

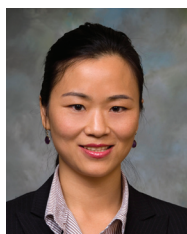
SHOULD A FOREIGN-INVESTED RMB FUND BE ESTABLISHED AND MANAGED BY A MANAGEMENT COMPANY IN CHINA?

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Currently, most yuan-denominated private equity and venture capital funds in China—RMB funds—with at least one non-Chinese investor are managed by entities located outside of China. For example, if an RMB fund is sponsored by a fund manager located in the US, the entity that manages the fund will often be a US or Cayman Islands-based entity.

This article summarizes some of the issues that a non-Chinese sponsor of an RMB fund should consider prior to forming a fund management company in China to manage it. Such a management company will be deemed a “foreign-invested enterprise” because of its non-Chinese beneficial ownership, and shall hereafter be referred to as a “Foreign-Invested Management Company”.

Foreign-invested management companies are often formed by the non-Chinese sponsor of an RMB fund, but may also be formed by an unaffiliated third party that becomes the RMB fund's management company through an investment management agreement. Generally, foreign-invested management companies are formed to manage RMB funds such as that are Foreign-Invested Venture Capital Enterprises (FIVCEs) or Foreign-Invested Equity Investment

Enterprises (FIEIEs). Because the regulations pertaining to FIEIEs largely depend on where they are located—depending on local regulatory authorities—the discussion below focuses on RMB funds that are formed as FIVCEs.

In the case of a FIVCE, a foreign-invested management company may serve as the FIVCE's management company and as its “necessary investor,” if it makes an investment into the fund. Under the Administrative Regulation on Foreign-Invested Venture Capital Enterprises issued in 2003—known as the FIVCE Regulations—each FIVCE is required to have a necessary investor. A non-Chinese manager that invests in the FIVCE can qualify as a necessary investor if it has managed at least \$100m over the last three years, of which \$50m was invested in private equity or venture capital deals involving qualified high technology companies. A Chinese manager that invests in the FIVCE qualifies as a necessary investor if it has managed RMB100m during the last three years, of which, RMB50m was invested in private equity or venture capital deals involving qualified high technology companies. One advantage of forming a foreign-invested management company is that it allows a non-Chinese manager to act as a

necessary investor under the requirements that apply to Chinese managers, because the entity is formed in China.

In addition, a sponsor of an “unincorporated FIVCE” RMB fund may want to form a foreign-invested management company to help minimize the tax burden on non-Chinese investors or offshore investors. Pursuant to Guo Shui Fa [2003] 61, a tax ordinance issued by the State Administration of Tax, an unincorporated FIVCE’s investors may file tax returns in China separately. If the sponsor can demonstrate that the FIVCE does not have any direct fund management functions because such management rights lie with a separate entity in China, such as a foreign-invested management company, then the offshore investors would be considered to have no establishment in China for tax purposes and would not be subject to China’s enterprise income tax. However, the offshore investors would still be subject to withholding tax on dividends distributed from China.

Although there may be some benefits to forming a foreign-invested management company, as discussed above, the sponsor of an RMB fund should be aware of the following considerations:

A foreign-invested management company is subject to China enterprise income tax if it is an incorporated entity. However, some jurisdictions currently permit a foreign-invested management

company to be established as an unincorporated entity, such as a foreign-invested partnership or a Sino-foreign unincorporated cooperative joint venture, which may help minimize its China enterprise income tax. Prior to forming an unincorporated foreign-invested management company, sponsors of RMB funds should ensure that the applicable local regulations permit unincorporated entities.

Foreign-invested management companies are subject to certain national regulations, such as the FIVCE Regulation—the national regulations—as well as applicable local regulations based on where the foreign-invested management company is registered. Under national regulations, in order to qualify as a foreign-invested management company, an entity must have at least three fund management professionals, each of whom must have at least three years of venture capital or private equity fund management experience. The company must also have at least \$150,000 of net capital, which must be wired to the account of the foreign-invested management company generally within the time frame specified in its business charter or partnership agreement, as applicable. To form a foreign-invested management company, the sponsor must complete the registration process that is generally required for all foreign-invested enterprises. The applicable local regulations may have different, more

rigorous standards than the national regulations. For example, the net capital requirements under the local regulations vary greatly from city to city and can be as high as \$2m. Accordingly, it is critical for fund managers to determine what local regulations will apply to a foreign-invested management company prior to registering the entity with the local regulators.

There is currently no practical way for a foreign-invested management company to convert foreign currency into Chinese renminbi to invest into an RMB fund. Although some local authorities are attempting to address this issue, it is unclear when and how the issue will be resolved. Accordingly, at this time most foreign-invested management companies that do not have sufficient RMB to satisfy their capital commitments prefer to invest indirectly into an RMB fund through a separate offshore affiliate.

As discussed, forming a foreign-invested management company has certain advantages as well as disadvantages. Whether or not it makes sense for a particular non-Chinese fund sponsor or manager to form a foreign-invested management company will depend on the relevant facts and circumstances. Prior to forming a foreign-invested management company, non-Chinese fund sponsors or managers should understand the local regulations that may apply to the entity and consult with competent legal counsel.