

Q&A

Kirkland & Ellis's Dolling, Liu, Say Recent RMB Fund Ruling 'Will Be Seen as a Blow'



Last month, China's National Development and Reform Commission issued its responses to certain questions raised by its Shanghai branch regarding the nature of an RMB fund sponsored by Blackstone Group established through the Shanghai QFLP pilot program. Under NDRC Circular 1023, a fund with a "foreign" GP and purely domestic LPs is to be regulated by the foreign investment rules and comply with the Foreign Investment Industry Catalogue. Previously,



the Shanghai authorities had implied that such a fund would be regarded as "domestic." **Justin Dolling** and **Carol Liu** of Kirkland & Ellis's Hong Kong office answered questions on what that means for fund managers via e-mail.

Q: How does this regulation impact foreign yuan funds and fundraising?

A: Without further clarifications from Chinese national authorities, its impact on RMB funds remains unclear. By way of background, China has bifurcated rules and regulations governing "domestic" and "foreign" investment, and there are several parallel governmental agencies involved in regulating certain aspects of foreign investments in China. The Ministry of Commerce (MOFCOM) is generally considered to be the authority in determining whether an investment is "foreign" or not, and while MOFCOM generally consults NDRC on issues regarding whether specific projects involving foreign capital are permitted, MOFCOM is not obligated to follow NDRC's determination on the nature of an investment or an entity. In relation to RMB funds specifically, prior to the NDRC regulation, we understood that certain RMB funds established by foreign sponsors had been granted a "domestic partnership" business

license by the local State Administration for Industry and Commerce (SAIC), which has the sole authority to grant business licenses to enterprises in China, and is another parallel agency to NDRC.

In relation to this NDRC regulation, it is unclear whether NDRC considers that an RMB fund with a foreign sponsor should be considered "foreign" for all purposes – compliance with the Foreign Investment Industry Catalogue and/or downstream deal approval purposes – and if that is the case, whether MOFCOM, SAIC and China Securities Regulatory Commission (CSRC) will take a similar view, which would appear to be inconsistent with certain of their practices to date.

Particularly in relation to any foreign sponsor looking to invest in restrictive or prohibited industries where NDRC has a degree of direct oversight, the NDRC ruling will be seen as a blow. Even for sponsors focused solely on encouraged and permitted industries, the ruling creates further uncertainty regarding the status of RMB funds, which will further complicate both fundraising and investment activity. The complication is likely to result in foreign sponsors continuing to be at a disadvantage when compared to the purely domestic sponsors.

Q: Are there ways around the ruling?

A: The NDRC ruling means increased uncertainty in relation to the status of an RMB fund with a foreign GP and/or having a small portion of foreign capital contributed by the sponsor. While certain sponsors have adopted alternative structures in an attempt to preserve the domestic nature of an RMB fund – for instance, nominee arrangements whereby the Chinese executives within a foreign sponsor own the GP directly – these structures are largely untested and present additional challenges for the sponsor such as corporate governance, taxation and enforceability. Purely domestic investors may also be skeptical of such arrangements and may prefer to invest in a purely domestic fund with no foreign interests.

Q: What other regulations are in the works in China that private equity firms should be aware of?

A: Over the last four to five years, various regulatory bodies having jurisdiction over foreign investments have been reacting to the dramatic growth in China's private equity industry while also seeking to clarify the scope of their jurisdiction. As a consequence, the legal and regulatory landscape is constantly evolving, sometimes without any clear strategic objective. Recent developments that are relevant to PE sponsors include proposed changes to the taxation of sponsors' carried interest, proposed changes to the taxation of certain investments held by PE funds, such as floating profit tax, rules relating to registration and marketing of PE funds in China and to the ability of specific investors, for instance insurance companies, to invest in RMB funds, and rules relating to outbound investment by RMB funds.

Q: Currency conversion has been an issue. Any progress there?

A: The Shanghai QFLP program and similar programs offered by other cities, to some extent, have provided a solution to the currency conversion issue by permitting a foreign sponsor to convert up to 5 percent of the commitments to a fund and offering a quota to convert capital for foreign investors in an RMB fund.

Q: How difficult is it to do business in China without running afoul of the Foreign Corrupt Practices Act?

A: This is a complex question, but generally we think that with proper planning and a strong commitment to compliance, companies can do business in China without violating the FCPA. The first step is to conduct a thorough assessment of where the relevant entities' greatest FCPA exposure lies. Once that is determined, the company should implement an FCPA compliance program aimed at those areas. Typically, a successful compliance program usually involves clearly articulated policies, thorough training, comprehensive audits and rigorous remediation when problems arise. While it may not be easy, with a commitment to that approach we believe that it is possible for companies to do business in China while remaining FCPA compliant.