



# Investment Funds Practice Special Report

## The Rising Tide of Chinese RMB Funds

Second Edition

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## Foreign Capital-Funded RMB Funds to be Treated as Foreign Investors

By Ying White, Akin Gump Strauss Hauer & Feld LLP<sup>1</sup>

On March 3, 2011, the Chinese Ministry of Commerce (MOFCOM) published on its Web site a notice (the “MOFCOM Notice”) clarifying certain current issues in the administration of foreign investments in China. Several items in the MOFCOM Notice will have implications for “foreign capital-funded renminbi (RMB) funds.”

“Foreign capital-funded RMB funds” generally refers to RMB-denominated limited partnerships established under Chinese law comprising both domestic Chinese investors and international investors. This type of funds is also called “QFLP-funded RMB funds” (“QFLP” meaning “qualified foreign limited partners”), “foreign-invested RMB funds” or “foreign-participated RMB funds.”

To date, the Shanghai government has issued implementation measures for Shanghai’s QFLP pilot scheme. The Beijing government is expected to publish rules for its pilot schemes in the near future.\*

One of the central issues surrounding these foreign capital-funded RMB funds is the characterization of the funds’ investor status. The MOFCOM Notice confirmed that such funds will be treated as “foreign investors” under China’s current foreign investment

regime (even though they are organized in China under Chinese law). Consequently, when a foreign capital-funded RMB fund makes investments in portfolio companies in China, it will be required to comply with China’s foreign investment and foreign exchange approval procedures.

Previously many international sponsors and institutional investors had hoped that such RMB funds could be granted “domestic investor” status and, therefore, not be subject to the approval regimes applicable to foreign investors if foreign capital participation in the fund is below a certain threshold. Thus, international sponsors that are sensitive to the “investor status” issue may want to reconsider their RMB structures. One hopeful glimmer behind all this is that the QFLP pilot programs of local governments (e.g., Shanghai and Beijing) may provide some relief in terms of foreign exchange approvals.

As the “foreign investor” status of foreign capital-funded RMB funds is confirmed, another issue relating to RMB funds and China’s new security

<sup>1</sup> See “[International Capital to Participate in RMB Funds: Becoming a Reality Soon](#)” for an introduction to QFLP concepts and “[International Capital Participating in RMB Funds: QFLP-Funded RMB Funds](#)” for a detailed discussion on Shanghai’s and Beijing’s QFLP pilot schemes.

review process has become clearer. In February 2011, the State Council issued a *Notice on the Security Review of Foreign Mergers and Acquisitions (M&A) of Domestic Enterprises* (the “State Council Notice”) instituting security reviews for foreign mergers and acquisitions that relate to China's national security. In March 2011, MOFCOM released related draft provisional implementing rules.

The State Council Notice and implementing rules provide for specific security review procedures for foreign investors’ acquisitions of, and equity investments in, Chinese companies in certain “critical” sectors, such as the military, critical agricultural production, critical energy and natural resources, critical infrastructure, critical transportation, crucial technology and major equipment building.

As a “foreign investor,” foreign capital-funded RMB funds would be covered by the provisional rules. Thus, when such an RMB fund makes equity investments in domestic Chinese companies, it will need to determine whether a proposed investee company falls within the “critical” sector scope. If the answer is “yes,” then the fund may be subject to the new security review process, in addition to the existing foreign investment and foreign exchange approvals.

The RMB funds sector is new and fast-developing. So is the regulatory regime governing RMB funds. International sponsors and institutional investors should consider which RMB fund structures are most suitable for them, both from the perspective of establishing a RMB fund and from the perspective of making subsequent investments in China.



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## International Capital Participating in RMB Funds: QFLP-Funded RMB Funds

By Ying White, Akin Gump Strauss Hauer & Feld LLP<sup>1</sup>

On January 11, 2011, the Shanghai government published its long-awaited implementation measures for Shanghai's qualified foreign limited partners (QFLP) pilot scheme (the "Shanghai Measures"). The QFLP pilot refers to pilot schemes in selected cities (such as Beijing and Shanghai) where renminbi (RMB)-denominated funds can be established that contain international investors that are qualified foreign limited partners. In fact, such funds can be more accurately described as "QFLP-funded RMB funds."<sup>\*</sup>

It is expected that the Beijing government will soon issue its own implementation rules (the parameters of Beijing's pilot QFLP scheme would be comparable to those of Shanghai's). For the time being, it appears that Beijing and Shanghai will be the only two cities that will be launching QFLP pilot schemes.

The significance of QFLP pilot schemes is that they finally make it possible for international investors to invest in Chinese RMB funds that are designed primarily to invest in private equity in China.

Previously, offshore USD-denominated funds with a China investment focus and domestic Chinese RMB funds have dominated this investment path.

Issues relating to QFLP schemes in which international sponsors and institutional investors have long been interested were summarized in "[International Capital to Participate in RMB Funds: Becoming a Reality Soon](#)." Many of them were clarified in the Shanghai Measures, including—

### *International Sponsor's Capital Contribution.*

Typically, an international sponsor would establish a wholly owned subsidiary or a joint venture with a Chinese company to serve as the general partner and/or the management company of the future RMB fund. One challenge under China's current foreign exchange/foreign investment regime is that international sponsors are not permitted to convert

<sup>\*</sup> See "[International Capital to Participate in RMB Funds: Becoming a Reality Soon](#)" for an introduction to QFLP concepts and "[RMB Funds in a Nutshell](#)" for an introduction to RMB funds.

their registered capital into RMB for purposes of making capital contributions. The Shanghai Measures expressly permitted this type of currency conversion under the pilot scheme. Furthermore, to the extent (i) all investors in the fund are domestic investors and (ii) the international sponsor's capital in the general partner and/or the management company of the fund accounts for no more than 5 percent of aggregate fund commitment, the fund can be treated as a domestic RMB fund.

*Application of Foreign Investment Restrictions to QFLP-Funded RMB Funds.* Generally a QFLP-funded RMB fund will be required to comply with China's foreign investment restrictions, i.e., RMB funds with international capital participation will not be able to invest in industries or sectors in which foreign investments are prohibited.

*Geographical Restrictions on Funds' Investments.* Investments by QFLP-funded RMB funds established in Shanghai will not be restricted to Shanghai and its surrounding areas by the Shanghai Measures.

*Qualification Criteria for QFLPs.* Criteria include: an international investor having no less than \$500 million of its own assets or \$1.0 billion in assets under management; at least five years of relevant investment experience (or an affiliate meeting such an experience test); and no regulatory sanction during the preceding two years.

*Administration of the Pilot Scheme.* A joint working committee, consisting of various Shanghai governmental departments and the Shanghai branch of the State Administration of Foreign Exchange, will be responsible for managing the pilot scheme. The Shanghai Financial Affairs Office will coordinate among the joint working committee members to review and approve applications and administer a filing system designed to monitor candidates selected into the pilot scheme on an ongoing basis.

The Shanghai Measures did not address some of the issues that have been closely watched by international sponsors and investors, including caps on international investors' capital commitments in each QFLP-funded RMB fund and the procedures for an expedited foreign exchange settlement approval. Details on these and many other issues will likely be part of the internal procedures and policies of the joint working committee.

It is understood that each pilot scheme will initially be allotted an overall foreign exchange quota of \$3 billion. This means (i) a total of \$3 billion of international capital can be converted into RMB under each pilot scheme, and (ii) this total quota will be divided among the participants in the scheme. Given that investing in RMB funds is a new development in the foreign investments arena, and much discretion is given to the local governments, interested international sponsors and investors should begin contacting Beijing and Shanghai officials to start the application process.

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