

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 (Entity). After that, a foreign fund manager may initiate and set

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

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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.

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