

Long-Awaited Breakthroughs for Foreign-Invested Private Equity Enterprises in Shanghai Finally Initiated

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Certain legal breakthroughs in foreign-invested private equity enterprises have finally been initiated in Shanghai.

After almost 10 months of discussion and deliberation, certain breakthroughs in foreign-invested private equity enterprises, including foreign-invested private equity funds and foreign-invested private equity management enterprises (collectively known as “FIPEEs”), have finally been initiated in Shanghai with the promulgation of Implementing Measures on Pilot Program of Foreign-Invested Private Equity Enterprises (《关于本市开展外商投资股权投资企业试点工作的实施办法》, “Implementing Measures”). The Implementing Measures were jointly issued by the Shanghai Financial Service Office (“SFSO”), Shanghai Commission of Commerce (“Shanghai MOFCOM”) and Shanghai Administration of Industry and Commerce (“Shanghai SAIC”) in December 2010 and came into force on January 24, 2011.

Obstacles

Before the Implementing Measures were promulgated, several big-name, early-bird private equity enterprises had already entered the Chinese market and established their FIPEEs. However, in practice all of them encountered legal obstacles as the FIPEEs regime is still under construction and government authorities prefer to adopt a more prudent attitude with respect to the operation of FIPEEs. The two most troublesome obstacles FIPEEs encounter are limited investment industries and approval requirements, and foreign exchange conversion restriction.

In the first obstacle, private equity funds (“PE funds”) raised and invested by foreign-invested private equity management enterprises will be treated as “subsidiaries of foreign-invested enterprises” (“Subsidiaries of FIEs”), even if such a management enterprise holds only less than 1 per cent of a PE fund. For Subsidiaries of FIEs, their investments in China are subject to limitation or even prohibition in certain industries, and the investments in limited industries are also subject to the approval of the Ministry of Commerce or its local branches.

The second obstacle involves regulations promulgated by the State Administration of Foreign Exchange (“SAFE”) where foreign exchange capital contributed by foreign investors in foreign-invested enterprises cannot be exchanged into RMB to make equity investments. In other words, the foreign financing channels of PE funds are still closed.

Breakthroughs

With the promulgation of the Implementation Measures, the procedures for establishing FIPEEs are listed in detail, with the following breakthroughs initiated with respect to the above mentioned issues/obstacles.

Detailed Requirements for Pilot FIPEEs

The concept of "pilot foreign-invested private equity enterprises" ("Pilot FIPEEs", which include pilot foreign-invested PE funds and pilot foreign-invested private equity management enterprises) is formally adopted.

Pilot FIPEEs shall be approved by a joint commission (the “Joint Commission”). The participants of the Joint Commission shall include the SFSO, Shanghai MOFCOM, Shanghai SAIC, Shanghai Development and Reform Commission, Shanghai Finance Bureau, Shanghai Tax Bureau, SAFE Shanghai branch and other related regulatory authorities.

For foreign-invested PE funds in applying for the Pilot FIPEE qualification, the foreign investors of the foreign-invested PE funds must:

- In the preceding fiscal year, own assets of no less than USD500 million or manage assets of no less than USD1 billion
- Have sound corporate governance and internal control system, and never be punished by any judicial institution or related authorities in the last two years
- Have more than five years’ investment experience, or its affiliates have such experience
- Other conditions required by the Joint Commission

For FIPEEs that are applying for the Pilot FIPEE qualification, the executive partners of such foreign-invested PE funds or executive partners of the proposed foreign-invested PE funds shall submit the application for Pilot FIPEE qualification to SFSO. Such executive partners or their affiliated entities shall have more than three years of solid experience in direct or indirect investment into Chinese domestic companies.

Pursuant to the Implementing Measures, the foreign investors of the foreign-invested PE funds that qualify for Pilot FIPEE shall mainly include overseas sovereignty funds, pension funds, donation funds, charity funds, funds of

funds, insurance companies, banks, securities companies and other foreign institutional investors admitted by the Joint Commission.

Maintaining Original Attribute of PE Funds

A foreign-invested private equity management enterprise with Pilot FIPEE qualification is permitted to invest into PE funds, which shall be raised by it, with foreign exchange. If such foreign exchange capital injected into the PE fund by such a foreign-invested private equity management enterprise is no more than 5 per cent of the total capital amount raised for the PE fund, such investment will not change the “original attribute” of the PE fund.

The term “original attribute” may be ambiguous, but many commentators believe it refers to whether such a PE fund will be regarded as a Subsidiary of FIE or as a pure domestic company. If so, this means that PE funds with 5 per cent or less capital from foreign-invested private equity management enterprises (usually as the general partners of the PE Funds) may avoid being treated as Subsidiaries of FIEs, and their investment will no longer be subject to the procedures and limitations applicable to Subsidiaries of FIEs.

Notwithstanding the above, it is specifically provided in the Implementing Measures, foreign-invested PE funds are not allowed to be engaged in the following businesses:

- Investing into foreign-prohibited industries
- Trading stocks or corporate bonds in the secondary market (except for the stocks of their portfolio companies, which have been listed)
- Investing in futures or other financial derivatives
- Investing directly or indirectly in non-self-use real estate
- Making investments with funds not owned by themselves
- Providing loans or guaranties to others
- Other matters prohibited by laws, regulations and the constitutional documents of such foreign-invested PE funds.

Foreign Currency Conversion into RMB for Equity Investment

It is provided in the Implementing Measures that Pilot FIPEEs shall handle the foreign exchange equity investment matters through a custodian bank. Foreign-invested private equity management enterprises that already had a capital account before the Implementing Measures was promulgated can handle the foreign exchange equity investments matters in the account-opening bank after being approved by the Joint Commission.

This provision is still vague, but many commentators believe it implies that with the approval of the Joint Commission, Pilot FIPEEs will be allowed to convert their foreign currency into RMB and to make equity

investment in China. According to recent reports, SAFE may grant a quota of the total conversion amount to the foreign-invested PE funds with Pilot FIPEEs qualifications, which are incorporated in Shanghai or some other cities. However, because the SAFE Shanghai Branch is not a co-promulgator of the Implementing Measures and it keeps silent regarding such quota and the related procedures, it is believed the practical conversion of such funds is still pending upon the detailed regulations promulgated by SAFE or its Shanghai branch.

Regulations

The Implementing Measures also provide for the detailed regulations of Pilot FIPEEs. Among others, Pilot FIPEEs must entrust a custodian bank to handle their capital matters and take the responsibility to report to the Joint Commission regarding the operation of the Pilot FIPEEs. Meanwhile, Pilot FIPEEs shall file their constitutional documents, business license and other requested documents with SFSO and its local branches at district level. Pilot FIPEEs shall also report the material events of their operation, including their investments, alteration of their constitutional documents or their senior management, change of their registered capital (or contributed capital), etc., semi-annually.

In conclusion, the Implementing Measures not only stipulate the establishment and operation of FIPEEs, but also initiate certain breakthroughs for the FIPEEs. It is believed that upon the effective date of this regulation on January 24 2011, more foreign investors will be attracted to form FIPEEs in Shanghai, though certain issues are still subject to further clarification by the government authorities.

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