

## RMB Funds: New Shanghai Pilot Program

### PENpoints

*On January 11, 2011, three Shanghai Municipality governmental agencies are formally announcing a pilot program under which certain approved qualified non-Chinese private equity sponsors and qualified funds will enjoy favorable treatment.*

In our August 30, 2010, [KirklandPEN](#), we discussed opportunities for a non-Chinese private equity sponsor to raise funds denominated in Renminbi (“RMB”), noting that strict foreign exchange controls and uncertain regulatory approval requirements for investments have delayed many non-Chinese sponsors’ plans to raise RMB funds.

In an important development for non-Chinese private equity sponsors, on January 11, 2011, three Shanghai Municipality governmental agencies are formally announcing the issuance of the *Implementation Measures for Launching the Foreign-invested Equity Investment Enterprise Pilot Program in the Municipality of Shanghai* (the “Measures”), effective January 29, 2011. Under the Measures, certain qualified non-Chinese private equity sponsors (“Qualified Sponsors”) and qualified funds (“Qualified Funds”) approved to participate in this pilot program will not require foreign investment approvals of investments and will enjoy limited currency conversion rights. These advantages are tempered by the continued applicability of China’s other foreign investment rules (even for a Qualified Sponsor/Qualified Fund), limitations and uncertainty regarding currency conversion, and uncertainty regarding the applicability of the Measures outside Shanghai.

### Key Implications of Pilot Program

#### A. Applicability of Foreign Investment Rules

As discussed in our previous [KirklandPEN](#), a non-Chinese sponsor and/or investor may directly invest in and/or control a Chinese limited partnership (known as a foreign invested partnership or “FIP”). However, ongoing uncertainties regarding currency conversion, taxation and regulatory approvals for investments have generally led non-Chinese sponsors to avoid the FIP and instead raise RMB funds solely from Chinese investors. Unfortunately, even this approach does not provide much certainty, as the mere presence of a non-Chinese sponsor may cause its RMB fund to be subject to China’s foreign investment rules, including

regulatory approvals for each investment proposed to be made by the fund.

Under the Measures, however, a Qualified Fund with a Qualified Sponsor and no other non-Chinese investors will generally not be required to obtain regulatory approvals for its investments, but will need to comply with the rest of China’s existing regulatory regime governing investment by non-Chinese investors.

However, while the Measures provide additional certainty regarding the ability of a non-Chinese Qualified Sponsor to establish and make investments in Shanghai, it remains to be seen whether regulatory authorities outside Shanghai will follow a similar approach if such a fund makes investments in other regions.

#### B. Currency Conversion for Qualified Sponsors

The Measures permit a Qualified Sponsor to make capital contributions to its RMB fund up to 5%<sup>1</sup> of the aggregate capital commitments of the fund in the form of a “freely convertible currency”<sup>2</sup> (which is then converted into RMB). While it is not expressly stated in the Measures, it is expected that regulators will have the discretion to permit a Qualified Sponsor to convert proceeds (including income and gains) received by it from an RMB fund into non-Chinese currency.

The Measures do not explicitly address the conversion of commitments to an RMB fund from non-Chinese investors (i.e., those other than the Qualified Sponsor), although the Measures do indicate that non-Chinese investors may continue to make commitments using RMB profits generated from their legitimate operations and investments in China.

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## Qualifications of Non-Chinese Sponsor and Investors

### A. Non-Chinese Sponsors

To be a Qualified Sponsor, a non-Chinese sponsor must (1) have at least two senior managers, each with more than five years' relevant investment experience, including experience in China-related equity investments or Chinese financial institutions, and (2) satisfy certain other requirements. In addition, the Joint Committee (as defined below) must determine that the non-Chinese sponsor has a "good" track record of making investments in China over at least a three-year period.

### B. Non-Chinese Investors

Non-Chinese investors in a fund established by a Qualified Sponsor must have assets of not less than US\$500 million, or manage at least US\$1 billion of assets on behalf of others, and at least five years' experience in equity investments.

The Measures indicate that the participating non-Chinese investors in a Qualified Fund are expected to include sovereign wealth funds, pension funds, endowment funds, charitable organizations, funds of funds, insurance companies, banks, securities companies and certain other approved non-Chinese institutional investors. However, because the Measures do not explicitly permit the conversion of a non-Chinese investor's non-RMB commitments into RMB, it seems unlikely that the Measures will be used to raise capital from non-Chinese investors unless regulators exercise discretion to allow such a currency conversion.

### **Other Considerations**

(a) *Supervisory authority.* While it remains unclear at a national level which governmental agencies will be responsible for supervising the Chinese private equity industry, the Measures establish a joint committee (the "Joint Committee"), comprised of members of several Shanghai Municipality governmental agencies, to oversee the pilot program. The Shanghai Financial Service Office ("SFSO") will be in charge of the Joint Committee's daily operation.

(b) *Application process.* A non-Chinese sponsor wishing to establish a management company, raise an RMB fund or participate in the pilot program must submit applications separately to the respective regulatory authorities as outlined in the Measures.<sup>3</sup>

(c) *Filings after registration.* A Qualified Fund and/or a Qualified Sponsor are required to make notice filings with a local division of SFSO where such fund or sponsor is domiciled 10 days after registration.<sup>4</sup>

(d) *Reporting.* Every six months, a Qualified Fund and a Qualified Sponsor must report to the local division of SFSO information regarding major events affecting the fund and the sponsor, including a summary of investments, any amendments to organizational documents and any changes in senior management.

(e) *Custodian.* A Qualified Fund is required to appoint a local bank as custodian. The role of the custodian bank appears to be quite extensive and it remains to be seen whether local banks have the requisite systems and know-how to undertake this role.<sup>5</sup>

(f) *Prohibited Investments.* The Measures prohibit certain types of investment-related activity, including: (i) investing in prohibited sectors (as pursuant to foreign investment industry policy); (ii) trading of stock and corporate bonds through the secondary public markets; (iii) trading futures and other financial derivatives; (iv) investing in real estate; (v) misappropriating non-self-owned funds for investment; and (vi) providing loans or guarantees.

### **Conclusion**

The Measures provide a more detailed and certain framework for non-Chinese sponsors seeking to raise RMB funds in Shanghai from Chinese investors. However, despite much press speculation, the Measures do not explicitly provide a solution for a non-Chinese sponsor looking to raise an RMB fund from non-Chinese investors. It is expected that regulators will have discretion to approve currency conversion of non-Chinese investors on a case-by-case basis. However, the presence of such non-Chinese investors will require such an RMB fund to obtain regulatory approval of each of its investments, thus defeating one of the key benefits of the Measures.

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- 1 We understand that, pre-Measures, in Shanghai the maximum percentage of aggregate capital commitments allowed to be converted by a non-Chinese sponsor from foreign currency into RMB is 1%.
  - 2 The term “freely convertible currency” is not defined in the Measures, but we understand that in China it generally means a currency the International Monetary Fund determines (i) is, in fact, widely used to make payments for international transactions and (ii) is widely traded in the principal exchange markets.
  - 3 The SFSO is expected to process an application to establish an RMB fund within 20 business days, to establish a management company in 28 business days, and to participate in the pilot program within 15 business days. Applications must also include information relating to the qualification of the prospective non-Chinese investors (if any).
  - 4 The filings must include the fund’s constitutional documents, a photocopy of the fund’s business license, a list of capital commitments and contributed capital to the fund, a list of senior management members of the foreign-invested management enterprise and information about the fund’s decision making process.
  - 5 The role of the custodian bank includes (i) reporting information to the Joint Committee regarding the status of the capital account, (ii) filing an annual report to the Joint Committee regarding the fund’s investment activities in the preceding year and (iii) supervising the fund’s operation.
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If you have any questions about the matters addressed in this *KirklandPEN*, please contact the following Kirkland authors or your regular Kirkland contact.

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## PENbriefs

# Forum Selection Bylaws—Not So Fast?

In reaction to comments made by a Delaware Chancery Court judge in a 2010 opinion, many companies amended their bylaws to provide that Delaware courts are the exclusive jurisdiction for settling corporate disputes. However, a recent federal court decision in California, which refused to dismiss a derivative claim in that court against a Delaware corporation with such a bylaw provision, calls into question the effectiveness of those measures when evaluated by courts outside of Delaware. To learn more, please see our recent [M&A Update](#).

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# IRS Delays Effective Date of Harsh Excise Tax Imposed on Discriminatory Health Insurance Plans

The IRS recently released a notice delaying the effective date of the harsh excise tax imposed on an employer’s insured medical plan that is considered “discriminatory” under recent legislation, indicating that the excise tax will not be implemented until after the IRS issues further guidance. However, the underlying legislation, as discussed in our prior [KirklandPEN](#), remains unchanged and raises serious questions regarding a company’s grant, or agreement to grant in the future, better medical benefits or more reimbursement for the cost of medical benefits for some employees than others.

## PENbriefs

# Tax Laws Enacted at Year-End Create Tremendous Wealth Transfer Opportunities

The recently-enacted tax law includes drastic changes in the estate, gift and generation skipping transfer taxes, creating tremendous wealth transfer opportunities. To learn more, please see our recent [Kirkland Alert](#).

## PENnotes

**Kellogg's School of Management's 2011 Private Equity and Venture Capital Conference**  
Chicago, Illinois  
February 9, 2011

The 2011 Private Equity and Venture Capital Conference, sponsored by Kirkland & Ellis, will provide a forum to discuss how firms, venture capitalists, private equity investors, entrepreneurs and LP's can create value in the new decade. Kirkland partner Margaret A. Gibson, P.C., will moderate for keynote speaker John "Jay" W. Jordan II, chairman and managing principal of The Jordan Company. Kevin Efrusy, a partner at Accel Partners, will also keynote. For more information, or to register, please visit: [www.kellogg.northwestern.edu/privateequityconference/index.htm](http://www.kellogg.northwestern.edu/privateequityconference/index.htm).

**The Practising Law Institute's "Drafting and Negotiating Corporate Agreements 2011"**  
Chicago, Illinois  
February 10, 2011

At PLI's "Drafting and Negotiation Corporate Agreements 2011," participants will learn key terms of standard transactional agreements and how they are organized; when and how to use letters of intent, confidentiality and standstill agreements; the wide range of M&A agreements, both public and private, and common ethical errors in contracts. Kirkland partner Gerald T. Nowak, P.C., will speak on "Credit/Indenture Agreements" and "Ethical Issues in Drafting Corporate Agreements," and partner Keith S. Crow, P.C., will speak on "Acquisition Agreements." For more information, or to register, please visit: [www.pli.edu](http://www.pli.edu).

**The 17th Annual Columbia Business School Private Equity and Venture Capital Conference: "Navigating New Opportunities And Challenges"**  
New York, New York  
February 25, 2011

The Columbia Business School Private Equity and Venture Capital Conference, sponsored by Kirkland & Ellis, will bring together alumni, professionals and students for informative discussions on recent opportunities and challenges that have emerged in the private equity and venture capital industries. Kirkland partner Kirk A. Radke will speak on a private equity panel titled "The Leveraged Buyout in 2011" and partner David MacDonald will speak on a panel titled "Private Equity in the Emerging Markets: Charting the Course." Keynote speakers will include Russell L. Carson, co-founder, Welsh, Carson, Anderson & Stowe; Stuart J. Ellman, co-founder and managing partner, RRE Ventures; John D. Howard, chief executive officer, Irving Place Capital, and Stephen P. Murray, president and chief executive officer, CCMP Capital. For more information, or to register, please visit: [www.cbspevconference.com/index.html](http://www.cbspevconference.com/index.html).

**IBA/ABA 12th Annual International Conference on Private Investment Funds**  
London, England  
March 13 - 15, 2011

This Kirkland-sponsored conference, presented by the International Bar Association and American Bar Association, will focus on the impact of recent U.S. and EU regulatory initiatives, including the AIFMD and IAA, on alternative investment funds; new developments in fund terms; compensation issues and tax developments; the role of regulators and related enforcement action, and Asia and India funds, among other topics. Kirkland partner Mark Mifsud is a chair of this event. For more information, or to register, please visit: [www.int-bar.org/conferences/conf366/](http://www.int-bar.org/conferences/conf366/).

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## Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Law Firm of the Year" in *Buyouts* magazine's "2010 Deal of the Year Yearbook," and was also honored with the 2010 "Award for Excellence" in Investment Funds by Chambers & Partners at its annual Chambers USA Awards. Kirkland was ranked in the first tier among law firms for both Private Equity Buyouts and Private Equity Funds by *The Legal 500 U.S. 2010*. Additionally, *Pitchbook* named Kirkland as the most active law firms representing private equity firms in its 2010 "Private Equity Breakdown."

*The Lawyer* magazine recognized Kirkland as one of the "The Transatlantic Elite" in 2008, 2009 and 2010, noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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