Executive Summary

In response to the ongoing development of the private equity industry in Mainland China, many foreign private equity fund managers are considering how to form pure RMB private equity funds in China to capitalize on the vast PRC capital and market opportunities available there. To help explain this new trend, this report will review various structuring options that can be used to set up RMB private equity funds, how to establish a fund management entity and a RMB private equity fund, and related benefits and difficulties. It is hoped that this report will throw out a brick to attract a jade in foreign PE fund firms’ probes for formation of RMB funds.
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Foreword

The private equity and venture capital business in China is a dynamic and fast-growing industry. As early as 2003, rules were issued regarding “foreign-invested venture capital investment enterprises” (“FIVCIE”). With the release of these rules, it seemed like the Chinese government was giving the market its implicit approval that a foreign private equity fund or fund manager could apply to establish an onshore FIVCIE in China. However, except for a few “brave” movers, most market players were (and remain) hesitant about the viability of FIVCIEs.

In late 2008, the State Council, in a formal policy document, mentioned the magic words for the first time: “Gu Quan Tou Zi Ji Jin” (Chinese pinyin), or “private equity investment fund” or “private equity fund” in English. In early 2009, China’s securities regulator, the China Securities Regulatory Commission, finally permitted the “growth enterprise market” to be launched on the Shenzhen Stock Exchange later this year. Meanwhile, local governments in Tianjin, Shanghai, Beijing, and other Chinese cities have issued various local policy documents and measures in the past year that permit the formation of private equity funds and fund management companies, which welcome (in broad terms) foreign private equity funds and private equity fund managers to set up onshore private equity funds and onshore private equity fund management entities in their respective administrations.

These recent private equity developments in China, combined with the global financial crisis, have resulted in a number of foreign fund managers starting to look towards the vast capital pool available in China and explore the possibility of setting up pure RMB funds in Mainland China that seek capital commitments from Chinese domestic institutions and persons as limited partners (“Pure RMB Fund”), and how best to accomplish this.

To date, a foreign-invested Pure RMB Fund in the form of a limited partnership, with a foreign fund manager (or a foreign company controlled by a foreign fund manager) as the general partner and Chinese domestic investors as limited partners has not been feasible. This is due to the fact that regulations concerning foreign investment in a Chinese limited partnership and foreign direct investment in a Chinese onshore private equity fund have not yet been promulgated by the Chinese central government. However, an indirect structure for a Pure RMB Fund has been made practical by some local governments trying to attract foreign funds and fund managers.

Therefore, if a foreign private equity fund or fund manager intends to establish a RMB fund in Mainland China, it can be structured either as a FIVCIE or as an indirect Pure RMB Fund. A fundamental question exists as to whether a FIVCIE, in the form of either a company or a non-legal person entity, could serve as a viable structure that is similar to a typical private equity fund structure in the U.S. or Europe. Other problems may also include possible portfolio investment restrictions, heavier tax burdens (compared with an offshore fund structure), limited exit options, and possible practical restraints of investing out of the region where the FIVCIE is incorporated.
On the other hand, an indirect Pure RMB Fund at first appears to be a very practical vehicle for foreign private equity fund managers wishing to establish a pure RMB fund in China immediately, rather than at a later time. It likely offers some “early mover” advantages to brave practitioners in attracting capital investments from Chinese domestic capital as limited partners in the long run. However, there are certain legal and practical uncertainties and risks associated with an indirect Pure RMB Fund structure that foreign fund managers should be aware of.

This report will analyze the structures and formation of a Pure RMB Fund and a FIVCIE structure, potential benefits and opportunities for foreign fund managers, and related legal uncertainties and practical issues.
A. RMB PE Funds – Structuring Issues

To set up a typical indirect Pure RMB Fund, a foreign fund manager would likely need to incorporate an onshore private equity fund management entity (“Onshore Fund Management Entity”) and an onshore private equity investment entity in China (“Onshore PE Investment Entity”). Then, with the Onshore Fund Management Entity as the fund manager and the Onshore PE Investment Entity as the general partner, a foreign fund manager may initiate and set up a domestic RMB private equity fund in the form of a limited partnership, with the PRC domestic investors as the capital providers or limited partners. This typical structure is illustrated in Exhibit 1 below:

Exhibit 1: Pure RMB Fund – Structure 1

![Diagram of Pure RMB Fund Structure 1]

The RMB Fund may be incorporated as either a limited partnership or a limited liability company (a/k/a limited company). The limited partnership structure has been used successfully as a suitable legal form for this type of private equity investment fund in other mature market economies for some time now. However, the limited partnership is a new type of legal entity only recently adopted by PRC law in 2006. The company registration and tax authorities are only gradually learning how to permit registrations for and levy taxes on limited partnerships. The operation of a limited partnership is also a new phenomenon in China, so it is likely that many operational issues may need to be addressed once the limited partnership is established.

On the other hand, the PRC Company Law has been in existence since 1994. The legal framework, rules, and practices relating to a company with limited liabilities are already well-established and widely practiced in China. If a RMB fund is incorporated as a Chinese company (either a limited company or a joint stock company), there would likely be less legal and operational uncertainties. However, an apparent disadvantage is
that a company is an independent tax-paying entity and is subject to PRC uniform corporate income tax (25 percent).

It is also worth noting that under PRC general foreign investment laws and policies, the RMB Fund would, in most cases, be treated as a PRC domestic entity, not as a foreign-invested enterprise. However, this fund should be careful in the industries and sectors in which its portfolio companies are engaged in business, because this fund would be subject to certain legal and policy constraints if it wants to invest in a portfolio company that is restricted or even prohibited under PRC foreign investment laws and policies (even though the Fund is treated as a domestic entity). To facilitate foreign investors’ participation in the PE industry development in China, with due consideration of the characteristics of the PE industry itself, relevant governmental authorities may consider clarifying that foreign investment industrial restrictions or prohibitions should be lifted in instances where a foreign investor (or its subsidiary in China) makes a *de minimis* capital contribution as a general partner in a domestic PE fund. It is virtually meaningless to apply foreign investment industrial restrictions or prohibitions to such small contributions.

The Onshore Fund Management Entity can be incorporated as a PRC limited company, which is an independent legal person under the PRC law. This would permit this company to maintain its own name, office, and fund management team. However, the tax burden for this company is at best neutral, for it would be subject to corporate income tax and its dividend pay-out to a foreign shareholder would be levied with a withholding income tax of 10 percent (or as low as 5 percent if a tax treaty applies).

The Onshore PE Investment Entity (i.e., the general partner) can be incorporated as a PRC limited company or, in special instances, a joint stock company. The general partner may also be an affiliated onshore subsidiary of the foreign parent.

The Onshore Fund Management Entity may concurrently act as the general partner. (See Exhibit 2 below.) In this case, the Onshore PE Investment Entity can be dispensed with. However, there is an apparent downside if the RMB Fund is structured as a limited partnership: the general partner legally assumes unlimited legal liability in the RMB fund, and thus the carried interest of the Onshore Fund Management Entity may be encroached on if the Onshore Fund Management Entity concurrently acts as the general partner in the RMB Fund.

**Exhibit 2: Pure RMB Fund – Structure 2**

*[Continued on the next page]*
Technically, the fund management function may also be carried out by an offshore fund management entity. This appears to be an extremely tax efficient structure. However, this structure may not be acceptable to PRC local governments as a matter of local policy, because this would not help boost the local government’s tax revenue. In any case, this provides an additional structuring option, and may be contemplated and/or tested in one way or another by foreign private equity fund managers in the future, particularly when the private equity industry has been established for some time and the local governments are less stringent with their policy concerns. Please refer to Exhibit 3 below.

Exhibit 3: Pure RMB Fund – Structure 3
As already mentioned above, a foreign-invested direct structure for a Pure RMB Fund in the form of limited partnership is not yet legally permissible to date. The regulations on the establishment of partnerships by foreign investors will be likely promulgated by the State Council soon, and this may result in additional structuring options being available.

Additionally, a foreign investor should be aware that there may be other structuring options depending on different PRC strategies, development purposes of the foreign company, and different company holding and operating structures. For instance, setting up a traditional wholly foreign-owned enterprise (WFOE) may satisfy a foreign company’s purpose of establishing investment management and consulting businesses in China.

**B. Formation of an Onshore PE Fund Management Entity**

A foreign fund manager or investor may establish a foreign-invested Onshore Fund Management Entity in Tianjin, Shanghai, Beijing, or several other localities.

The government of the Pudong New Area in Shanghai issued some pilot measures on June 10, 2009, that expressly permit a foreign investor to set up an Onshore Fund Management Entity in Pudong. The key rules in said regulation include:

- **Legal form:** The Onshore Fund Management Entity must be a limited company (limited company), rather than a limited partnership.

- **Capitalization:** The minimum registered capital is USD 2 million, of which 20 percent should be contributed within three months of the issuance of the business license, and the remaining 80 percent within the next two years.

- **Shareholder qualifications:** At least one shareholder (or its affiliate) must have engaged in private equity investment or private equity investment management.

- **Management qualifications:** At least two management members must have more than two years of experience in private equity fund investment or private equity fund management and more than two years of experience in a senior management position.

Tianjin local governmental authorities have also issued several regulations that permit foreign investors to establish an Onshore Fund Management Entity. These regulations resemble the Shanghai Pudong regulations outlined above. Major requirements including the following:

- **Legal form:** A private equity fund management company may be either a limited company or a limited partnership. However, in practice, a foreign investor may establish an Onshore Fund Management Entity only in the form of a limited
company due to legal restrictions.

- **Capitalization**: The minimum registered capital is RMB 1 million if the company is incorporated as a limited company, and RMB 5 million if the company is incorporated as a stock limited company. The registered capital should be paid in cash only.

- **Shareholder qualifications**: The primary investor must have maintained good-standing financial status for the past two years, and must not have been subject to any major penalties by relevant administrative or judicial authorities.

- **Management qualifications**: The management team should have proven investment achievement, and should include at least three senior managers who jointly assume investment manager responsibilities, each of whom must have two or more years of experience in equity investment (or related business experience), including at least one senior manager who has five or more years of experience in equity investment and economic management.

### C. RMB Private Equity Funds – Policies and Rules

The NDRC and several other central ministries are drafting relevant regulations regarding the administration of private equity investment funds in China. Reportedly, a draft has already been submitted to the State Council, but there is no confirmed news as to when the regulation may be approved.

However, some local governments have issued pilot regulations with respect to private equity investment funds. For example, rules issued by the Shanghai Municipal Financial Services Office and three other departments of the Shanghai government in August of 2008 set forth the following:

1. A private equity investment fund enterprise may be in the form of a limited company, a limited partnership, or a joint stock company.

2. A private equity investment fund in the form of a limited company or a limited partnership should have no more than 50 shareholders (or partners). A private equity investment fund in the form of a joint stock company should have no more than 200 shareholders.

3. A private equity investment fund should have a registered capital of at least RMB 100 million (or USD 14.7 million), all of which is to be contributed in cash.

4. The partners of a limited partnership shall enjoy a pass-through tax status. An individual acting as a general partner shall be subject to a progressive tax rate of 5-35 percent, which is the rate normally applied to a “self-employed individual, industrial, or commercial business”. An individual acting as a limited partner
shall be subject to the 20 percent income tax rate which is normally applied to “interest, dividends, and bonus income” under the current income tax regulations.

(e) The assets of a private equity investment fund in the form of a limited partnership must be entrusted to the custody of a commercial bank that offers trust services in order to protect the assets of partners.

(f) A private equity investment enterprise must submit an annual report to its shareholders (partners) at the end of each fiscal year. This annual report must include summaries of the corporate government and operational and financial affairs, along with audited financial statements.

Likewise, authorities under the Tianjin government recently issued several rules regarding private equity investment funds that include the following important items:

(a) A private equity investment fund may be in the form of a company, a partnership, or a trust, or may be based on contracts. Again, a limited company or limited partnership should have not more than 50 shareholders (or partners). A joint stock company should have no more than 200 shareholders.

(b) A private equity investment fund in the form of a company must have a registered capital of at least RMB 10 million, with the upfront contribution being no less than RMB 1 million. All contributions should be in cash.

(c) The permitted scope of business for a private equity investment fund includes: “to make investments in non-listed enterprises and privately-placed shares of listed companies,” and “to perform related consulting services.”

(d) A private equity investment fund should entrust a commercial bank verified by the Chinese Banking Regulatory Commission to keep custody of its fund assets. The un-invested funds of a private equity investment fund may only be deposited in a bank account or be used to purchase fixed-income securities such as state-issued bonds.

If a PRC domestic private equity fund adopts the legal form of a limited partnership, there are some special structuring and planning issues to be considered under the PRC Partnership Enterprise Law (last revised in August of 2006). For instances:

- The law prohibits a wholly state-owned company, a state-owned enterprise, a PRC-listed company, or a non-profit institutional entity from acting as a general partner.

- A general partner may make equity contributions to a partnership in various forms including cash, in-kind, intellectual property, land use rights (or other property rights), and labor services. A limited partner may not contribute labor services.

- A limited partnership may have a maximum of 50 partners, including general partners and limited partners. Assuming a limited partnership has
only one general partner, then it may have at most 49 limited partners.

- A limited partner by its nature may not carry out ordinary affairs of the partnership; otherwise, it may loss the “limited liability” privilege. From different perspectives, though, the partnership law provides some safe harbors to a limited partner with respect to its involvement in a limited partnership in certain circumstances. For instances, a limited partner may propose suggestions as to the operation and management of the partnership. A limited partner may urge a partner managing partnership affairs to exercise the rights said partner has been derelict in exercising. A limited partner may also claim rights and initiate a lawsuit against a responsible partner if the rights or benefits of the relevant partner or the partnership are involved.

D. RMB Private Equity Funds - Benefits and Advantages

Setting up an indirect Pure RMB Fund through the use of an Onshore Fund Management Entity appears to be a commercially viable and advisable route. A foreign private equity fund management company that sets up an Onshore Fund Management Entity and subsequent Pure RMB Funds earlier rather than later will very likely benefit from significant early-mover advantages, such as early name recognition in the Chinese private equity investment management industry, more connections with and access to limited partner capital available or soon to be available in China, and accumulation of local private equity investment management experience in China.

Possible capital providers or limited partners in the PRC would include: the China National Social Security Fund, private equity funds allocated by insurance companies, policy banks and commercial banks, and securities houses, as well as other varied types of enterprises such as large and mid-size SOEs, a vast number of privately-owned enterprises, and foreign-invested enterprises in China. The China National Social Security Fund plans to allocate more of the funds under its management to private equity funds available on the market. Reportedly, the China Insurance Regulatory Commission may soon permit qualified insurance companies to allocate portions of their vast capital pool to private equity funds as a distinct asset class. In addition, many SOEs, listed companies, and privately-owned companies have attempted to either establish their own in-house private equity investment programs or allocate capital to external private equity funds.
E. RMB Private Equity Funds - Legal Uncertainties and Practical Difficulties

Considering that the private equity investment business remains a relatively new type of investment activity in China, a foreign private equity fund or fund manager should be well aware of the legal uncertainties and practical difficulties associated with the formation and operation of a private equity fund management company or a private equity fund in China.

(a) Under current PRC law, there is no complete legal framework in China for foreign direct investment in the private equity investment industry. The central government is still drafting national regulations with respect to the formation and management of private equity investment funds in China. Special regulations regarding foreign investment in the private equity investment fund industry can be legislated only at an even later stage. Meanwhile, regulations regarding foreign investment in limited partnerships were approved in principle by the State Council in late August 2009, and will be likely promulgated soon. These regulations on foreign investment in limited partnership might bring about more structuring options to a foreign private equity firm.

(b) Recently, several local governments have been keen to adopt local pilot regulations and policy rules to boost the development of the private equity investment fund industry in their respective administrations. As a practical matter, these local regulations and practices make it possible for foreign investors to set up private equity funds or fund management entities in some way. However, the local regulations are not complete and not detailed enough to cover the entire life of a private equity fund, and are often prone to frequent modification and willful interpretation by the local governments, making it difficult for foreign fund managers to stay abreast of and react to this ever-changing environment. This is especially so since the private equity investment industry in China is still a nascent phenomenon.

(c) There is still a paramount policy put in place by the State Administration of Foreign Exchange (the foreign currency regulator in China) that prohibits a foreign-invested enterprise to use its paid-in registered capital in foreign currencies to make equity investments in another PRC enterprise. This would likely affect a foreign-invested private equity fund management company’s ability to make its general partner contributions in an onshore private equity investment fund. However, it appears that a foreign-invested private equity fund management company has a good argument that its general partner contribution in an onshore private equity investment fund is made to help fulfill its primary objective of forming and managing a private equity investment fund by making a minimal capital investment (e.g., 1%) for ultimately realizing carried interest out of its management of the fund, rather than solely for making capital investments for capital gains. Some
local officials have expressed that they may help coordinate with the relevant foreign exchange authority to overcome this prohibition.

F. RMB Private Equity Funds - Other Important Issues to Consider

(a) Official registration with the National Development and Reform Commission ("NDRC") and/or local provincial counterparts

The NDRC issued certain provisional measures in November of 2005 which allow a private equity fund and its management entity to register themselves with the NDRC and/or local DRCs. In practice, the NDRC and local authorities may grant certain preferential policies to private equity funds and fund managers that have completed registration with the NDRC or local DRCs. For instance, as a policy matter so far, the China National Social Security Fund has been mandated to allocate its private equity capital only to private equity funds that have duly registered with the NDRC. It is possible that in the future other limited partner institutions or SOEs that are directly owned or supervised by central ministries may also be required to allocate private equity funds to private equity funds that have completed registrations with the NDRC and/or local DRCs.

(b) Exit Options: In terms of exit opportunities, an onshore private equity investment fund may consider a trade sale, a listing on the PRC domestic stock exchange (including the growth enterprise market to be launched later this year), a listing on an offshore stock exchange, or a share repurchase. At this moment, the securities regulators in China are hesitant and still researching the feasibility of whether and how a limited partnership may be permitted to become a registered shareholder of a PRC-listed company, although it appears probable that they will grant a green light soon.

(c) General tax effects

a. If the onshore RMB fund is structured as a limited partnership, a tax-exempt status is generally available to the limited partnership. There will be a question, however, as to whether the revenue received by a partner from a portfolio company is treated as dividend, capital gains, or ordinary business income, which may lead to different income tax burdens.

b. For the carried interest received by the Onshore Fund Management Entity, if such revenue is treated as service fees, business tax and corporate income tax would apply.

c. Any dividend pay-out by the Onshore Fund Management Entity to
its foreign shareholder shall be subject to a 10 percent withholding income tax, which may be reduced to 5 percent in the case of bilateral tax treaties.

**G. How Much is a FIVCIE Viable?**

While a FIVCIE provides a distinct, solid regulatory framework for a foreign investor to establish a RMB fund in China, there does exist some legal restrictions, legal uncertainties, and structuring issues that prevent a FIVCIE from becoming a viable or popular vehicle for establishing a RMB private equity fund.

A popular structure now adopted for forming a FIVCIE is to set up a Sino-foreign FIVCIE as either a company or a “non-legal-person enterprise”. In a Sino-foreign FIVCIE, both the foreign partner and the Chinese partner should contribute a substantial portion of the registered capital, in ratios such as 49:51, 40:60, or 30:70. The Chinese partner often is a Chinese fund or company owned or sponsored by local governments.

If a FIVCIE is incorporated as a legal person enterprise, the minimum registered capital is USD 5 million, and the “primary investor” needs to contribute no less than 30 percent of the total registered capital. The primary investor must meet certain special shareholder qualifications. The primary investor would assume limited liabilities in the FIVCIE.

If a FIVCIE is incorporated as a “non-legal-person” enterprise, the minimum registered capital is USD 10 million. The primary investor should contribute at least 1 percent of both the registered and the paid-in capital. The primary investor shall assume unlimited liabilities in the FIVCIE.

An obvious advantage of a Sino-foreign FIVCIE structure is that if the Chinese partner is owned or sponsored by the local government, the Sino-foreign FIVCIE would likely benefit from various strong support provided by the local government and its associated entities, such as the ready availability of local enterprises as investment targets, co-investments by local banks or local investment companies, and the support of local governments in granting investment approvals. However, this local support advantage is also available to any other type of onshore investment funds and vehicles established in the PRC.

The PRC Ministry of Commerce has delegated the powers for approving a FIVCIE to provincial and other local authorities. This will greatly facilitate the FIVCIE approval process. In addition, some will say that setting up a FIVCIE would make a 2nd tier investment faster and easier to close. However, this is only a half–truth, because in most cases investing in PRC portfolio companies from an offshore fund, if structured and planned carefully, may also obtain PRC approval quickly and may be closed without delay.

There is a paramount restriction in the FIVCIE Regulations: The capital of a FIVCIE
should be invested *mainly* in high and new technology enterprises ("HNTEs") that are not yet listed on the stock exchange. Tax rules issued by PRC tax authorities permit a FIVCIE incorporated as a company to deduct an amount equal to 70 percent of its equity investment in a HNTE from its taxable income two years after making the investment. However, there is an ensuing question as to what extent or limit that a FIVCIE may invest in enterprises other than HNTEs. This is subject to the discretionary interpretation of the relevant approval and administrative authorities, but this may become a serious restriction for a FIVCIE that wants to invest freely in non-HNTE enterprises.

A FIVCIE in the form of a company would not serve as a viable private equity fund structure for a foreign fund manager. The primary investor (in a similar status as the general partner in a typical private equity fund) needs to contribute at least 30 percent of the registered capital of the FIVCIE, far more than the regular one percent equity commitment expected of a general partner in a typical private equity fund. A FIVCIE in the form of a company also needs to pay PRC corporate income tax at a rate of 25 percent. An offshore fund, on the other hand, can simply avoid this layer of tax obligation by making direct offshore-onshore investments in PRC portfolio companies.

There are also problems associated with a FIVCIE in the form of a "non-legal-person". Following the adoption of the uniform corporate income tax in 2007, PRC national tax authorities so far have not clarified in writing whether a non-legal-person FIVCIE can enjoy pass-through tax status. This reflects a possible hesitation by the PRC national tax authorities to grant a green light (as they did before 2007). It is worth noting that there is no solid national legal framework under PRC law for a so-called "non-legal-person" FIVCIE.

Another possible disadvantage of a Sino-foreign FIVCIE is that as a practical matter, the Chinese partner and the Chinese local government would likely prohibit or discourage a Sino-foreign FIVCIE to invest in potential portfolio companies outside of their administration. A foreign investor is advised to consider this possible restraint and, if necessary, discuss and reach an agreement with its Chinese partner prior to the formation of a FIVCIE.