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China NDRC Denies the “National Treatment” for RMB Funds with Foreign GPs

China’s National Development and Reform Commission (“NDRC”), one of the major regulatory authorities in charge of foreign investments in the People’s Republic of China (the “PRC” or “China”), recently denied the “national treatment” of RMB funds in the form of a limited liability partnership with a foreign-invested company as general partner (“GP”) and with only PRC domestic investors as limited partners (“LPs”).

Background

Foreign investments in China are subject to certain restrictions as well as various governmental approval procedures, which are often considered to be onerous and time-consuming. In early 2011, to attract the establishment of private equity funds, Shanghai, followed by Beijing and Tianjin, introduced the so-called Qualified Foreign Limited Partners (“QFLP”) program, under which, among others, a private equity fund formed as a limited liability partnership with a foreign-sourced GP and Chinese LPs and no foreign LPs would be deemed to be a Chinese investor for purposes of foreign investment regulations, provided that the GP’s capital commitment to the fund does not exceed 5% of the total capital commitments (the “5% Exception Rule”). Such “national treatment” exempts qualified funds from complying with China’s foreign investment regulation regime when such funds make investments in portfolio companies.

The 5% Exception Rule is particularly attractive to those foreign fund managers who intend to raise capital only from China’s domestic sources while hoping to ensure that such type of funds receive equal treatment with their purely domestic private equity competitors (which are RMB funds with a domestic GP and domestic LPs) in the process of portfolio investments. Therefore, with other merits, the QFLP program has led to a surge in the number of RMB funds, especially in Shanghai, including funds managed by Blackstone Group, Carlyle Group, etc.

Regulation

In response to the Shanghai Development and Reform Commission’s request to clarify the “national status” of a fund with a PRC subsidiary of Blackstone Group as its GP, NDRC, however, issued a letter¹ on April 23, 2012 (the “NDRC Letter”), affirming that such type of RMB funds shall still be deemed as foreign investors, and their portfolio investments

¹ The Reply Letter of the General Office of NDRC on Relevant Issues Relating to Foreign-invested Equity Investment Enterprises 《国家发展改革委办公厅关于外资股权投资企业有关问题的复函》

are therefore subject to *the Catalogue for Guiding Foreign Investment*², a major PRC regulation specifying the industry restrictions for foreign investments and other applicable PRC laws relating to foreign investments.

Implications

The NDRC Letter denies the applicability of the 5% Exception Rule under the QFLP program to the effect that a contribution of even a nominal amount of foreign-sourced capital comprising a small fraction of the total fund size would make the fund “foreign.” It would also cause uncertainties as to the legality of the finished portfolio investments made by foreign-invested RMB funds if such investments had enjoyed the “national treatment” according to the 5% Exception Rule.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. Please note that under current law of the PRC, foreign lawyers such as ourselves are not permitted to practice law in the PRC and thus are not permitted to render formal legal opinions on matters of PRC law. This summary is for your reference only.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Lorna Xin Chen
Hong Kong
+852.2978.8001
lorna.chen@shearman.com

Azam H. Aziz
New York
+1.212.848.8154
aaziz@shearman.com

Nathan J. Greene
New York
+1.212.848.4668
njgreene@shearman.com

John W. Finley III
New York
+1.212.848.4346
sean.finley@shearman.com

Paul S. Schreiber
New York
+1.212.848.8920
pschreiber@shearman.com

Laura S. Friedrich
New York
+1.212.848.7411
laura.friedrich@shearman.com

Alan Seem
Shanghai
+86.21.6136.5018
alan.seem@shearman.com

Lee Edwards
Beijing
+8610.5922.8001
lee.edwards@shearman.com

Paul Strecker
Hong Kong
+852.2978.8000
pstrecker@shearman.com

Shuang Zhao
Hong Kong
+852.2978.8002
shuang.zhao@shearman.com

Richard Metsch
Hong Kong
+852.2978.8010
metsch@shearman.com

Pang Lee
Hong Kong
+852.2978.8005
pang.lee@shearman.com

Bill Murdie
London
+44.20.7655.5149
bill.murdie@shearman.com

John Adams
London
+44.20.7655.5740
john.adams@shearman.com

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069 | WWW.SHEARMAN.COM

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² Issued by NDRC and China's Ministry of Commerce on December 24, 2011.