

New rules extend opportunities for foreign private equity in Shanghai

Rules issued in late December offer further clarity on the opportunities for foreign private equity (PE) fund managers and their investors in Shanghai.

The new rules, the latest opening up of Shanghai's nascent PE industry to foreign capital, offer a stronger regulatory framework for the launch and management of onshore Renminbi (RMB) funds and may make it easier for qualified foreign investors to convert foreign currency into RMB for onward investment.

However, while offering a welcome upgrade to the regime for foreign PE investors, considerable uncertainty remains as to how foreign-invested RMB funds will actually be able to operate in practice and how their activities may be treated outside the Shanghai area.

The briefing explains the background to the changes, the new opportunities available, and explores some of the grey areas that remain in the regulation and its likely operation.

Background

Shanghai's authorities have long sought to boost the development of a private equity (PE) industry in Shanghai, seeing it as an important part of the city's development as an international financial centre.

In August 2008, a PE Circular set out the registration process and tax treatment for PE investment and management enterprises in Shanghai. However, the rules did not address how foreigners could participate in or manage onshore PE funds.

To fill that regulatory gap, the Shanghai Pudong government launched a pilot programme in June 2009. These "Pudong Measures" provided the terms and incentives of foreign participation in the PE industry in the Pudong area.

Due to the limited geographical application of the Pudong Measures and the fact that they expired on 30 June 2010, more comprehensive regulations were widely anticipated.

These regulations have now been promulgated, on 24 December 2010, by the Shanghai Municipal Financial Services Office, the Shanghai Municipal Commission of Commerce and the Shanghai Administration of Industry and Commerce (Shanghai AIC) as the *Shanghai Implementing Measures on the Launch of the Pilot Program for Foreign Invested Equity Investment Enterprises in Shanghai* (Shanghai PE Measures). The Shanghai PE Measures will come into effect on 23 January 2011 and implement in effect certain elements of the rumoured qualified foreign limited partner (QFLP) regime that has been widely discussed over the last few months.

The new Shanghai PE Measures introduce two forms of participation by foreign investors in the PE sector:

- foreign-invested equity investment enterprises (FIE Funds), which are essentially investment funds, and
- foreign-invested equity investment management enterprises (FIE Fund Managers).

Key Issues

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The Shanghai PE Measures also contain a pilot programme under which certain qualifying FIE Funds and FIE Fund Managers may benefit from certain advantages, which will be discussed below.

Key issues

Scope of business and eligibility requirements for FIE Fund Managers

The primary business of an FIE Fund Manager will be to establish and provide management services to equity investment enterprises (i.e. RMB investment funds) by acting as their general partner (GP).

This is a significant improvement over the Pudong Measures, which did not explain whether an FIE Fund Manager could act as GP of an onshore investment fund. An FIE Fund Manager is also permitted to conduct equity investment consultancy or other activities as permitted by the relevant authorities. FIE Fund Managers can be established as partnerships or corporate entities.

An FIE Fund Manager must satisfy certain requirements to obtain approval from the Shanghai Municipal Financial Services Office and register with the Shanghai AIC, including:

- (1) it must have at least one investor who, or whose affiliate, engages in PE investment or management business,
- (2) it must have at least two senior management staff with (i) prior experience in PE investment or PE management for more than five years, (ii) prior experience in senior management for more than two years, and (iii) China-related PE investment experience or working experience in similar Chinese financial institutions, and
- (3) its registered capital or subscribed capital must be no less than US\$2 million, at least 20 per cent of which must be paid in within three months upon the issuance of the business licence, with the balance payable within two years.

These eligibility requirements are similar to those imposed on foreign invested PE fund managers under the earlier Pudong Measures.

Scope of business and eligibility requirements of FIE Funds

FIE Funds are a new concept. The Shanghai PE Measures define them as enterprises established by foreign enterprises or individuals as partnerships or other organisational forms, whose primary business is to make equity investments in non-listed companies. If established as partnerships, FIE Funds would take the familiar form of foreign-invested partnerships, which were introduced last year.

An FIE Fund is permitted to make equity investments by establishing a new company or by investing in existing companies through new issues or the acquisition of existing shares.

However, FIE Funds cannot invest in real estate (other than for their own use), nor can they trade listed stocks or corporate bonds (except for shares acquired before the investee company is listed), or trade futures or other financial derivative products.

The minimum capital for an FIE Fund is US\$15 million, with each limited partner (LP) contributing no less than US\$1 million. Foreign investors are permitted to make their capital contributions with freely convertible foreign currency or with legitimate RMB revenues or earnings generated in China, while domestic investors may only contribute RMB.

Opportunities and limitations under the pilot programme

Qualification requirements for the pilot programme

Subject to the examination and approval of a committee consisting of various municipal authorities led by the Shanghai Financial Services Office, an FIE Fund may qualify for the pilot programme if its foreign investors are offshore sovereign funds, pension funds, endowment funds, charity funds, fund of funds, insurance companies, banks, securities companies and other institutional investors approved by the relevant authorities.

These foreign investors must satisfy certain eligibility requirements, including, among others, that (1) the foreign investor has proprietary assets of not less than US\$500 million or assets under management of not less than US\$1 billion, and (2) the foreign investor or its affiliates have no less than five years' investment experience.

There are no specified requirements to qualify as an FIE Fund Manager under the pilot programme.

Foreign exchange conversion restrictions

While over a dozen foreign PE houses have set up fund management entities in China in the past year, investments have been scarce.

One of the major obstacles is the foreign exchange restriction imposed by the State Administration of Foreign Exchange (SAFE) under SAFE Circular 142, which prohibits the conversion of foreign exchange into RMB for equity investments.

The Shanghai PE Measures aim to relax this restriction by permitting FIE Fund Managers qualified under the pilot programme to invest their foreign exchange capital in PE funds that they sponsor, up to a limit of 5 per cent of the total capital of the relevant fund.

However, it remains unclear under the Shanghai PE Measures whether such foreign exchange capital can be converted into RMB before or after it is contributed to the relevant PE fund. Likewise, it also remains unclear as to whether LPs in qualified FIE Funds are able to convert capital contributions to the FIE Fund into RMB.

It is interesting to note that since the SAFE Circular 142 is still in effect and is of national application, compared to the Shanghai PE Measures which are rules issued only by Shanghai local authorities, an express exemption by SAFE from the application of SAFE Circular 142 would be necessary to allow such a conversion.

So far, SAFE has not issued any rules approving the capital conversion arrangement for FIE Fund Managers or FIE Funds under the Shanghai PE Measures, and SAFE's Shanghai Branch is not one of the issuing authorities of the Shanghai PE Measures.

Therefore, a question mark remains as to how SAFE will deal with foreign exchange conversion requests in practice.

Back in 2008, when foreign-invested venture capital investment enterprises (FIVCIEs) faced the same foreign exchange problem, a written reply issued by central SAFE to its Shanghai branch solved this problem by enabling FIVCIEs approved by the Ministry of Commerce (MOFCOM) to make equity investments within its permitted scope of business with its foreign exchange capital. It is to be hoped that SAFE will take similar actions in respect of the Shanghai PE Measures.

It was also rumored that the predicted QFLP regime would contain a quota of US\$3 billion to allow qualifying FIE Funds and FIE Fund Managers to convert foreign exchange capital into RMB. However, the Shanghai PE Measures contain no mention of such a quota. Again this may have to be supplemented by further regulations or guidance.

Domestic treatment

One of the potentially most important features of the pilot programme is that a qualified FIE Fund Manager who makes foreign exchange capital contributions as a GP to an RMB fund up to 5 per cent of the total amount of the fund size will not affect the (domestic) nature of the relevant RMB fund.

This means that RMB funds launched by a qualified FIE Fund Manager as GP with only domestic LPs contributing in RMB will be treated as a purely domestic RMB fund – and no foreign investment restrictions will apply nor MOFCOM approval required by the fund for its downstream investments.

It is important to note that currently, while the domestic treatment will be recognised for investments in Shanghai, there is no certainty that investments in other localities will be treated similarly. However, national recognition for such treatment is anticipated.

In any event, the domestic treatment only applies to the specific scenario where an FIE Fund Manager qualified under the pilot programme makes capital contributions as GP in an otherwise purely *domestic* fund.

Where the fund has *foreign* LPs, it may not benefit from this treatment, as the Shanghai PE Measures specify that the investments made by the FIE Funds should comply with normal PRC laws and regulations applicable to foreign investments.

This is the same requirement as that imposed previously on foreign-invested partnerships (FIPs) which primarily engage in investment business under the FIP registration provisions.¹

In practice, whether FIE Funds will be treated as foreign investors or domestic investors when conducting downstream investments will ultimately be at the discretion of MOFCOM or its local counterparts. Compared to FIVCIEs, whose onshore investment in encouraged and permitted industries only require filings with local level MOFCOM, the absence of national recognition of the domestic nature of FIE Funds makes these a less attractive option for foreign investors and managers.

This cautious approach adopted by the authorities in opening up restricted or prohibited industries to foreign investment reflects a practical concern over foreign speculative capital flowing into China.

¹ See Article 64 of the *Provisions on the Administration for the Registration of Foreign-invested Partnership Enterprises* promulgated by the State Administration of Industry and Commerce, effective as of 1 March 2010.

Conclusions

The Shanghai PE Measures are an important step for foreign-sponsored PE funds and PE managers, who have been operating in a regulatory grey area for the past few years, especially by allowing a qualified FIE Fund Manager to make capital contributions to a local fund in foreign exchange capital.

However, the circumstances in which foreign-sponsored RMB funds are treated as purely domestic RMB funds are still limited and the national recognition of such treatment is uncertain.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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