NDRC Issues China's First State Level Rule Regulating RMB Funds Nationwide

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The *Notice on Promoting the Standardized Development of Equity Investment Enterprises* (the Notice) is the first state level rule to regulate the PE industry nationwide. The Notice signals that RMB funds will face stricter supervision going forward. However, at the same time, other regulatory developments appear to be opening up China's RMB fund market to more foreign investment.

On November 23, 2011, the General Office of the National Development and Reform Commission (the NDRC) promulgated the Notice, which focuses on the supervision of domestically formed Renminbi-denominated PE Funds (RMB Funds). The two most salient provisions of the Notice are expanded filing requirements and look-through examination.

Expanded Filing Requirements

Under the Notice, filing requirements for RMB Funds are expanded from six pilot areas — Shanghai, Beijing, Tianjin, Jiangsu, Zhejiang and Hubei — where they were first established pursuant to a notice issued by the NDRC on January 31, 2011 (Chongqing was later added to this group), to become applicable nationwide. Any RMB Fund with a fund size of at least RMB 500 million, or equivalent foreign currency, is now required to file certain fund-related materials with the NDRC, while smaller RMB Funds are required to file similar materials with the local counterpart of the NDRC at the provincial level. The materials to be filed include, among other things, prospectuses, contribution commitment letters, capital verification reports and legal opinions. In addition to the required initial filing, RMB Funds also need to file annual financial reports and business reports, as well as reports of significant events (e.g., amendment to articles of association, capital increase or decrease) with the NDRC or its local counterparts, as applicable.

Compliance with new filing requirements under the Notice may increase costs associated with certain RMB Funds, but, more importantly, the new filing requirements may necessitate the disclosure of potentially sensitive transaction terms, especially in respect of smaller RMB Funds, which previously were not subject to such filing requirements, even in the pilot areas.

However, filing with the NDRC may have certain benefits. Most notably, satisfaction of the filing requirement gives RMB Funds access to funds from the National Social Security Fund (the NSSF), the largest institutional investor in China. The NSSF, which is permitted to invest in RMB Funds only if they are filed with the NDRC, has invested a total of RMB 19.5 billion in 13 RMB Funds, or 31% of the aggregate fundraising amount of these 13 funds, as of the end of 2011, and has recently indicated its intention to increase RMB Fund investments in 2012.

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Look-Through Examination

The Notice also introduces a "look-through" examination of "non-legal person investors" of RMB Funds. Except for a fund of funds (FOF), which would not be subject to "look-through" examination and would be counted as one single "ultimate" investor, each ultimate investor of other types of "non-legal person investors" (e.g., a collective capital trust or a partnership enterprise) would be counted towards the applicable investor numerical limit. This means that, for an RMB Fund organized in the form of a limited liability company or a limited partnership, there may not be more than 50 ultimate investors, whereas, for an RMB Fund organized in the form of a company limited by shares, there may not be more than 200 ultimate investors.

According to official interpretation, the "look-through" treatment aims to block "illegal fund raising." However, it may, as a result, exclude fundraising from LPs such as collective capital trusts and partnership enterprises that are usually used by smaller investors as collective investment vehicles. One potential alternative to deal with the "look-through" treatment may be to structure a "non-legal person investor" in RMB Funds as an FOF. However, "FOF" is not clearly defined under the current PRC legal framework. Another potential alternative is to form a company, which would qualify as a single legal person investor for purposes of investment in RMB Funds, where each company could have up to 50 or 200 shareholders, as applicable. Of course, tax considerations applicable to FOFs and companies may ultimately affect the desirability of these alternatives. Additionally, even if such alternatives were used, there could still be some concern regarding being deemed to be engaged in "illegal fund raising," since this concept is not clearly defined either.

Other Important Provisions in the Notice

The Notice further provides that fundraising for RMB Funds should be limited to qualified investors able to identify and tolerate risk. There is no definition for "qualified investors" provided in the Notice, though in practice the NDRC appears to have set up a minimum contribution threshold for LPs of RMB Funds of RMB 10 million per LP. It is expected that such minimum contribution requirement may be officially established in the near future, practically excluding smaller investors from investing in RMB Funds, but paving the way for increased participation by big institutional investors (e.g., pension funds and FOFs).

Additionally, the Notice specifically provides certain qualification requirements for senior executives of RMB Funds and fund management entities. Senior executives at an RMB Fund must not have records of criminal activity or other wrongdoing or have been involved in litigation arising from significant economic disputes in the last five years, and at least three senior executives at each RMB Fund must have two or more years of experience in equity investment or related work.

Increased Market Access

While the Notice imposes stricter supervision of RMB Funds on the national level, other recent regulatory developments appear to be opening up China's PE market to further foreign participation, and the Notice makes no attempt to scale back these developments. It seems that China is working towards creating a unified regulatory regime to regulate the RMB PE industry, while at the same time taking cautious steps to open up its PE market.

Historically, foreign participation in RMB Funds has faced foreign exchange regulatory restrictions and barriers to market entry. Since 2008, to prevent "hot money" from flowing into China and further fueling pressure on RMB values, capital contributions of foreign partners into RMB Funds could not be directly converted into RMB to be held for later investment. Instead, each time an investment would be made, an RMB Fund that expected to receive a foreign capital contribution would have to obtain specific approval from the foreign exchange authority for such investment, and the RMB Fund would then have to make a foreign currency investment, leaving portfolio companies and their selling shareholders to deal with conversion of the foreign currency into RMB. Furthermore, RMB Funds that have foreign investors have themselves been deemed "foreign investors," and as a result their investments in China are subject to approval by relevant foreign investment regulators and cannot be made into sectors in which foreign investment is "prohibited" or "restricted." These currency conversion restrictions and foreign investment approval requirements have generally made RMB Funds with foreign investors much less competitive than RMB Funds without any foreign investors.

For the past several years, many local governments in China, eager to build their cities into RMB Fund hubs, have been trying to tackle foreign exchange regulatory restrictions, while at the same time implementing various preferential policies for RMB

Funds (e.g., seed money, financial incentives and tax refunds). In 2011, four jurisdictions (Shanghai, Beijing, Tianjin and Chongqing) initiated significant pilot programs. Under the pilot programs, pilot RMB Funds in the form of foreign invested partnerships can potentially avoid the major hurdles generally facing foreign-invested funds in China. For example, to avoid foreign exchange conversion restrictions, under the pilot programs foreign capital contributions by foreign-invested GPs and qualified foreign LPs may not be subject to the foreign exchange conversion approval described above; while, to circumvent foreign investment approval requirements, certain jurisdictions (e.g., Shanghai and Tianjin) have attempted to more narrowly define a "foreign investor" so that qualified RMB Funds would not be counted as "foreign investors."

The Notice is notable in that it has not sought to reverse or limit the progress and liberalization achieved under the various local pilot rules. The central government seems to be currently allowing local governments to move forward with systems of special preferences, including pilot fund structures that encourage foreign investment, and has, as of yet, not acted to prevent the incentive for forum shopping brought about by competing regional incentives. The NDRC's decisions to monitor these developments on a national basis, while tacitly accepting local initiatives, may be seen as a step towards the emergence of a larger, more sophisticated market for RMB Funds in China.

As an additional sign that national authorities are moving towards more accommodating policies with respect to RMB Funds, in October 2011, the Ministry of Commerce MOFCOM and the People's Bank of China issued regulations that allow foreign investors to invest RMB obtained offshore from certain specific legal channels in onshore RMB Funds. With the total amount of RMB deposited in Hong Kong expected to reach 2 trillion by the end of 2012, allowing offshore RMB to flow back onshore and be invested in onshore RMB Funds could potentially greatly expand sources of fundraising for RMB Funds.

Challenges and Opportunities Going Forward

Despite these positive recent developments, the RMB Fund industry in China is far from mature, and regulatory uncertainties still remain. Fundamentally, it is still unclear which PRC national authorities will be primarily responsible for monitoring, supervising and regulating RMB Funds, since various state level entities — including the NDRC, MOFCOM and the China Securities Regulatory Commission — could each potentially fill this role.

Until state level entities coordinate their efforts to create a unified national policy, developments in the RMB Fund market may continue to occur in a piecemeal fashion. Nevertheless, the central government's "hands-off" approach and the trend towards opening up China's key markets to certain foreign participation in RMB Funds are positive developments for foreign PE investors with an interest in China, and it appears likely that opportunities for foreign investment to participate in RMB Funds will continue to expand in the coming years.

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Historically, the term "emerging manager" has been applied to minority- and woman-owned money management firms with less than $1 billion in assets under management. There is, however, no universally accepted definition and many public pension plans and other institutional investors have their own views on what constitutes an emerging manager and whether to limit that designation to firms controlled by historically underrepresented communities.

What Are the Criteria That Institutional Consultants Should Use to Analyze and Evaluate Emerging Managers?

An emerging manager has traditionally been identified by its short, or non-existent, investment track record and modest assets under management. As a result, institutional investors struggle to evaluate these managers using traditional tools, which often rely heavily on the prior track records of earlier funds.

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Emerging managers often pursue innovative investment strategies that are designed to capture market inefficiencies that have not yet been recognized by other firms. Typically, these younger firms have ownership structures that provide financial incentives to all of the key participants, rather than ownership structures which disproportionately benefit an older generation of founding partners.

Size can be a hindrance to many funds. Although size can bring undeniable advantages, such as greater resources and opportunities for diversification, growth can also lead to diminishing returns when larger firms lose their focus and are forced out of the sectors and transaction sizes which brought their early success. Research indicates that emerging managers often perform better across asset classes, and with less risk, than their larger, more established counterparts.

Due diligence is an essential exercise that all investors must do prior to investing in a fund. In the case of an emerging manager, due diligence is of particular importance since these firms are often in an early developmental stage and consequently lack the staffing and infrastructure that more established firms have.

Further, emerging managers can operate in a number of different asset classes, such as private equity, mezzanine, real estate or hedge funds. As a result, the due diligence that a prospective investor conducts should be robust enough to consider and evaluate a wide variety of investment objectives.

Accordingly, prior to investing with an emerging manager, the following questions should be asked:

- What prior history do these particular individuals have in working together on the same platform?
- Does this collection of individuals provide a complete set of those skills necessary to run a successful fund?
- If there are gaps in those skills, how does the management team propose to fill them?
- What is the team's decision-making process for determining which investments to acquire and at what price?
- If members of the investment team have different philosophies on investing, how will these different approaches be reconciled?
- If the emerging manager is being considered because it is woman- or minority-owned, will the control and economic participation of the manager be divided in such a way that reinforces such ownership or undermines it?
- Who are the emerging manager's professional advisers and have they taken the time to analyze and adopt the most appropriate structure for the fund, given recent changes in the market?
- For each of the investment professionals, what is their individual investment history and can they provide detailed back-up to support their track record on realizations?
- Do any of the key personnel have a history with relevant regulators or otherwise been involved in litigation or regulatory enforcement actions?
- Is there a management oversight program in place to identify and address any questionable actions that may occur within the team?

An adequate evaluation of the prospective fund will necessarily include a thorough review of the fund manager and his or her team. In the case of an emerging manager, this review will need to be based on a wider investigation of prior firms, affiliations and platforms because the current team will have only been together for a limited time.

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German Private Label Funds—Contractual Design and Liability Issues

Investment managers that traditionally take care of their clients' money by investing in third-party funds are questioning whether to offer their "own" funds to make their brand more visible to potential new clients and to motivate their teams with profit-sharing agreements. Private label funds might be an effective instrument to achieve both goals. The following article outlines the main features of this German mutual fund structure.

Private Label Funds—Definition and Structure

A private label fund (also referred to as "third label fund" or "white label fund") is based on the economic assumption that family offices, investment boutiques and other investment managers want to attract new clients without operating outside their circle of competence. They want to continue to provide high-quality asset management, determine their investment style as well as their fee structure, and nurture new clients for their main services. The fund administration (accounting, compliance and risk controlling), on the other hand, should be transferred to an investment management company (*Kapitalanlagegesellschaft*). This structure bears advantages for the investor because such an efficient regime allows for the pursuit of niche strategies that generally aren't good for considerable fund volumes.

Under the described structure, the investment management company, in cooperation with the investment manager, sets up a mutual fund (*Investmentfonds*). The name of the fund generally includes the name of the investment management company and investment manager and a description of the investment strategy to be pursued. The total volume of private label funds in Germany is estimated to be around €40-50 billion. Euro with a total of 850-1,000 funds, approximately 8% of the whole universe of publicly-distributed German mutual funds. 1970 saw the launch of the first German private label fund, *HWG-Fonds* of Heidenheimer Volksbank, which still exists.

Contractual Design—Legal Basics

Section 16, paragraph 1 of the German Investment Act (*Investmentgesetz*, InvG) provides the basic rule that essential activities of the investment management company may be delegated to third-party companies.

Section 16, paragraph 2 of the InvG, however, rules that in the case of delegation of portfolio management functions, only third-party companies that are certified investment managers and subject to public supervision, which doesn't exclude foreign supervision, would qualify.

These opportunities lead to the platform structure of a master (with numerous sub-funds) or service (with potentially only one fund) investment management company that offers economics of scale through a bundling of administrative services that allows investment managers to operate without setting up their own relatively large investment management company.

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Still, the investment management company could be held liable for misconduct of the investment manager/outsourcing partner which seems reasonable when taking into account the following contractual details.

Contractual Details

A core element of the contractual structure is the investment management agreement between the external asset manager and the master or service investment management company. This agreement will address a number of regulatory issues, e.g., instruction rights of the investment management company, disclosure obligations of the investment manager and rights to information granted to the German financial services supervisory authority, *Bundesanstalt für Finanzdienstleistungsaufsicht*.

In each case, a consistent contractual framework has to be negotiated in terms of the apportionment of liability. On the one hand, the investment manager would generally be held liable where he operates outside the investment limits of the fund's dedicated policy. On the other hand, the investment management company would generally be held liable in case of improper instructions. It should be noted that this contractual arrangement does not in any way limit investor's claims against the investment management company.

Additional contractual arrangements in the described structure would address the fund distribution and the role of the depositary.

Liability Issues

It is the investment management company's obligation to secure an effective internal compliance system. In case of violations, this might lead to a claim of the investor either based on (i) a positive breach of contract under Sec. 280 of the German Civil Code (*Bürgerliches Gesetzbuch*, BGB) which would include a liability for presumed fault of the investment management company or (ii) a violation of protection law within the meaning of Sec. 823 para 2 BGB in connection with Sec. 9 InvG.

The investment management company might also be subject to third-party liability for misconduct of the depositary.

Conclusion

Private label funds provide an efficient way to allow independent and emerging investment managers to set up their "own" fund, thereby leveraging their existing brand. The system of contractual checks and balances would generally leave no "liability gaps" inside such a structure. The coming years will show whether the private label fund can also serve as an alternative for smaller investment managers that generally do not fall within the scope of the European AIFM Directive, but still want to offer their clients a tested regulatory regime.

This article is a shorter version of a piece originally published in the January 2012 issue of the German legal monthly Law of Financial Instruments (Recht der Finanzinstrumente, http://www.rdf-online.de/).

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Thomas A. Jesch to Present on AIFMD at Euroforum Conference "Capital Markets Law Update"

Thomas A. Jesch, Counsel in the Frankfurt office, will deliver a presentation on the EU's Alternative Investment Fund Managers Directive (AIFMD) and the status of its implementation into German law at the Euroforum Conference "Capital Markets Law Update" in Frankfurt. Thomas will also give an outlook on the UCITS V Directive dealing with the depositary function and managers' remuneration in the area of mutual funds. The presentation is scheduled for May 9, 2012.

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JOBS Act Creates Significant U.S. Capital-Raising Opportunities for U.S. and Non-U.S. Companies and Funds

After racing through Congress, the Jumpstart Our Business Startups Act (the JOBS Act) has stranded in the Senate Committee on Banking, Housing and Urban Affairs ("Senate Banking Committee") at least 11 Senate and House bills (most passed in 2011) which deal with securities law reforms. H.R. 3606 sped through the legislative process due to its bipartisan popularity as a jobs growth bill, owing in significant part to a finding by the IPO Task Force that 90% of job creation occurs after a company's IPO. At the time of this alert, it is expected that the JOBS bill will be delivered to President Obama for his signature in the next few days.

The Act accomplishes private offering rules reforms, implements many recommendations of the IPO Task Force and endeavors to create a healthy equity market food chain. While it seems likely that the U.S. will again be a jurisdiction of choice for both domestic and non-U.S. companies contemplating an IPO, it also seems that much of the oxygen was removed from the lower end of the food chain by Senator Merkeley's amendments to the crowdfunding provisions of Title III of the JOBS Act, which were motivated by concerns about potential for fraud on small investors.

At the upper end of the equity market food chain, H.R. 3606 creates a new category of issuer (including hedge funds, private equity funds and special purpose entities)—an "emerging growth company" ("EGC")—which benefits from various significant IPO inducements and related concessions. Essentially, an EGC is any domestic or non-U.S. company (or other entity including funds) with total annual gross revenues (presumably on a U.S. GAAP basis) of less than US$1 billion (as adjusted for inflation by the SEC every 5 years) during its most recently completed fiscal year.

H.R. 3606 also lifts the prohibition on general advertising and general solicitation that has since 1962 been essential to characterize an offering as private and not subject to registration under the '33 Act. As long as a Rule 506 offering is made only to "accredited investors" and "qualified institutional buyers" (within the meaning of Regulation D and Rule 144A, respectively), general advertising will be permitted for all issuers (including hedge funds, private equity funds and special purpose entities), after a 90-day period during which the SEC is to issue implementing rules.

The confluence of allowing general advertising and raising the number of record holders of an issuer's shares to 2,000 (or 500 record holders which are not accredited investors) before the registration and ongoing periodic reporting requirements under Section 12(g) of the '34 Act are triggered, should result in a substantial increase in pre-IPO financings in the United States by both domestic and non-U.S. companies from the approximately US$609 billion raised during 2009 in the United States.

The prognosis for the lower end of the equity market food chain is less promising. Crowdfunding has been a popular method of capital formation where "groups of people pool money typically comprised of very small individual contributions to support an effort by others to accomplish a specific goal" (SEC Chairman Mary Schapiro). Yet concerns about possible frauds expressed during Senate Banking Committee hearings on earlier alternative measures to H.R. 3606 apparently motivated various constraining amendments, including, among others, increased canvassing for shareholder accredited investor status requirements and a requirement that all capital raises via crowdfunding have to be conducted through a registered broker-dealer.

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