Investment Funds Practice Special Report

The Rising Tide of Chinese RMB Funds
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RMB Funds in a Nutshell

Current private equity investment into China occurs within two distinct frameworks. One is investment by offshore United States dollar-denominated funds (USD funds), and the other is investment by onshore renminbi-denominated funds (RMB funds). This bifurcation is largely due to China’s foreign direct investment (FDI) and currency control regimes. An international investor is subject to governmental approvals, ownership and other restrictions when investing in Chinese companies, while a domestic Chinese investor is generally not subject to such restrictions.

Specifically, USD-denominated funds, which are typically organized offshore under foreign law and funded by non-domestic Chinese investors, are classified as foreign investors under China’s FDI regime and, thus, subject to China’s FDI restrictions. To limit the impact of such restrictions, some offshore USD funds have structured their investments through offshore holding companies that hold Chinese companies. After a regulation issued by the Chinese government in 2006, however, these structures have become more difficult to achieve.

Hence, both international investors and managers have become increasingly interested in RMB funds as vehicles for making investments into China. In particular, if funded entirely by domestic investors, an RMB fund can invest in a broader range of industries and sectors in China than its USD fund counterpart. Additionally, because it invests in local currency, central government approvals are not required for the conversion of foreign currency into RMB and associated repatriation.

Two Types of RMB Funds

Generally, there are two types of RMB funds: (1) purely domestic RMB funds and (2) foreign-invested RMB funds. Purely domestic RMB funds are funds denominated in RMB, organized under Chinese law, raised from domestic Chinese investors and invested in domestic Chinese companies. Foreign-invested RMB funds are also denominated in RMB and organized under Chinese law, but are essentially foreign-invested enterprises (FIEs) with full or partial foreign ownership.

Foreign-Invested RMB Funds Sponsored by International Sponsors

The current regulatory framework provides for two types of foreign-funded RMB funds: (1) foreign-invested venture capital enterprises (FIVCEs) and (2) foreign-invested limited partnerships (FILPs). Both are subject to Chinese laws that govern foreign investment into China. As such, foreign-invested RMB funds do not necessarily present many distinct advantages compared to offshore USD funds investing in Chinese companies.

FIVCEs are generally established under the Measures on Administration of Foreign-Invested Venture Capital...
Enterprises (the “FIVCE Measures”), which went into effect on March 1, 2003. The FIVCE Measures allow foreign investors to establish joint ventures and/or wholly foreign-owned enterprises (WFOEs) as a means to engage in venture capital investments in China. The FIVCE model can be an ineffective means to address the restrictions associated with Chinese laws that govern foreign investments, given that investments made through this structure, despite their conversion to RMB and potential pooling with domestic RMB capital commitment, are still treated as FIEs under Chinese law.

FILPs can be set up in accordance with the Administrative Measures on Establishment of Partnership Enterprises by Foreign Enterprises or Individuals in China (the “FILP Measures”), which took effect on March 1, 2010. The FILP Measures left a regulatory vacuum that will be filled by future national regulations regarding FILPs, which are intended to be set up as foreign-funded private equity or venture capital funds with the purpose of making equity investments.

Nevertheless, major municipalities such as Beijing, Shanghai, Tianjin and Chongqing are developing local rules and pilot programs to allow Sino-foreign joint venture private equity funds, organized in the form of limited partnerships, to be established in their jurisdiction. The Carlyle-Fosun RMB fund is the first reported foreign-invested RMB fund organized under the FILP Measures. Registered in Shanghai, it’s a 50/50 joint venture between Carlyle and Fosun, and each is a general partner. More flexibility in local FILP regulations is expected in the future.

Purely Domestic RMB Funds Sponsored by International Sponsors

International sponsors that seek to establish RMB funds in the current financial climate have an additional option to consider when establishing an onshore fund in China: establishing a fund that is funded by domestic Chinese investors. Such a fund can be organized under the Chinese limited partnership law and regulations and, if structured properly, can be considered a domestic investor not subject to China’s FDI restrictions.

The operational model would be to raise limited partner capital from domestic Chinese investors and to invest those funds in onshore Chinese companies that could be sold to the public through domestic listings or to trade buyers.

To establish a purely domestic RMB fund, international sponsors must consider establishing a management entity in China to raise and manage the RMB fund. This management entity can be a Sino-foreign joint venture, a WFOE or a foreign-invested limited partner and will act as the general partner/manager of the RMB fund. One main advantage of the Sino-foreign joint venture approach is to have a Chinese partner that can assist with fund raising from Chinese investors. To date, foreign private equity managers have used both joint venture and WFOE vehicles.

The fund can be organized either as a limited partnership according to the Chinese partnership law or as a limited liability company under China’s company law. Partnerships may have an added advantage of “pass through” treatment under Chinese tax law.

In terms of the domicile of the fund, large municipalities, such as Beijing, Shanghai, Tianjin and Chongqing, may be better candidates, since each is in the process of negotiating with the central government and seeks to initiate pilots to attract international sponsors to the local private equity industry. Still, an international sponsor should select a jurisdiction based on factors such as its operating history in China, local governmental relationships, local preferential policies and strength of local investor base.

In terms of investor solicitation, the current Chinese regulatory regime is fragmented without unified private offering and solicitation rules. As there is not yet a national regulation governing the establishment of private equity funds, sponsors must continue looking to rules governing other investment vehicles for guidance. Ongoing supervisory authority over domestic RMB funds generally rests with local “development and reform commissions” (DRCs) or “financial affairs bureaus” (FABs). Various local DRCs and FABs have developed a registration system for funds and managers established in their jurisdiction.

Finally, investors typically require some sponsor capital commitment to the fund. Capital contribution by a joint venture or WFOE general partner to the RMB fund represents some legal challenge to international sponsors. However, this is being done on a case-by-case basis in various localities.

In sum, new laws and regulations are under development that could improve or alter the existing legal and operational framework with potentially significant implications for both domestic and international sponsors, as well as limited partners.

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On September 5, 2010, the China Insurance Regulatory Commission (CIRC) issued Tentative Measures for Insurance Funds Invested in Private Equity (the “Measures”). The Measures served as the first set of comprehensive rules adopted pursuant to the amended Chinese national insurance law (which took effect on October 1, 2009), detailing how the insurance sector funds were to be invested in domestic private equity. It is widely expected that insurance companies will join China’s National Social Security Fund and become major players among institutional investors in China’s domestic private equity market. According to the Measures, insurance funds would be permitted to invest in purely domestic Renminbi (RMB) funds, anticipated joint venture RMB funds and direct private equity portfolio investments.

The Measures set forth certain qualification criteria that insurance companies must meet in order to qualify to take advantage of the Measures. For example, to be able to engage in direct private equity investments, insurance companies must satisfy minimum net assets requirements (i.e., RMB 1.0 billion during the company’s preceding fiscal year) as well as requirements regarding the number of investment professionals at the company’s asset management division (e.g., at least five investment professionals with over three years of relevant experience).

The Measures also laid down the criteria that private equity management firms must meet in order to qualify to manage insurance funds. These criteria include registered capital requirements (at least RMB 100 million), a minimum number of investment professionals (e.g., at least 10 experienced professionals), minimum assets under management (RMB 3.0 billion) and track record requirements (e.g., a record of three complete exits). Other than the capital requirement, which is high for a typical private equity management firm, these criteria are not expected to be particularly challenging to satisfy.

In terms of qualification criteria for private equity funds in which the insurance funds may invest, the main criteria include a custody requirement (i.e., the funds must be held at custodian banks) and a fund size requirement (i.e., minimum commitments of RMB 500 million).

The Measures also set forth several investment restrictions that would be applicable to funds investments and/or direct portfolio investments, as appropriate. One notable restriction is a strict prohibition against investing insurance funds in venture capital funds. Others include typical diversification restrictions.

According to CIRC, total assets at Chinese insurance companies stood at RMB 4.5 trillion (approximately $661 billion) at the end of the 2nd quarter of 2010. This means insurance funds available to invest in private equity could potentially reach RMB 220 billion. Long-term institutional investors, such as insurance companies, will certainly help promote the healthy development of China’s domestic private equity industry.

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A hot topic for international private equity sponsors and investors concerning Chinese private equity is the possibility of allowing international capital to be invested in Renminbi (RMB) funds. Currently, major cities such as Beijing, Shanghai and Tianjin are actively working with the Chinese central authorities and developing their local pilot programs to make the so-called “QFLP,” or “qualified foreign limited partners,” regime a reality.

Under the QFLP regime, international investors (or limited partners) that meet certain qualification criteria will be allowed to invest as limited partners or shareholders in RMB funds. Typically RMB funds are RMB-denominated, organized under Chinese law, funded by domestic Chinese investors and focused on investing in private equity in China. These RMB funds may be sponsored by domestic Chinese managers or by international private equity firms’ Chinese subsidiaries or joint ventures with Chinese firms. (See “RMB Funds in a Nutshell” (p.3) for an introduction to RMB Funds)

For international private equity sponsors and investors, the existing RMB funds regime poses several challenges. One major challenge is potential conflicts of interest involved in deal allocation and resource competition between the international sponsors’ offshore China-oriented private equity funds and their onshore Chinese RMB funds. Another major challenge is the settlement of the international sponsors’ and investors’ foreign exchange into RMB for capital contribution purposes.

The QFLP pilot programs could potentially ameliorate some of these concerns. One obvious advantage of the QFLP regime is that it would allow a sponsor to combine international capital and domestic Chinese capital in one vehicle. As such, international and Chinese investors in such a “joint venture” RMB fund will have the same portfolio investments and performance returns. The conflicts over deal allocation and resource competition are ameliorated to some extent.

Related to this feature of the QFLP regime, all of the local jurisdictions’ (such as Beijing, Shanghai and Tianjin) pilot programs are expected to contain rules and procedures to facilitate the settlement of international investors’ and sponsors’ foreign exchange into RMB for purposes of their capital contributions. There will also be “express approval” procedures to facilitate such “joint venture” RMB funds’ investments in Chinese portfolio companies.

Nevertheless, a ceiling on the amount of international capital participation in each “joint venture” RMB fund is expected. In the case of international investors, the cap on their capital could be between 1-5 percent of the total fund size.

There are many practical issues of interest to international sponsors and investors, including the overall foreign exchange quota allotted to each local pilot program, selection criteria for joining a local pilot, qualification criteria for international investors (and possibly sponsors) and application processes. Competition among different local jurisdictions in attracting international sponsors and investors and the resulting differences among the local rules will also be worth watching.

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