

### Renminbi Private Equity Funds – Opportunities and Limitations

RMB private equity funds (“RMB PE funds”) are Renminbi-denominated funds organized under the laws of the People’s Republic of China (the “PRC”) for the purpose of making private equity investments primarily in China.

In recent years, RMB PE funds have emerged rapidly in China’s fledgling private equity market. Recent regulatory developments in China, particularly the implementation of the 2006 M&A Rules (described below), and certain other restraints have made offshore private equity funds a less desirable investment structure compared to RMB PE funds. The prospects of China’s economic growth have also encouraged private equity firms and investors to increasingly utilize China-based investment structures. As a result, RMB PE funds have gained in popularity, even among foreign investors.

RMB PE funds can offer opportunities for:

- foreign private equity investors to invest in China;
- foreign investment professionals to raise and manage funds in return for management fees and carried interest; and
- foreign banks, private equity and venture capital firms to use the RMB fund structure to facilitate investments in China.

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### Basic Structures

RMB PE funds may be categorized as foreign-invested or domestic depending on the investors’ country of origin. Foreign-invested and domestic RMB PE funds are regulated under different regimes:

- Foreign-invested RMB PE funds are regulated primarily under the 2003 Administrative Rules on Foreign-Invested Venture Capital Investment Enterprises (“FIVCIE Rules”);
- A domestic RMB PE fund may be formed under the 2005 Interim Measures on Administration of Venture Capital Investment Enterprises (“Domestic VC Rules”) if it qualifies as a “domestic venture capital investment enterprise” (a “Domestic VC”), and may be organized as a limited partnership under the amended PRC Partnership Law.

The table below sets forth the primary legal requirements for the formation and operation of both foreign-invested and domestic RMB PE funds.

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	<b>Domestic RMB PE Funds</b>	<b>Foreign-invested RMB PE Funds</b>
<b>Organizational form</b>	Corporation, limited partnership or other forms of business entities	Corporation or unincorporated entity
<b>Regulatory authorization</b>	Record filing with competent authorities	Approval by competent authorities
<b>Competent authorities</b>	National: National Development and Reform Commission	National: Ministry of Commerce (“MOFCOM”); Ministry of Science and Technology (“MST”)
	Local: determined by provincial government	Local: provincial MOFCOM and provincial MST
<b>Minimum capital requirements</b>	Domestic VCs: paid-in capital $\geq$ RMB30 million; or first installment thereof $\geq$ RMB10 million with the remainder to be paid within 5 years of the registration of the Domestic VC with the Industrial and Commercial Administration Others: regular minimum capital requirements for PRC corporations; unspecified for limited partnerships	Foreign-invested venture capital investment enterprises (“FIVCIEs”): <ul style="list-style-type: none"> <li>• corporation: US\$5 million</li> <li>• unincorporated entity: US\$10 million</li> </ul> Commitment period: up to five years
<b>Each investor’s minimum commitment</b>	Domestic VCs: RMB1 million Others: unspecified	<ul style="list-style-type: none"> <li>• “Requisite investors” <ul style="list-style-type: none"> <li>○ corporation: 30% of total commitments and 30% of total invested capital</li> <li>○ unincorporated entity: 1% of total commitments and 1% of total invested capital</li> </ul> </li> <li>• Other investors: US\$1 million</li> </ul>
<b>Form and currency of capital contributions</b>	Domestic VCs: RMB cash Limited partnerships: cash, assets, IP rights, land use rights and/or other property rights	Foreign investors: cash in freely convertible currencies Chinese investors: RMB cash
<b>Number of investors</b>	Domestic VCs: $\leq$ 200; but if a limited liability company, $\leq$ 50 Limited partnerships: 2-50 with at least one general partner	FIVCIEs: 2-50 with at least one “requisite investor”
<b>Management personnel</b>	Domestic VCs: $\geq$ 3 investment management professionals each with 2+ years’ experience in venture capital investments or related areas Others: unspecified	FIVCIEs: $\geq$ 3 investment management professionals each with 3+ years’ experience in venture capital investments

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	<b>Domestic RMB PE Funds</b>	<b>Foreign-invested RMB PE Funds</b>
<b>Investment limits</b>	<p>Domestic VCs:</p> <ul style="list-style-type: none"> <li>• unlisted companies, each no more than 20% of total assets of the Domestic VC;</li> <li>• common, preferred and convertible preferred shares;</li> <li>• bank deposits, government bonds and other fixed income securities permitted;</li> <li>• no guarantees;</li> <li>• no investments in publicly traded securities (other than fixed income securities) or real property.</li> </ul> <p>Others: unspecified; regulatory approval may apply to investments in certain industries</p>	<p>FIVCIEs:</p> <ul style="list-style-type: none"> <li>• equity investments only in unlisted high- and new-technology companies;</li> <li>• subject to industry restrictions applicable to foreign investments;</li> <li>• no guarantees (except on corporate bonds maturing after 1 year and convertible bonds, in either case, issued by portfolio companies);</li> <li>• no investments in publicly traded securities or real property</li> </ul>
<b>Term</b>	<p>Domestic VCs: <math>\geq 7</math> years</p> <p>Others: unspecified</p>	FIVCIEs: generally $\geq 12$ years; extendible upon regulatory approval

## Domestic RMB PE Funds

To encourage investments in high-technology enterprises, the Domestic VC Rules:

- permit local governments to form funds of funds to invest in Domestic VCs or guarantee their financing;
- introduce tax incentives for investments in Domestic VCs and their investments in small- and medium-sized high-technology enterprises; and
- permit initial public offerings (“IPOs”), trade sales or portfolio company repurchases as exit strategies.

The 2006 amendments to the PRC Partnership Law introduced the limited partnership as a valid form of organization. The limited liability and tax pass-through features of limited partnerships have gained popularity among investors and spurred the growth of domestic RMB PE funds.

This year, the launch of a long-awaited growth enterprise board (“GEM”) on the Shenzhen Stock Exchange and the relaxation of investment restrictions on the National Social Security Fund (the “NSSF”) are expected to fuel the further growth of domestic RMB PE funds. The launch of the GEM market is expected to improve the ability of RMB PE funds to exit their investments through IPOs by portfolio companies. The NSSF, now permitted to invest up to 10% of its assets in domestic RMB PE funds, has been reported to have injected a significant amount of capital into two domestic RMB PE funds.

### *Opportunities and Limitations for Foreign Investors*

Only Chinese investors are eligible to invest in domestic RMB PE funds. However, foreign investors can channel investments into such funds through a layered holding structure in which a foreign-invested enterprise (“FIE”) is formed to invest in a Chinese company, which in turn invests in a domestic RMB PE fund.

#### *Opportunities*

This structure permits foreign investors to gain access to domestic RMB PE funds and take advantage of the benefits associated with a domestic investment, including:

- More streamlined government clearance procedures for fund formation and investments. Only a record filing is required to form a domestic RMB PE fund as opposed to the more cumbersome government approval process required for forming a foreign-invested RMB PE fund. Furthermore, no MOFCOM approval is required for domestic RMB PE funds to invest in Chinese companies.
- Ability to organize the fund as a limited partnership. The PRC Partnership Law only applies to partnerships whose partners are all Chinese entities or individuals.
- Ability to exit through IPOs on the GEM market. In comparison, the ability of foreign-invested RMB PE funds to do the same is restricted under current regulations.

#### *Limitations*

This layered holding structure may be inefficient from tax and capital utilization perspectives, and may not be practicable due to regulatory risks and uncertainties, among other things:

- Although this layered holding structure is feasible under the current PRC legal framework, future regulatory interpretations may impose limitations, given the fact that the structure enables foreign investors to effectively circumvent the government clearance procedures for foreign-invested RMB PE funds.
- Although investments by a domestic RMB PE fund in Chinese companies do not require MOFCOM approval and presumably are not subject to the restrictions on foreign investments, such fund’s ability to invest in any “restricted” or “prohibited” industries listed in the Industry Catalogue for Foreign Investments (the “Catalogue”) is subject to significant uncertainty.

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- It has been difficult to invest in “red-chip” companies, an offshore structure preferred by foreign private equity investors, following the promulgation of the 2006 Rules Governing Acquisitions of Domestic Enterprises by Foreign Investors (the “M&A Rules”). The M&A Rules have imposed significant regulatory approval requirements for forming an offshore special purpose vehicle (a “SPV”) by a PRC company and the “return investments” in China and overseas IPO by such offshore SPV. The rules also set a one-year limit for the completion of such IPO. Furthermore, several circulars released by the State Administration of Foreign Exchange (“SAFE”) in recent years have imposed rigorous restrictions on currency conversions in connection with the “red-chip” structure.
- This structure inefficiently deploys capital. Two layers of entities in China – an FIE and its subsidiary – both trap capital due to the minimum capital requirements for each entity. Foreign investors can only repatriate dividends received from the FIE but may not repatriate invested capital until (i) the dissolution of the FIE, (ii) the reduction of the FIE’s registered capital or (iii) the transfer of its equity interest in the FIE to another foreign investor.
- This structure is less tax-efficient compared to the typical limited partnership structure where no income tax is levied at the fund level. Subject to certain deductions of up to 70% of the capital invested in a qualified Domestic VC, a 25% PRC enterprise income tax (“EIT”) applies to incorporated funds. Even a PRC limited partnership (a pass-through entity) is subject to a 20% withholding tax for certain income (e.g., royalty, rents and capital gains). The indirect subsidiary of the foreign investor which is a limited partner of the fund can only distribute investment returns through dividends to its immediate parent (i.e., the FIE), which, in turn, distributes dividends to the foreign investor. Both the indirect subsidiary of the foreign investor and the FIE are subject to a 25% EIT, and the dividends to the foreign investor are subject to a 10% withholding tax (subject to treaty deductions). Therefore, any amount that the foreign investor receives will have been taxed multiple times.
- Exiting through an IPO on the Chinese stock markets may present challenges. The standards for listing on the GEM are stringent for small, growth-stage portfolio companies and generally more demanding than NASDAQ standards. Also, the GEM Listing Rules require disclosure of the company’s “de facto controlling persons”, who are required to sign a representation letter endorsing the company’s disclosure, thus exposing these persons to securities law liabilities. In addition, if a foreign investor holds a significant block of the portfolio company’s shares through a domestic RMB PE fund, the disclosure of the foreign investor’s interest in such company may jeopardize the latter’s ability to list on the GEM as a domestic company and, under such circumstances, the company may be required to go through an onerous MOFCOM approval process to be converted into a foreign invested joint stock company (“FIJSC”) before being listed on the GEM.

## *Opportunities and Limitations for Foreign Investment Management Companies and Professionals*

### *Opportunities*

A domestic RMB PE fund may outsource investment management functions through contractual arrangements to an FIE formed by a foreign company. Foreign investment professionals are permitted to join such an FIE or a domestic investment management company. Such companies and professionals are able to earn management fees based on the amount of capital under management and performance fees (equivalent to carried interest) based on returns on invested capital. Furthermore, a foreign private equity firm may seek to control a domestic fund or its general partner through managers who are PRC nationals.

### *Limitations*

- The decision-making powers of the investment managers are limited by contract. Even if they may be granted wide discretion, the fund investors typically have approval rights with respect to certain important matters, particularly regarding conflicts of interest.
- A management agreement typically provides for termination for “cause” or without “cause” (if voted by the requisite threshold of limited partner interests), thus the investment managers can be dismissed by fund investors unilaterally.

- The tax burdens are significantly more burdensome than in an offshore fund structure, where the investment management company is typically organized in a tax haven (e.g., BVI) and subject to no income tax. An onshore structure is subject to various levels of taxation. The management fees and performance fees are subject to a 5% business tax. The net income of a company is subject to a 25% EIT. In addition, any dividends from an FIE to its foreign investor are subject to a 10% withholding tax (subject to treaty deductions). Compensation paid to investment professionals is taxed at progressive individual income tax rates ranging from 5% to 45%. Although an investment management company can be a pass-through entity (i.e., a limited partnership for a domestic company or an unincorporated joint venture for an FIE) to avoid the company-level EIT, other taxes noted above still apply.

## Foreign-Invested RMB PE Funds

The FIVCIE Rules permit foreign investors to invest, under the current legal framework regulating foreign investments, in a tax-transparent structure that resembles the traditional limited partnership structure utilized by a typical offshore private equity fund. However, as discussed below, the FIVCIE Rules have a narrow focus and only apply to the venture capital funds investing in high and new technology companies.

A FIVCIE may be formed as a “legal person FIVCIE” (an incorporated joint venture or wholly owned FIE) or a “non-legal person FIVCIE” (an unincorporated cooperative joint venture (“CJV”)) under the PRC foreign investment laws. At least one “requisite investor” meeting the specified qualification requirements is required. In an unincorporated CJV structure similar to a limited partnership, the “requisite investor” functions like a general partner and assumes joint and several liabilities with the FIVCIE.

## Opportunities and Limitations for Foreign Investors

### Opportunities

- Ability to replicate the governance and economics of a traditional offshore private equity fund.
  - *Unincorporated CJV structure.* A foreign private equity firm can act, in its own name or through an affiliate, as the “requisite investor” of a FIVCIE. A FIVCIE is required to have a joint management committee, which can mirror an investment committee in a traditional offshore fund. The day-to-day operations of a FIVCIE can be run by a management company through contractual arrangements, as is common among offshore funds. Properly structured FIVCIEs can implement the carried interest and management fees mechanisms that are familiar to foreign private equity firms.
  - *“Parallel fund” or “feeder fund” structure.* This structure comprises an onshore RMB PE fund in China (an unincorporated CJV) and an offshore fund (a limited partnership) to achieve the maximum degree of flexibility in structuring investments and profit sharing. The two funds may achieve integrated management by the same professionals through contractual arrangements and be treated for all intents and purposes as one fund, with substantially similar investment objectives, governance and economics structures. However, due to regulatory restrictions and various practical issues, these funds will likely invest in different portfolio companies and thus may not be able to make parallel investments.
- Streamlined government clearance procedures for investing in Chinese companies. Only a record filing with the local MOFCOM is required for a FIVCIE to invest in an “encouraged” or “permitted” industry, which is much less onerous than the substantive review and approval process involving the central or local MOFCOM for a foreign investor to make direct investments in China.
- Flexibility in timing of capital contributions. As in a typical private equity fund, investors in a FIVCIE need only make capital commitments at the inception of the fund. Capital contributions can be drawn down in installments over five years. In comparison, capital contributions for a foreign direct investment are required to be paid in full within three years, with the first 15% payable within 90 days after the FIE obtains its business license.
- Improved ability to repatriate capital. A FIVCIE can distribute to its foreign investors proceeds from the dispositions of investments as they occur without waiting until the dissolution of the fund. As a comparison, repatriation of the

registered capital of an FIE can only be made upon liquidation of, disposition of interest in, or reduction of registered capital of, the FIE, all subject to MOFCOM approval.

- Tax benefits. A 2003 tax circular clarified that unincorporated CJV FIVCIEs can be pass-through entities, thereby avoiding EIT at the fund level. Distributions to the foreign investors, including capital gains (including carried interest for the foreign “requisite investors”) and dividends, are generally subject to a 10% withholding tax subject to treaty deductions. However, uncertainties have arisen as to whether the pass-through recognition is still valid since the EIT Law was amended effective January 1, 2008. If this recognition is reversed, the fund level EIT will be levied, but it is then unclear whether FIVCIEs can benefit from the tax incentives provided to qualified Domestic VCs (as discussed earlier). In practice such benefits have not been made available to FIVCIE.

### *Limitations*

Despite these advantages, the number of FIVCIE funds and the amounts raised to date are limited, which may be attributable to the following reasons:

- “High-technology” focus only. The FIVCIE Rules only apply to foreign-invested RMB funds making venture capital investments in unlisted high and new technology companies. It is unclear whether other foreign-invested RMB PE funds are able to adopt the same profit allocation and distribution mechanisms and are entitled to the benefits provided by the FIVCIE Rules.
- Lack of precedents. Until very recently, forming any FIVCIE required the central MOFCOM's approval. Effective March 5, 2009, the approval authority for FIVCIEs with total investments of US\$100 million or less have been delegated to provincial MOFCOMs. Since relatively few FIVCIEs have been formed, provincial MOFCOMs are not typically familiar with the FIVCIE structure, which may create uncertainties at the regulatory approval process.
- Rudimentary legal framework. PRC laws do not yet accommodate foreign-invested limited partnerships. Although an unincorporated CJV FIVCIE can resemble a limited partnership, there is no established body of law to support such a structure. Thus, the governance matters and the other features inherent to limited partnerships have to be explicitly set forth in detail in a fund's documentation. Where ambiguities arise, the lack of underlying laws may lead to undesirable or unexpected results.
- Limited exit strategies. As discussed above, investing in a “red-chip” structure and exiting through an overseas IPO, which remains the preferred route for many foreign investors, is no longer viable following the release of the M&A Rules and the several SAFE circulars. The launch of the GEM, undoubtedly good news for domestic RMB PE funds, may not offer the same exit opportunities for FIVCIEs. If the capital invested by the foreign investors of a FIVCIE together with the capital contributions from all other foreign investors of a portfolio company constitute more than 25% of its registered capital, such company has to satisfy significant qualification requirements (e.g., three years' profitability) and a lengthy MOFCOM approval process to be converted into a FIJSC before it can seek an IPO. If a FIVCIE is a promoter of a FIJSC portfolio company, the FIVCIE is subject to a three-year lock-up period, limiting its ability to dispose of shares in the FIJSC. The lock-up period may have been shortened to one year pursuant to a recent MOFCOM circular. However, how the MOFCOM approval practice develops on this issue remains to be seen.

### *FIVCIE as an Investment Vehicle*

The FIVCIE structure benefits from an easy and speedy government clearance process for investing in Chinese companies, an improved ability to seek onshore exits and to repatriate gains and potential tax pass-through. As a result, some foreign banks, private equity and venture capital firms have used FIVCIEs as an investment vehicle rather than as a capital raising tool.

Such FIVCIEs are typically unincorporated CJVs with no or little third-party investor participation. The required Chinese partner is either a nominee or a captive entity controlled by the foreign investor.

However, given the small number of such FIVCIEs formed to date, the FIVCIE as an investment vehicle has yet to be fully tested. Whether all of its desired benefits will be realized remains unclear.

## Conclusion

Amidst the uncertainty surrounding the global economy in its recovery from the financial crisis, China stands out as an attractive investment destination. Recent regulatory action has spurred a movement of foreign private equity firms and investors onshore through participation in RMB PE funds. An understanding of the current regulatory framework for RMB PE funds will enable investors to take full advantage of the prospects for growth afforded by this increasingly popular investment platform.

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