Client Alert

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Private Equity

China

Investment Funds &
Investment Management

January 20, 2011

A Red Envelope From Shanghai? New RMB Fund Rules Create Opportunities for Non-Chinese Fund Managers

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On January 11, 2011, the Shanghai Municipal Government released its Implementation Measures on Trial Projects of Foreign-Invested Equity Investment Enterprises in Shanghai *(the "Shanghai RMB Fund Regulation"), which will become effective on January 23, 2011. Prior to the release of this regulation, it was widely expected that the Shanghai Municipal Government would launch a Qualified Foreign Limited Partners ("QFLP") legal regime to help large international institutional investors invest in Shanghai-based private equity funds. Although the Shanghai RMB Fund Regulation was implemented in response to such expectations, we believe it is just the first of many regulations designed to confer national treatment to private equity funds formed by non-Chinese fund managers.*

The Shanghai RMB Fund Regulation vs. the FIVCE Regulation

The Shanghai RMB Fund Regulation specifically permits non-Chinese fund managers to establish private equity funds that are organized as partnerships in Shanghai and sets forth the benefits of operating such funds in Shanghai. Until now, non-Chinese fund managers have relied on the *Administrative Regulations on Foreign-Invested Venture Capital Enterprises*, issued by China's central authorities in 2003 (the "FIVCE Regulation"), to form private equity and venture capital funds in China. Under the FIVCE Regulation, a fund established in China with non-Chinese investors or non-Chinese fund managers would be formed as a foreign-invested venture capital fund (also known as "business starting enterprise" in China) or a "FIVCE." At this time, it appears that a Shanghai-based fund organized as a partnership may obtain the requisite approval under either the Shanghai RMB Fund Regulation or the FIVCE Regulation. Due to the differences in the approval processes between the Shanghai RMB Fund Regulation and the FIVCE

Regulation, as discussed below, the industry may see a period of "rule shopping," until more guidance is provided in either the Shanghai RMB Fund Regulation or the FIVCE Regulation.

Under the FIVCE Regulation, investments are generally limited to equity in private, high-technology Chinese companies. FIVCEs may be organized as either incorporated entities (i.e., entities similar to limited liability companies in the U.S.) or unincorporated entities (i.e., non-legal-person cooperative joint ventures and partnerships). Depending on its size, a FIVCE must receive approval to engage in investment activity from the central Ministry of Commerce ("MOFCOM") or one of MOFCOM's provincial offices. In contrast, domestic funds are not required to obtain MOFCOM's approval to engage in investment activities. For more details, see our Alert titled *China RMB Funds: The Far East Is Closer Than You Think*.

Under the Shanghai RMB Fund Regulation, a non-Chinese fund manager may establish in Shanghai (i) a "foreign-invested equity investment management enterprise" ("FIE FMC") as a limited liability company or partnership (i.e., the fund management company) and/or (ii) a "foreign-invested equity investment enterprise" ("FIE PE Fund") as a partnership (i.e., the private equity fund), provided that certain requirements are met. An entity must have at least US$2 million in net capital and a track record of at least 5 years to qualify as a FIE FMC—more than what is required for a fund management company under the FIVCE Regulation (RMB1 million and a 3-year track record). A partnership must have committed capital of at least US$15 million in order to qualify as a FIE PE Fund, which again is more than what is required under the FIVCE Regulation (US$10 million for incorporated funds and US$5 million for unincorporated funds).

Benefits of Establishing a FIE PE Fund in Shanghai

As of March 2010, the *Administrative Measures on Domestic Partnership Enterprises Established by Foreign Enterprises or Individuals* (the "FIP Regulation") permitted foreign investment in partnerships in China (known as "foreign-invested partnerships" or "FIPs"). For more details on the FIP Regulation, see our Client Alert titled *"RMB Funds: Foreign-Invested Limited Partnerships Now Feasible in China*." Although MOFCOM approval was not explicitly required in order to establish a FIP, the FIP Regulation did reference the FIVCE Regulation with respect to the approval of FIPs in the investment fund industry. Currently, there is no consensus on whether such FIPs are required to obtain MOFCOM approval or just approval from the corporate registrar in China, the Administration of Industry of Commerce ("AIC"). The Shanghai RMB Fund Regulation explicitly provides that FIE PE Funds may be formed as partnerships (which appears to be the only type of FIE PE Fund structure available) and would only require the approval of the Shanghai Municipal AIC and Finance Office. As no MOFCOM approval is required, the approval of FIE PE Funds is equivalent to the approval regime for domestic funds without non-Chinese investors (i.e., the process is much less complex than it would be if MOFCOM approval was required).

FIE PE Fund Pilot Program

The Shanghai Municipal Government has also announced the launch of a pilot program to grant certain qualified FIE PE Funds additional regulatory benefits, as discussed below. The pilot program contains detailed rules pertaining to the regulation of FIE PE Funds qualified for such program.

Pilot FIE PE Funds With Only Chinese Investors. Under the pilot program, if all of the cash investment in a FIE PE Fund is raised from Chinese investors in RMB (other than the FIE FMC's investment into the fund), it would be treated as a "domestic" fund rather than a "foreign-invested" fund. If a FIE PE Fund is treated as a domestic fund, it may invest in any industrial sector in which a domestic fund may invest. In contrast, a FIVCE may not invest in or control entities in certain industries such as the Internet, telecom, certain real estate development projects and certain energy sectors. In addition, in a FIE PE Fund, its FIE FMC may convert up to 5% of the FIE PE Fund's capital commitments from non-RMB currency into RMB to invest in the FIE PE Fund. In contrast, "*SAFE Circular 142*," a currency control regulation, generally prohibits an investment by a foreign-invested fund management company into a FIVCE using a non-RMB currency.

Pilot FIE PE Funds With Both Non-Chinese and Chinese Investors. If a FIE PE Fund has any non-Chinese investors (in addition to the FIE PE Fund's non-Chinese fund manager), the Chinese portfolio investments by the FIE PE Fund would be deemed to be foreign direct investments and thus subject to the industrial sector restrictions. In addition, a FIE FMC may still convert non-RMB currency into RMB in order to make investments in a FIE PE Fund with non-Chinese investors, provided that the FIE PE Fund's non-Chinese investors are limited to large non-Chinese institutional investors, such as sovereign funds, funds of funds, pensions, endowments, insurance companies, banks and securities companies, all of which must own assets of at least US$500 million and have managed at least US$1 billion.

Pilot FIE PE Funds With Only Non-Chinese Investors. If a FIE PE Fund has only non-Chinese investors, the Chinese portfolio investments by the FIE PE Fund would be deemed to be foreign direct investments and thus subject to the industrial sector restrictions. Also, a FIE FMC may still convert non-RMB currency into RMB in order to make investments in a FIE PE Fund with only non-Chinese investors, provided that the FIE PE Fund's non-Chinese investors are limited to large non-Chinese institutional investors.

Once qualified to participate in the pilot program, a FIE PE Fund is required to regularly report major transactions and changes to the Shanghai Municipal Government authorities, such as transactions ranging from portfolio investment to reorganization of the FIE PE Fund itself. Most FIVCEs are not required to report these types of transactions and changes to any regulatory authority. In addition, although a FIE FMC in a FIE PE Fund may more easily convert up to 5% of the total capital commitments of the fund into RMB, it is likely that the conversion of the non-RMB currency from any other non-Chinese investors will continue to be subject to the same approval process applicable to FIVCEs under the SAFE Circular 142. Of course, the regulatory reporting requirements applicable to FIE PE Funds could mean more scrutiny on their activities compared to the activities of FIVCEs.

Conclusion

The Shanghai RMB Fund Regulation should be welcome news for non-Chinese fund managers considering forming and operating a private equity fund in Shanghai. At this time, it appears that the biggest beneficiaries of this regulation will likely be the private equity funds raised by non-Chinese fund managers for Chinese investors. We will continue to follow this new development and prepare follow-up Client Alerts as more guidance is released.

If you have questions, contact the Pillsbury attorney with whom you regularly work or the authors below.

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