

# Client Alert.

March 5, 2010

## Update on Foreign-Invested Partnerships in China -

### FIP Measures Take Effect; First FIP Registered; Implementing Rules and Policies Clarify Scope of Important New Vehicle for Foreign Investment

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This week heralds the official launch of a new structure for foreign investment — the foreign-invested partnership (“FIP”) — with the long-awaited *Administrative Measures on the Establishment of Partnership Enterprises in China by Foreign Enterprises or Foreign Individuals* (《外国企业或个人在中国境内设立合伙企业管理办法》; the “FIP Measures”)<sup>1</sup> and their implementing rules, *Regulations for the Administration of the Registration of Foreign-invested Partnership Enterprises* (《外商投资合伙企业登记管理规定》; the “FIP Registration Regulations”)<sup>2</sup> both coming into effect on March 1, 2010 and local media already reporting the registration of China’s first FIP.<sup>3</sup>

The advent of the FIP represents an important watershed for foreign investment in China. First, in connection with investments into a variety of industry sectors, the FIP offers a more flexible form of investment vehicle and more streamlined establishment procedures than have been available to date under Chinese foreign investment legislation. In many cases, investments can be made into a FIP without the foreign investment regulatory approvals required for establishment of a traditional foreign investment enterprise (外商投资企业; “FIE”). This may be of benefit to, among others, foreign acquirers seeking to compete on a more equal footing with domestic investors than has been possible to date. Second, the offshore-style partnership structures possible using a FIP will likely provide a platform for foreign private equity and real estate investment managers to manage domestic capital pools.

The FIP Measures themselves provide only high-level guidance on issues such as the permissible operations of a FIP and the procedures for establishing a FIP. The FIP Registration Measures, issued in late January, provide much more detailed guidance on these issues. Given the advance in foreign investment rules the FIP represents, a host of additional legislation is still needed. This client alert nonetheless provides an introduction to the chief features of a FIP

<sup>1</sup> State Council Decree No. 567, promulgated on December 2, 2009 and effective as of March 1, 2010.

<sup>2</sup> SAIC Decree No. 47, promulgated on January 29, 2010 and effective as of March 1, 2010.

<sup>3</sup> See “我国首家外商投资合伙企业诞生” (The Country’s First Foreign-Invested Partnership Emerges), reported by Beijing Daily on March 2, 2010. See <http://news.163.com/10/0302/05/60OEDPRM000146BB.html>.

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relevant both to strategic investors and to investment managers.

## 1. FOREIGN INVESTMENT APPROVAL PROCESS

Other than FIPs, FIEs are the principal vehicles for foreign investment in China and include the equity joint venture, the cooperative joint venture (“**CJV**”), the wholly foreign-owned enterprise and the foreign-invested company limited by shares.

The establishment of an FIE (which includes the conversion of a domestic company into an FIE by way of foreign investment) in every case is subject to approval from the Ministry of Commerce or its local counterparts (“**MOFCOM**”). This approval process, together with various other structuring and operational restrictions applied to FIEs but not to pure domestic companies, often creates obstacles and delays for onshore deal execution by foreign financial investors.

The FIP Measures provide that the establishment, modification, liquidation or de-registration of a FIP that is “in compliance with China’s industrial policies for foreign investment” requires only registration with the local counterpart of the Administration for Industry and Commerce (“**AIC**”) and does not require MOFCOM’s approval.<sup>4</sup> In fact, AIC is only required to send the relevant office of MOFCOM (i.e., at the same level as the registering AIC office) a notice concurrently with the establishment and registration of the FIP that conforms to such policies for foreign investment. Thereafter, AIC is required to notify MOFCOM only in respect of key changes to an FIP, such as its liquidation or de-registration.

The FIP Measures do not address the question of what constitutes compliance with China’s industrial policies for foreign investment. This question is addressed to a large extent by the FIP Registration Regulations. The FIP Registration Regulations provide that a FIP may be established only in a category where 100% foreign ownership is allowed, as provided by the *Catalogue for Guidance of Foreign Investment in Industry* (the “**Foreign Investment Catalogue**”).<sup>5</sup> In other words, a FIP may not be established in (i) “prohibited” categories, or (ii) categories where foreign investment is restricted to equity joint ventures and/or cooperative joint ventures or other structures involving co-investment with domestic parties.

As such, the FIP Registration Regulations appear to confirm that MOFCOM has a narrowed role in regard to foreign investment undertaken through a FIP structure. At the same time, they provide for a consultation process in some cases, requiring that the relevant AIC seek a written opinion from the relevant governmental authority within 5 days of the acceptance of an application for the establishment of a FIP in (i) a “restricted” category, as provided by the Foreign Investment Catalogue, which does not require “prior approval” or (ii) other projects within the scope of responsibility of a particular governmental authority. Beijing and Shanghai AIC authorities have suggested that a written opinion from the relevant industrial governmental authority and/or MOFCOM could be solicited for this purpose. Notably, there is no time limit for registration of a FIP that is subject to this consultation process. In other cases, the relevant AIC is supposed to complete registration within 20 days after receiving the application documents and determining that it is complete.

<sup>4</sup> This development is even more surprising considering the MOFCOM approval-centric approach that was proposed in the initial draft of the *Foreign-Invested Partnership Regulations* (外商投资合伙企业管理办法 (送审稿)) circulated by MOFCOM to other governmental agencies for comments in January 2007. In accordance with this draft, MOFCOM approval would have been required for the establishment of all FIPs. For our analysis of these previous draft regulations, please refer to our June 2007 legal update at [http://www.mofo.com/international/CN\\_en/news/12530.html](http://www.mofo.com/international/CN_en/news/12530.html).

<sup>5</sup> (外商投资产业指导目录 (2007年修订)) promulgated by the National Development and Reform Commission and MOFCOM on October 31, 2007 and effective December 1, 2007.

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The FIP Registration Regulations also specify that all approvals needed for the establishment and operation of a FIP must be obtained and submitted to AIC as part of the application process. For example, in applying for the establishment of a FIP to manufacture and sell a particular kind of pharmaceutical drug, the applicant must obtain approval from the State Food and Drug Administration (the “SFDA”) for the establishment of a pharmaceutical enterprise before applying for registration of the FIP with AIC and must include a copy of the SFDA approval with the application.

## 2. STRUCTURING FLEXIBILITY OFFERED BY FIPS

The FIP Measures and the FIP Registration Regulations include relatively few provisions on the structuring of FIPs, in light of the fact that the 2006 amended *Partnership Enterprise Law*<sup>6</sup> already includes detailed provisions on the structuring of partnerships.

Based on relevant provisions of the *Partnership Enterprise Law*, it would appear that FIPs offer structuring flexibility not typically available using FIEs. This flexibility includes the following provisions:

- Flexibility for Capital Contributions

Partnerships, including FIPs, are not subject to any statutory minimum capitalization requirement. As expressly confirmed by the FIP Registration Regulations, cash and in-kind contributions are recognized — as are services contributed by general partners. Partnerships are not subject to the 70% limitation on the contribution of non-cash assets applicable to PRC companies under the *Company Law*.

Unlike with FIEs, the payment of contributions is not subject to statutory time limits, which in turn facilitates “just-in-time” capital contributions fundamental to investment fund operations.

- Flexibility for Distribution of Profits/Dividends

Profits can be distributed among partners on a basis other than pro rata based on partners’ contributions, which is critical to the carry arrangements between general partners and limited partners of investment funds. CJVs provide some flexibility in this regard, but the flexibility is limited and in any case is subject to regulatory approvals.

- Pass-through Tax Treatment

The Partnership Enterprise Law provides for “pass-through” taxation, whereby each partner is responsible for the tax on its share of partnership income. Neither it nor the FIP Measures nor the FIP Registration Regulations address the following question of how a foreign limited partner’s interest in a FIP is to be taxed in China. We expect that the State Administration of Taxation and the Ministry of Finance will in the future provide regulatory guidance on this and other tax questions associated with FIPs.

## 3. FIPS AND FUNDS

One issue in relation to FIPs that has been widely discussed is the possible use of a FIP structure in the establishment of foreign-invested and foreign-managed investment funds.

<sup>6</sup> 《中华人民共和国合伙企业法》, promulgated by the Standing Committee of the National People’s Congress on February 23, 1997 and revised on August 27, 2006. Prior to the effectiveness of the FIP Measures, the Partnership Enterprise Law ostensibly permitted partnerships involving only domestic parties as partners.

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The FIP Measures only allude to use of a FIP structure for a fund, stating in effect that if other regulations specifically governing a FIP whose primary business is investment are inconsistent with the FIP Measures, then those other regulations will prevail. However, no such other regulations have been issued.

The FIP Registration Regulations help somewhat to fill the regulatory void, including the following provisions relevant to FIP investment funds:

- A requirement that a FIP engaged in investment as its core business must register with provincial level AIC, while FIPs engaged in other types of business may register with local level AIC.
- A general statement that onshore investments made by a FIP investment fund must comply with Chinese laws, administrative regulations and rules on foreign investment.

Whether this latter statement refers to the more stringent rules applicable to investment by FIEs or the more relaxed rules applicable to re-investment by FIEs remains to be determined. At a minimum, however, this statement suggests that industrial policy restrictions on foreign investment in “restricted industries” will likely continue to apply to investments made by FIPs notwithstanding their onshore domicile.

A number of additional ambiguities remain. For example, it is unclear how the existing foreign-invested venture capital enterprise (“FIVCE”) regulatory scheme may interface with various FIP regulations or whether existing FIVCEs may be restructured as FIPs. Similarly, there remains a lack of detailed guidance as to foreign exchange conversion and settlement in the operation of FIP investment funds. In light of other regulatory initiatives underway in relation to the formation of foreign-invested RMB funds (e.g., the *Provisional Measures for the Management of Equity Investment Funds* currently being drafted by the National Development and Reform Commission), we expect additional regulations will be issued providing more specific rules on the establishment of FIP investment funds and on questions such as the industry rules governing portfolio investments by such funds.

Despite some remaining questions that have not yet been addressed, the FIP Measures and FIP Registration Regulations successfully address many of the regulatory uncertainties that have traditionally served as threshold obstacles for the establishment of onshore investment funds in China. We expect that the FIP Measures, FIP Registration Regulations, and the further clarifications that we anticipate over the coming months, will facilitate the increased and more systematic establishment of onshore investment funds in China.

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