

**Title: An Overview of Private Equity And Venture Capital Investment in The Private Business Sector**

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Foreign direct investment has been one of the most important driving forces behind the development of the People's Republic of China (PRC) economy in the past two decades. In addition to foreign industrial investors, private equity and venture capital investors have become increasingly interested in investing in Chinese start-up companies and other private business entities. The problematic state-owned enterprises, which may also need private equity investors, used to be the main players in the Chinese economy, but now, the private business sector is attracting more attention.

Chinese entrepreneurs need funding to realize their business visions, or prove their business concepts.

### **Foreign Direct Investment Regulations**

So far, foreign investors are still not allowed to form joint ventures with Chinese individuals. A Chinese individual must set up a domestic company before forming a joint venture with foreign investors. Notwithstanding the government's policy encouraging foreign investment, various rigid rules can create critical difficulties for typical private equity and venture capital investment models. Such difficulties may include:

#### **Capital injection requirement**

Both foreign and domestic parties must contribute capital to any joint ventures. Under Sino-foreign Joint Venture Law, the capital can be contributed either in cash or in kind. However, a mere business plan, or an unproved technology idea, is not qualified to be injected capital. Therefore, people with only a business idea or unproved technology are unlikely to obtain foreign funding through a joint venture with foreign investors.

Alternatively, foreign investors may invest in an established domestic company by acquiring part of the equity interest in an existing Chinese company. However, money paid by investors to the founders is not for them to cash out. The founders must guarantee that they would contribute the received money to the company after the acquisition.

## **Industry policies for foreign investment**

Foreign investment is restricted or prohibited in certain industries, including basic telecom services, value-added telecom services and the media. However, foreign investment is generally encouraged by the Chinese government in the technology sector.

## **Protection of preference shareholders' rights**

The commonly used preference share scheme is not recognized by Chinese laws and regulations on Sino-foreign joint ventures. Under this, the premise for a joint venture is equality and mutual benefit. It is almost impossible for foreign investors to create certain privileges attached to preference shares that are frequently used in some foreign jurisdictions.

## **Implementation of stock option plan**

All Chinese companies, including Sino-foreign joint ventures, need to register their capital with the State Administration of Industry and Commerce (SAIC). The variation of the registered capital needs to be approved by the approval authority and registered with the SAIC. Under a stock-option plan scheme, the exercise of any granted share options will result in the increase of the company's issued capital (i.e., the registered capital under PRC laws). In consequence, the approval and registration requirements will be triggered, which almost make the stock option plan impossible to be implemented in the practice. Except for Sino-foreign joint stock companies, a joint venture in the form of a limited liability company is not limited by shares. The lack of the share concept for Chinese limited liability companies prevents them from implementing a customary stock option plan.

## **Exit of foreign investment**

### a) Through private sales

The sale of an investor's equity interest must be approved by the original approval authority of the invested company. In general, this approval is not difficult to get. However, if the equity interest is to be sold to a domestic buyer, the purchase price must be paid in renminbi, under Chinese foreign exchange regulations. Meanwhile, an approval is required from the State Administration of Foreign Exchange (SAFE) to convert the received purchase price into foreign currencies and remit it outward. This foreign exchange control does not apply to the sales of equity interest to foreign buyers and the purchase price can be paid in a foreign currency agreed by the vendor and the buyer.

It is uncertain and yet to be proven whether Chinese laws recognize certain schemes

avored by private equity and venture capital investors, such as tagalong rights.

b) Initial public offering

Before an IPO can be done, a Sino-foreign joint venture in the form of a limited liability company must be converted into a Sino-foreign joint stock company. This has to be approved by the Ministry of Foreign Trade and Economy Cooperation (MOFTEC).

A Sino-foreign joint stock company can be floated in either the Chinese stock market or international stock markets. Under PRC laws, there is no express prohibition on companies with foreign investments from listing on domestic stock exchanges. Precedents of public offerings by companies with minority foreign shareholdings, and the subsequent listings on the main boards of the stock exchanges in Shanghai and Shenzhen have been reported recently. However, until now, companies with foreign controlling shareholders cannot list on domestic stock exchanges under government policies. So far there is no report of a listing of a joint stock company with a foreign controlling shareholder cannot list on domestic is no report of a listing of a joint stock company with a foreign controlling shareholder. This policy restriction is expected to be lifted following the China's entry to the World Trade Organization (WTO).

The liquidity of the shares held by those who founded the listed joint stock company is a serious question to be considered by foreign investors. So far, only the shares held by the investing public can be freely traded on the main board. The legal-person (who found the joint stock companies) shares are not eligible to be freely traded in the open market and can only be sold to other parties, subject to compliance with the information disclosure obligation of listed companies under various regulations and listing rules. This is provided that the shares to be transferred are less than 30% of the issued shares (otherwise, the transferee is obliged to make a general offer to all the other shareholders unless a waiver is granted by the China's Securities Regulatory commission, CSRC). The foreign investors also need approval from the SAFE to convert the proceeds realized from the sales of the shares into foreign currencies, and then remit them outward.

The to-be-launched second board market in Shenzhen may bring more opportunities for small and medium-sized companies with growth potential to access the capital markets, as well as the liquidity of shares held by the founders of the listed companies. However, given that the relevant regulations and listing rules are not yet in place, the position of the second board regulators remains unclear over whether a Sino-foreign joint stock company can be listed.

A Sino-foreign joint stock company can also opt for an IPO in a recognized international stock market. The overseas listing must be approved by the CSRC before the listing application is submitted to a foreign stock exchange.

## **Using an Offshore Vehicle**

It is very common for foreign private equity and venture capital investors to use an offshore vehicle to invest in China. Investors may invest in an offshore company in which the founders and the investors can hold stakes subject to their agreement. The offshore company may then set up a subsidiary in China to operate the business that the founders intend to do.

### **Chinese shareholdings in an offshore vehicle**

No Chinese law or regulation expressly prohibits Chinese individuals from holding shares in a foreign company, although there is some debate on this subject. However, owing to foreign exchange controls, Chinese individuals cannot convert their renminbi into foreign currencies and remit cash outward to subscribe to shares issued by the offshore vehicle, unless approved by the SAFE. This approval is unlikely to be granted. Certain assets, such as intellectual property owned by the Chinese individual founders, can be transferred to the offshore vehicle, as a consideration to subscribe to shares if required by the transaction structure. However, the transfer of the business in whole by the founders to an offshore vehicle may not be possible, because a foreign company is not allowed to do business in China without establishing a presence.

Chinese entities wanting to hold shares in a foreign company is more complicated. Approval by the MOFTEC is required for a Chinese entity to invest overseas, including holding shares in an offshore vehicle.

### **Listing the offshore vehicle**

Listing an offshore vehicle whose main operation and assets are in China still falls under the jurisdiction of the CSRC. The listing needs to be approved by or filed with the CSRC, according to various government decrees or notices.

According to a notice issued by the State Council on June 20 1997 (State Council Notice), the listing of a foreign company with Chinese capital should be approved by the State Securities Commission, which function has been succeeded by the CSRC. However, the definition of Chinese capital is not given under the State Council Notice. According to recent cases, the stake in listing companies held by Chinese individuals was not deemed as Chinese capital and the State Council Notice did not apply to such listings.

The CSRC issued another notice on June 9 2000 in which it requires that the listing of foreign companies with a Chinese interest should be filed with the CSRC. A no-comments letter will be issued by the CSRC if it has no objection after the review of such filing. However, according to this notice, a mere filing is not sufficient for

those companies to which the State Council Notice applies. In other words, the CSRC Notice only applies to those companies to which the State Council Notice does not apply. The criteria of Chinese capital remain vague under both the State Council Notice and the CSRC Notice, and therefore, the CSRC may use its own discretion in judging to which notice a foreign company with Chinese individual shareholders is subject.

The CSRC Notice requires the issuer's Chinese counsel to file a legal opinion addressing various requisite issues, including whether the foreign company holds its Chinese interest legally, whether its investment in China complies with Chinese laws and whether the Chinese shareholder, if any, legally holds its shares in the foreign company. It is obvious that the CSRC pays attention to how Chinese shareholders obtain shares in a foreign company. Before every investment structure can be finalized, investors should test themselves by answering those questions that the CSRC may raise at the time of the IPO.

### **Summary**

Although it is anticipated that further liberalization of the capital markets will follow after China enters the WTO, the uncertainties of Chinese legal framework may not be changed in the near future, which will unavoidably increase difficulties for international private equity and venture capital investors targeting the Chinese market. The CSRC has a very good reputation for being open-minded. However, it is not in a position to change the entire legal framework and the regulations of its peer ministries. Investors should be aware of these risks before sharing the prospects of this huge market in the new millennium.