engine, China. And for all their checkered history and miserable performance over the past 12 months, alternative public offerings in Chinese issuers offer one of the most promising means to achieve that goal.

\*APO is a trade-marked structure of Halter Financial, although the term is often used generically and without attribution. A WRASP is a related trade-marked structure of Westpark Capital of Los Angeles that involves a private placement to fund transaction costs, a reverse merger in to a Form-10 (non-trading) shell, and then a small registered retail offering concurrent with a listing on the NYSE AMEX.

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## **FINANCING HIGH-GROWTH CHINESE COMPANIES AFTER "CIRCULAR 10"**

**March 2009**

**Thomas M. Shoesmith and Woon-Wah Siu – Pillsbury Winthrop Shanghai Office**

PRC regulations issued in 2006 made the process of financing Chinese high-growth companies much more difficult. Most international investors want to make their investment into an offshore parent of a Chinese operating company. The 2006 regulations, known as "Circular 10," made it necessary to get central MOFCOM approval to transform a Chinese company into an offshore holding company structure by the most obvious method - setting up a new offshore company owned by the PRC entrepreneurs and simply acquiring the onshore entity. This is termed a "round-trip investment" and

Circular 10 required entrepreneurs to get approval from Beijing in order to do it.

Unfortunately, Beijing approvals are essentially impossible to obtain for middle-market financings, so the legal and financial professions have developed several structures to permit Chinese companies to access international financing without running afoul of the new regulations.

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### **VIE Structures**

The "variable interest entity" (VIE) structure has been used for many years by PRC companies operating in restricted industries (those where direct foreign investment is restricted or prohibited), such as the Internet. SINA, SOHU, and Baidu are only a few examples of companies that have gone public in the U.S. using this structure. The VIE arrangement can also be used by other PRC companies, whether they are in a restricted industry or not.

The VIE structure involves an offshore entity owned at least in part by the PRC entrepreneurs. The international investors make their investment into the offshore entity. The offshore entity owns a PRC subsidiary, called a WFOE ("wholly foreign-owned entity"), which is a party to a "web of contracts" with the PRC operating company.

The contracts shift the bulk of the economic benefits and obligations of the operating company to the WFOE and thus, indirectly, to the offshore investors. Some or most of the operating assets and personnel may also be transferred to the WFOE, depending on applicable regulations.

In most cases, the web of contracts results in the WFOE having effective control over the PRC operating company, or at least over major decisions, and the operating company's financials will be consolidated with those of the FIE under the FIN 46r (Variable Interest Entity Consolidation Rules) issued by the Financial Accounting Standards Board.



Since no actual acquisition of an existing domestic company is involved, the structure should fall outside the scope of Circular 10 and therefore make unnecessary any central MOFCOM approval. Of course local approvals are required for the establishment of the WFOE. (It should be noted that a recent foreign exchange regulation opened the door for some regulators to assert jurisdiction over WFOEs that acquire “control” over operating entities, but how this will be applied remains to be seen.)

This structure is well understood and acceptable to international investors in industries restricted to foreign investment, such as the

Internet, education, and national security-related sectors – probably because there is no alternative. The structure can just as well be used in non-restricted sectors. In those cases, however, some international investors are uncomfortable that some of the valuable assets used in the company’s operations may not be directly owned by one of the investee companies. There is of course always the possibility that the PRC parties may breach one or more of the contracts making up the “web,” although lawyers have become quite adept at putting in place a detailed set of disincentives.

### ***“Slow walk” or “option” arrangement***

A “round-trip investment” occurs when an offshore company owned or established by PRC nationals acquires a related company in China. Another structure that can avoid this characterization involves the use of an offshore company that was neither established by, nor is owned by PRC nationals at the time of its acquisition of the Chinese operating company. Instead of an immediate ownership interest in the offshore company, the PRC entrepreneurs are granted the right, but not the obligation, to acquire that interest in the future. Some investors and companies have combined a VIE structure with a slow walk arrangement.

When and if the PRC entrepreneurs acquire their interest in the offshore company, they must register their interest in the offshore equity with the Chinese foreign investment authorities under so-called “SAFE Circular 75.” Depending on the size of the consideration

paid for that acquisition, registration with other authorities may be required as well. And, of course, the entire arrangement must have sufficient economic substance so that it is not a mere sham designed to avoid the approval requirements of Circular 10.

One concern with this approach is that the PRC authorities could collapse the various transactions and view the end result as a “round-trip investment.” It is generally thought this has not yet occurred, perhaps because the deals that have used this structure have in fact demonstrated sufficient economic substance to avoid collapse as “step transactions.” A second concern is that of the PRC entrepreneurs, who must have sufficient trust in the option and other agreements to relinquish direct ownership of their company until such time as they exercise their options.

### ***Joint Ventures***

A third method of avoiding a “round-trip investment” is to have the offshore entity (in which the international investment is made) acquire part, but not all, of the PRC operating company – leaving the PRC entrepreneurs with a sufficient remaining stake in the operating company to meet the terms of the deal. In this structure, at least at the outset, the offshore company has no PRC ownership and thus avoids any “round-trip investment.” The PRC entrepreneurs can later acquire a direct interest in the offshore entity either through a delayed option arrangement, or through a “put” of their remaining interest in the operating company to the offshore entity. It may also be possible to deliver offshore equity to the PRC entrepreneurs by

means of an equity incentive compensation plan, using restricted stock or stock options.

The disadvantage of this approach is that the investors do not obtain 100% ownership over the PRC operating company during the time it is operating as a joint venture – even though the structure can easily be set up to produce exactly the same economic and control features of a total acquisition. The PRC entrepreneurs may also resist not immediately getting equity in the offshore entity – even though their legal rights to that equity can be made completely airtight.

### ***The Bottom Line***

As the saying goes, “In China everything is possible, but nothing is easy.” This is especially true when it comes to the international financing of high-growth Chinese companies. It is absolutely critical that investors and entrepreneurs alike respect the laws and regulations which apply to their activities and structure their

investments carefully as a result. Chinese laws permit considerable latitude in their interpretation, and good-faith consultation with relevant authorities, as well as intelligent design of the investment structure, are the keys to success.

## April 2009 Issue Contributors Special Contributor

### Mr. Shoosmith / Managing Director Pillsbury Winthrop Partner



Mr. Shoosmith is the leader of the firm's China Practice and a partner in the Corporate & Securities practice group. He has more than 25 years of experience in international business transactions, representing large multinational corporations and financial institutions as well as smaller companies and private venture capital and private equity funds. His practice concentrates on international corporate transactions, including corporate finance transactions (such as reverse mergers, PIPEs, and cross-border IPOs); mergers and acquisitions; joint ventures and strategic alliances; venture capital and private equity matters; and counseling clients on the expansion of their international operations. He also has considerable experience in international securities, corporate reorganizations, inversion transactions, foreign direct investment and commercial transactions, intellectual property counseling and contentious matters, and cross-border labor and employment.

Mr. Shoosmith's clients have invested or engaged in transactions for clients throughout the world, including Asia (Hong Kong, India, Israel, Japan, Korea, Kuwait, Russia, Peoples' Republic of China, and the United Arab Emirates); Europe (Belgium, France, Germany, Italy, the Netherlands, Switzerland, and the U.K.); North America (Bermuda, British Virgin Islands, Canada, Mexico, and the U.S.); South America (Argentina, Brazil, Chile, Costa Rica, Panama, and Peru), as well as in Australia and Africa (Mauritius).

### Ms. Siu / Counsel Pillsbury Winthrop Counsel



Ms. Siu is counsel in the firm's office in Shanghai, China. She has extensive experience in securities and general corporate law, having practiced for 15 years in the area. She regularly counsels clients on corporate governance matters and securities law and SRO compliance, and has substantial experience in domestic and cross-border M&A transactions and in organizing start-up ventures and hedge funds. A significant portion of her current practice involves assisting companies based in the People's Republic of China in "reverse acquisitions" and in U.S. securities law matters. In addition, she counsels U.S. and international investors in M&A transactions and other FDI-related matters.

## CCG Contributors

### Elaine Ketchmere Partner/ VP Financial Writing



Elaine is the VP of the financial writing department and helps craft compelling and consistent investment messages across all lines of shareholder communication. She has over ten years experience in the finance and communications industries. Prior to joining CCG, Elaine worked at William O'Neil + Company, most recently as the Manager of WONDA Client Services. WONDA (William O'Neil Direct Access) is a client-server based equity research tool used by over 200 of the largest domestic and international financial institutions. Prior to that, she worked in William O'Neil + Company's research department as a Senior Research Analyst. She began her career at T. Rowe Price Associates assisting clients with investments in their employer-sponsored retirement plans. She is a CFA Charter holder. Elaine graduated from California State University, Fullerton with a Bachelor of Arts in.