

April 24, 2003

China -- Venture Capital Investment Fund Rules Effective March 1, 2003

On January 30, 2003, China's Ministry of Foreign Trade and Economic Cooperation ("MOFTEC")*, Ministry of Science and Technology ("MOST"), State Administration of Industry and Commerce ("SAIC"), State Taxation Administration ("STA") and State Administration of Foreign Exchange ("SAFE") promulgated new Regulations on the Administration of Foreign-Invested Venture Capital Enterprises ("Rules"), replacing the unworkable Temporary Measures on the Administration of Foreign-Invested Venture Capital Enterprises of February 18, 2001 ("Temporary Rules").

Effective as of March 1, 2003, the Rules provide a sophisticated template for foreign-invested investment fund activity at least in China's high-tech sector, and break significant new ground in the laws and regulations applicable to China's foreign-invested enterprises ("FIEs") and capital-raising in China generally.

This memorandum highlights some of the most important aspects of the Rules, and their relevance to foreign private equity fund managers and investors:

- VC Investment Funds: The Rules allow for the establishment of both legal person (called "corporate") and non-legal person China-domiciled investment enterprises with foreign investment ("VC investment funds"), each of which will be permitted to make investments "principally" in unlisted and high-tech oriented China-domiciled enterprises (including enterprises which already have foreign investment) and provide advisory and management services to effect capital appreciation – such services to be provided not only to the fund's own portfolio companies but even to other VC investment funds. (It would appear that the requirement that such funds participate "principally" in high-tech enterprises may not be interpreted that stringently, even though the establishment of a fund and its initial, stated, orientation will always

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be subject to MOFTEC and MOST approval.) The establishments must include the Chinese characters for "venture capital investment" in their registered names.

- Relationship with Traditional FIE Forms: The Rules explicitly refer to the PRC Company Law, and the three statutes governing China's traditional FIE establishments – Chinese-foreign equity joint ventures ("EJVs"), Chinese-foreign cooperative joint ventures ("CJVs") and wholly foreign-owned enterprises ("WFOEs"). However, no mention is made of China's Partnership Law. (In what may be a drafting slip, the Rules do provide that VC investment fund management entities – see discussion below – may be formed as corporate entities or "partnerships". It seems unlikely that the drafters chose this narrow aspect to forbid the use of non-legal person CJVs for such management entities.) This in turn would seem to imply that VC investment funds are not meant to be a new species of FIE or a new entity form under China's developing corporate and commercial law, but instead organized as EJVs, corporate form CJVs or WFOEs (for the legal person form investment funds) and non-legal person CJVs (for the non-legal person form investment fund) – in each case established and operated in accordance with the EJV, CJV and WFOE laws and regulations, except as provided under the Rules. That understanding still begs the question however as to how non-legal person *wholly foreign-owned* VC investment funds might be established – with no Chinese participant there is no legal basis for their qualification as a CJV under the CJV rules and regulations, nor is there any basis for wholly-foreign invested PRC partnerships.

- Approval and Scope of Business: As was required under the now-repealed Temporary Rules, the establishment of VC investment funds must be approved by MOFTEC in Beijing (with input from MOST in Beijing), generally for a term not exceeding twelve (12) years. VC investment funds are to use their participant-invested capital to obtain equity participations in newly-established enterprises, purchase newly-issued equity in existing enterprises and buy out the equity interests of existing investors in such targets. Subordinate powers of the funds themselves include the offering of venture capital consultancy and management consulting services to portfolio companies and even other VC investment funds – this being a departure from customary activity for funds. VC investment funds are not permitted to invest in listed companies (although they can of course maintain their investment in a portfolio company once a portion of its shares become listed), make direct or indirect investments in real estate, "make investments by loans", use capital that is not owned (*i.e.*, funneled through) the fund, or make loans or provide guarantees (provided that they may purchase corporate bonds issued by portfolio companies with a term of more than one (1) year, or make loans convertible into equity).

- Minimum Capitalization: The Rules stipulate minimum aggregate capitalization requirements for VC investment funds: the equivalent of USD 10 million for non-legal person form funds, and USD 5 million for corporate form

establishments. These minimum thresholds are lower than they might otherwise have been, and should encourage smaller scale venture capital activity in the PRC market.

- **Fund Participants:** VC investment funds must have from 2 to 50 participants: foreign participants (a term that for purposes of the Rules continues to include Hong Kong, Macao and Taiwan investors) may include foreign companies, enterprises, "other economic organizations" (like partnerships), and individuals, while Chinese participants are limited to Chinese companies, enterprises or other economic organizations. Thus, Chinese "individuals" or natural persons may not participate in such VC investment funds, while foreign individuals may. (The sole exception is in situations where individual PRC investors are already invested in wholly PRC enterprises that foreign money subsequently buys into, with the original enterprise being converted into a VC investment fund.) At least one (1) participant must be an anchor-like investor (the "Mandatory Investor"), and meet the special qualifications described in the following bullet. Participants who are not Mandatory Investors may transfer their interests in VC investment funds to other qualified participants, and new participants may be brought into a fund, and in each case such transfers or additions only need to be "reported for the record" to MOFTEC -- not "approved".

- **Mandatory Investor:** Article 7 of the Rules sets forth the qualifications for the "Mandatory Investor". Such participants must: be primarily involved in venture capital investing; in the three (3) years prior to establishment of the China VC investment fund have had under management at least USD 100,000,000, of which USD 50,000,000 is dedicated to venture capital investments (in the case of a Chinese party, these amounts are RMB 100,000,000 and RMB 50,000,000 respectively); and have at least three (3) professionals each of whom possesses at least three (3) years of venture capital investment experience. Participants in the VC investment fund may apply to be Mandatory Investors if they are part of an "affiliated group" (as defined in the Rules) which meets these qualifications. Finally, there exist thresholds for the minimum amount of participation by such Mandatory Investors: at least 1% of subscribed for and actually contributed funding for non-legal person form VC investment funds (and unlimited liability), and at least 30% of subscribed for and actually contributed funding for corporate form VC investment funds. In general, such Mandatory Investors are not permitted to withdraw from the VC investment fund during its life; in special circumstances, and with the approval of other participants holding more than 50% of the fund and the approval of MOFTEC, a Mandatory Investor may transfer its interest in the VC investment fund to another participant (new or existing) which qualifies under Article 7 of the Rules. Note that only a transfer by the Mandatory Investor requires MOFTEC approval -- transfer by other participants requires only amendment to the fund's governing contract and a mere "report for the record" to MOFTEC. It seems likely that most will find the status of Mandatory Investor in a corporate form VC investment fund rather unappealing – forced to qualify (and bear unlimited liability), invest a very large amount of the capital for the fund (30%), and stay in the fund for its full life. More generally, the qualifications required for

status as Mandatory Investor, or the folding in of affiliated entities (and unlimited liability) in the case of a failure to qualify, may make it impossible to establish a truly limited liability, special purpose corporation, type Mandatory Investor – a serious disincentive to fund promoters.

- **Liability -- General Partnerships and Limited Partnerships:** The non-legal person form of investment vehicle described in the Rules can be fashioned (by contract) into two alternative forms closely akin to U.S.-style general partnerships or limited partnerships. The default rule under the Rules describes a general partnership, wherein all investors in a non-legal person VC investment fund have joint and several unlimited liability with respect to the debts of the VC investment fund. However, the Rules also allow for the VC investment fund organizing contract to stipulate a situation resembling a limited partnership, wherein only the Mandatory Investor has unlimited liability, while the other participants enjoy limited liability (*i.e.*, limited to their subscribed for but unpaid capital contributions). (The corporate form VC investment fund is arranged as per the traditional FIE statutes, and promises limited liability for all investors.) The non-legal person form of VC investment fund thus constitutes what may come to be a new form of FIE, and, as has so often been the case throughout 20 years of China's economic reform, be a harbinger of real limited partnership establishment in Chinese commercial law generally. (While the PRC has promulgated a Partnership Law, that Law has proven unworkable precisely because of its failure to assure limited liability for investors or obviate double taxation of partners.)
- **Capital Calls and Funding:** Funding of corporate form VC investment funds must be implemented in accordance with existing FIE laws and regulations (meaning a fairly inflexible, pre-agreed schedule of funding inappropriate to investment fund activity). However, non-legal person VC investment funds are permitted to effect flexible capital calls, based upon the needs of the investment fund with respect to portfolio investments, and in accordance with the fund contract. In general, the period for capital calls by the fund is not to exceed five (5) years. Capital calls are subject to the issuance of "capital verification certificates", with the amount of funds injected into the fund noted on the non-legal person VC investment fund's business license. (It is not clear from the Rules whether investments into the fund are noted on the business license in the aggregate, or by investor.)
- **Investment Period:** The Rules leave the required period of investment by a VC investment fund in portfolio companies up to the participants in the fund, provided that the period is described in the governing fund contract. The five (5) year limitation on the period for capital calls of a fund will probably act as a limitation on the investment period.
- **Distribution of Investment Proceeds and Allocation of Returns:** In perhaps the most significant and useful departure from the Temporary Rules, VC investment funds which take the non-legal person form are at last allowed to escape the

straight-jacket of China's traditional FIE laws. First, traditional FIE regulations (and the Temporary Rules) make it very difficult to reduce formal registered capital investment (a book valuation of initial equity capitalization, which becomes the legal notion of "equity" in the enterprise) in a Chinese FIE and thus return investment proceeds to fund investors during the life of an entity organized as a traditional FIE. The Rules now explicitly allow "reduction of registered capital" of the VC investment fund when participants who have contributed 50% of the fund's capital and the Mandatory Investor agree and, critically, with the approval of MOFTEC. The circumstances allowing reduction of registered capital must be set forth in the VC investment fund's governing contract. Second, the Rules further explicitly allow VC investment funds to distribute proceeds arising from the disposition of fund portfolio investments directly to the fund investors. (However, thirty (30) days before such distributions the fund must submit a written explanation of such proposed distribution and the accompanying reduction in capital investment in the fund to SAFE. Importantly, this submission is merely "for the record" and is not submitted to SAFE for approval.) Third, the Rules leave it entirely up to the participants as to how investment gains (after return of invested capital) are to be allocated between such participants, requiring only that such allocations of returns be in accordance with "international custom" and set forth in the VC investment fund's governing contract. Each of the three aspects described above represents a very significant departure from traditional FIE law and practice in China -- significant and necessary, as failing these changes, real investment fund activity in China might be impossible to implement.

- **Fund Management:** VC investment funds are to establish boards of directors (corporate form funds) or joint management committees (non-legal person funds). Such boards or committees are to delegate day-to-day investment management to either internal management organizations or external investment management entities. Internal management organizations must comply with certain requirements, including an undefined "experience" standard. External investment management entities may include venture capital investment management enterprises or even other VC investment fund entities established under the Rules. Venture capital investment management enterprises may be wholly Chinese entities, FIEs, or even purely foreign-domiciled fund management entities, but all have to meet certain qualifications, notably the requirements that at least three (3) individuals each have at least three (3) years of experience in venture capital investing, that such enterprises have registered capital or contributed capital of RMB 1,000,000, and that effective internal controls be in place. Such management arrangements with entities external to the VC investment fund must be governed by contract, which contract is to be disclosed to and *approved* by MOFTEC before becoming effective. It is important to note that even wholly foreign management entities must register a presence inside China, thereby creating a basis for taxation of the gains of such management entities under PRC tax law.

Certain miscellaneous aspects of the Rules are worth noting:

- **Foreign Investment Restrictions:** With one important difference, VC investment funds remain constrained in their investment activities by laws and policies limiting foreign investment in China generally. Thus, the establishment of a China-domiciled VC investment fund entity does not allow foreign investors to avoid the sectoral and ownership restrictions under Chinese law with respect to foreign investment. The Rules make explicit provision for investments by funds in "encouraged", "permitted" and "restricted" sectors. In what may be a significant departure however from more than two decades of regulation, the Rules allow that investment by a VC investment fund in portfolio companies need not be approved by any level of the MOFTEC system, merely "filed for the record".
- **Taxation:** VC investment funds are subject to PRC income tax. Non-legal person funds may elect to have the participants report and pay tax "directly" (the implication being that they will not be subject to double taxation at the fund and investor levels) or at the fund level. Given current exemptions on tax of dividends to foreign investors in traditional FIEs, taxation at the fund level should be beneficial to foreign investors, but possibly risky for PRC participants (who may again be subject to taxation on their profits distributed from the fund). The Rules promise that the STA will issue forthcoming regulations on the specific tax treatment of VC investment funds.
- **Foreign Tax Preferences and Exemptions for Portfolio Companies:** If a VC investment fund portfolio company has at least 25% of its invested capital from foreign sources (with attribution up through the VC investment fund), then the VC investment fund portfolio company will be entitled to enjoy tax exemptions and reductions applicable to FIEs. Aggregate foreign participation (as determined above) of less than 25% will deprive the portfolio company of such taxation preferences.
- **Foreign Exchange Conversion and Remittance:** The Rules promise the conversion and remittance (upon minimal showings) of VC investment fund profits and the return of invested capital. SAFE however is to promulgate follow-up rules on the remittance of invested capital by non-legal person VC investment funds to foreign participants.
- **Stock Buy-backs:** Chinese corporate law, and a good deal of rule-making by the China Securities Regulatory Commission with respect to listed issuers, generally forbids stock buy-backs by Chinese companies. However, the Rules depart from this prohibition in specifically pointing to portfolio company stock buy-backs as a method of exit for VC investment funds.

Finally, the Rules describe in some detail the required application and approval or filing procedures for VC investment fund establishments, amended arrangements, proceeds, dissolution, etc. These include the following:

- Application for a VC investment fund establishment is made first through the Provincial-level Commission on Foreign Trade and Economic Cooperation ("COFTEC")*. Only fifteen (15) days after an initial review of all materials and an initial review of the application, the COFTEC must forward the application materials to MOFTEC in Beijing. Within forty-five (45) days of receipt by MOFTEC of the complete application materials (and the "consent" of MOST), MOFTEC must render a decision approving or disapproving the application. If approved, MOFTEC is to issue a "foreign invested enterprise approval certificate" at such time. Within a month of issuance and receipt by the investors of such certificate, registration with the Provincial-level bureau of the SAIC to gain a business license for the VC investment fund must be handled. For corporate form VC investment funds, the SAIC will issue an "enterprise legal person business license", for non-legal person establishments, only a "business license".

- Documents required for the COFTEC application include the documents normally required for FIE applications, but also contain some surprises, including: a statement from the Mandatory Investor in the VC investment fund attesting to the truth of the application materials and warranting that participants in the VC investment fund will comply with PRC law and regulations, and a signed legal opinion regarding such statement and its contents. (It remains unclear as to whether or not law firms will be required to attest to factual matters in such opinions – something requested under other Chinese statutes.) The application to the SAIC for the business license of the VC investment fund must also include a number of documents familiar from FIE practice, but also a description of the registered address or business place of the VC investment fund (indicating that offices must be already procured even prior to the SAIC application for formal establishment). In the case of a non-legal person VC investment fund, the articles of association or partnership agreement of the foreign Mandatory Investor must be disclosed and submitted – possibly a serious disincentive to such foreign participants. Where a normal participant is applying for its affiliated group to act as the Mandatory Investor, the application for registration must include an undertaking of joint and several liability by the affiliated entities with respect to the VC investment fund.

- The Rules also detail the application and approval procedures for the establishment, registration and operation of foreign-invested VC investment fund management entities, which, like the VC investment funds themselves, must be approved by MOFTEC in Beijing. Other than properly approved entities, no other FIEs may use the Chinese characters for "venture capital investment management" in their registered enterprise names.

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* Now, the local branch of the MOC.