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RMB Funds in China

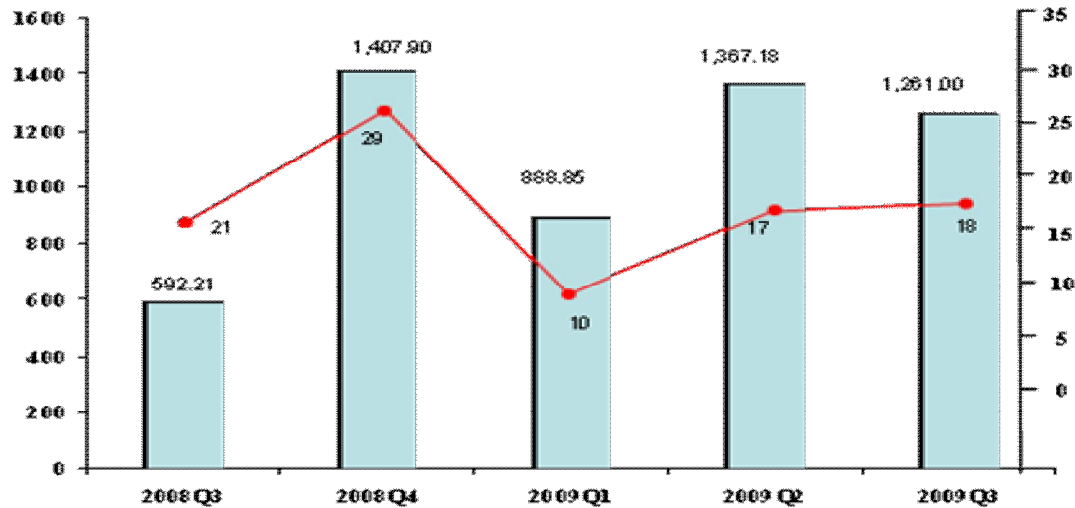
An analysis prepared
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Despite the global financial crisis, China remains one of the favorite investment destinations for global investors. According to China's National Bureau of Statistics (NBS), China's economic growth accelerated to 8.9 percent year on year in the third quarter of 2009, and 7.7 percent year on year in the first nine months. Moreover, while the global market is suffering a lack of liquidity, China RMB investors are both liquid and hungry to make investments.

**Chart 1 Quarter-on-quarter Comparison of Fundraising
Between Q3'08-Q3'09**

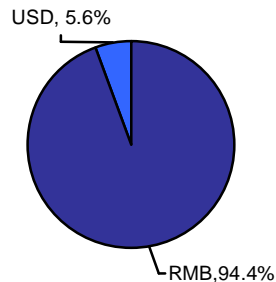


Amt. Raised (US\$ M)
 No. of New Funds

Source: Zero2IPO Research Center 2009.10

www.zero2ipo.com.cn

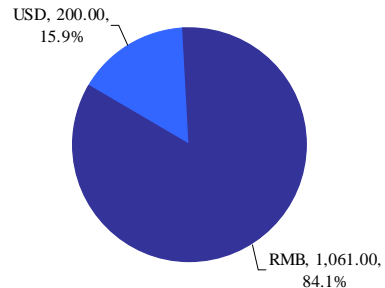
**Chart 2 Distribution of Newly-raised Funds by Currency of Q3'09
(By No. of New Funds)**



Source: Zero2IPO Research Center 2009.10

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**Chart 3 Distribution of Newly-raised Funds by Currency of Q3'09
(By Amount Raised, US\$M)**



Source: Zero2IPO Research Center 2009.10

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RMB funds are not new in China. In 2003, China's Ministry of Commerce (MOFCOM) issued the first regulation regarding Foreign Invested Venture Capital Enterprises (FIVCE), which created the preliminary framework for RMB funds. The first RMB industrial investment fund approved by the National Development and Reform Commission (NDRC) was established in 2005. In late 2008, the State Council of China issued the *Several Opinions on Providing Financial Support for Economic Development*, which paved the way for a codification of the private equity (PE) industry in China and the regulation of PE investment funds. In June 2009, the NDRC confirmed that the draft of the *Administrative Rules of Private Equity Investment Funds* has been completed, and submitted to the State Council for approval. Moreover, since 2008, Beijing, Shanghai and Tianjin have all promulgated local policies to promote the development of RMB funds business.

China's economic growth and the development of RMB funds in China, combined with the global economic situation, have resulted in many foreign fund managers reviewing the possibility of setting up RMB funds in China, which can raise funds from China local investors and facilitate investments in the Chinese market. However, since laws and practices in this area are developing rapidly and largely ad hoc, many fund managers have been confused by the types and structures of RMB funds and the requirements to access to them.

The current framework for RMB funds in China has developed piecemeal based on various regulations issued at different times, which has resulted in structures and practices that lack logical consistency. There are four main forms of RMB funds currently used in practice, which form the subject of this analysis.

1. Industrial investment funds (IIF) which are subject to special approval from the NDRC and the State Council

IIFs are usually established by government-back investors (combined with private investors) or based on multi-lateral treaties and mainly use a corporate structure. Since the Bohai IIF established in 2005, there have been dozens of IIFs approved but most of these IIFs were not successful. In October 2009, the NDRC and the Ministry of Finance (MOF) newly approved 20 new IIFs focusing on high-tech industries. The total investment in these IIFs is RMB9.2 billion, in which central and local governments contributed RMB2.2 billion, and the balance will be raised from private investors.

2. Venture capital enterprises (VCE) which are subject to specific administrative rules applicable to domestic VCEs and FIVCEs



VCEs and FIVCEs are established under special regulations and can take the form of either pure RMB funds or sino-foreign RMB funds under a corporate or partnership structure (for FIVCEs, the regulation establishes a quasi-limited-partnership structure). By using VCEs, fund managers can raise funds from both offshore and onshore investors and establish onshore RMB-denominated funds. Some qualified VCEs and FIVCEs can also enjoy certain incentive policies including tax benefits. The limitations of VCEs and FIVCEs are that, the legal structures of these funds are limited by the regulations, which are very inflexible, and that FIVCEs can, in principle, only invest into high-tech or new-tech companies.

3. Equity investment funds (EIF) which are currently formed under local policies using a corporate or partnership structure

National rules on PE funds are still under discussion but local governments, such as in Beijing, Shanghai and Tianjin, have begun to explore practical ways to develop PE funds in their jurisdictions.

For example, since August 2008, the Shanghai government has allowed PE fund enterprises, which can be structured in the form of limited companies, limited partnerships or foreign invested enterprises. These PE funds must have a registered capital of at least RMB 100 million, all of which shall be contributed in cash. Under the limited partnership structure, the partners of the PE funds enjoy pass-through taxation, among which the general partners bear unlimited liability and are subject to corporate income tax of 25% or a progressive individual income tax of up to 35%. The limited partners enjoy limited liability and are subject to corporate income tax at a rate of 25% or the individual income tax at a rate of 20%.

PE fund enterprises are now allowed to be established in several cities in China and those PE funds are also allowed to make investments in many industries, but investors still face many practical problems.

According to the current regulations, these PE fund enterprises can only make equity investments, which means they can only hold equity interests of portfolio companies but cannot provide debt financing or directly hold assets by themselves.

With respect to the legal and tax structure, corporate structure is not tax-efficient because the dividends distributed by the portfolio companies are subject to 25% enterprise income tax at the PE fund level. The form of a limited partnership also has its own limitations. First, since the rules for foreign invested limited partnerships are still under discussion, foreign investors still cannot become partners of domestic



partnerships. Second, even if the foreign investors intend to use a foreign-owned enterprise (a Chinese legal entity) to act as partner of these PE funds, there are additional hurdles. According to the rules of the State Administration of Foreign Exchange (SAFE), such a foreign-owned enterprise may not be able to make investments into these PE funds by using its registered capital since the investments are beyond its business scope. PE funds which have investments from a foreign-owned enterprise may also face foreign investment restrictions when making investments.

In order to encourage the establishment of PE funds, local governments are actively seeking incentive policies from the central government. For example, the government of Shanghai Pudong New Area issued some pilot rules in June 2009 to allow foreign investors to set up onshore fund management enterprises (FEIMC) as WFOEs or Sino-foreign joint venture companies in Pudong, which have the business scope of fund management services and can be used to manage RMB funds in China. By contributing at least US\$2 million as registered capital in these FEIMCs, foreign PEs may set up an onshore vehicle to raise and manage RMB funds in China, which will be used to pioneer the development of foreign-managed RMB funds. At the end of October 2009, the government of Shanghai Pudong New Area reached an arrangement with SAFE that, FEIMCs will receive an automatic waiver to convert foreign currency into RMB for investment in their own RMB funds. This waiver will be for up to 1% of aggregate capital commitments of the RMB fund as a whole.

Encouraged by local incentive policies and the trend of promoting onshore PE development, many prestigious foreign PEs have begun to explore the possibility of setting up RMB funds in China. This year, the Blackstone Group, First Eastern Financial Investment Group, CLSA Asia-Pacific Markets, Prax Capital, Draper Fisher Jurvetson, among other foreign PEs, have established FEIMCs in Pudong Shanghai and plan to set up RMB funds.

4. Trust investment plans (TIP) formed by qualified trust investment companies

China enacted its Trust Law in 2001. Although any individual or legal person can act as a trustee, in practice, qualified trust investment companies (TIC), as non-bank financial institutions, are the only entities which are qualified to establish commercial trust plans and sell to unit holders. In 2007, the central government issued several regulations to standardize the regulation of TIC business and clarify the requirements for establishing commercial trust plans. Since then, the TIP has become one of the most important vehicles for RMB funds. Currently, there generally are three types of trust plans which can be used:



- (1) The TIC establishes a TIP to raise funds from unit holders and then makes equity investments in or loans to portfolio companies. Dividends, revenues from sales of equity, and loan interest will be used to make distributions to unit holders;
- (2) The TIC establishes a TIP to raise funds from unit holders and then acquires and holds the pooled assets. The revenues from the sale, lease or operation of these assets will be used to make distributions to the unit holders;
- (3) The TIC establishes an assets TIP for portfolio companies focusing on specific assets and then sells the preferred beneficiary interests of these assets to unit holders, under which the funds raised will be used to fund the portfolio companies, and the revenues generated by the underlying assets will be used to make distributions to the unit holders.

These TIPs are all pure RMB funds and usually are only open to Chinese investors. Therefore, at this time, both foreign general partners and limited partners cannot engage in these plans. However, foreign PEs' onshore subsidiaries can provide paid management services to these RMB funds. Foreign PEs may also establish hybrid fund structures to raise funds from domestic and foreign investors side by side to engage indirectly in the target projects so that foreign limited partners can also indirectly invest in the same projects.

One of the most useful functions for TIPs is pooling funds for real estate investment. TIPs established for real estate investment are often referred to as "Quasi-REITs". The central government has been drafting rules to regulate REITs. Several central government departments including China Banking Regulatory Commission (CBRC) and China Securities Regulatory Commission (CSRC) are drafting their own REIT rules, which they hope to be adopted by the State Council. The CBRC's version of a REIT is a debt financing product, under which the owner of the real estate will not transfer title to investors and will only assign the beneficiary interests to the investor, which is similar to the third type of TIP described above. These REIT products will not be listed but may be traded in inter-bank market. The CSRC's proposed REIT, however, is more like a US-style REIT under which the title of the real estate assets is transferred and the products can be publicly traded. It has been suggested that the central government will first adopt the CBRC's proposed REIT structure and then later adopt the CSRC's proposed REIT structure. The CBRC's draft of the REIT rules (80 clauses) were published for comments in December 2008.

After many years of hearing footsteps on the stairs, it seems that foreign participation in RMB funds is finally becoming a reality in the PE, VC and real estate industries. The advantages of RMB funds are clear: they can make investments without foreign exchange



controls, they can raise funds from local investors, including high net worth individuals, onshore companies, government fund of funds (FOF), insurance companies and social security funds, and they can speed up the transactions because they are not weighed down by the baggage of foreign investment approvals. There are also disadvantages: the legal structure is still unclear and foreign participation is still restricted, as is liquidity and exit strategies. Moreover, the lack of mature local limited partners and their expectations of high yields are limiting the development of RMB funds. Despite these uncertainties, the rapid development of China's economy and the need for increasingly diverse financing tools will ensure that RMB funds will play an increasing role in the near future.



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