The Shanghai Pilot Programme: The Path to Foreign LPs in RMB Private Equity Funds

For years, the private equity industry has hoped to create RMB private equity funds that can accept international LP capital but that can compete within China on equal footing with domestic private equity funds, free from foreign exchange and foreign investment restrictions. The recent introduction by the government of Shanghai of Measures on a Pilot Program of Foreign Invested Equity Investment Enterprises ("**Shanghai Pilot Program**") is a positive but limited step in this direction.

Types of RMB Private Equity Funds

RMB private equity funds broadly fall into 2 categories. Onshore RMB funds are funds domiciled and which raise capital in China. Offshore RMB funds are funds, either domiciled in China or elsewhere, which raise capital overseas for investment in China. Unlike onshore RMB funds, offshore RMB funds have historically been subject to strict foreign investment restrictions and foreign exchange restrictions in China. As a result, onshore RMB funds have enjoyed a considerable competitive advantage.

Foreign Investment Restrictions

Investments by offshore RMB funds into domestic enterprises in China are subject to government approvals. The establishment of a foreign invested enterprise ("**FIE**") from such an investment must be approved by the Ministry of Commerce ("**MOFCOM**") or its provincial counterpart and registered with the State Administration for Industry and Commerce ("**SAIC**") or its local counterparts. Depending on business of the domestic enterprise and the size of the investment, approval may

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For more information

Timothy Loh,
Principal
tloh@timothyloh.com
Hong Kong: +852 2899.0179

Guy Connell *
gconnell@timothyloh.com
Hong Kong: +852 2899.0140

Rose Zhao,
Associate
rzhao@timothyloh.com
Hong Kong: +852 2899.0119

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** Solicitor, England and Wales. Not admitted or registered as a lawyer in Hong Kong*

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also be required from the National Development and Reform Commission ("**NDRC**") or its provincial or local counterparts pursuant to the Catalogue of Guidance for Foreign Investment Industries ("**Catalogue**").

Foreign Exchange Controls

At the same time, investments by offshore RMB funds into domestic Chinese enterprises are subject to foreign exchange controls. Circular 142 issued by the State Administration of Foreign Exchange ("**SAFE**") in August 2008 prohibits FIEs from using renminbi converted from foreign capital to make equity investments in China unless the domestic equity investment is within the approved business scope of the FIE and has been approved by SAFE. In practice, SAFE approval is a lengthy process and may be difficult to obtain.

Fund Structures Available Today

At present, there are no national laws or regulations which would facilitate the establishment of offshore RMB funds which are free from both foreign investment and foreign exchange restrictions.

Foreign Invested Venture Capital Investment Enterprises

It is now (and has been, since 2003) possible to establish offshore RMB funds either through foreign invested venture capital investment enterprises ("**FIVCIEs**"). FIVCIEs are essentially FIEs established with the primary purpose of venture capital investment in China.

The FIVCIE structure was the first attempt by the Chinese government to directly allow foreign investors to form offshore RMB funds in China. In practice, FIVCIEs are often jointly formed by a fund of funds sponsored by Chinese local governments and foreign investors.

FIVCIEs enjoy certain incentive policies and tax benefits, including exemption from SAFE foreign exchange conversion approval requirements. However, their use is limited in various ways.

- *Foreign Investment Restrictions* - Equity investments by FIVCIEs are subject to the Catalogue and accordingly, are not on equal ground with their domestic counterparts particularly in relation to investments in "restricted" and "prohibited" industries.
- *Limited Investment Focus* – FIVCIEs are required to focus on unlisted hi-technology and new technology investments.
- *Capital Requirements* – FIVCIEs are subject to strict minimum capital requirements which are required to be contributed in cash.

Following their inception, FIVCIEs became the most widely adopted investment vehicle for foreign investors. However, due to their limitations, their use as offshore RMB funds has been limited.

Foreign-invested Partnerships

Early last year, China introduced regulations to govern foreign-invested partnerships ("**FIPs**"). Under current law, it appears that it is possible to establish FIPs as limited partnership private equity fund vehicles. However, the rules applicable to such FIPs remain unclear. Chinese regulations suggest that national measures will govern such FIPs but no such regulations have yet been introduced.

For the time being, FIPs remain subject both to foreign investment restrictions under the Catalogue and foreign exchange restrictions.

Pilot GPs who establish a private equity fund may contribute in foreign exchange up to 5 per cent. of the capital commitments of the fund without changing the original nature of the fund. It is not clear whether this means that a Pilot GP can establish an onshore RMB fund into which it may invest without triggering foreign investment restrictions…

Shanghai Pilot Program

The Shanghai Pilot Program represents but a small step towards overcoming limitations in FIPs as private equity fund vehicles. The Shanghai Pilot Program introduces foreign invested equity investment enterprises ("**Foreign Invested PE Funds**") and foreign invested equity investment management enterprises ("**Foreign GPs**"). As Foreign Invested PE Funds may take the form of FIPs, the Shanghai Pilot Program appears to allow FIPs to be used as private equity fund vehicles in the absence of national measures to that effect.

Foreign Investment Restrictions

Under the Shanghai Pilot Program, Foreign GPs ("**Pilot GPs**") who qualify under the pilot program and who establish a private equity fund may contribute in foreign exchange up to 5 per cent. of the capital commitments of the fund without changing the original nature of the fund. It is not clear whether this means that a Pilot GP can establish an onshore RMB fund into which it may invest without triggering foreign investment restrictions in respect of each investment by the fund and if so, whether the fund may make investments outside Shanghai within the scope of these measures.

Foreign Exchange Restrictions

The Shanghai Pilot Program further provides that a Foreign Invested PE Fund ("**Pilot PE Funds**") who qualifies under the pilot program may process foreign exchange for their investments in China through a custodian bank for the Pilot PE Fund. If this enables offshore RMB funds who qualify as Pilot PE Funds to avoid SAFE approval for each individual investment, it would offer substantial benefits. However, despite news reports, the Shanghai Pilot Program makes no specific reference to SAFE.

Joint Conference

Both Pilot GPs and Pilot PE Funds are subject to approval by a joint conference ("**Joint Conference**") of Shanghai municipal authorities, including the Municipal Financial Services Office, the Municipal Commission of Commerce, the Municipal Administration for Industry and Commerce, the Municipal Development and Reform Commission and the Shanghai Branch of State Administration of Foreign Exchange. It is not clear on what basis the Joint Conference will exercise its discretion to approve Pilot GPs or Pilot PE Funds.

Pilot PE Funds

The foreign LPs of a Pilot PE Fund must include primarily offshore sovereign wealth funds, pension funds, endowment funds, charitable funds, funds of funds, insurance companies, banks, securities companies and other institutional investors approved by the Joint Conference. Each of these foreign LPs must meet the following requirements:

- *Size* - Each foreign LP must either have its own assets of at least US$500 million or manage assets of no less than US$1 billion in the fiscal year prior to its application for approval.
- *Governance and Compliance* - Each foreign LP must have a good governance structure and internal control system and must not have been subject to any penalty from any judicial or regulatory authority in the 2 years prior to its application for approval. It is unclear what is meant by "good" governance and internal controls.
- *Experience* - Each foreign LP must have or its affiliates must have at least 5 years of relevant investment experience.

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Pilot GPs

The minimum requirements for a Pilot GP are less clear. The Shanghai Pilot Program requires Foreign GPs who use the term "equity investment fund management" in their name to meet the following minimum criteria:

- *Business Scope* –A Foreign GP must be owned by or affiliated with a person whose business scope is related to equity investment or equity investment management.
- *Senior Management* – A Foreign GP must have at least 2 senior executives who have at least 5 years of experience in equity investment or equity investment management, some of which is China related, more than 2 years of senior management experience and a clean compliance record.
- *Capital* –A Foreign GP must have minimum registered or committed capital of US$2 million.

The Shanghai Pilot Program however, does not mandate the use of the term "equity investment fund management" in the name of a Foreign GP and it remains to be seen whether all Pilot GPs will be required to meet these criteria.

Consequential Position

As is evident, the Shanghai Pilot Program does not facilitate the creation of RMB funds free from foreign investment and foreign exchange restrictions. Perhaps most significantly, it does not allow foreign LPs to invest into onshore RMB funds without triggering foreign investment restrictions. Nor does it facilitate offshore RMB funds in bypassing foreign investment restrictions. It thus represents a small but incremental step towards liberalization in China of private equity investments.

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