

No pain, no gain

Private equity and venture capital provides many opportunities, but the industry is still in its infancy and foreign investors must take note of the limitations of current regulations

The private equity and venture capital industry in China is dynamic and fast-growing. In late 2008, the State Council, in a formal policy document, used the magic words for the first time: 股权投资基金 – private equity investment fund. Local governments in Tianjin, Shanghai, Beijing and other cities have issued various local rules in the past year that permit the formation of private equity funds and fund management companies. In the meantime, many foreign private equity fund managers also started to look towards the vast capital pool available in China and explore ways to set up pure *renminbi* (RMB) funds in mainland China.

If a foreign private equity fund manager intends to establish an RMB fund in mainland China, it can be structured either as an indirect pure RMB fund (RMB Fund) or as a foreign-invested venture capital investment enterprise (FIVCIE). An indirect pure RMB Fund at first appears to be a practical vehicle, but there are certain legal and practical uncertainties associated with this structure.

On the other hand, there is a fundamental question as to whether an FIVCIE established under regulations issued in 2003, could serve as a viable structure. Other problems may also include possible investment restrictions with regard to industries or geographies, and heavier tax burdens.

Structuring issues

To set up a typical indirect pure RMB Fund, a foreign fund manager would need to incorporate an onshore private equity fund management entity (Onshore Management Entity) and an onshore private equity investment entity in China (Onshore PE Investment

Entity). After that, a foreign fund manager may initiate and set up a domestic RMB private equity fund, with the PRC domestic investors as the capital providers or limited partners. The general partner may also be an affiliated onshore subsidiary of the foreign parent. This typical structure is illustrated in Figure 1.

The RMB Fund may be incorporated as either a limited partnership or a limited company. A limited partnership is a new type of legal entity only adopted by PRC law in 2006. Of course, a significant benefit is taxation. If the RMB Fund is incorporated as a PRC limited company, this company would be subject to corporate income tax and its dividend pay-out to a foreign shareholder would be levied with a withholding income tax of 10% (or as low as 5% if a tax treaty applies). Since the *PRC Company Law* came into existence in 1994, an RMB fund incorporated as a company would likely give rise to many fewer legal and operational uncertainties.

Technically, the fund management function may also be carried out by an offshore management entity. This appears to be an extremely tax efficient structure. However, this structure may not be favoured by PRC local governments as a matter of local policy.

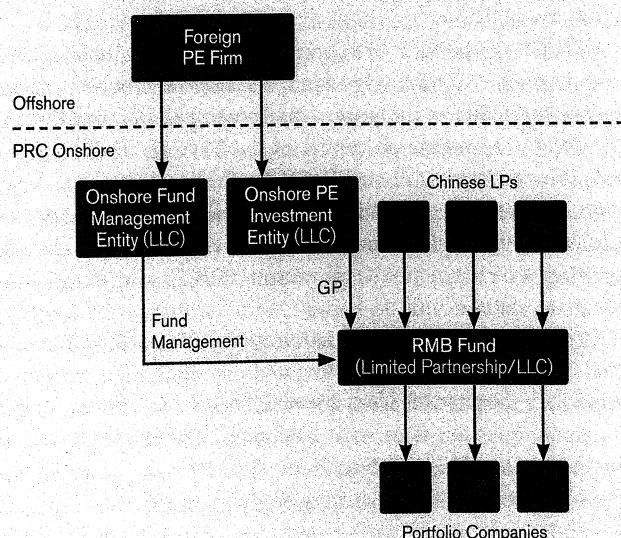
Additionally, a foreign PE firm should be aware that there may be other structuring options depending on different PRC strategies, development purposes of the foreign company, different company holding structures, and PRC PE-related legislation developments. For instance, setting up a traditional wholly-owned subsidiary may satisfy a foreign company's purpose of establishing an investment management and consulting business in China.

Formation of an Onshore PE Management Entity

A foreign-invested Onshore Management Entity may be incorporated in Tianjin, Shanghai, Beijing or other localities. For instance, the government of the Pudong New Area in Shanghai issued pilot measures in June 2009 – *Trial Measures for the Establishment of Foreign-invested Equity Investment Management Enterprises* (上海市浦东新区设立外商投资股权投资管理企业试行办法) – which included the following rules:

- **Legal form:** The Onshore Management Entity must be a limited company rather than a limited partnership.
- **Capitalisation:** The minimum registered capital is US\$2 million, of which 20% should be contributed within three months following establishment, and the remainder within the next two years.
- **Shareholder qualifications:** At least one shareholder (or its affiliate) must have engaged in private equity investment or private equity investment management.
- **Management qualifications:** At least two management members must have more than two years of experience in private equity fund investment or private equity fund management and more than two years of experience in a senior management position.

FIGURE 1: A TYPICAL PURE RMB FUND STRUCTURE



Tianjin local governmental authorities have also issued similar local rules.

Formation of RMB PE funds

Some local governments have issued pilot regulations with respect to private equity investment funds. For example, rules issued by the Shanghai Municipal Financial Services Office in August 2008 set forth the following:

- (a) A private equity investment fund enterprise may be in the form of a limited company, a limited partnership, or a joint stock company;
- (b) A private equity investment fund in the form of a limited company or a limited partnership should have no more than 50 shareholders (or partners). A fund in the form of a joint stock company should have no more than 200 shareholders;
- (c) A private equity investment fund should have a registered capital of at least Rmb100 million (US\$14.7 million), all of which is to be contributed in cash;
- (d) The partners of a limited partnership shall enjoy a pass-through tax status. An individual acting as a general partner shall be subject to a progressive tax rate of between 5% and 35%. An individual acting as a limited partner shall be subject to the 20% income tax rate which is normally applied to "interest, dividends, and bonus income";
- (e) The assets of a private equity investment fund in the form of a limited partnership must be entrusted to the custody of a commercial bank that offers trust services; and
- (f) A private equity investment enterprise must submit an annual report to its shareholders (partners) at the end of each fiscal year.

Benefits, legal uncertainties and practical difficulties

A foreign private equity firm that sets up an indirect RMB fund in China earlier rather than later will very likely benefit from significant early-mover advantages, such as early name recognition, more connections with and access to limited partner capital available or to be available in China, and accumulation of local investment management experience in China.

It is worth noting that there is not yet a national legal framework in China for foreign direct investment in the PE industry. The central government is still drafting national regulations with respect to the formation and management of PE investment funds in China, and may approve them soon. Regulations regarding foreign investment in limited partnerships were approved in principle by the State Council in late August 2009, and will be likely promulgated soon. Rules issued by local governments are not complete and not detailed enough, and are often prone to frequent modification and wilful interpretation by local governments.

Under foreign investment laws, an RMB Fund would be characterised as a PRC domestic entity, not as a foreign-invested enterprise. But the fund would still be subject to PRC foreign investment legal and policy restrictions in the types of industries or sectors in which it may invest. In order to facilitate foreign investors' participation in the development of the PE industry in China, it is

hoped that relevant PRC governmental authorities could officially lift such restrictions where an Onshore Management Entity makes a *de minimis* capital contribution (e.g. 1% or 2%).

In addition, the State Administration of Foreign Exchange still prohibits a foreign-invested enterprise to use its paid-in registered capital in foreign currencies to make equity investments in another PRC enterprise. This would likely affect a foreign-invested private equity fund management company's ability to make its general

Rules issued by local governments are not complete and not detailed enough, and are often prone to frequent modification

Lawrence Linjun Guo, partner, Broad & Bright



partner contributions in an onshore private equity investment fund. Some local officials have expressed that they may help coordinate with the relevant foreign exchange authority to overcome this prohibition.

How viable is an FIVCIE?

An FIVCIE provides a distinct regulatory framework for a foreign investor to establish an RMB fund in China. Recently, the Ministry of Commerce delegated significant powers for approving a FIVCIE to provincial and other local authorities. This will greatly facilitate the approval process. An advantage of a Sino-foreign FIVCIE structure is that if the Chinese partner is owned by the local government, the Sino-foreign enterprise would likely benefit from strong support, such as sourcing of local deals and/or co-investments by local entities.

If an FIVCIE is incorporated as a company, the minimum registered capital is US\$5 million, and the "primary investor" needs to contribute no less than 30% of the total registered capital. If an FIVCIE is incorporated as a "non-legal-person" enterprise, the minimum registered capital is US\$10 million, in which the primary investor should contribute at least 1% of both the registered and the paid-in capital.

A FIVCIE in the form of a company would not serve as a viable PE fund structure for a foreign fund, because the primary investor (in a similar status as the general partner) needs to contribute at least 30% of the registered capital of the FIVCIE. There are also problems associated with an FIVCIE in the form of a non-legal-person. Following the adoption of the uniform corporate income tax in 2007, PRC national tax authorities so far have not clarified in writing whether a non-legal-person FIVCIE can enjoy pass-through tax status.

There is a paramount restriction applicable to FIVCIEs: The capital of an FIVCIE should be invested mainly in high- and new-technology enterprises that are not yet listed on the stock exchange. An ensuing question is to what extent an FIVCIE may invest in other enterprises. This is subject to the discretionary interpretation of the relevant approval and administrative authorities.

Lawrence Linjun Guo, partner, Broad & Bright