

## 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 Measures<sup>1</sup> contemplate the formation of a foreign invested fund management enterprise. The other cities are not yet processing applications from foreign invested management enterprises.

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<sup>1</sup> *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 partnership<sup>2</sup>.

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**")<sup>3</sup>, for example,

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

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

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

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

<sup>3</sup> 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.

### 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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## RMB Funds - An Update

The Measures for the Administration on the Establishment of Partnership Business by Foreign Enterprises or Individuals in China were issued by the State Council on 25 November 2009.

Pursuant to the Measures, it is now possible for private equity funds, in the form of foreign invested partnerships governed by PRC law, to be registered with local offices of the State Administration for Industry and Commerce without the approval of the Ministry of Commerce. Foreign investors can now participate in RMB Funds by either establishing a new partnership, or acquiring an interest in an existing partnership, governed by PRC law.

A partnership can now include a general partner and limited partners incorporated or established under laws other than PRC law.

However, a number of aspects remain unresolved. For example, the Measures do not provide foreign investors structuring PRC focused funds with any reassurance that a private equity fund formed as a foreign invested partnership will be treated any differently from other foreign invested enterprises with respect to the NDRC's prohibitions and restrictions on foreign investment in certain industries in the PRC. In relation to the conversion of foreign currency denominated capital contributions and repatriations to foreign partners, it is not clear whether international norms can be applied to facilitate fund flows.

From a tax perspective, it is clear that a partnership is transparent but the current tax rules do not clarify whether the activities of the general partner in the PRC will result in foreign limited partners being treated as having a permanent establishment in the PRC and therefore subjecting their distributions to PRC tax.

We expect these and other aspects to be clarified upon publication of rules and regulations in 2010, specifically for RMB Funds, pursuant to Article 14 of the Measures.

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## Fund Management in the PRC - Beijing - A Further Update

The Interim Measures on Foreign-Invested Equity Investment Fund Management Enterprises, issued jointly by the Beijing Municipal Administration of Industry and Commerce, the Municipal Commerce Commission, the Municipal Finance Bureau and the Municipal Development and Reform Commission, came into effect on 1 January 2010.

The Interim Measures set out the requirements for foreign invested investment managers to operate in Beijing in the legal form of a partnership, a joint venture or a wholly foreign owned enterprise established in accordance with PRC law. For these purposes, a foreign invested entity includes foreign investment from Hong Kong, Macau and Taiwan.

The regulation of foreign invested investment managers is the joint responsibility of four bodies, namely, the Municipal Development and Reform Commission, the Municipal Commerce Commission, the Municipal Administration of Industry and Commerce and the Municipal Finance Bureau.

The following requirements are specified in the Interim Measures:

- The entity must have at least USD 2 million in registered capital
- The entity's scope of business must be limited to fund management
- The entity must employ at least two key personnel of good repute and record with more than two years of relevant experience

These Interim Measures shall be in place until 31 December 2012.

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## Registering an RMB Fund as a Foreign Invested Partnership - An Update

The State Administration for Industry and Commerce (the “SAIC”) wishes to see the management experience, techniques and corporate governance of foreign enterprises and individuals applied to promote the development of the private equity industry in China. In this regard, the SAIC has recently issued Decree 47 which paves the way for the registration and operation of PRC law governed, foreign invested partnerships (“FIPs”).

### Background

The Partnership Enterprise Law of the PRC (the “Partnership Law”) came into force on 1 June 2007. Article 108 of the Partnership Law contemplates the formation of FIPs. Pursuant to Article 108, the State Council issued the Measures for the Administration on the Establishment of Partnership Business by Foreign Enterprises or Individuals in China (the “Measures”) with effect from 1 March 2010.

The Measures allow private equity funds, in the form of FIPs, to be registered with a local SAIC office without approval from the Ministry of Commerce. Article 14 of the Measures contemplates the publication of more detailed measures and procedures to apply to FIPs.

Pursuant to Article 14, the SAIC issued the Administrative Measures for the Registration of Foreign-invested Partnership Enterprises (“Decree 47”), also with effect from 1 March 2010. Decree 47 sets forth rules and procedures for the registration and operation of FIPs. This update relates to Decree 47.

### Operative Provisions

In accordance with Decree 47, an FIP is required to register with the local SAIC office where the principal

place of business of the FIP is located. Foreign invested private equity funds, in particular, are required to register with local SAIC office at the provincial or sub-provincial level. A representative authorized or appointed by all partners is required to submit the following information: name of the FIP; the principal place of business; the names of the partners in charge of partnership affairs; the scope of business; type of FIP (i.e. general or limited partnership); the names, addresses and categories of the partners and the form and amount of their capital commitments/contributions, the commitment period, and valuation methodology.

The local SAIC office may approve the registration and issue the business license on receipt of the prescribed registration documents if the documents submitted comply with the requirements of Decree 47. If not, the local SAIC office is required to notify the applicant of its decision, in writing, within 20 days of receiving such documents.

In the event of any change to the information filed with the local SAIC office including increases or reductions of capital commitments, the admission of new partners and/or transfers of partnership interests, an FIP is required to apply to the local SAIC office to amend its registration within 15 days of such change.

An FIP and its branch office are required to submit annual inspection reports, between March 1 and June 30 in each year, in accordance with the requirements of the local SAIC office.

An FIP may establish a branch office by registering with local SAIC office where the branch office is to be located, and then completing a filing with the local SAIC office where the FIP was registered within 30 days of the establishment of such branch office.

## Prohibited and Restricted Industries

As expected, FIPs must comply with the Catalogue for the Guidance of Foreign Investment Industries ([http://www.fdi.gov.cn/pub/FDI\\_EN/Laws/law\\_en\\_info.jsp?docid=87372](http://www.fdi.gov.cn/pub/FDI_EN/Laws/law_en_info.jsp?docid=87372)) issued by the State Development and Reform Commission and the Ministry of Commerce in 2007 (the “Catalogue”) - Decree 47 prohibits the registration of FIPs whose investment policy includes investment in ‘prohibited foreign investment industries’ and ‘restricted foreign investment industries’ that are either reserved for equity or contractual joint ventures or require a majority shareholding by Chinese parties, as more fully described in the Catalogue. FIPs are therefore on a level playing field with wholly foreign owned enterprises and other foreign invested enterprises operating in China.

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