

Title: **New Regulation on Chinese Foreign-invested Venture Capital Firms**

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Author: **By Kenneth Lu, Fangda Partners**

Venture capital investment has been developing rapidly over the past few years in the coastal regions of China (and especially in Beijing, Shenzhen and Shanghai) along with the boom of Chinese domestic and foreign-invested high tech and internet-related companies. Market players include both domestically funded venture capital (VC) firms and foreign VCs, private equity funds and investment companies. Although some cities, like Beijing and Shenzhen, have already formed their own local rules governing venture capital investment and target businesses, there has been no national legislation until the promulgation of the *Establishment of Foreign-funded Venture Investment Enterprises Tentative Provisions* (the Tentative Provisions).

Legal Forms of Foreign-invested Venture Capital Firms and Their Business Scope

In nature, the Tentative Provisions is an administrative document subordinate to those national laws on foreign-invested enterprises, i.e., *PRC, Sino-foreign Equity Joint Equity Law* (1979), the *PRC, Wholly Foreign-owned Enterprise Law* (1986), the *PRC, Sino-foreign Cooperative Joint Venture Law* (1988), and the *PRC, Company Law* (1994). So, in terms of legal forms of foreign-invested venture capital enterprises (hereinafter FIVCE), the Tentative Provisions permit foreign investors to use those forms previously specified: equity joint venture, cooperative joint venture or wholly foreign-owned company. However, no FIVCE can be set up as a "company limited by shares" (which means the FIVCE is not allowed to attract investment from the general public by floating its shares), and Chinese citizens are not allowed to be shareholders and to hold equity interest, despite the general view held in both business and legal circles now that such restriction on Chinese individuals' participation is unfair and out of date.

On the one hand, the Tentative Provisions clearly provides for the businesses open to the FIVCE, including equity investment using its own funds in high and new tech areas and other areas encouraged or permitted to have foreign investment and investment and management consulting services. On the other, it is prohibited from making equity investment in those areas not open to foreign investment, in any securities, options, futures or other financial derivatives (with the exception of a case in which a portfolio company has an IPO and then has its shares listed on a stock exchange; the FIVCE's holding of its shares will not be deemed as a violation of this prohibition) and in any real estate property that is not for its own use. Also, a FIVCE

is not permitted to raise loans and then use such loans to make investment.

Obviously, like Chinese foreign-invested holding companies, the FIVCEs are not subject to the outward investment limit stipulated in the *PRC, Company Law* that a company's aggregate investment to other companies shall not exceed 50% of its net asset value.

It is provided in Article 8 of the Tentative Provisions that a FIVCE's total registered capital amount contributed by its investors shall also be its total investment amount. This is different from the case of a normal foreign investment enterprise (FIE) whose "total investment amount" is larger than the registered capital, with the gap to be raised in loans. Given this special provision and those restricting its business scope, it appears that a FIVCE is allowed neither to raise any loans nor to manage other person's monies by whatever arrangement.

Incentives for Management

The Tentative Provisions has a general provision that a FIVCE formed as a limited liability company (the investors can select to set up a cooperative FIVCE as a partnership instead of a limited liability company) may grant its management with incentives on its performance. It remains to be clarified by the authorities what such incentives can be. But it appears under the present "Chinese legal framework that whatever it is, it can not be stock options or shares to the management members, because as mentioned above, a Chinese citizen is not allowed to be a shareholder of the FIVCE, and so far a stock option plan in a Chinese company is not recognized under Chinese laws and is incompatible with the governmental approval and registration requirements in terms of an FIE.

A FIVCE's Outward Investment

The MOFTEC and SAIC issued jointly a regulation in July 2000 as *Tentative Provisions on Domestic Investments by Foreign-invested Enterprises*. By that regulation, a FIE is permitted to make outward investment with the cap of such investment being 50% of its net asset value. Some requirements exist, including that all of its registered capital shall be contributed in full by its investors and it has already made profits from its own operations. If an FIE makes investment in a company registered in central or western China with its shareholding being 25% or more of that company, or if an FIE sets up a new company with a foreign investor where the foreign investor's shareholding is at least 25%, then that company will be deemed as a foreign investment enterprise and entitled to all preferential treatments.

The Tentative Provisions is not clear whether that regulation of July 2000 will also apply to a FIVCE's outward investment. However, it looks from the relevant provisions of the Tentative Provisions that the system it creates is totally different and

separate from the one set up by the July 2000 regulation: in the case of a FIVCE's outward investment, the foreign share of the portfolio company's total equity interest (being the investment of the FIVCE plus the investment of other foreign investors, if any) shall not be less than 25%, that all such portfolio companies will be entitled to the preferential treatments available to FIEs, and that such investments shall be approved by the MOFTEC or its local branches depending on their approval authority.

A FIVCE's Exit from Portfolio Companies

The FIVCE can sell and transfer its shareholding to other persons, it may help the portfolio company to float on stock exchanges and then sell out its shares, or it can enter into a share redemption agreement with the portfolio company for the latter to purchase back its own shares. The last mechanism, the share redemption arrangement, is unique under Chinese law because the *PRC, Company Law* is silent on whether a limited liability company (as opposed to a "company limited by shares") can purchase back its own equity. On this, the Tentative Provisions provides that MOFTEC will prepare and issue specific rules on how such a redemption arrangement should be operated.