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New Pilot Program for Shanghai-based RMB Funds – Missing Pieces Falling into Place

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In the latest regulatory development in the closely watched RMB partnership funds sector that has been taking shape over the past year, three Shanghai Municipal governmental agencies — the Shanghai Municipal Financial Service Office (“**SFSO**”), Shanghai Municipal Commission of Commerce (“**Shanghai CoC**”), and Shanghai Municipal Administration for Industry & Commerce (“**Shanghai AIC**”) — jointly announced on January 11, 2011, the *Implementation Measures on the Pilot Program for Development of Foreign-invested Equity Investment Enterprises in Shanghai* 《关于本市开展外商投资股权投资企业试点工作的实施办法》 (Hu Jin Rong Ban Tong [2010] No. 38, the “**Pilot Measures**”).

The Pilot Measures provide helpful guidance for the formation and operation of foreign-invested RMB funds. Importantly, the Pilot Measures also establish a special program (the “**Pilot Program**”) offering the potential for “national treatment” (i.e., the ability to invest without being subject to most foreign investment restrictions) for RMB funds managed by qualified foreign-invested fund managers that draw their limited partners solely from the ranks of domestic investors. However, such treatment remains controversial among regulators, and preliminary indications suggest that it may not be extended to certain areas such as real estate. More broadly, the Pilot Measures establish a coordinated inter-agency approval process for the establishment of RMB partnership funds and fund managers within the Shanghai municipality. It is expected that this coordinated approval process may begin to ease the limits on foreign exchange conversion that have bedeviled foreign investors in early RMB partnership fund cases.

I. FIE FUNDS

The Pilot Measures only apply to funds and fund management companies established within the Shanghai municipality. The Pilot Measures define “Foreign-invested Equity Investment Enterprises” (“**FIE Funds**”) as Shanghai-based enterprises invested by foreign enterprises or individuals which primarily engage in the business of equity investment in non-listed enterprises.

Key takeaways with regard to Funds under the Pilot Measures include:

- **Form.** An FIE Fund may be established in the form of a partnership. Note that although an FIE Fund may theoretically be formed as a limited liability company, the Pilot Measures do not specify the procedures to set up an FIE Fund in corporate form.
- **Capital Contribution.** The committed capital of the FIE Fund must be no less than US\$15 million and may be contributed in cash only. The partners must contribute capital in their own names, and the amount of capital contribution by each limited partner must be no less than US\$1 million. The Pilot Measures do not provide for any minimum GP contribution.
- **Procedures to Set Up Partnership FIE Funds.** The provisions of the Pilot Measures for the establishment of partnership FIE Funds essentially codify existing practice in Shanghai, setting out procedures that closely follow those used for the establishment of the Carlyle-Fosun RMB fund and other early pilot RMB funds. Shanghai AIC, which is

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designated as the registration authority for establishment of partnership FIE Funds, is required to consult with the SFSO with respect to any application for the establishment of a new FIE Fund. Notably, the Pilot Measures also set forth an accelerated timetable for coordinated review by these agencies with the Shanghai AIC required to issue its decision within 20 working days from the date of application.

The Pilot Measures also require the Shanghai AIC to solicit opinions from the SFSO when a partnership FIE Fund applies for changes to its business scope, the composition of the partnership, committed capital or paid-in capital, capitalization deadlines, or partnership type. The Pilot Measures do not specify any limit on the percentage of foreign participation in an FIE Fund.

- Onshore Investments by FIE Funds. Much like foreign-invested venture capital enterprises (“**FIVCEs**”) established under the Ministry of Commerce’s legacy scheme for venture capital funds, FIE Funds must comply with foreign investment policies when making onshore investments. Accordingly, so-called “national treatment” under which an FIE Fund will be treated as a domestic investor, does not appear to be available as a general matter regardless of the percentage of domestic investors in the FIE Fund. In contrast, certain RMB funds with a “Pilot FIE Fund Manager” but no foreign limited partners may be permitted to enjoy a certain level of “national treatment” (see below for further discussion).
- Permitted Businesses. FIE Funds may engage in the following businesses:
 - (i) to the extent permitted by PRC law, making equity investments, including setting up new enterprises, investing in existing enterprises, acquiring equity interests in existing enterprises or otherwise as permitted by PRC law;
 - (ii) providing management consulting services to its investee enterprises; and
 - (iii) other related businesses approved by the registration authority.
- Prohibited Businesses. The investment activities of FIE Funds are subject to certain restrictions very similar to those applicable to FIVCEs. Accordingly, they may not invest in real estate or listed securities or extend loans or third-party guarantees.
- Tax Treatment. The Pilot Measures do not provide any guidance on tax issues. Although the PRC Partnership Law clearly provides for pass-through taxation for a domestic partnership, so far, the application of PRC taxes to a foreign partner in a partnership FIE Fund remains a gray area. It is currently expected that foreign limited partners would be subject only to withholding tax, which is typically set at 10% or such lower rate as may apply under bilateral tax treaties.

II. FIE FUND MANAGER

In addition to regulating the formation and operation of FIE Funds, the Pilot Measures provide for the establishment of foreign-invested equity management entities (“**FIE Fund Managers**”). An FIE Fund Manager would typically be set up to function as the general partner of either an FIE Fund established under the Pilot Measures or (as discussed below, if qualifying as a Pilot enterprise) an RMB fund established under the PRC domestic partnership regime that draws all of its limited partners from domestic investors. Interestingly, the Pilot Measures impose qualification requirements on both foreign investor promoters and personnel in connection with the formation of a new management entity.

Key takeaways under the Pilot Measures include the following:

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- Definition. The term “Foreign-invested Equity Investment Management Enterprises” refers to Shanghai-based enterprises invested by foreign enterprises or individuals which primarily engage in the businesses of establishing equity investment enterprises as promoters and/or to provide authorized equity investment management.
- Form. FIE Fund Managers may be established in the form of a company or a partnership.
- Permitted Businesses. FIE Fund Managers may engage in the following businesses:
 - (i) establishing equity investment enterprises as promoters;
 - (ii) management of the investment business of equity investment enterprises and providing relevant services;
 - (iii) providing equity investment consulting services; and
 - (iv) other relevant businesses permitted by Shanghai AIC.
- Qualifications for Setting Up FIE Fund Managers. The following conditions must be satisfied to set up an FIE Fund Manager:
 - (i) The FIE Fund Manager must have at least one investor whose business scope (or the business scope of its affiliate) is related to equity investment or equity investment management.
 - (ii) The FIE Fund Manager must have at least two senior management personnel with the following qualifications at the time of application for establishment:
 - (a) More than five years’ experience in the business of equity investment or equity investment management;
 - (b) More than two years’ experience as senior management personnel;
 - (c) China-related equity investment experience or work experience in a Chinese financial institution; and
 - (d) No record of noncompliance, pending economic disputes, or lawsuits in the past five years; a good individual credit record.
 - (iii) Registered capital (or committed capital) of an FIE Fund Manager must be no less than US\$2 million regardless of its legal form and be contributed in cash only. Twenty percent of the registered capital (or committed capital) must be paid within three months of the issuance of the business license, with the remainder to be paid within two years of such issuance.
- Establishment Procedures. Application procedures for FIE Fund Managers largely parallel the relevant procedures for FIE Funds. However, in line with broader legislation on FIEs and partnerships, applicants wishing to establish a corporate-form FIE Fund Manager (rather than a partnership-form FIE Fund Manager) must apply to Shanghai CoC rather than only Shanghai AIC.

III. PILOT FIE FUNDS & PILOT FIE FUND MANAGERS

While it remains unclear at a national level which governmental agencies will be responsible for supervising foreign-invested private equity funds, the Pilot Measures contemplate a special pilot program for select funds and equity management entities that will fall under the supervision of an interagency task force in Shanghai (the “**Joint Commission**”). This Joint Commission will apparently comprise representatives from 14 different Shanghai Municipal

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government agencies, including among others the SFSO, Shanghai CoC, Shanghai AIC, the Shanghai Branch of the State Administration of Foreign Exchange (“**Shanghai SAFE**”), and the Pudong District People’s Government. Under the Pilot Measures, FIE Funds designated as “Pilot FIE Funds” and FIE Fund Managers designated as “Pilot FIE Fund Managers”, which are subject to more onerous qualification requirements than apply to FIE Funds and FIE Fund Managers generally, will fall under the ongoing regulatory purview of the Joint Commission.

Arguably, the most important development under the Pilot Measures is the possibility that RMB funds raised by Pilot FIE Fund Managers may be afforded so-called “national treatment” in certain cases. More specifically, under the Pilot Measures, if the investment by the Pilot FIE Fund Manager acting as the general partner of a fund does not exceed 5% of the aggregate capital commitments of the RMB fund, the RMB fund’s “nature will not be changed” by such investment. In other words, a Pilot FIE Fund Manager is entitled to raise RMB funds solely from domestic limited partners, presumably under the domestic partnership regime, without affecting the character of the fund as a domestic fund. By implication, such an RMB fund should be able to invest its funds free of most foreign investment restrictions or approval requirements applicable to FIE Funds and FIVCE funds. However, such national treatment does not appear to be unequivocal.

Despite the language of the Pilot Measures, informal preliminary indications suggest that certain restrictions, such as prohibitions on investing in real estate (other than for self use) and listed securities, will continue to be imposed on domestic RMB funds managed by Pilot FIE Fund Managers. Similarly, it appears such RMB funds may not make investments in some or all of the categories that are prohibited to foreign investment. We anticipate further clarity in the near future on the nature of any restrictions applicable to investments by such funds.

Even with such restrictions, any level of national treatment constitutes an advance in China’s foreign invested fund regime. In recent years, the procedural and regulatory hurdles thrown up by PRC foreign investment law have represented a significant competitive disadvantage for offshore private equity funds and FIVCEs seeking to compete with domestic funds in securing onshore deal mandates. Accordingly, the availability of national treatment or a certain level thereof, while of little relevance for foreign institutional investors, would represent a boon to foreign private equity managers hoping to raise money from domestic investors and compete on a more equal footing with domestic competitors in deal sourcing.

However, it should be noted that this policy remains controversial in central government policy circles. Even with the Pilot Measures, it is unclear whether “national treatment” for such RMB funds will be respected outside of Shanghai when such funds seek to deploy investment capital or the level of “national treatment” that will be afforded even in Shanghai.

Although unstated in the Pilot Measures, sources indicate that the most significant advantage of being qualified as a Pilot FIE Fund may relate to foreign exchange conversion. To date, existing SAFE regulations have created substantial obstacles for the onshore investment of foreign-invested private equity funds, given the lack of a sanctioned mechanism for the conversion of foreign partner capital contributions into RMB. Reportedly, Shanghai has obtained a US\$3 billion “quota” from central SAFE which may be made available on a preferential basis to Pilot FIEs (i.e., Pilot FIE Funds and Pilot FIE Fund Managers) to enable foreign partners to convert foreign exchange into RMB when making onshore investments.

While the Pilot Measures do not expressly address how the conversion quota would be granted and utilized in practice, it has been reported that Pilot FIEs may be afforded the so-called “one-stop” foreign exchange approval privileges. This is understood to mean that once a Pilot FIE has been granted a quota by SAFE, it may convert foreign currency into RMB

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as funds are deployed into onshore investment targets without the need to seek further SAFE approvals at the time of each conversion. In any event, we anticipate that SAFE and SFSO will clarify the particulars of the foreign exchange regime in the near future.

Given the unusual level of inter-agency cooperation in sanctioning and monitoring Pilot FIE Funds and Pilot FIE Fund Managers, it is likely that this initiative represents a trial balloon for PRC policy-makers in testing a gradual erosion of the distinctions between foreign and domestic capital in the Chinese economy, as well as a measured loosening of current barriers against inbound portfolio investment.

The Pilot FIE scheme imposes qualification requirements that are reminiscent of the Qualified Foreign Institutional Investor scheme and quota system used to provide controlled foreign access to China's A-share securities market. In a nutshell, the scheme appears designed to attract large-scale foreign institutional investors, as well as reputable private equity managers.

Key takeaways include the following:

- Admissible Foreign Investors. Qualified foreign investors for Pilot FIE Funds are stated to primarily include offshore sovereign wealth funds, pension funds, endowment funds, charitable funds, funds-of-funds, insurance companies, banks, securities companies, and other foreign institutional investors approved by the Joint Commission.
- Qualified Foreign Investors. The foreign investor of an FIE Fund applying to be qualified as a Pilot FIE Fund under the Pilot Program must meet the following qualifications:
 - (i) own assets of no less than US\$500 million or manage assets of no less than US\$1 billion in the fiscal year prior to the year which the application is filed;
 - (ii) have a good governance structure and internal control system and have not been subject to any penalty from judicial authorities or regulatory bodies in the prior two years;
 - (iii) have or its affiliate must have no less than five years' relevant investment experience; and
 - (iv) meet other conditions required by the Joint Commission.
- Applications for Pilot FIE Funds or Pilot FIE Fund Managers. An FIE Fund or FIE Fund Manager applying to qualify under the Pilot Program must file an application with the SFSO through its executive partner or the executive partner of the FIE Fund or FIE Fund Manager to be formed. Such executive partner or its affiliate is required to have a good track record of at least three years of direct or indirect investments in enterprises in China.
- Potential "National Treatment" for RMB Funds Raised by an FIE Fund Manager. A Pilot FIE Fund Manager may act as a general partner of an RMB fund and raise funds solely from domestic limited partners without affecting the character of the fund as a domestic fund, if its investment in the fund does not exceed 5%. However, in practice, such RMB funds may be subject to prohibitions on investments in real estate, publicly traded securities and industry sectors where foreign investment is prohibited.

Although not indicated in the Pilot Measures, it has been reported that FIE Funds focusing on investments in emerging strategic industries, high-technology sectors, and innovative small and medium enterprises will obtain priority to be qualified as Pilot FIE Funds.

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- *Regular Reporting to Functional Department.* Pilot FIE Funds or Pilot FIE Fund Managers are required to file a semiannual report to the local government agency overseeing the Pilot FIE (the “**Functional Department**”) disclosing the occurrence of any of various enumerated major events during the reporting period including investment projects, amendments to constituent documents, and changes to either committed capital or management personnel.

CONCLUSION - REGULATORY SCHEME BEGINS TO TAKE SHAPE

The Pilot Measures effectively codify existing practice with respect to the establishment of foreign-invested partnership funds in Shanghai, and suggest that foreign exchange conversion issues that have bedeviled foreign investors seeking to set up RMB funds are one step closer to resolution. Intriguingly, the Pilot Measures also suggest that a certain level of national treatment of RMB funds managed by a foreign-invested GP may be available; this represents a significant market-opening development.

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