

Recent Developments in the Regulation of RMB Funds

Introduction

RMB Funds, investment funds whose capital commitments and contributions are denominated in renminbi, the currency of the People's Republic of China, have been the subject of considerable discussion in recent months.

This update focuses on recent announcements by the authorities in Shanghai, Beijing, Tianjin and Chongqing to encourage the formation and operation of RMB Funds in their municipalities.

The trend, toward a decentralised approval process, is also seen in a decision of the Ministry of Commerce ("MOC") in March 2009 to allow local authorities to approve a foreign invested venture capital investment enterprise ("FIVCIE") seeking to raise less than US\$100 million.

Meanwhile, two new regulations at the national level, which may reverse this trend, are pending, namely, the Foreign Partnership Regulations and the Provisional Measures for the Management of Equity Investment Funds.

We anticipate that we will soon see foreign invested GP's or other such management enterprises, especially those based in Shanghai and possibly elsewhere, managing private equity funds sourced from either domestic investors or foreign investors or both in the form of partnerships. Parallel USD/RMB fund structures and FIVCIE's may nevertheless remain a viable alternative.

Full Update

LOCAL REGULATIONS

The authorities in Shanghai, Beijing, Tianjin and Chongqing have issued the following regulations (the "**Local Regulations**") in order to attract fund managers.

Shanghai:

- i. *Notice in connection with the Registration of Equity Investment Enterprises in Shanghai* issued by the Shanghai Municipal Government in August 2008;
- ii. *Measures for Promoting the Development of Equity Investment Enterprises in Pudong New District of Shanghai* issued by the government of the Pudong District of Shanghai in March 2009;
- iii. *Tentative Measures for Establishing Foreign Invested Equity Investment Management Enterprises in Pudong New District of Shanghai* issued by the government of the Pudong District of Shanghai in June 2009 ("**June Measures**") (the "**Shanghai Regulations**").

It should be noted that only Shanghai's June Measures¹ contemplate the formation of a foreign invested fund management enterprise. The other cities are not yet processing applications from foreign invested management enterprises.

¹ The June Measures only envisage the adoption of a corporate form for management enterprises. The reason for this could be the absence, currently, of laws allowing foreign participation in limited liability partnerships.

Furthermore, as another step to attract foreign invested management enterprises, the Shanghai branch of the State Administration of Foreign Exchange has confirmed that foreign invested management enterprises based in Shanghai can enjoy a waiver from Circular 142 with respect to the conversion of foreign currency into RMB in respect of a foreign invested management enterprise's own capital contribution into an RMB Fund - up to 1% of total capital contributions made to the fund.

Beijing:

Opinions for Promoting the Development of Equity Investment Funds jointly issued by the Beijing Financial Service Office, the Beijing Financial Bureau, the Beijing Tax Bureau and the Beijing Administration for Industry and Commerce on 19 January 2009 (the "**Beijing Regulations**").

Tianjin:

- i. *Opinions on Registration for Private Equity Investment Funds and Private Equity Investment Management Enterprises* issued by the Tianjin Administration of Industry and Commerce in November 2007;
- ii. *Tentative Measures on the Registration and Filing of Equity Investment Funds and Equity Investment Management Enterprises in Tianjin* issued by the Tianjin Financial Service Office, the Tianjin Financial Bureau, the Tianjin Tax Bureau, the Tianjin City Administration of Industry and Commerce and the Tianjin Development and Reform Commission in November 2008 (the "**Tianjin Regulations**").

Chongqing:

Opinion of the People's Government of Chongqing on Encouraging the Development of Equity Investment Enterprises issued by the People's Government of Chongqing on 18 November 2008 (the "**Chongqing Regulations**").

Suzhou:

A number of RMB Funds are being established in the Suzhou Industrial Zone which is the pilot area designated by the Suzhou government for the development of RMB Funds, although no formal regulations tailored for RMB Funds have been issued.

HIGHLIGHTS

i. Formation of an RMB Fund

Pursuant to the Shanghai Regulations, Beijing Regulations and Chongqing Regulations, an RMB Fund and the related management enterprise may be established as either a company or as a partnership².

In addition, the Tianjin Regulations contemplate an RMB Fund being formed pursuant to contractual or trust arrangements although a management enterprise may only be in the form of a company or a partnership.

ii. Registration and Registered Capital/Contribution Requirements

All of the Local Regulations require registration with the local Administration of Industry and Commerce ("**AIC**")³, for example,

Shanghai Administration of Industry and Commerce ("**SHAIC**")

Beijing Administration of Industry and Commerce ("**BAIC**")

Tianjin City Administration of Industry and Commerce ("**TJAIC**").

² The revised edition of the Partnership Enterprise Law allows for the formation of limited liability partnerships.

³ The establishment of foreign invested enterprises will also be generally subject to the approval of the local branches of the National Development and Reform Commission and the Ministry of Commerce of the district where such enterprises are established.

Shanghai:

The minimum fund size is RMB100 million.

The minimum capital contribution by each individual investor is RMB5 million. No minimum capital contribution is specified for other types of investors.

The registered capital of a domestic fund management enterprise organised in the form of a company with limited liability must be at least RMB 1 million.

The registered capital of a foreign invested fund management enterprise must be at least USD2 million.

Beijing: Not yet released

Tianjin:

The registered capital of a fund management enterprise organised in the form of a company with limited liability must be at least RMB1 million.

Chongqing:

The minimum fund size is RMB100 million. The minimum first instalment must be at least RMB50 million.

The registered capital of a fund management enterprise must be at least RMB1 million.

i. Decentralised approval process for smaller FIVCIE's

Pursuant to a notice dated 5 March 2009, certain local authorities are permitted to approve the formation of FIVCIEs and to license the fund management enterprise but only if the target fund size is equal to or less than USD100 million. Previously, the formation of such vehicles was subject to MOC approval which involved a lengthy and complicated process. The local authorities include the relevant authorities in the provinces, autonomous regions, municipalities directly under the Central Government, the cities under

separate planning, Harbin, Changchun, Shenyang, Jinan, Nanjing, Hangzhou, Guangzhou, Wuhan, Chengdu, Xi'an and Xinjiang Production and Construction Corps, and all national economic and technological development zones. The notice also provides for (a) replacement of the Ministry of Science and Technology by its local bodies, (b) simplified reporting of investments and (c) an approval time limit of 30 days.

ii. Pass through tax treatment of Partnerships

Pursuant to the Local Regulations and other tax regulations, income received by an RMB Fund or a related fund management enterprise constituted as a partnership will be taxed at the individual partner level and any income tax privileges will be enjoyed by each individual partner i.e. not at the fund or enterprise level.

TAX INCENTIVES

Shanghai:

- i. A one-off cash grant may be awarded by the government to an RMB Fund or a related fund management enterprise depending on, in the case that the fund is in the form of a company, the aggregate amount of registered capital, or in the case that the Fund is in the form of a partnership, the aggregate amount of capital contributions.
- ii. Various allowances may be granted to those persons taking positions in the RMB Fund or the fund management enterprise as chairman of the board, vice chairman, general manager and/or deputy general manager.
- iii. 50% of tax generated from the investment return secured by an RMB Fund from its investment in enterprises that are on the list of encouraged industries or which fall into the category of newly emerging industries the development of which is encouraged, will be refunded.
- iv. RMB Funds located in Lujiazui Functional Zone or the Zhangjiang Functional Zone of Pudong

District will receive an office rent allowance at RMB500/square meter/year and an office purchase allowance equal to 1.5% of the total purchase price.

Beijing:

- i. A fund management enterprise managing an RMB Fund with capital contributions in excess of RMB500 million, established in line with the industrial policies of Beijing, may enjoy favourable tax and accounting treatment pursuant to the *Opinion on Promotion of the Development of Financial Industry of the Capital City and its Implementation Rules*. Individuals working for such fund management enterprises may enjoy reduced rates of individual tax on bonus payments. Senior managerial executives may enjoy reduced tax liability with regard to carried interest and any awards granted by the government. The enterprise itself may also benefit from higher deductions from taxable income by increasing its contribution to the social housing fund relating to its employees.
 - ii. In kind capital contributions by a fund management enterprise to an RMB Fund, by way of intangible assets or real property or the transfer of its interests in such investee, are exempt from any business tax.
 - iii. Any benefits awarded by the government to personnel of a fund management enterprise are exempted from individual income tax.
- ii. The full amount of business tax paid during the first and second operating years will be refunded and an amount equal to 50% of tax paid during the third to the fifth operating years will also be refunded. Enterprise income tax retained within the local fiscal system (rather than the central government) paid during the first and second years may also be refunded and a half amount paid during the third to the fifth years will be refunded.
 - iii. Individual income tax retained within the local fiscal system and paid by the senior executives of RMB Funds or fund management enterprises during the first to the third years will be refunded and a half amount paid during the fourth and fifth years will be refunded.

Tianjin:

There are no particular tax incentives available pursuant to the Tianjin Regulations.

Chongqing:

- i. Fund management enterprises located in the central business district, financial centre district and the 'New Area' in the northern part of the city will receive an office rent allowance based on 30% of the yearly rental during the first three

years and a one-off office purchase allowance at RMB1,000/square meter.

- ii. The full amount of business tax paid during the first and second operating years will be refunded and an amount equal to 50% of tax paid during the third to the fifth operating years will also be refunded. Enterprise income tax retained within the local fiscal system (rather than the central government) paid during the first and second years may also be refunded and a half amount paid during the third to the fifth years will be refunded.
- iii. Individual income tax retained within the local fiscal system and paid by the senior executives of RMB Funds or fund management enterprises during the first to the third years will be refunded and a half amount paid during the fourth and fifth years will be refunded.

NATIONAL REGULATIONS EXPECTED

- i. *Draft of the Measures on the Administration of the Establishment of Partnership Enterprises in the PRC by Foreign Enterprises and Individuals*

These measures, which will enable foreign investors to be limited partners in a partnership governed by PRC law pursuant to the Partnership Enterprise Law, were approved in draft form by the State Council on 19 August 2009.

It is unclear from the draft of these measures whether foreign LP's will be entitled to the same foreign exchange conversion exemption from SAFE Circular 142 as enjoyed by FIVCIE's as these measures do not specify any repatriation process for foreign LP's receiving distributions.

We expect SAFE to issue rules to address this issue when these measures come into force.

- ii. *Draft of the Provisional Measures for the Management of Equity Investment Funds*

Currently, there is no national legal framework with respect to the formation, operation and

governance of private equity funds. These provisional measures will bridge that gap.

Although these provisional measures have been submitted to the State Council by the National Development and Reform Commission, a draft has not been released.

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