China asset management:
The state of play in onshore and offshore China-related private investment funds

October 2011
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Developments in asset management in and related to the People’s Republic of China (PRC) present some of the greatest opportunities in the global asset management industry and are poised to revolutionize significant aspects of the sector. Three separate but inextricably linked market trends are driving these developments. First, the staggering level of pent-up government, institutional and individual wealth in the domestic PRC market presents the immediate need for both onshore and offshore investment products into which to channel this capital and the onshore and offshore asset management expertise to ensure efficient, rational and diversified capital deployment and growth and associated risk management. Second, investment opportunities in many key sectors in the domestic PRC market abound and, as such, continue to attract a high level of interest from both trade and institutional investors, along with a concomitant need for effective onshore and offshore asset managers through which to channel this investment. Third, the interplay between these first two areas presents dynamic synergies for onshore and offshore asset managers to leverage respective comparative advantages in investor bases, investment opportunities and asset management expertise (including addressing the unique challenges of the PRC’s investment fund regulatory regime) in combined onshore and offshore asset management platforms that will provide a basis for achieving the full potential of each of the onshore and offshore participants.

This note provides an overview of the potential structures and related legal frameworks for private investment funds targeting the PRC that will have the ability to:

(a) raise offshore funds for investment into the PRC (Offshore Funds);
(b) raise funds denominated in RMB from inside and outside the PRC for investments within the PRC (RMB Funds); and
(c) raise funds in the PRC for investment outside of the PRC (Outbound Investment Vehicles, and collectively with Offshore Funds and RMB Funds, the PRC Fund Products).

After summarizing the critical issues that arise in connection with these products, this note looks at:
– the market potential;
– the key regulators and regulations that are relevant to establishing and operating PRC Fund Products; and
– common structures utilized and key issues arising with:
  – Offshore Funds;
  – RMB Funds formed for investment both onshore and offshore;
  – Outbound Investment Vehicles; and
  – a potential combined platform that would allow an Offshore Fund and RMB Fund to raise funds and invest in parallel, both in the PRC and offshore.

The main sections of this note, as outlined above, provide a practical guide to structuring and implementing these various products, given their relatively new ascendance in the PRC.
1. Critical issues

The PRC Fund Products described in this note are relatively new products, unlike Offshore Funds that raise capital for investment in the PRC and are well-established products for sponsors in the U.S., London, Luxembourg, Hong Kong and other major fund centers (Offshore Sponsors). A key factor that has constrained growth of the onshore market is regulation. The regulatory framework within the PRC relating to asset management, including fund structuring, formation, marketing and investment, is at an embryonic stage. The PRC authorities have been slowly creating an environment to allow foreign-style investment funds, and all signs point to an opening of the market in this area. However, both RMB Funds and Outbound Investment Vehicles are in their early stages, and, as such, there is limited guidance on issues relating to tailored structuring and cross-border issues, particularly foreign exchange and distribution. No one product has been tested on a large scale. Certainly, no one structure has emerged that is capable of setting a market standard. Although there has been much press coverage of late regarding Offshore Sponsors tapping the vast PRC asset management market, the reality is that only a handful of these projects have reached fruition, representing, on a relative basis, a very small amount of assets under management. Most of the projects announced over the past two years in the press are still in the planning stages or have yet to reach a first close.

Given this, the structures and regulatory position described below remain in flux, and the success of any particular product will be a function of the direction and speed of prevailing policy winds, the regulators’ view of that product, and the standing of the sponsors of the fund. Based on that, and the analysis set out in more detail below, the following approaches pose the greatest likelihood of success for tapping into the PRC’s capital and investment bases (both for raising capital and placing capital raised domestically and abroad) in the near term:

– Tapping into the onshore investor pool – With respect to RMB Funds, establishing an onshore fund that would raise capital in RMB from a range of PRC investors (banks, insurance companies, corporations, pension funds and retail investors whether high net worth individuals or otherwise (Onshore Investor Pool)) for investment in the PRC. There are several domestic partners with which an Offshore Sponsor could work to raise capital from the Onshore Investor Pool, including private wealth managers, banks and insurance companies. With recent regulatory developments, such an RMB Fund could also be expanded to include offshore investors as limited partners. But as discussed below in greater detail, this may create other issues by subjecting the entire RMB Fund to regulation as an FIE as defined below.

– Aligning with an onshore strategic partner to offer a linked product – With respect to Outbound Investment Vehicles, a fund sponsor could establish a linked product between the Offshore Sponsor and one or more strategic partners in the PRC that would provide a basis for raising capital onshore and investing that capital both onshore and offshore directly and possibly synthetically. The basis of this product would be a contractual relationship between the Offshore
Sponsor and its onshore partner whereby (i) the onshore partner would be responsible for raising capital onshore through its asset management network (from the Onshore Investor Pool); (ii) the capital raised onshore would be linked in its capital return and placement to one or more Offshore Sponsor investment fund products offshore; and (iii) the onshore partner (through itself and an offshore affiliate) and the Offshore Sponsor would enter into a contractual relationship for placement of the amounts raised onshore with one or more Offshore Sponsor offshore products.

- **Raising offshore capital for investment onshore** – With respect to Offshore Funds, an Offshore Sponsor could utilize the traditional products that have successfully raised capital from investors across the U.S., Europe, the Middle East and elsewhere for investment into the PRC and Asia generally.

- **Establishing a combined platform capable of raising capital both onshore and offshore for investment both onshore and offshore** – Lastly, there is potential for an Offshore Sponsor to partner with an onshore asset manager to form and operate a parallel fund combining both onshore and offshore components. The onshore sponsor would be responsible for forming an RMB Fund and raising capital from the Onshore Investor Pool, while the Offshore Sponsor would raise capital for a traditional Offshore Fund. The RMB Fund and Offshore Fund would then be contractually linked to jointly invest in portfolio companies in the PRC, with the onshore and offshore asset managers jointly acting as investment advisor. To the extent that PRC regulations would bar the participation of the Offshore Fund in a particular investment based on restrictions on foreign investment, the RMB Fund would make up the difference and both funds would be subject to contractual rebalancing so that all investors, both onshore and offshore, would share in all investments.

The two main hurdles facing Offshore Sponsors in establishing an RMB Fund are foreign exchange issues and the concern that foreign capital investment will cause the RMB Fund to be subject to all the restrictions of a foreign investor in the PRC.

- **Foreign Exchange** – Foreign exchange presents two key issues: convertibility and rate risk. First, an Offshore Sponsor must have means to efficiently fund capital contributions to the RMB Fund from offshore and remit its management fee, carried interest and other economic interest in the fund outside of the PRC. Second, any cross-border fund product presents issues of foreign exchange rate risk (i.e., the financial risks of foreign exchange rate fluctuations).

There have been very significant recent regulatory developments impacting on both of these areas. Certain jurisdictions in the PRC are beginning to issue regulations that would create a pilot program to grant certain foreign investment quotas to qualified offshore investors. As discussed below in Section 3.6(c)(ii) below, Shanghai was the first municipality to implement such a program allowing foreign general
partners and management companies to convert a certain percentage of a fund’s expected size into RMB for purposes of its investment in an RMB Fund, as well as permitting foreign limited partners to make currency exchanges for investment in an RMB Fund. We understand Chongqing has recently enacted a similar pilot program to permit foreign limited partners to invest in an RMB Fund, and other jurisdictions in the PRC are likely to follow this path to allow for more efficient foreign exchange management by fund sponsors and move towards resolving this issue.

In addition, there has been a sudden and very considerable liberation of the ability to settle RMB transactions offshore, giving rise to a considerable offshore RMB market in Hong Kong and, to a lesser extent, other global financial centers. This is treated in detail in Section 3.2(b) below. This development allows for the ability to both raise RMB directly from offshore investors and make RMB investments and payments from outside the PRC.

– **FIE Restrictions** – The current position of the PRC regulators is that any amount of foreign investment in a domestic RMB Fund will cause that fund to be subject to all the restrictions applicable to foreign-invested enterprises (FIEs) in the PRC. This includes an investment made by a foreign-owned general partner or foreign limited partners in an RMB Fund. On its face, this is counter-intuitive since subjecting an RMB Fund to such restrictions, even if all the limited partners are PRC entities and individuals, negates the benefits available to an RMB Fund as a domestic entity. Likewise, investors in an RMB Fund will expect the Offshore Sponsor, as general partner, to contribute some portion of capital into the fund as is standard in most investment funds. There are limited structural fixes to address this issue.

Lastly, in an attempt to slow investment in certain overheated areas of the economy (such as real estate) and promote investment in certain others, regulators are generally promoting the creation of funds that invest in nine major encouraged areas. Those sectors are broadly defined as: (i) integrated circuits and software; (ii) communications; (iii) digital audio and video; (iv) new electrical components; (v) automotive electronics; (vi) information and value-added services and digital content services; (vii) new pharmaceuticals; (viii) new materials; and (ix) energy-saving environmental technologies. Although it is uncertain whether funds that are organized to invest outside of these areas will be denied approval, it is clear that funds that intend to invest within these industries will be given preferential treatment when seeking approvals for establishment.
2. Market potential

The market in the PRC presents an extraordinarily deep wealth of opportunity for asset management services and capital raising for investment both within and outside of the PRC as borne out, at its simplest level, by the following sampling of statistics:

– the PRC’s foreign-exchange reserve was at a record high of USD2.4 trillion in December 2009, and reports have indicated that this will primarily be invested overseas;

– the PRC fund management business grew by 37.9% by the end of 2009, with the industry’s total assets under management rising to USD392bn;

– capital investments by PRC insurance companies were at USD358bn through the first seven months of 2009 alone;

– pension assets available for investment in the PRC are expected to rise to USD130bn by 2013;

– PRC overseas direct investment may see double-digit growth this year, to around USD60bn on the back of government support and overseas expansion plans of domestic firms;

– China Investment Corp (CIC), the PRC’s USD300bn sovereign wealth fund, recently disclosed that it currently holds USD9.6bn in U.S. stocks alone;

– according to Private Equity Online, 30 private investment funds either investing only in the PRC or with exposure to the PRC raised USD13bn in 2009 and of these funds, 21 were denominated in RMB, garnering total commitments of USD8.73bn;

– the National Social Security Fund (NSSF), the PRC’s national pension fund, disclosed that its assets jumped by 38% to USD113.7bn at the end of 2009, and the NSSF also raised its overseas investment limit from 7% to 20% of its total assets; and

– with several of the world’s largest banks by market capitalization (including the world’s largest), a vast network of branches across the PRC and internationally, and clients forming the core of the pool of investors onshore, PRC commercial banks also present considerable opportunities for PRC inbound and outbound asset management and investment.
These statistics point to two separate but inter-linked realities in respect of the onshore market. First, there is an enormous pool of pent-up government, institutional and individual wealth requiring asset management services. Second, the capacity and depth of the nascent onshore asset management industry is grossly insufficient to meet this extraordinary pent-up demand.

In addition to the above, the PRC has been one of the most attractive target markets for foreign direct investment over the last decade, raising its popularity as a port for investment by private investment funds. From 2006 through 2008, over 300 new dollar-denominated Offshore Funds were formed, raising approximately CNY600bn to target investment in the PRC. However, the traditional model of raising offshore funds for investment into the PRC is quickly breaking down. In 2010, an estimated 55 Offshore Funds were formed (raising approximately CNY100bn), while 35 RMB Funds were established (raising approximately CNY75bn). It is expected that 2011 will be the year that RMB Funds overtake Offshore Funds as the primary private investment fund vehicle targeting the PRC market.1

Finally, as testament to this, several prominent global fund managers have announced plans to launch RMB Funds, and some have already achieved first closings.2 In each of those cases, the foreign sponsor has teamed up with a strong local partner to assist in sourcing onshore capital from the vast wealth of potential opportunities mentioned above. Several others in the market are either about to launch, or actively exploring, similar products, and there is every indication that this trend will continue to gain momentum.

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1. Z-Ben Advisors estimates that by the end of 2011, 45 RMB Funds and slightly under 40 Offshore Funds will be established, with RMB Funds out-fundraising Offshore Funds by approximately CNY20bn. All data from Z-Ben Advisors, April 2011 report.

2. As of this writing, Blackstone, Carlyle, Goldman Sachs and Morgan Stanley have all closed on RMB or parallel funds with investment commitments of well over USD1bn (all are sized at roughly CNY$5bn, with the exception of the Morgan Stanley fund, which has commitments over roughly CNY1.5bn. The local partners for these funds are, respectively, Shanghai Pudong Government, Fosun Group, Beijing Municipal Government and Hangzhou Industrial & Commercial Trust Co.
3. Regulatory framework

3.1 Introduction

Any foray into PRC Fund Products will require an understanding of a number of regulators in the PRC, including those relating to foreign exchange, capital markets, financial regulation, foreign investment and others relevant to raising capital onshore and foreign investment in the PRC. The PRC financial markets are highly regulated and the establishment and operation of an onshore asset management venture or fund vehicle is subject to a patchwork of laws and regulations across several instrumentalities and layers of government. The regulatory regime applicable to the activities of PRC Fund Products also comes under the purview of several regulators, and within each of these regulatory bodies the approval and supervisory authority may be further divided at the central government and provincial levels.

As a general matter, the private equity and venture capital industry in the PRC is dynamic and fast-growing. Over the past few years, local governments, including Tianjin, Shanghai, Beijing, Shenzhen and Chongqing, have issued various local rules that permit the formation of private investment funds and fund management companies. In addition, the PRC State Council has issued the *Measures for the Administration of the Establishment of Partnership Enterprises in China by Foreign Enterprises or Foreigners* (the *Foreign Partnership Measures*), which became effective on March 1, 2010, allowing foreign investors to be partners in onshore partnerships.

However, there is currently no national legal framework concerning foreign direct investments in private investment funds in the PRC. There are numerous legal issues that a foreign investor must confront before it may make an investment in an RMB Fund. These issues include the permissible structures for investments, legal restrictions on the contribution of foreign capital in an RMB Fund, limitations on the industries that may be invested in by a foreign-invested RMB Fund or an Offshore Fund, and foreign exchange conversion issues.

This section will provide a broad overview of the general regulatory framework impacting the establishment and operation of PRC Fund Products. The discussion in Sections 4 through 7 below regarding specific fund structures will give greater detail of how the various regulators would be involved in each such product. The laws and regulators discussed below are not an exhaustive list of those relevant to PRC Fund Products but touch on those that in our experience will be the most crucial, including:

(i) foreign exchange;

(ii) securities and futures laws;

(iii) foreign direct investment;

(iv) Qualified Domestic Institutional Investor (QDII); and

(v) foreign invested partnerships.
3.2 Foreign Exchange Regulatory Framework

The State Administration of Foreign Exchange (SAFE) is the primary regulator responsible for implementing and enforcing the foreign exchange policy of the PRC’s central bank, the People’s Bank of China (the PBOC). It formulates and administers the regulations that govern the investment of foreign funds in the PRC and the remittance of funds (both foreign currencies and RMB) out of the PRC. These restrictions impact how an Offshore Fund may utilize offshore capital for investments in the PRC, as well as whether an onshore RMB Fund or other Outbound Investment Vehicle may use funds raised within the PRC for investments outside the PRC. In addition, these restrictions also affect how a foreign investor may extract profits from its investments in the PRC.

(a) Foreign Exchange Restrictions Applicable to PRC Fund Products

The most relevant set of rules with respect to foreign investment were promulgated by SAFE in August 2008 (the Relevant Operating Issues Concerning the Improvement of the Administration of Payment and Settlement of Foreign Currency Capital of Foreign-funded Enterprises (SAFE Circular 142), which:

(i) explicitly prohibits any FIE from using any RMB converted from foreign capital to make equity investments in the PRC unless the domestic equity investment is within the approved business scope of the FIE and has been approved by SAFE. On the face of the circular, the prohibition seems to apply only to RMB converted from foreign capital, and does not appear to prevent an FIE from deploying RMB generated onshore or directly making a contribution to the FIE in RMB from offshore, as further discussed below;

(ii) specifically prohibits the purchase of domestic real estate using RMB converted from foreign capital other than for the FIE’s own use, unless the FIE is licensed as a real estate enterprise; and

(iii) provides that the settlement of the purchase consideration denominated in foreign currency must be effected through an exclusive foreign currency account approved by a local branch of SAFE.

The Regulations of the PRC on Foreign Exchange Administration issued in August 2008 (the SAFE Regulations) further prohibit the circulation, trading, pricing or settlement of foreign currencies within the PRC. Foreign exchange receipts of domestic entities and individuals may be repatriated or placed outside the PRC on such conditions as SAFE may prescribe. A further general article in the SAFE Regulations provides that foreign exchange receipts and payments for current account transactions shall be based on bona fide and legal transactions. This last provision may impact some of the Outbound Investment Vehicles described below in this note, which rely on contractual payment obligations.

3. There is an exemption from this prohibition for a foreign-invested holding company and for a foreign-invested venture capital investment enterprise which is discussed in Section 5.3 below.
In relation to private investment funds, the foreign exchange restrictions will shape the methods by which Offshore Funds can be used to invest in the PRC, how offshore investors may invest in RMB Funds and how profits, management fees and carried interest can be transferred out of the PRC from an RMB Fund involving foreign investors. Generally, foreign exchange restrictions apply to all foreign currency and RMB flowing in and out of the PRC. Although there are also certain exemptions from foreign exchange restrictions provided under specific measures implemented by provincial governments to promote the development of the funds industry, there is no distinct structure available under the current regulatory framework that satisfactorily deals with the issue of repatriating profits, management, carried interest and capital out of the PRC. In the planning and approval stages of any project, it will therefore be important to the Offshore Sponsor, to the extent possible, to get blanket approvals regarding foreign exchange up front so as to avoid any potential financial barriers during implementation and operation. As mentioned above, regulations in Shanghai already permit a certain foreign exchange quota for FIE general partners and management companies, and both Shanghai and Chongqing allow for investments by foreign limited partners in RMB Funds. If, as expected, other jurisdictions follow this path, it would allow Offshore Sponsors to obtain RMB exchange quotas on a larger scale for its general partner and limited partner investments into RMB Funds.

When structuring a fund, Offshore Sponsors hoping to raise capital from investors within the PRC will also need to consider conversion and remittance issues under Article 17 of the SAFE Regulations, which may arise in the return of foreign fund investor capital and profit. Article 17 requires all (i) overseas direct investments and (ii) overseas securities or derivatives transactions by domestic entities to be registered with SAFE. Upon the termination of an RMB Fund or the winding up of an FIE, the relevant provision in the SAFE Regulations provides that “after an FIE that is terminated in accordance with law has completed liquidation and paid taxes in accordance with the relevant provisions of the State, the income in RMB owned by the foreign investor may be converted into foreign currency though a financial institution conducting foreign exchange settlement and sale operations and may be remitted abroad.”

Lastly, as with any investment across national borders, any of the PRC Fund Products would need to take into account exchange rate fluctuations between the RMB and any foreign currency involved in any fund products and the impact of these fluctuations on achieving target returns. A cross-border fund will need to put into place appropriate hedging arrangements and disclose this risk adequately in the fund’s offering document. Of course, a parallel fund platform, as discussed in Section 7 below, could go a long way in addressing this critical commercial issue. In addition, foreign exchange risk may be mitigated by utilizing RMB both inside and outside of the PRC, as discussed in Section 3.2(b) immediately below.
(b) Developments in Offshore RMB Regulations

Recent developments in the PRC’s foreign exchange policy and regulations have permitted RMB to be remitted into and out of the PRC much more freely than was previously possible. However, to date, cross-border settlements in RMB are permitted primarily for current account, and not capital account, items, as discussed in more detail below.

(i) Current Account Items

Prior to July 2009, all current account items (ie, payments for goods and services and of income) were required to be settled in foreign currencies. Since July 2009, the PRC has commenced a pilot scheme pursuant to which RMB may be used for settlement of imports and exports of goods between approved pilot enterprises in five designated cities in the PRC (Shanghai, Guangzhou, Dongguan, Shenzhen and Zhuhai) and enterprises in designated offshore jurisdictions including Hong Kong and Macau. On June 17, 2010, the PRC promulgated the Circular on Issues Concerning the Expansion of the Scope of the Pilot Program of RMB Settlement of Cross-Border Trades (Circular 186), pursuant to which (i) RMB settlement of imports and exports of goods and of services and other current account items became permissible; (ii) the list of designated pilot districts was expanded to cover twenty provinces including Guangdong; and (iii) the restriction on designated offshore districts was lifted. Accordingly, any enterprises in the designated pilot districts and any offshore enterprises are entitled to use RMB to settle any current account items between them. In particular, any FIEs located in the designated pilot districts may remit all lawful dividends and distribution payments in RMB to its foreign investors outside the PRC.

As a new regulation, Circular 186 will be subject to interpretation and application by the relevant PRC authorities. Local authorities may adopt different practices in applying Circular 186 and impose conditions for settlement of current account items. That said, this new development appears to hold some promise for easing the regulatory burden in transferring funds across borders on a contractual basis, to the extent that the offshore party involved is willing to accept, and has a use for, RMB outside of the PRC (or a legitimate means of repatriating the funds). In addition, some offshore counterparties, or even investors in Offshore Funds themselves, may prefer to receive RMB as a means of reducing foreign exchange risk. However, while these eased restrictions eliminate the need for SAFE approval for foreign exchange (because none will take place), they do not eliminate the need for SAFE approval for remittance. To the extent a contract meets or exceeds the monetary thresholds above which SAFE approval is required for remittance, that will remain the case.
(ii) Capital Account Items

While policy on cross-border RMB settlement of current account items has liberalized rapidly over the past two years, PRC regulators have been slower to liberalize in respect of capital account items. There are currently no widely available PRC rules that expressly permit the cross-border remittance of RMB for capital account payments, including capital contributions, securities investments, derivative products and loans. Instead, capital account items are generally required to be made in foreign currencies. Most relevant in the context of PRC Fund Products, foreign investors (including any Hong Kong investors) are generally required to make any capital contribution to FIEs in a foreign currency in accordance with the terms set out in the relevant joint venture contracts and/or articles of association as approved by the relevant authorities. FIEs or any other relevant PRC parties are also generally required to make capital item payments, including proceeds from liquidation, transfer of shares and reduction of capital to foreign investors, in a foreign currency.

Increasingly, however, PRC authorities are willing to permit cross-border flows of RMB for capital account items on a case-by-case basis. In January 2011, the PBOC announced a pilot program that will allow certain qualified PRC companies to make outbound direct investments in RMB, and repatriate profits from such offshore investments in RMB as well, so long as the company has obtained approval of the investment from the relevant PRC authorities and has registered the transaction with SAFE. In addition, PRC authorities may permit a foreign entity to make capital contributions to an FIE with RMB lawfully obtained by it outside the PRC on a trial basis.

Again, to the extent that an offshore entity in an Outbound Investment Vehicle structure has a use for RMB outside of the PRC (or a legitimate means of repatriating the funds), offshore investment in RMB may be an attractive option to address foreign exchange risk. In the opposite direction, to the extent an offshore investor in an Offshore Fund or an Offshore Sponsor has an accumulated pool of RMB outside of the PRC, they may wish to use that RMB as all or part of their capital contribution. In both cases, however, additional approvals will be required.
3.3 Securities and Futures Market Regulatory Framework

The China Securities and Regulatory Commission (CSRC) is the main regulator of the PRC’s securities and futures market. It is also responsible for the approval and regulation of fund management companies and domestic securities investment funds. The CSRC also reviews and approves overseas applicants for Qualified Foreign Institutional Investor (QFII) securities investment licenses and grants QDII status to fund management companies and other securities institutions to make investments overseas.

Under the current regulatory regime prescribed for fund management companies by the CSRC, such an entity must submit certain documents to the CSRC when raising capital for a fund. These documents include a draft fund contract, a draft fund custodian agreement, a draft prospectus, documents evidencing the qualifications of the fund management company and the fund custodian, and certain financial reports of the fund management company. A foreign investor seeking to raise private investment capital in the PRC should be prepared to satisfy a similar approval process. Lastly, there is thus far little official guidance regarding the process of offering a domestic fund product, and the investor protection standards that the CSRC may impose on offering fund investments to any class of investor, whether sophisticated, onshore, offshore or otherwise. The domestic fund disclosure documents that we have reviewed are skeletal, if that. Nonetheless, even in the absence of specific legal or regulatory disclosure standards, there are a sufficient number of general legal bases under PRC contract and civil law to provide the basis for claims by fund investors were a fund or investment to go bad. Therefore, in terms of disclosure standards in an offering memorandum, it would be prudent to adhere to market standards when making disclosures for a private fund.

Securities regulations with respect to marketing and sale restrictions in the context of a private offering as they would apply to PRC Fund Products are still developing. Although the relevant authorities have developed more detailed regulations for products like QDII and QFII, rules in other areas such as RMB Funds largely remain vague. For the most part, offering and selling interests in the limited partnerships forming these RMB Funds is only limited to a certain total number of investors, rather than imposing a clear set of criteria (equivalent to Reg D in the U.S.) on these investors.

3.4 Inbound and Outbound Direct Investments Regulatory Framework

The Ministry of Commerce (MOFCOM) regulates foreign direct investments into the PRC and, with its predecessor agencies, has been the main approval authority for FIEs for decades. Except with respect to certain industries where other regulators take the lead (eg, foreign investment in the banking or insurance sectors), approval from MOFCOM is required for setting up FIEs, including joint ventures (JVs), wholly foreign-owned enterprises (WFOEs) and foreign-invested venture capital investment enterprises (FIVCIEs). In addition, MOFCOM is also responsible for the regulation of the PRC’s outbound direct investments.
Implemented by the National Development and Reform Commission (NDRC) and observed by MOFCOM as the approval authority for foreign direct investments, the Catalogue Guiding Foreign Investment in Industry (the Foreign Investment Catalogue) is used to regulate foreign investments in the PRC by dividing foreign investments into three categories: encouraged, restricted, and prohibited. FIEs in encouraged industries are often permitted to establish WFOEs and are generally eligible for certain investment incentives. Foreign investment in industries under the restricted category may be limited to equity or contractual JVs, in some cases, with the local partner being the majority shareholders and are subject to higher level governmental approvals. Industries in the prohibited category are closed to foreign investments. Industries not listed in the Foreign Investment Catalogue are generally open to foreign investment and deemed permitted unless specifically barred by other PRC regulations. The catalogue also sets limitations on foreign ownership on specific types of investments.

The Foreign Investments Catalogue restricts the type and scope of any foreign direct investment that an Offshore Fund may make. We understand that RMB Funds with foreign investors (either directly or indirectly through PRC established SPVs) are likely to be restricted in their investments as if the RMB Fund were an FIE. These restrictions would apply if even the only investment of foreign capital in an RMB Fund is by its Offshore Sponsor controlled general partner. This is an issue still being addressed by the regulators, but there may be certain structural options available to resolve the issue and these are addressed in Section 5 below.

3.5 The QDII Regulatory Framework

The QDII regime allows for domestic institutional investors to invest offshore in various financial products. There is currently no unified QDII regime with each of the relevant regulators for the permitted categories of QDII setting the relevant regulatory framework. The categories of QDIIs are qualified commercial banks (under the supervision of the Central Banking Regulatory Commission (CBRC)), qualified trust and investment companies (supervised by the CBRC), qualified fund management and other securities institutions (supervised by the CSRC) and qualified insurance companies (supervised by the China Insurance Regulatory Commission (CIRC)).

Each of the different regulators has prescribed different investment scope and investor qualifications applicable to each category of QDII. For example, the overseas investment scope of qualified insurance companies is much narrower than that of qualified commercial banks. Likewise, CBRC imposes a “sophisticated investor” requirement for purchasers of QDII products marketed by qualified commercial banks but there is no corresponding requirement for retail purchasers of QDII products marketed by qualified securities institutions.
3.6 RMB Funds General Regulatory Framework

(a) Foreign Partnership Measures

The State Administration for Industry and Commerce (SAIC) is responsible for drafting and issuing new regulations concerning business enterprise (corporate and partnership entities, among others) formation and on-going corporate oversight and recently issued the Foreign Partnership Measures. Prior to the promulgation of these measures, the partnership laws in the PRC did not allow foreign investors to directly invest in PRC partnerships. As such, offshore private investment funds traditionally invested in an RMB Fund through a PRC subsidiary (either in the form of a JV or a WFOE), which would act as the general partner to the RMB Fund’s limited partnership vehicle. However, in this structure there is a limit to the amount of capital injection by the offshore investor in the RMB Fund due to foreign exchange restrictions.

The Foreign Partnership Measures now generally allow a foreign investor to set up a foreign-invested partnership (FIP) and to act as a general partner or a limited partner of such partnership. While these measures clearly allow foreign investors to directly establish partnerships in the PRC, there remains uncertainty about the applicable framework for the establishment of private investment funds in the PRC. In fact, the current wording of the Foreign Partnership Measures seems to suggest that there will be detailed rules to be implemented in the future.

(b) NDRC Regulations

In January 2011, the NDRC issued the Circular on Further Regulating the Development and the Administration on Filings of Equity Investment Enterprises in Pilot Areas (Circular No. 253) (the NDRC Circular) which generally requires each private investment fund (whether domestic or foreign-invested) established in specified local jurisdictions (including Beijing, Tianjin and Shanghai, which are discussed below) with commitments equal to or greater than RMB 500 million to file with the NDRC. In March 2011, the NDRC Circular was supplemented by additional implementing guidelines. These regulations set out general procedural details of the filing, as well as a list of documents that need to be submitted in connection with each filing. Once filed with the NDRC, a fund is also required to make certain periodic disclosures to the NDRC, including submitting its annual audited financial statements and notice of certain material events (including modification of fund documentation, changes in the capital of a fund or its fund manager, changes in key management or dissolution).

In addition to mandating these filing requirements, the NDRC Circular also sets out certain best practice principles for RMB Funds and fund managers in areas such as disclosure, recommended provisions for private placement memoranda, the form and content of partnership agreements and other constitutional documents of an RMB Fund and its fund manager and a suggested minimal capital commitment from investors of RMB 10 million. The NDRC Circular and its implementing guidelines
also provide further guidance on fund raising, and prohibit public offerings of interests in RMB Funds through the internet or other forms of general solicitation. In addition, the NDRC Circular restricts investments of registered funds to non-public equity investments. The NDRC Circular also requires an RMB Fund to appoint a qualified custodian to hold its assets if its fund manager is foreign-invested.

The NDRC Circular is the first major step, at a national level, by the PRC authorities to regulate and standardize the asset management industry in the PRC. In certain respects, the NDRC Circular is a response to the various (and sometimes conflicting) regimes that were being implemented at the local levels (as discussed in more detail in Section 3.6(c) below). The goal of the NDRC Circular and its implementing guidelines is to increase transparency, prevent abuses and create a more uniform system for the establishment and monitoring of RMB Funds and fund managers. Despite this, local jurisdictions continue to issue their own regulations in this sector and, although the ultimate goal may be to centralize regulations at the national level, there still is a lot of activity at the local level.

(c) Local Regulations

In addition to the national laws implemented through SAIC and the NDRC, local governments have issued their own rules to allow FIEs to act as fund managers, and for the establishment of funds in their jurisdictions. Although several municipalities have issued such rules, Beijing, Shanghai and Tianjin have been at the forefront of these developments. As with many previous major commercial law developments that have taken place in the PRC over the last few decades, legal reform tends to take root at the local and regional level before advancing to the national level. The local markets provide an opportunity to test certain measures on a small scale before introducing them at the national level, but are also used by the local regions as a means to incentivize growth and investment in specific, local jurisdictions. This can be used to the advantage of foreign asset managers as the local administrations will be in competition with one another to a certain degree to attract business and sponsors to their region.

Set forth below is a brief description of the regulations in Beijing, Shanghai and Tianjin as the leaders in this area. These rules are all generally very similar, and therefore any decision by an Offshore Sponsor as to which jurisdiction to establish an RMB Fund will be informed by several outside factors, including: (i) the region where the targeted investments of the fund are likely to be; (ii) the quality of the local partners in each municipality for purposes of assisting the Offshore Sponsor in sourcing investments and PRC investor capital; and (iii) any additional incentives that the local governments may be able to provide to an Offshore Sponsor (for example, tax incentives, ease of regulatory oversight or further loosening of foreign exchange or investment restrictions). There are various other local governments in the PRC that have enacted regulations similar to those in Beijing, Shanghai and Tianjin. Upon request we can provide you with a supplement chart that provides a more complete comparison of the rules as in effect in Beijing, Shanghai, Tianjin, Chongqing, Liaoning and Shenzhen.

(i) Beijing Rules
On January 4, 2010 the Beijing Municipality issued the *Tentative Measures for the Establishment of Foreign Invested Equity Fund Management Enterprises in Beijing* (the *Beijing Rules*) to encourage the participation of foreign private investment fund managers in the development of the private equity industry in Beijing. These measures are only applicable within the Zhongguancun National Innovation Model Park for a period of three years from January 1, 2010. The salient provisions of the Beijing Rules provide that:

(a) A foreign investor may set up a foreign-invested private investment fund management enterprise (FM FIE) in the legal form of either a Sino-foreign equity JV or in the form of a WFOE;

(b) An FM FIE shall have an equity capital of at least USD2m;

(c) An FM FIE may be eligible for the same policy support as is available for a domestic private investment fund in Beijing; and

(d) An FM FIE may have access to capital support from the Beijing Municipal Private Equity Development Fund, provided that it satisfies the industry policies of the central government and Beijing Municipality and has an outstanding management team.

(ii) Shanghai Rules

On December 24, 2010, Shanghai promulgated its *Implementing Measures on the Pilot Program for Foreign-Invested Equity Investment Enterprises* (the *Shanghai Rules*), which, for the first time, clearly outlines the requirements and procedures for setting up an FIE RMB Fund (including an FIE-sponsored RMB Fund) and an FIE fund management company in Shanghai. Under these measures, an FIE RMB Fund or an FIE fund management company qualified under the pilot program (a Pilot RMB Fund and a Pilot Management Company) is entitled to enjoy certain preferential treatment, the most significant of which is the long awaited relaxation of the foreign currency conversion regime for these entities. Specifically, a Pilot Management Company is allowed to use its foreign currency to make a contribution to an RMB Fund it establishes, provided that such contribution does not exceed 5% of the fund’s size. The foreign currency capital can be converted into RMB for downstream investment in onshore entities. Additionally, it appears that foreign limited partners are now permitted to invest directly in a Pilot RMB Fund as a qualified foreign limited partner (a QFLP) and that Pilot RMB Funds will be permitted to convert the foreign capital currency of QFLPs into RMB for downstream investment in onshore entities. There are no specific limits on the amount of foreign currency that can be converted by foreign limited partners, and the limits for each RMB Fund are expected to be decided on a case-by-case basis. It has been reported that, to date, Shanghai has granted five foreign-invested funds (namely, Blackstone, Carlyle-Fosun, DT Capital, Hony Capital and 3i Group) QFLP status.

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4. This is a fund of funds established by the Beijing Government in 2009 to promote and invest in funds such as industrial investment funds, venture capital investment funds and Sino-foreign co-operative funds incorporated in Beijing.
(iii) Tianjin Rules

Tianjin has been the pioneer in the local regulation of private investment funds and issued the *Trial Measures on the Registration and Filing of Equity Investment Funds and Equity Investment Fund Management Companies* (the Original Tianjin Rules) on November 17, 2008. On July 11, 2011, however, several agencies within Tianjin jointly issued the *Administration Measures on Tianjin Equity Investment Enterprises and Equity Investment Management Institutions* on July 11, 2011 (the New Tianjin Rules) that became effective on September 1, 2011 and repealed and replaced the Original Tianjin Rules. The New Tianjin Rules reset the requirements and procedures for the setting up of RMB Funds and fund management companies in Tianjin. The New Tianjin Rules apply to both purely domestic funds and foreign-invested funds. Some of the key aspects of the rules are:

(a) Higher minimum capital requirement

The New Tianjin Rules lift the minimum registered capital requirement of a Tianjin based RMB Fund from the previous RMB 10 million to RMB 100 million. The rules also set out the minimum initial paid-up capital requirement for RMB Funds and fund management companies at: (a) RMB 20 million for RMB Funds in company form and RMB 10 million for RMB Funds in partnership form, and (b) RMB 2 million for fund management companies.

(b) Districts outside of the Tianjin Binhai New Area need accreditation to register RMB Funds and fund management companies

The New Tianjin Rules provide that all RMB Funds and fund management companies established in Tianjin should in principle be registered in the Tianjin Binhai New Area. Other districts or counties in Tianjin have to meet certain requirements and get accreditation from the Tianjin Industry (Equity) Investment Fund Development and Filing Administration Office (the Tianjin Filing Office) before they can become an accredited place of registration for RMB Funds or fund management companies. Therefore, sponsors should be mindful of whether the local authorities that are dealing with are accredited, or are likely to become accredited.

(c) Compulsory custodian bank

Every RMB Fund in Tianjin must enter into a custodian agreement with a qualified commercial bank to hold the fund’s assets. This broadens requirements under the NDRC Circular that would only require foreign-invested RMB Funds to appoint a qualified custodian to hold an RMB Fund’s assets. The New Tianjin Rules also impose additional responsibilities on the custodian banks, including conducting due diligence on an RMB Fund before engagement and verifying the use of capital raised by the RMB Fund.
(d) New filing obligations

The New Tianjin Rules impose new filing obligations at various levels. Under the NDRC Circular, only RMB Funds with a size of RMB 500 million or above are obliged to file with the NDRC. The New Tianjin Rules, however, require RMB Funds with capital contribution of RMB 100 million or above, together with their fund management companies, to file with the Tianjin and/or central NDRC. Since the New Tianjin Rules require RMB Funds established in Tianjin to have capital contribution of no less than RMB 100 million, this requirement essentially means all RMB Funds established in Tianjin (regardless of size) must file with Tianjin and/or central NDRC, and any RMB Fund or its fund management company failing to file will be labeled as “circumventing filing supervision” on the NDRC website. In addition to the RMB Funds and fund management companies, custodian banks and other service providers to RMB Funds, such as accounting firms and law firms, are also subject to filing with the Tianjin Filing Office.

Quite a few of the requirements in the New Tianjin Rules, such as the additional responsibilities of the custodian banks and the new filing obligations imposed on intermediaries and custodian banks, were not mentioned in the NDRC Circular and are being seen for the first time in Tianjin. The strengthened supervision from the Tianjin authorities reflects their intent to crack down on illegal fund-raising and other financing activities in the name of private equity and to promote the healthy development of the local private equity industry. As one of the earlier jurisdictions to initially issue rules in the private investment fund sector, the changes recently made in Tianjin may indicate that similar changes are to come in other local jurisdictions (such as Beijing, Shanghai or Chongqing) or at the NDRC level.
4. Offshore investments into the PRC through an Offshore Fund

4.1 Introduction

Offshore Sponsors have been capitalizing on the immense opportunities that the PRC market provides through the formation of funds outside of the PRC that target exclusively or primarily investment in the PRC. This section describes the manner in which these investments may be made. An Offshore Fund may invest in the PRC through the following regimes:

(a) Foreign direct investment regime (FDI) – this is the traditional route which allows foreign investors to make direct equity investments in the PRC;

(b) QFII – this allows foreign investors to place funds to purchase A-shares via domestic securities companies in the PRC capital market where capital accounts are not fully opened to the global market; and

(c) Contractual arrangements – this could be used to allow foreign investors to make investments offshore with the return on such investment being linked to investment activities carried out by an onshore asset manager in the PRC.

Below is a brief description of each method of investment, including structure, approvals required, certain regulatory implications and an analysis of the advantages and disadvantages of each.

4.2 Pooled FDI Model

(a) Description

This route of investment allows offshore investors to pool their funds offshore in a master fund that, in turn, invests in one or more special purpose vehicles to make equity investments in private equity-type or alternative class fund investments in the PRC. This is the model that has to date been the most heavily relied upon by Offshore Funds targeting onshore PRC real estate, infrastructure and other private equity investments.

The foreign direct investment is made through either a sino-foreign JV or a WFOE. The choice of the form of the investment vehicle largely depends on the purpose of investment and other commercial, regulatory and tax considerations. A WFOE will offer the foreign investor the greatest level of control over, and the best protection of, its investment. But by not involving a PRC partner in a WFOE, a foreign investor will not benefit from the PRC party's expertise, market share, local experience and contacts.

The typical structure of an offshore fund involves the formation of at least one master fund vehicle offshore, with feeder entities as required by the tax and other regulatory circumstances of the expected investor base. The master fund then forms individual holding companies offshore, which in turn hold interests in each onshore portfolio company. The holding companies provide an extra layer of flexibility for financing and exit alternatives. As mentioned above, the onshore portfolio companies will generally
either be organized as a WFOE or JV with a local partner, depending on the industry involved and the requirements of the particular project. The investment advisor and general partner are both offshore in this structure, and therefore payment of the management fees and carried interest are generally not impacted by PRC regulations or foreign currency controls. The basic indicative structure of an offshore foreign fund formed primarily for onshore direct investment is illustrated below:

(b) Regulatory approvals

The PRC regulatory approvals for an Offshore Fund geared to onshore direct investment are required mainly at the project level. That is, the Offshore Fund will have to seek approval for each and every investment it makes in the PRC. There are four general approvals with which an Offshore Fund engaged in onshore investments must concern itself: (i) project approval; (ii) corporate formation; (iii) corporate registration; and (iv) foreign exchange approvals. There may also be other industry or activity-specific approvals.

The project approval evidences satisfaction of evaluation of the project on an overall macroeconomic basis by the National Development and Reform Commission (NDRC) (or its local counterparts), in consultation with other relevant regulators and authorities. Corporate formation is complete upon receipt of MOFCOM (or its local counterparts) approval establishing the FIE. Corporate registration
culminates in issuance of the FIE’s business license which evidences corporate and business registration of the FIE with the SAIC (or its local counterparts). Finally, the fund will need to secure SAFE approval to ensure the availability, convertibility and remitability of foreign exchange to be used by the onshore fund investment vehicles.

The appropriate level of approval authorities will depend on the category that the investment industry falls into and the total investment amount.

(c) Scope of Investments

This structure achieves a pooling of the usual FDI projects that may be undertaken in the PRC. As such, the scope of fund investments will mainly be informed by and subject to the Foreign Investment Catalogue and its encouraged, restricted and prohibited categories. Regulations in certain sectors may also impose certain limitations that would be relevant to structuring an onshore fund investment vehicle and/or its commercial terms.

(d) Foreign Exchange Risks

The Offshore Fund will need to secure SAFE approval for the conversion of foreign currency into RMB to capitalize each FIE invested by the fund and to use such capitalization for any purchase of equity investment by each such FIE in the PRC.

Once MOFCOM and SAFE approves the inbound investment, the remittance of profits and dividends after the payment of taxes offshore will not require the prior approval of SAFE. The remittance is usually done through an intermediary bank which converts the RMB into foreign currencies to be remitted to the Offshore Fund. However, given that remittance can only be made after the payment of taxes, and an audited report for the relevant financial year is a document that must be submitted to the bank to process the remittance, there is a substantial time lag for the payment of final dividends and the payment of interim dividends is virtually not possible. This may be an issue for Offshore Funds that aim to provide periodic quarterly or half-yearly returns to their investors.

4.3 QFII Inbound Model

(a) Description

Offshore Sponsors desiring to offer investor returns off the back of onshore PRC equities will be more limited in the fund structures available. Historically, the A-share market (pure domestic PRC equities) in the PRC was closed to foreign investors. The QFII measures promulgated in November 2002 (and later amended in September 2006) allow qualified foreign institutions to invest in the PRC’s A-share market under certain foreign exchange flow and disclosure requirements. Institutions that may apply for QFII status include fund management companies, insurance companies, securities firms and commercial banks with the qualifications prescribed by the CSRC and other relevant regulators. Upon the approval of CSRC, a QFII will be granted an investment quota in a minimum amount of
USD20m and maximum amount of USD1bn by SAFE. After selecting a PRC custodian bank and one or two local brokers, a QFII can place orders to buy and sell stocks in the PRC’s A-share market. According to the QFII Securities Investment Management Method announced by CSRC and the PBOC, the investment scope of QFII includes: A-share stock listed in securities exchanges, treasury bonds, convertible bonds, corporate bonds, warrants and other financial products approved by CSRC.

In order to capitalize on QFII opportunities, an Offshore Sponsor must engineer a rather complex fund structure comprised of a qualifying QFII entity, custodian banks, securities firms, insurance companies and others. As depicted by the illustration below, the structure involves the offshore QFII entity appointing an onshore custodian bank and securities firms, and the opening of an onshore securities account with the CSDCC. The securities firms will undertake the trading activities on behalf of the QFII, while the custodian bank manages the foreign currency and RMB accounts. Offshore investors in the QFII could be comprised of commercial banks, funds, insurance companies, securities firms and other investors.

(b) Regulatory Approvals

The inbound QFII model implicates two broad areas of regulatory approval: (i) CSRC approval for QFII status and (ii) SAFE approval of the QFII’s investment quotas and the inward and outward remittance of funds.
(c) Scope of investment

The QFII inbound model would only be appropriate for investors seeking appreciation through domestic PRC listed securities, because QFIIs may only invest in RMB-denominated financial instruments, including shares, bonds and warrants traded on the PRC stock exchanges, securities investment funds and other instruments permitted by CSRC. In addition to the limitations on instruments, share investment by QFIIs must comply with shareholding ceilings as set out by CSRC. The shares held by one QFII in one listed company must not exceed 10% of the total shares of such listed company and the shares held by all QFIIs in one listed company must not exceed 20% of the total shares of that listed company. There are also corresponding dollar amount caps of USD1bn for individual QFIIs, and USD30bn for QFIIs combined.

A three-month lock-up period is applicable to certain types of QFIIs such as pension funds, insurance funds, mutual funds, charity funds, endowment funds, government and monetary authorities and open-ended PRC funds. A one-year lock-up period is applicable to all other QFIIs.

(d) Foreign Exchange risks

QFIIs must remit inbound investment principal within six months of the approval of its investment quota. It may not remit quota outside the six-month period without SAFE approval. A QFII may instruct its custodian bank to directly convert foreign currency into RMB required for investment and transfer such funds to an RMB special account ten business days in advance of the actual investment in accordance with the investment plan submitted in its application for investment quota. Under the current regime, there is no express provision regulating remittance offshore of any investment profits or principal for QFIIs other than for open ended PRC funds. As such any outward remittance of principal or profit by the QFII (other than by open-ended PRC funds) will be subject to approval by SAFE.

An open-ended PRC fund (ie, an open-ended securities investment fund that is publicly raised outside the PRC and invests at least 70% of its assets in the PRC) may enjoy monthly liquidity and may remit money into or out of the PRC based on the net redemptions of subscriptions of the fund on a monthly basis, subject to certain filing requirements (where the amount to be remitted is equal to or less than USD50m) or approval (where the amount exceeds USD50m) from SAFE.

4.4 Contractual Arrangements

(a) Description

Another potential avenue through which offshore investors could pool their resources to make investments in the PRC is through a contractual arrangement between an Offshore Sponsor and an onshore entity. The offshore investors would pool their capital in an offshore master fund that would enter into a contractual investment arrangement with an onshore entity that is qualified to invest in the
type and class of investments that the offshore investors are interested in. The Offshore Fund would then place its capital with an affiliate or branch of the onshore partner, and those funds would be held in one or more secured accounts. The onshore entity will then use its own RMB Funds onshore in an amount equivalent to the amount of offshore capital raised, to make investments in the PRC. The onshore entity enters into a management or services contract with its offshore affiliate or branch, and as gains are made by the onshore entity they can be remitted offshore as a management or service fee pursuant to such contract. The offshore affiliate or agent in turn will distribute investment gains to the offshore master fund, and then ultimately to the offshore investors. If there is any loss in the onshore investments, the offshore agent or affiliate will, through intra-company arrangements or transfers, remit a portion of the offshore capital it collected from the investors to the onshore entity. At the end of the investment term, any investment funds left at the offshore agent/affiliate will be returned to the investors. In this structure, the investment advisor and general partner are both offshore, and therefore payment of the management fees and carried interest are generally not impacted by PRC regulations or foreign currency controls.

Following is a chart illustrating the basic structure of this contractual arrangement as described above:
There are, however, certain limitations and concerns associated with this structure. First, it will require the onshore entity to have sufficient capital in RMB equal to the total amount raised offshore so that it can make the onshore investments without the need to remit the offshore capital onshore. Second, the onshore entity must have an affiliate or branch offshore which can collect offshore investment funds from investors. Third, the offshore investors will bear additional creditor and insolvency risk with respect to the offshore branch or affiliate that holds the investment funds during the term of the investment. Finally, the offshore investors may not be able to enforce their rights against the onshore entities directly because this structure may not be recognized by the PRC regulators as within the scope of the PRC foreign exchange regulations.

(b) Scope of investments

Since a PRC entity will be making the investments directly, those investments will not be subject to the Foreign Investment Catalogue or other general restrictions on foreign investment in the PRC. There is, however, a residual risk that the authorities may deem the contractual arrangements as a scheme to avoid foreign investment restrictions in the PRC.

SAFE approval would be required for the remittance of management fees by the onshore contracting party. Depending upon the size of payments under this contract, the bank processing the transfer may have authority to approve the remittance of funds without seeking SAFE approval.

(c) Regulatory approvals

Subject to the SAFE approval required to process the management fee payment, no approvals in the PRC would generally be required for the Offshore Fund investor, or for the investment by the onshore entity in actual investments. However, this structure may be viewed by the relevant PRC authorities as a way to circumvent required approvals, and therefore may still draw scrutiny. In addition, an in-depth tax analysis of the structure based on the domicile of the offshore entities would need to be completed before pursuing this structure.

(d) Contractual risks

As this structure is wholly reliant on contractual rights, the investors have only indirect beneficial interests in the onshore investments. Therefore, the offshore investors’ rights will be subject to various risks at the onshore asset and holding company level, including intervening creditor and bankruptcy risks. The offshore investors will not have direct claims of ownership with respect to the onshore assets and, other than through contractual means, will not be able to prevent the onshore entities from incurring debt, selling off assets or otherwise bringing in new equity investors. All of those activities could decrease the value of the assets indirectly held by the offshore investors, or result in a total loss of such assets or the ultimate bankruptcy of the onshore entities.
5. Raising funds and investing in the PRC – RMB Funds

5.1 Introduction

This section discusses how an Offshore Sponsor, using onshore capital, offshore capital or both, can establish an RMB Fund to make investments in the PRC. The number of RMB Funds, and their interest to Offshore Sponsors, have increased greatly over the past few years. RMB Funds are now outperforming many foreign funds in the PRC market and raising capital at a much greater pace than foreign funds investing in the PRC. The growing popularity of RMB Funds among offshore private equity investors can be attributable to several factors, including:

– the access to onshore capital and local deal flow;
– increased interest of onshore investors in private equity investments and alternative class investments;
– the potential advantage of investment execution speed compared to Offshore Funds which generally require approvals for each investment made; and
– the generally favorable climate that the PRC government has created for private equity investments in the PRC.

RMB Funds can be divided into the following two general categories: (i) domestic RMB Funds managed by domestic private equity firms in the PRC and (ii) RMB Funds raised by Offshore Sponsors (a Foreign Invested RMB Fund) with or without participation by foreign limited partners. It is this second category that interests most offshore asset managers looking to establish RMB Funds in the PRC and therefore the focus of our discussion here. The structural options for a Foreign Invested RMB Fund as discussed in greater detail are:

(a) a domestic partnership formed under local rules (including a local partnership with an FIE general partner);

(b) an unincorporated/incorporated FIVCIE;

(c) a pure domestic limited liability partnership with an onshore nominee general partner; and

(d) a limited liability partnership with an offshore general partner under the Foreign Partnership Measures.
It is currently not possible for an Offshore Sponsor to raise capital directly in the PRC, whether in RMB or in a foreign currency, without utilizing one of the structures set out above. Likewise, due to foreign exchange restrictions, RMB Funds are only permitted to raise capital in RMB and not in foreign currencies in the PRC. However, as discussed, Shanghai has announced rules that allow Pilot RMB Funds to convert foreign currency capital contributed by an FIE general partner and both Shanghai and Chongqing permit foreign limited partners to convert foreign currencies into RMB as QFLPs for purposes of making investments in onshore entities. Other jurisdictions are expected to follow this lead. While the current foreign exchange regulations permit FIEs conducting business in the PRC to remit their after-tax profit out of the PRC to their foreign shareholders, the current foreign exchange framework does not clearly specify how returns from an RMB Fund may be repatriated to its foreign investors.

In addition, under the current PRC legislative and regulatory regime, there is no complete legal framework to govern foreign investment in private investment funds in the PRC. The PRC Partnership Law and the Foreign Partnership Measures do not yet provide full clarity and suggest that more detailed regulations will be implemented over time. While certain local governments (for example Tianjin, Beijing and Shanghai) have adopted pilot regulations which apply to their municipality to boost the development of private investment funds, the local regulations are not detailed enough to cover all aspects of investments in private investment funds and are prone to subsequent modification and discretionary interpretation where the regulations are unclear. The recent developments in available partnership structures may finally offer a vehicle that will permit an investment fund to be structured by sponsors in a more flexible manner, from a financial, contractual and operational perspective.
5.2 Domestic Partnership with an Onshore General Partner

(a) Description

To date, this appears to be the most common structure through which Offshore Sponsors are establishing RMB Funds, and has been the structure of choice for large Offshore Sponsors such as Blackstone and Softbank. This structure involves the Offshore Sponsor setting up (directly or indirectly) a PRC subsidiary with a whole or partial foreign interest (which may be a WFOE a JV or an FIE-reinvested company) to act as the general partner of the RMB Fund. The Offshore Sponsor would also set up a wholly owned onshore management company to act as the investment adviser to the RMB Fund. Shanghai, Beijing and Tianjin have each implemented local rules which permit a foreign controlled entity to provide investment advisory services to an RMB Fund. PRC investors or offshore investors could then participate in the RMB Fund as limited partners, and the RMB Fund would invest directly in portfolio companies.

The following is a diagram illustrating the basic structure:
As described in Section 3.6(c)(ii) with respect to Shanghai, as well as Chongqing, rules have been issued that explicitly permit foreign investors to participate in an RMB Fund as QFLPs. Foreign investors would be permitted to directly invest in and fund capital contributions in a foreign currency into an RMB Fund, which can be converted into RMB for future investment in onshore entities. Although detailed rules have not yet been established regarding remittance of returns to foreign investors participating in an RMB Fund, all indications are that these returns will be convertible back into foreign currency and remitted out of the PRC as long as the returns are in accordance with the RMB Fund documentation, as approved by the relevant regulators. This would include remittance to the general partner of its carried interest profits from the RMB Fund.

Despite potential uncertainty, it seems that an RMB Fund with an FIE general partner will be subject to the Foreign Investment Catalogue and other restrictions applicable to foreign investment in the PRC. This, therefore, removes one of the primary incentives of establishing an RMB Fund and may discourage domestic PRC investors from participating in an RMB Fund that is controlled by an FIE general partner. Although there is some evidence (as discussed below) that an investment in foreign currency by an FIE general partner (capped at 5% of the overall fund size) will not “taint” the RMB Fund, the market has been evolving in two ways to address this issue. First, fund sponsors have been raising capital for RMB Funds only from onshore PRC investors in order to avoid any tainting by foreign investors. Second, the general partner is typically not formed as a WFOE of the Offshore Sponsor. Instead, the general partner will either be formed: (i) by a local asset management partner or the investment arm of the municipality in which the RMB Fund is being established (eg, Shanghai or Beijing) or (ii) as a JV in partnership with such an entity. The onshore management company can remain a direct subsidiary of the Offshore Sponsor as that does not appear to create issues for the fund under the Foreign Investment Catalogue. The Offshore Sponsor then enters into contractual arrangements with its onshore partner in order to share in the benefits (ie, the management fee and the carried interest return) as if the Offshore Sponsor were participating in the general partner.
(b) Regulatory Approvals

In order to establish all the onshore PRC entities required for the RMB Fund (the management company and, to the extent the general partner is an FIE and/or foreign investors are admitted to the fund, the general partner and the fund partnership itself), MOFCOM and local SAIC approval will be required because these would be considered regulated FIEs. If the total investment amount is less than USD300m, then approval from only the provincial level of MOFCOM is required. If investment amounts exceed this, then central MOFCOM approval is required. Assuming that the general partner is structured as discussed in clause (a) above, and no foreign limited partners participate in the fund, then the RMB Fund should be considered a purely domestic entity and will not be subject to MOFCOM approval. Similarly, in this case, the investments of the RMB Fund itself will not be subject to the Foreign Investment Catalogue or to any other regulatory approvals that would be required by foreign investors in the PRC. However, if the general partner is an FIE there is a chance that the RMB Fund will be treated as an FIE and its downstream investment will be subject to the FIE reinvestment restrictions. There is some anecdotal evidence that suggests that if the only foreign capital in the RMB Fund comes from the FIE general partner (capped at 5% of the overall fund size), and there are no foreign limited partners in the RMB Fund, then the fund will be treated as purely domestic for purposes of making its investments onshore. However, such treatment would need to be confirmed on a case-by-case basis for each fund. In addition, the RMB Fund (and its fund manager) will be required to register with the NDRC to the extent its commitments are equal to or greater than RMB 500 million and it otherwise fits into the criteria set forth in the NDRC circular (as discussed in 3.6(b) above) and may also be required to register with local authorities as is the case in Tianjin as described in S3.6(c)(iii) above.

(c) Capital Commitment

There is generally no prescribed minimum capital contribution by the partners. However, as described in Section 3.6, certain local rules may require minimum amounts. There is a general limit of 50 partners (including the general partner) for each RMB Fund. This requirement is likely not on a look-through basis and could potentially mean more investors with the use of feeder entities.

(d) Scope of Investments

As discussed above, if the general partner or the limited partners in the RMB Fund are comprised of foreign entities or individuals, then the RMB Fund under this structure would generally be subject to all the investment restrictions under the Foreign Investment Catalogue. In order to avoid that, sponsors have been taking the structuring steps discussed in clause (a) above, to ensure that such restrictions will not apply, and that the fund will enjoy all the benefits of a purely domestic vehicle. Also, as discussed in clause (b) above, an RMB Fund may be treated as purely domestic if the only source of foreign investment is its FIE general partner.
(e) Foreign Exchange risks

If the general partner is an FIE, SAFE Circular 142 imposes limitations on the convertibility foreign currency for investment purposes, but local regulations in this area often do vary. For instance, the Shanghai regulations generally permit a foreign-controlled general partner to directly contribute up to 5% of the fund’s aggregate size in foreign currency to the RMB Fund it establishes which is allowed to be converted into RMB for future investment in onshore entities. Similarly, foreign limited partners under the Shanghai regulations are also permitted to directly invest in foreign currency into the RMB Fund which is then allowed to be converted into RMB for future investment in onshore entities.

Payment of interim dividends and repatriation of capital for any foreign capital invested in an RMB Fund would be subject to SAFE approval. As mentioned above, although detailed rules have not yet been established regarding remittance of returns to foreign investors participating in an RMB Fund, the expectation is that these returns (including the carried interest to the general partner) will be convertible back into foreign currencies as long as the returns are in accordance with the RMB Fund documentation, as approved by the relevant regulators. For the repatriation of the management fee from the onshore management company to the Offshore Sponsor, this could be structured as a contractual service payment thereby making it a current account item and subject to only to bank processing review, and not SAFE approval.

(f) Advantages

The approval procedures for setting up an RMB Fund should be more streamlined as the fund itself is a domestic entity (assuming there are no foreign partners) and only a record filing is required. However, MOFCOM approval is still necessary for the establishment of the general partner (if it is foreign invested) and for the management company. The real advantage, however, for Offshore Sponsors, is that if structured properly, this type of vehicle will give them access to the large PRC investor base, a domestic partner with access to deal-flow and RMB Funding and the ability to make investments in the PRC without the restrictions placed on foreign investors.
5.3 Foreign Invested Venture Capital Investment Enterprise (FIVCIE)

(a) Description

The 2003 FIVCIE Rules were one of the first in the PRC to explicitly address private equity investing, and generally allow for an onshore fund structure which closely resembles a typical offshore private investment fund structure. Under these rules, foreign investors are permitted to be investors in the FIVCIE which, prior to the implementation of the Foreign Partnership Measures, was the only way a foreign investor could directly participate in an RMB Fund.

The scope of investment that a FIVCIE is permitted to make, however, is limited to unlisted “high and new technology” companies. This severely limits the investments that an RMB Fund under the FIVCIE rules may make, and in most cases, this limited scope of investments will fall outside the investment objectives of most foreign private equity investors. There is no clear definition of what is intended by high and new technology enterprises, which means that this is likely to be subject to discretionary interpretation by the relevant authorities.

A FIVCIE can either be unincorporated or incorporated. An incorporated FIVCIE has a statutory reserve requirement which may result in trapped cash at the FIVCIE level. A FIVCIE is required to have at least one “Requisite Investor” (akin to a general partner) who must meet certain qualification requirements. In an unincorporated FIVCIE, the Requisite Investor has unlimited liability. Other than the Requisite Investor, a FIVCIE must have at least one other investor (limited partner) and the number of investors must not exceed 50. The term of a FIVCIE is twelve years or less and extensions are subject to regulatory approvals.
In addition, while the regulations appear to allow a FIVCIE, as an investment vehicle, to take advantage of a relatively straightforward and speedy regulatory approval process for investing in PRC companies within the prescribed investment scope, due to the small number of FIVCIEs formed to date, there may be a degree of uncertainty as to whether the given benefits will be realized in practice.

As illustrated below, the basic structure of a FIVCIE involves the Offshore Sponsor establishing an entity offshore to act as Requisite Investor to the FIVCIE, and also establishing an onshore management company to advise the FIVCIE in partnership with the domestic advisor. Onshore investors would then make investments into the FIVCIE, which would hold interests in portfolio companies onshore.
(b) Regulatory Approvals

Since the FIVCIE is intended to attract foreign investment and allow investment by FIEs, it is subject to approval by MOFCOM. If the total investment amount is less than USD100m, then approval from only the provincial level of MOFCOM is required. If investment amounts exceed this, then central MOFCOM approval is required. In addition, the Ministry of Science and Technology must also approve the establishment of the FIVCIE in order to ensure that its investment scope falls within the “high and new technology” enterprises requirement. A streamlined regulatory approval is available for FIVCIE funds for investing in domestic companies in the PRC. Only a record filing with local MOFCOM is required for a FIVCIE to invest in an “encouraged” or “permitted” industry, which is much less onerous than the substantive review and approval process involving the central or local MOFCOM for a foreign investor to make direct investments in the PRC. However, investments made by FIVCIEs are nonetheless subject to the restrictions in the Foreign Investment Catalogue.

(c) Capital Commitment

The commitment period of a FIVCIE is limited to five years, which is on the short side for a fund of this type but could be extended with the relevant regulatory approvals. For an unincorporated FIVCIE, the minimum aggregate committed capital is USD10m. The Requisite Investor must contribute at least 1% of the total committed capital and at least 1% of the actual paid-in capital. All other investors must contribute at least USD1m. For an incorporated FIVCIE, the minimum aggregate committed capital is USD5m. The Requisite Investor must contribute at least 30% of the total committed capital and 30% of the actual paid-in capital. All other investors must contribute at least USD1m. This minimum capital commitment from investors is on the high side, especially if the FIVCIE is aiming to attract high net worth individuals.

(d) Scope of Investments

As mentioned above, the 2003 FIVCIE Rules generally limit investments by a FIVCIE to privately held high and new technology enterprises. There is no clear definition of this in any FIVCIE related legislation, however a high-tech list was jointly published by the Ministry of Science and Technology, the Ministry of Finance and the State Administration of Taxation in April 2008. In practice, what constitutes “high and new technology” is subject to discretionary interpretation by the relevant approval authorities and it is not clear to the public whether the published list is used in determining the satisfaction of this requirement. Portfolio company investment by a FIVCIE is subject to the regulation of the Foreign Investment Catalogue. The 2003 FIVCIE Rules expressly forbid a FIVCIE from investing, directly or indirectly, in publicly traded stocks, corporate bonds and non-self use real estate. A FIVCIE may also not borrow to make investments or extend loans or guarantees, except for corporate bonds with at least one year’s maturity and convertible bonds, in each case issued by a portfolio company of the FIVCIE.
(e) Foreign Exchange Risks

Foreign investors may freely convert their foreign currencies for purposes of making capital contributions. PRC investors may only make capital contribution in RMB. A FIVCIE is exempt from the restrictions in SAFE Circular 142 and is explicitly allowed to convert foreign currency for investment purposes. Capital reduction and repatriation by an unincorporated FIVCIE meeting certain requirements does not require government approval, only advance notice, provided that there is sufficient capital remaining for investment obligations. Capital reductions for other FIVCIE entities does require prior approval. An incorporated FIVCIE, however, does have a statutory reserve requirement. For the repatriation of the management fee from the onshore management company to the Offshore Sponsor, this could be structured as a contractual service payment thereby making it a current account item and subject only to bank processing review, and not SAFE approval.

(f) Advantages

The FIVCIE structure allows an Offshore Sponsor to generally replicate the governance and economics of a traditional offshore private investment fund. This structure also allows for the creation of a “parallel fund” or a “feeder fund” structure with an onshore FIVCIE RMB Fund in the PRC and an Offshore Fund with a degree of flexibility in structuring investments and profit sharing. The onshore and Offshore Fund may achieve integrated management by the same professionals through contractual arrangements and may be treated as one fund with substantially the same investment objectives, governance and economic structure. However, due to regulatory constraints (for example, the limit on the scope of investments), the onshore and offshore funds may have to invest in different portfolio companies and thus may not be able to make parallel investments all the time.

Another major advantage of a FIVCIE structure is that it allows an FIE (whether a WFOE or a JV) to use its converted registered capital to make equity investments in the PRC which is currently not generally permitted by foreign exchange regulations.

This structure also allows for flexibility in timing of capital contributions. As in a typical private investment fund, investors in a FIVCIE need only make capital commitments at the inception of the fund. Capital contributions for an unincorporated FIVCIE can be drawn down in instalments over a five-year period, with the first 15% to be made within the first three months after the establishment of the FIVCIE.

An unincorporated FIVCIE can distribute proceeds to its foreign investors (including the carried-interest portion of the Requisite Investor's return) from the disposition of investments as they occur without waiting until the dissolution of the fund. By way of comparison, the registered capital of an FIE can only be made upon the liquidation or, disposition of interest in, or the reduction of registered capital of, the FIE which is subject to MOFCOM approval.
5.4 Domestic Partnership with an Onshore “Nominee” General Partner

(a) Description

This is another potential structure that addresses the concerns raised in Section 5.2 above regarding whether the RMB Fund will be considered domestic or foreign for purposes of the Foreign Investment Catalogue and other relevant regulations. Here, an onshore nominee is formed to act as the general partner of a purely domestic fund partnership on behalf of the Offshore Sponsor. The Offshore Sponsor establishes an onshore management company as a WFOE in order to act as investment advisor to the fund (and receive its management fees), and then enters into a contractual relationship with the PRC individuals or entities controlling the onshore nominee to receive its carried interest and any other benefits it would receive as general partner of the RMB Fund. The RMB Fund itself is formed as a purely onshore entity with domestic limited partners, and it holds its interests directly in portfolio companies. Set out below is an illustration of this structure:
There are several limitations and potential issues with this structure in practice. First, the general enforceability of the contractual arrangements between the nominee and the Offshore Sponsor are in practice uncertain, and give rise to concerns of intervening creditors and bankruptcy or other major defenses of the nominee. The regulators may decide to review this on a look-through basis and determine that it was established with the purpose of circumventing the FIE investment rules. Second, the Offshore Sponsor would also have to determine how to best fund the capital needed by the nominee in order for it to invest in the RMB Fund on its behalf within the constraints of the foreign exchange restrictions. Options for this include certain loan transactions with offshore affiliates of the nominee or further contractual arrangements. And finally, the remittance of funds to the Offshore Sponsor under its contract with the nominee would be subject to foreign exchange controls. In particular, SAFE regulations require foreign exchange payments for current account transactions to be based on bona fide and lawful transactions, and there is a risk that paying carried interest and returns on investments under the guise of contractual fees may not be deemed bona fide by the relevant authorities.

(b) Scope of Investments

The domestic RMB Fund should not be subject to the Foreign Investment Catalogue restrictions on the basis that all its partners are domestic. However, there is a risk that the authorities may “look through” the arrangements and deem the RMB Fund to be an FIE subject to the Foreign Investment Catalogue and other restrictions (including foreign currency flows) applicable to an FIE.

(c) Foreign Exchange Risks

SAFE Circular 142 restrictions do not apply to the nominee domestic general partner since it is funded by domestic partners in RMB. However, foreign exchange restrictions would apply to the flow of funds under the contractual arrangements between the nominee and the Offshore Sponsor, as well as with respect to the repatriation of the management fee by the management company offshore. In the first case, depending on the size and scope of the nominee’s payments under contract, only the bank processing the remittance may need to review the contract, and it would not be subject to SAFE approval. For the repatriation of the management fee, this can also be structured as a contractual service payment thereby making it a current account item subject to a similar streamlined process.

(d) Regulatory Approvals

The local SAIC would need to approve the establishment of the RMB Fund partnership. The onshore nominee would be registered as the general partner and the Offshore Sponsor would not appear as the beneficial owner of the partnership interests. The additional SAFE approvals would also be needed per the foregoing.

(e) Capital Commitment

The capital commitment requirements for the partners of the RMB Fund here is similar to that set out for the domestic partnership with an FIE general partner described in Section 5.2 above.
5.5 RMB Fund with a Foreign General Partner

(a) Description

The Foreign Partnership Measures which came into effect on March 1, 2010 allow a foreign entity to directly act as a general partner of a PRC partnership.

Under the Foreign Partnership Measures, foreign partners can set up a foreign-invested partnership in the PRC in three models: (i) with other foreign partners; (ii) with PRC individuals, legal persons and the other organizations registered and located in the PRC; or (iii) through participating in existing domestic partnerships. Foreign investors have the option to create a general partnership, limited liability partnership or limited partnership, but a limited liability partnership is only available for professional institutions such as law firms and accounting firms. The approval authority for this partnership structure is the local SAIC. This means that the approval process for both domestic and foreign partnerships in the PRC are streamlined under the ambit of SAIC and its local delegate. Given that it is expressly stipulated in an MOC Circular issued in February 2011 that a foreign-invested partnership that has investment as its main business shall be treated as a foreign investor, an RMB Fund with a foreign general partner will be subject to the Foreign Investment Catalogue and all other restrictions on foreign investment in the PRC.

Per the illustration below, the Offshore Sponsor would establish an offshore entity which would act directly as the general partner to the RMB Fund, which would take investments from domestic investors. The Offshore Sponsor would also establish an onshore management company to advise the fund. The RMB Fund would then hold interests in its portfolio companies.
Notwithstanding the above, we understand from certain regulatory contacts that, given new measures like the Shanghai Rules which allow for Pilot RMB Funds, a foreign entity wishing to act as a general partner may be required to establish an FIE in order to do so. This may mean that, although the Foreign Partnership Measures exist as law, the foreign general partner structure is not fully accessible in practice. For instance, we understand that certain recent RMB Funds that initially proposed to use this structure (eg, the Carlyle-Fosun JV) were eventually requested by the regulators to set up their general partner as an FIE.

(b) Scope of Investments

The Foreign Partnership Measures have only recently been implemented and the permitted scope of its investments remains largely untested. Generally, however, unless there are specific regulations (either national or local) that provide otherwise, foreign investment restrictions under the Foreign Investment Catalogue would apply to this structure.

(c) Foreign Exchange Risks

The Foreign Partnership Measures provide that cash capital contributions to a partnership by a foreign enterprise or individual should either be in freely convertible currency or legitimately obtained RMB. However, it is likely that this form of partnership would be subject to the restrictions in SAFE Circular 142 for its downstream investments. In addition, remittance of carried interest, returns on investments and return of capital to the general partner (including its carried interest) would be subject to foreign exchange restrictions and subject to SAFE approval. As mentioned above, quota regulations are expected to be issued that would address these foreign exchange issues. For the repatriation of the management fee from the onshore management company to the Offshore Sponsor, this could be structured as a contractual service payment thereby making it a current account item and subject to only to bank processing review, and not SAFE approval.

(d) Regulatory Approvals

The local SAIC would be required to approve the formation of the partnership entity in this structure. As with the other structures mentioned above, the management company would be subject to both MOFCOM (at either the provincial or national level, depending on the size) and SAIC approval. Additionally, because the fund itself will likely be deemed an FIE because it is controlled by a foreign general partner, then each of its investments will be subject to those approvals as generally set out in Section 5.2(b) above.

(e) Capital Commitment

The Foreign Partnership Measures do not stipulate a minimum capital investment threshold.
6. Outbound investments from the PRC

6.1 Introduction

The prominence of the PRC's prevailing “Go Outward” policies promoting outbound direct investment (ODI) combined with the lack of a sizeable and creditable onshore asset management industry that can service the very considerable portion of domestic wealth seeking or requiring offshore investments make outbound fund structuring and implementation an area of key importance in the PRC-related asset management area. This section discusses the legal framework governing the raising of funds within the PRC for outbound investments from the PRC. Outbound investments from the PRC are regulated by a myriad of approval authorities which includes the NDRC, MOFCOM, SAFE and where applicable, industry-specific regulators like the CBRC and the CIRC. Any fund manager looking to raise funds in the PRC for offshore investments must be aware of the limitations involved in terms of timing, approvals and foreign exchange restrictions. Outbound investments from the PRC occur in one of three principal ways, as further described below in this section:

(a) a direct outbound investment subject to regulatory approvals (a Direct Outbound Investment);
(b) the QDII regime; and
(c) contractual arrangements with an offshore entity.

The first two products, as described below in more detail, are highly limited in their scope of investment and flexibility in implementation. Therefore, although it entails certain of its own restrictions and risks as described below, the contractual arrangement between an offshore asset manager and a well-positioned, onshore institution (ie, a large bank or insurance company) may provide the best avenue for raising RMB from domestic investors and placing it in a variety of fund investments abroad.

6.2 Direct Outbound Investment

(a) Description

PRC enterprises, including RMB Funds, may make direct outbound investments through the establishment of a new overseas enterprise, the merger with or acquisition of an existing overseas enterprise or obtaining control rights or business rights of an overseas enterprise, subject to obtaining the requisite regulatory approvals. Generally, this will involve the onshore entity, on a case-by-case basis, applying with the relevant authorities as described below for the ability to convert RMB for the purposes of making an offshore acquisition or investment. These approvals are often tied to political and other policy issues and concerns, and are often reserved for state-owned enterprises, or larger private enterprises looking to invest or expand abroad with the blessing of the PRC government.

In the short-term, there is therefore a degree of uncertainty regarding the application of this process to offshore investments by RMB Funds. In particular, the regulators may not understand that the nature of outbound investments made by domestic RMB Funds is very different from that made by a PRC manufacturer to acquire a facility overseas.
Set out below in diagram form are several ways in which Direct Outbound Investment can proceed. Generally, there are three options: the first is for an RMB Fund to make a direct acquisition of a target company offshore; the second is for the RMB Fund to establish an offshore special purpose vehicle to make the offshore acquisition; and the third is for the RMB Fund to make an investment in an Offshore Fund in order to gain exposure to an asset. We also understand that steps are underway, at least at the local and provincial level, to loosen restrictions on the ability of individual PRC citizen’s to make direct investments abroad. Earlier this year, Wenzhou issued a local regulation that would have allowed these types of investments on a limited basis, but that effort was immediately suspended by the central government. Similarly, Shanghai has submitted similarly drafted regulations to the State Council for approval. If approved and implemented, these rules would open yet another avenue for capital to leave the PRC for investment offshore.
(b) Scope of Investments

Each investment is subject to the approval of the NDRC (for the approval of the investment project), SAFE (for foreign exchange clearance) and MOFCOM (approval of the commercial contracts). As mentioned above, each particular investment and circumstance will generally be made on a case-by-case basis, with preference given to the larger domestic players looking to invest or expand abroad in line with stated PRC policy initiatives. A good understanding of how the approval process works and the optimal way to cooperate with the regulators is essential to the outbound investment process, though these rules have been relaxed considerably over the past few years as ODI has become more integral to the PRC’s economic development.

(c) Foreign Exchange Risks

Organizations in the PRC may use their own foreign exchange reserves (including funds in the current account-related foreign exchange accounts and the accounts for the business capital of the FIE), foreign exchange loans taken out in the PRC in compliance with applicable regulations, foreign exchange converted from RMB or physical and intangible assets, as well as other foreign exchange assets verified and approved by SAFE or its branches to conduct ODI. Profits obtained from overseas direct investment by organizations in the PRC may also be retained overseas for further ODI. There is a foreign exchange registration and record filing system for ODI implemented by SAFE and the sources of foreign-exchange funds used for overseas investment must be stated in such registration.

(d) Regulatory Approvals

Each investment is subject to the approval of the NDRC (for the approval of the investment project which involves the review of feasibility of the project), SAFE (for foreign exchange clearance) and MOFCOM (approval of the commercial contracts). If a state-owned company is involved, the State-owned Assets Supervisory and Administration Commission must also give approval or be provided with an appropriate filing. The necessity to obtain approvals from three different regulatory authorities and in some cases, approvals from other ministries or quasi-governmental bodies where certain industries (for example, mining) are involved, may be take time and would restrict the ability of the RMB Fund to act quickly when strategic opportunities arise.
6.3 QDIIs

(a) Description

Due to foreign exchange restrictions, PRC entities and individuals are generally prohibited from investing in offshore capital markets. However, the QDII scheme permits qualified domestic institutional investors (including commercial banks, fund management companies and insurance companies) to invest in certain overseas products. This allows qualified domestic institutional investors to either use foreign currency already held by participating investors or proceeds raised from wealth management products sold to domestic individuals and institutions and convert them into foreign currency for overseas investment purposes. The QDII program also allows individual PRC investors to have access to indirect pooled investments overseas. The QDII program is designed to help address the PRC’s growing foreign exchange surplus and provides domestic institutions with the opportunity to gain greater experience in making investments overseas while providing new investment options for the emerging investor class of the PRC.

Permitted QDII participants include qualified commercial banks, qualified trust and investment companies, qualified fund management and other securities institutions and qualified insurance companies. This provides a wide base of potential investors for private investment funds seeking to raise funds in the PRC. However, in order to take advantage of this, an Offshore Sponsor will have to establish relationships with QDII participants and market their products which may take time and patience. The process will be highly competitive as offshore asset managers scramble to access PRC private equity resources to a QDII program with limited quotas. Also, qualified insurance companies and qualified fund management and other securities institution are currently not permitted to invest in private offshore fund products. Likewise, although permitted bank QDII wealth management products include investments in equities and Offshore Funds, these are currently limited to equities listed in Recognized Markets (as defined below) and public funds approved, registered or authorized by a regulator that has signed an MOU with the CSRC. This will eliminate virtually all of the standard unlisted private investment funds.
The QDII structure is in many ways the reverse of the QFII regime described above, and the chart illustrating the typical QDII structure as set out below highlights the similarities. Here, the QDII is responsible for appointing an onshore custodian bank and offshore asset manager. The onshore custodian establishes the relevant foreign currency and RMB accounts, and also appoints the offshore custodian that will enter into arrangements with offshore securities custodians and clearing houses to undertake the actual trades. The investors behind the QDII are similar to those who would invest in a QFII, and include onshore commercial banks, trust companies, funds, insurance companies, securities firms and other investors.

(b) Qualification Standards

Each category of QDII is required to meet certain qualification standards as set out by its relevant regulatory body. Commercial banks, for example, must have a sound risk management system, effective internal control systems and a clean regulatory record to allow them to apply to CBRC for QDII status. A trust and investment company must have a registered capital of no less than CNY1bn and have made profits during the preceding two years before it can be qualified as a QDII. In addition, an entity must have been approved and qualified to engage in foreign exchange business and have had experience doing so.
Each investor in a QDII bank’s wealth management product that will invest in overseas shares must make a minimum investment of CNY100,000 (or the foreign currency equivalent), and must have “corresponding experience in share investment” as evaluated by the bank and confirmed in writing by the said investor. There is no corresponding “sophisticated investor” standard applicable to purchasers of QDII products from funds management companies and other securities institutions.

(c) Scope of investments

The investment scope for a QDII differs depending on the category of QDII. Qualified commercial banks may invest in fixed-income products and derivatives as well as overseas equity markets and its structured products, but cannot invest in commodity derivatives, hedge funds and securities below a “BBB” credit rating. The overseas share investment value must not exceed certain percentages of the value of a QDII bank’s pooled wealth management product—the aggregate value of all such shares is limited to 50%, while the respective value of the shares of a single company is limited to 5%.

Fund management entities and other securities institutions may invest in bonds, asset backed securities or securities issued by international financial organizations recognized by CSRC, equities and other securities listed in countries which have signed memorandums of understanding with the CSRC for bilateral cooperation and supervision (Recognized Markets) and public funds registered with securities regulators of any Recognized Market.

(d) Foreign exchange risks

Qualified commercial banks may use foreign currencies already held by participating investors to raise RMB Funds from domestic institutions and individuals and convert them into foreign currencies (within a SAFE-approved quota) and invest in overseas financial products.

Qualified trust and investment companies are allowed to set up trusts for individuals or institutional investors for the purpose of investing in overseas financial products in the name of the trust and investment company and in such form as may be agreed to in relevant trust documents either with the foreign currencies held by such investors or convert the RMB held by the investors, both within a SAFE-approved quota.

Qualified fund management companies and other securities institutions may collect foreign currencies held by domestic institutions and individuals for the purposes of overseas investments (within a SAFE-approved quota).

Qualified insurance companies are allowed to use their own foreign-exchange funds to invest overseas and may, subject to the pending operational guidelines, convert their RMB assets (within a SAFE-approved quota) into foreign currency and invest in foreign fixed-income products and foreign money market instruments.
The QDII program allows for its participants to bypass foreign exchange restrictions in its overseas investments within the investment quota that is approved by SAFE.

(e) Regulatory Approval

Qualified commercial banks are subject to the approval of the CBRC. Qualified fund managers and other securities institutions are subject to the approval of the CSRC, which must approve each QDII product marketed.

(f) Advantages

The QDII program provides an avenue through which Offshore Funds can have access to the enormous capital pool in the PRC. Qualified commercial banks and qualified trust and investment companies can market QDII products linked to the performance of publicly raised offshore funds to PRC sovereign funds, pension funds, corporations and wealthy individuals, hence allowing certain Offshore Funds access to the capital raised by QDII participants. The QDII participants in the PRC will be responsible for the obtaining the requisite onshore approvals, not the Offshore Funds.

6.4 Contractual Arrangements

(a) Description

This arrangement is similar to the contractual arrangement for inbound investments by foreign funds discussed in Section 4.4, but in reverse. An Offshore Sponsor could potentially partner up with a PRC entity capable of raising capital in order to use that pool of capital for investment abroad. The contractual arrangements would allow PRC investors to make investments onshore that link to offshore products and investment returns. Under this structure, there will be no or little flow of investment funds across borders, thereby potentially eliminating some of the restrictions imposed on the other products described above.

In essence, this arrangement involves:

– PRC investors entering into a contractual investment arrangements with an onshore entity that is able to raise capital onshore, and that is either already qualified to invest funds offshore or which has a branch and access to foreign capital overseas (the Conduit Entity);

– the Conduit Entity collecting investment funds in RMB from the onshore investors through offering a product that is linked to the return of the offshore product;
– the Conduit Entity holding these funds in one or more secured accounts, or as commitments subject to call down at the direction of the Conduit Entity;

– the Conduit Entity, through itself or its offshore affiliate (the **Conduit Investor**), entering into a linked product arrangement with an offshore asset manager to invest in one or more foreign private funds, utilizing the capital it has raised onshore;

– the Conduit Investor using its own foreign currency funds (in an amount equal to the amount of RMB Funds raised by the Conduit Entity in the PRC) to invest or commit to invest in the linked product;

– when the offshore investments mature, crediting any gains made by Conduit Investor back to the Conduit Entity through internal mechanics (either through a contractual relationship or internal book-keeping); and

– the Conduit Entity distributing investment gains and returning investment principal to the onshore investors.

This basic arrangement as described above is illustrated as follows:
As with the contractual arrangement for inbound PRC investment described, there are, however, certain limitations and concerns associated with this structure. First, it will require the offshore entity to have sufficient capital in foreign currency equal to the total amount raised onshore so that it can make the offshore investments without the need to remit the onshore capital offshore. Second, the onshore entity must either have the approvals required to remit funds offshore for investment, or have an affiliate or branch offshore which can advance funds offshore for investment. Third, the onshore investors may not be able to enforce their rights against the offshore entities directly because this structure may not be recognized by the PRC regulators as within the scope of the PRC foreign exchange regulations.

(b) Scope of Investments

There should generally be no limitation on the scope of investments since the PRC investors will be investing a domestic entity, and it will be the offshore contracting party who will be making the ultimate investments offshore.

(c) Foreign Exchange Risks

SAFE approval will be required for the remittance of fees and profits pursuant to the contractual arrangements (if any) between the Conduit Investor and the Conduit Entity. However, if the gains and losses are booked internally between the Conduit Investor and the Conduit Entity, then no actual currency should flow across borders. As an example, if the Conduit Entity is a PRC bank that has raised capital onshore, it can then request one of its offshore branches to act as the Conduit Investor. The Conduit Investor would then loan or otherwise make available capital in the same amount that was raised by the Conduit Entity. Any gains or losses would then be booked by the bank internally. In this structure, the investment advisor can be structured offshore, and therefore payment of the management fees are generally not impacted by PRC regulations or foreign currency controls. Likewise, the general partner could structure its investment through the Conduit Investor so that the carried interest is received offshore as well.

(d) Regulatory Approval

There are no approvals required in the PRC necessary to effect this structure, except for the potential SAFE approval mentioned above. However, as with the contractual arrangements discussed in Section 4.4., this structure is also subject to potential scrutiny by the relevant PRC regulators if it is deemed as a means of circumventing required approvals. In addition, this structure would potentially subject the onshore investors to the same types of intervening creditor and bankruptcy risks as the offshore investors in the structure described in Section 4.4.
7. Parallel Model

As discussed in the introduction, there are three key market forces driving the overall development of the asset management industry in the PRC: the sheer amount of onshore capital that needs to be effectively managed; the continuing desire by offshore investors to gain exposure to PRC investments; and a lack of experienced asset managers in the PRC and a desire of the existing domestic PRC asset managers to have access to offshore investors and fund management capability. The most likely ultimate convergence of these trends over the next few years will be the development of a combined platform that allows for investment into and outside the PRC by both PRC and foreign investors. Prior to PRC monetary policy reaching a point where currency exchange is completely unrestricted, thus allowing for free flow of funds across borders, we expect that there will be an interim period where a Parallel Model fund structure will be utilized to achieve similar results.

The Parallel Model contemplates a co-investment arrangement between an RMB Fund and an Offshore Fund. The foreign investors serve as the partners of the Offshore Fund and the domestic investors serve as partners of the RMB Fund. The Offshore Fund and RMB Fund co-invest in the same portfolio companies both onshore and offshore, with the terms of fund management and profit allocation set out in agreed contractual arrangements. If the Offshore Fund were barred from making an investment in the PRC due to legal or regulatory restrictions, then the RMB Fund could make the full investment. Likewise, if the RMB Fund were barred from making an investment outside of the PRC, then the Offshore Fund could make the full investment. Rights, obligations and benefits related to such investments could be shared among all onshore and offshore investors pursuant to a true up mechanism set out in the contractually arrangement between the RMB Fund and the Offshore Fund. The onshore and offshore sponsors would enter into a JV arrangement to act as investment advisor to the funds, and share in the management fees and carried interest generated by the two funds.

We are already seeing structures like this develop in the market. There are already several Offshore Sponsors we are aware of that are in the process of establishing RMB Funds to sit alongside their Offshore Funds to co-invest in PRC investments together. Although these may not yet include all of the true-up mechanisms we envision above, nor do they allow for investment by PRC investors outside of the PRC, it does demonstrate another evolutionary step towards giving both offshore and onshore investors access to the same asset pools.

Given the current uncertainty under the Foreign Partnership Regime and the foreign investment restrictions that apply to onshore RMB Fund partnerships with an FIE general partner or direct foreign partners, this may be the most accommodating structure for a fund that plans to raise money onshore and offshore to be invested onshore and offshore. This structure does not completely avoid the regulatory and foreign exchange risks to the foreign investors, and also potentially raises some of the issues discussed above under the contractual arrangements methods for onshore and offshore investment. But, it does provide a platform of separate onshore and offshore vehicles making co-investments where permitted and making investments solely where regulatory restrictions limit investments, while allowing access to onshore and offshore investors for capital raising.
Set out below is a chart showing one possible structure that could be used for the Parallel Model.

The market generally appears to be moving in the direction of giving both offshore and onshore investors exposure to investments across borders, and the PRC regulatory landscape has certainly been moving in the direction of moving towards greater flexibility in this area, albeit slowly. Given the numerous and complicated policy issues surrounding the free exchange of the RMB, it will likely be some time before we see the wholesale abolition of the restrictions on capital movement into and out of the PRC. However, it seems reasonable that something along the lines of the combined platform outlined above will emerge in the short term to allow varying investors greater access to a wider range of investment opportunities both in the PRC and abroad.
Conclusion

Developments in asset management in and related to the PRC present extraordinary opportunities in the global asset management industry and are poised to revolutionize significant aspects of the sector. The massive accumulation of wealth and assets in the PRC requiring effective management and the continuing presence of attractive investment opportunities within the PRC market have combined to create immense opportunities for offshore and onshore asset managers working together to create new products that leverage their respective comparative advantages. As with most developments in the PRC, the relaxation of regulatory barriers to allow for the realization of these benefits has occurred in measured steps over time. However, the pace is quickening rapidly, with new regulations coming into effect over the last few years, and several high-profile offshore fund managers teaming up with strong domestic partners to launch sizeable RMB Funds. Likewise, RMB Funds and Offshore Funds are starting to invest in parallel fund structures in the PRC. Lastly, and perhaps most tellingly, RMB Fund establishment is expected to outpace Offshore Funds in the PRC market for the first time in 2011. As such, while still evolving and taking shape, the market for PRC-related private investment funds and related products will continue to develop at a rapid pace, and remain a focal point of interest to a host of players involved in both the PRC and overseas, including investment and asset managers and investors. As always, the onshore PRC regulatory system poses interesting structuring challenges, as does harmonizing onshore and offshore asset manager/fund sponsor interests in the context of the various structures dealt with in this note. Those with the resolve to overcome these challenges, and commitment to this fertile market, and a chance of reaping immense rewards.
Your Key Contacts

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Mitchell Silk is a Partner in the Banking Department and Head of the U.S. China Group in the New York office. He has considerable funds experience and has advised a major investment bank on the structuring, formation, marketing and financing of a large PRC property fund and an Asian infrastructure fund. He has also represented the sponsors on a U.S. infrastructure fund, a transportation debt fund and a global maritime fund, and regularly advises large pension and other funds on their fund investments.

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Ji Zou is the Managing Partner in Allen & Overy’s Shanghai office. She has more than 16 years’ experience of private equity, venture capital, Funds, mergers and acquisitions and foreign direct investment in the U.S. and the PRC. Ji has advised a number of funds, financial investors and private equity investors on the structuring and establishment of their onshore investment platforms in China, including FIVCEs, PRC partnership and local level fund structures. She has recently been advising a number of fund clients in relation to their establishment of and participation in an RMB Funds platform. Ji is a regular speaker and commentator on RMB funds. Prior to her return to China in early 2003, Ji practised in New York and Silicon Valley for a number of years, where she focused her practice on private equity, venture financing, funds and mergers and acquisitions. Ji is Chinese, and has an LLB from Peking University Law School and a J.D. from Vanderbilt University Law School in the United States. Ji is qualified in New York and California and is fluent in English and Mandarin.

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Gary Lazarus is Senior Counsel in the Banking Department and a member of the Investment Funds Group and the U.S. China Group. Gary’s funds experience is extensive and includes advising clients on structuring and forming funds, co-investment vehicles and managed accounts in a wide range of sectors, including real estate, infrastructure and private equity. The funds he has worked on have targeted investment in the PRC, Greater China and Asia generally. He also regularly represents several large pension funds and other investors in their participation in fund investments.

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