China Foreign Invested RMB Funds Report 2010

Zero2IPO Research Center

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1.1 Overview

The Zero2IPO Research Center has observed that more and more foreign VC/PE firms are accelerating their pace to participate in establishing RMB funds, attracted by the rapid development of China's equity investment industry and the returns on investment well above those in the European and American mature markets. With this strategic choice, foreign investors are expected to share the capital gains derived from the rapid development of the Chinese market. What's more important, however, is how to quickly build up their comprehensive competitive strengths and become universal investment agencies that can "walk with two legs" as RMB funds have grown to share half of China's equity investment market with their foreign currency rivals.

1.1.1 Background

The development of China's VC investment has coincided with the government-driven transformation from the planned economy to the market economy. The government's policies, regulations and institutional design regarding VC have produced significant impact on the development of China's VC industry, while China's VC practices have reciprocally driven the policy adjustment. As early as in May 1995, the *Decision of the CPC Central Committee and the State Council on Accelerating the Scientific and Technological Progress* stressed the development of technology VC business, the establishment of the technology VC mechanism, and strong attraction of domestic and overseas funds to support the scientific and technological cause. Since the second half of 1998, China's local VC has entered the stage of substantial development, influenced by the global Internet economy and guided by the encouraging policy of the state. At the same time, foreign funds have also tentatively entered China's market.

In the early stage, foreign VC/PE firms usually employed the "red chip mode" in China. Under this mode, an offshore company serves as a platform and observes offshore laws, thereby bypassing the domestic supervision and realizing the listing and financing on overseas capital markets. Thus, this mode has become the financing and listing mode extremely favored by Chinese private enterprises, and been adopted frequently. In 2006, six ministries and commissions of the State Council jointly decreed the *Provisions on Foreign Investors' Acquisition of Domestic Enterprises* (No. 10 Document), which has restricted the overseas listing channel of Chinese enterprises through the "red chip mode", and also squeezed the operating mode of foreign VC/PE funds with both ends abroad. Since then, foreign investors have started their way to return to the establishment of RMB funds within the Chinese territory.

On the other side, China's VC/PE industry is now going international step by step. In 2003, relevant authorities published the *Provisions on Administration of Foreign-invested Venture Capital Enterprises* (the Provisions), which specifies the establishment, operation, supervision and other aspects of foreign-invested VC firms, and provides the legal basis for their entry to China. On July 14, 2006, the Ministry of Commerce (MOC) promulgated the *Measures for the Administration of Venture Capital Enterprises* (the Measures) to solicit opinions on revision from the entire society. Compared to the Provisions, the exposure draft of the Measures revises the provisions concerning the establishment, registration, capital contribution, relevant changes and business management of foreign-invested venture capital firms (foreign VC firms), approaches the *Interim Measures for the Administration of Venture Capital Enterprises* (Interim Measures) in detail and wording, is more compliant with the international practices in the management of foreign VC firms, and becomes stronger in management operability.

In organizational form, the Provisions make it clear that "a venture capital enterprise may take either the non-legal-person organizational form, or the company organizational form". A VC fund without legal person status is close to a limited partnership in liability undertaking, capital contribution method, profit distribution and other dimensions. The *Administrative Measures for the Establishment of Partnership Enterprises within China by Foreign Enterprises* *or Individuals* promulgated by the State Council in early December 2009 and the *Provisions on the Administration of Registration of Foreign-funded Partnerships* published by the State Administration for Industry and Commerce were implemented as of March 1, 2010, which make Chinese-foreign partnerships possible. For this reason, local and foreign VC institutions will encounter no legal barrier when they adopt the company system, limited partnership system, trust system or other organizational forms prevailing in the international business circle.

As to the industries that can be invested in, the Provisions pointed out that the investment of foreign VC firms in China must comparatively observe the stipulations under the *Provisions on Instructing the Directions of Foreign Investment* and *Catalogue for the Guidance of Foreign Investment Industries*. The *Provisions on Instructing the Directions of Foreign Investment* (2002) divided foreign investment industries into encouraged type, restricted type and prohibited type, while the *Catalogue for the Guidance of Foreign Investment Industries* (2007) regularized the concrete segmented industries. Relevant legal documents for reference include the *Provisions on Instructing the Directions of Foreign Investment* (2002), *Catalogue of Encouraged Hi-tech Products for Foreign Investment* (2002), *Catalogue of Priority Industries for Foreign Investment in the Central-Western Region, Catalogue of Industries, Products and Technology Currently Particularly Encouraged by the State for Development* (2005) and *Catalogue for the Guidance of Foreign Investment Industries* (2007).

In terms of tax preference, the State Administration of Taxation (SAT) specially distributed the *Notice of the State Administration of Taxation on Relevant Taxation Issues Concerning the*