

CHINA MATTERS

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Draft Foreign-Invested Partnership Regulations – New Possibilities for Global Funds in China?

On August 24, 2009, it was reported that the latest draft of the long-awaited *Administrative Measures for the Establishment of Partnership Enterprises by Foreign Entities or Individuals in China* (the "Draft FIP Regulations") was approved in principle by the State Council of the People's Republic of China (the "PRC"), and has been returned to the Ministry of Commerce ("MOFCOM") for further refinement.

It has been two years since the PRC Partnership Enterprises Law (Amended) (the "Partnership Law") came into effect in June 2007. However, the Partnership Law provided for only partnerships among PRC legal persons, and called for the State Council to enact specific regulations for foreign-invested partnerships ("FIPs"). Since then, in the absence of a national legal framework for FIPs, Tianjin, Shanghai and Beijing all adopted their own local rules and structures to promote formation of RMB funds where foreign fund managers might participate "indirectly" through their direct or indirect subsidiaries established in China. In the meantime, foreign fund managers and investors remain intensely interested in FIPs because they most resemble the prevalent structure for most international and offshore funds. The Draft FIP Regulations, if adopted in the current form, should allow a foreign investor (subject, as always, to governmental approvals) to directly form a PRC limited liability partnership ("LLP") as a general partner ("GP"), or to directly invest in a PRC LLP as a limited partner ("LP").

MOFCOM Approval

Under the Draft FIP Regulations, the establishment of FIPs would be subject to approval by MOFCOM or its designated local commerce authorities. The approval authority should make its decision within 45 days after receiving a complete set of application documents, and issue an approval certificate if it so approves. Since it is not uncommon for MOFCOM to gradually decentralize its approval authority only after a period of time following the adoption of new rules, it is currently unclear whether the local commerce authorities would have authority to approve smaller FIPs immediately after the Draft FIP Regulations take effect. If all applications have to be approved by the central MOFCOM, smaller fund managers may find it more challenging or time consuming to gain market entry.

The applicant must then, within 30 days upon receipt of the approval certificate, apply with the State Administration for Industry and Commerce or its designated local authorities for registration and issuance of the business license.

Industry Restrictions

The Draft FIP Regulations subject FIPs to the same industry restrictions as other types of foreign-invested enterprises ("FIEs"). The Foreign Investment Guidance Catalogue, promulgated by the National Development and Reform Commission ("NDRC") and MOFCOM on May 29, 2007 (the "2007 Foreign Investment Catalogue"), categorizes

certain industries as “restricted” or “prohibited” for foreign investments (e.g., telecommunications, development of large tracts of land and so forth). FIPs are not relieved from such restrictions. The Draft FIP Regulations provide that if national policy would permit foreign investment in an industry only in the form of Sino-foreign equity or cooperative joint venture, or joint venture where the Chinese party would retain control, a foreign investor would not be allowed to bypass such restriction by investing through an FIP.

In this regard, the “foreign-invested” status of the FIPs may defeat some foreign investors’ rationale to set up funds “onshore” in China to gain more flexibility in their investments. It is also interesting to note that some industry participants take the position that under the current Tianjin and Pudong RMB fund models, an LLP with indirect foreign participation should be treated as a “domestic” partnership, and thus may not be subject to such investment restrictions.

Qualifications and Foreign LPs

The Draft FIP Regulations provide that two or more foreign investors (whether entities or individuals) may set up a PRC partnership (i.e., a wholly-foreign-owned FIP), or one or more foreign investors may set up a PRC partnership together with PRC companies or individuals (i.e., Sino-foreign joint venture type FIP). The Draft FIP Regulations do not impose any special qualification requirement on the foreign partner, except that it must have good business reputation and no record of violation of law for the three years immediately preceding its application.

On a related note, NDRC has proposed to regulate private equity funds, and is in the process of drafting the *Provisional Measures for the Management of Equity Investment Funds* (the “PE Fund Regulations”). It is likely that the PE Fund Regulations would regulate both foreign and domestic equity investment funds, and may include qualification requirements for foreign GPs or LPs. The PE Fund Regulations may also adopt a filing system requiring all private equity investment funds formed in the PRC to be filed with NDRC or other relevant authorities.

Under the Draft FIP Regulations, a foreign investor is also permitted to invest into an FIP as an LP. Therefore, it may be possible for a foreign fund manager to organize an offshore feeder fund, and use the offshore feeder fund, as an LP, to invest in an RMB-denominated master fund.

Capital Contribution

The Draft FIP Regulations generally require the foreign investors to make their partner contributions in freely-convertible foreign currencies. However, there are a few exceptions, pursuant to which multinational companies may “recycle” into FIPs their RMB – such as (i) profits received as distributions from an FIE owned by the foreign investor, (ii) proceeds received from an onshore sale of equity interest in an FIE, (iii) capital repatriation resulting from a reduction of an FIE’s registered capital, and (iv) proceeds from a liquidation of an FIE.

The Draft FIP Regulations are silent on the minimum partnership capital or contribution timeline. Accordingly, it appears that partners may agree on capital contribution related matters in the partnership agreement and that the commitment and capital call mechanism commonly used in offshore funds may also be allowed for FIPs.

Foreign Exchange

The Draft FIP Regulations do not provide for detailed procedures regarding foreign exchange matters for FIPs. It is unclear whether the foreign currency capital contribution made by the foreign partners would be permitted to be converted into RMB immediately after the contribution, or if it would be subject to the same conversion approval and restrictions applicable to FIEs, or how repatriation would work when the foreign partners receive their FIP distributions or carried interests. It is also unclear whether FIPs would be entitled to the same foreign exchange conversion exemption from SAFE Circular 142 as foreign-invested venture capital enterprises (“FIVCE”). We expect that upon the official promulgation of the Draft FIP Regulations, the State Administration of Foreign Exchange, the State Administration of Taxation and other relevant authorities would issue

implementing rules to address the practical FIP structural and operational issues.

More Flexibility than Non-Legal Person FIVCEs

Under the Draft FIP Regulations, the FIPs appear to enjoy more flexibility when compared to non-legal person foreign-invested venture capital enterprises (“Non-Legal Person FIVCEs”). For instance, a Non-Legal Person FIVCE must have registered capital of not less than US\$10 million, at least 1% of which must be subscribed by the indispensable investor. Such registered capital must be paid in within 5 years after the formation of the Non-Legal Person FIVCEs. Furthermore, the Non-Legal Person FIVCEs are only allowed to invest in unlisted high-and-new technology enterprises in PRC. FIPs under the Draft FIP Regulations, on the other hand, are not subject to these restrictions and requirements. But again, the PE Fund Regulations proposed by NDRC may stipulate further substantive requirements with respect to private equity funds in the form of FIP.

Conclusion

The LLP structure under the Draft FIP Regulations and the Partnership Law would, in many aspects, resemble the typical structure of international funds in other jurisdictions. Admittedly, considerable legal and policy uncertainty still surrounds the formation and operation of FIPs, and the current legal regime is still a work-in-progress. Nevertheless, the Draft FIP Regulations represent an important step toward a national-law level framework permitting foreign investors to utilize a PRC partnership structure to form onshore RMB private equity funds.

Paul, Hastings, Janofsky & Walker LLP is a global law firm with 18 offices in Asia, Europe and the United States. Paul Hastings has one of the largest, full service, multi-jurisdictional legal practices in Asia with offices in Beijing, Hong Kong, Shanghai and Tokyo.

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