

Onshore Financial Investing in China

White Paper

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ONSHORE FINANCIAL INVESTING IN CHINA

By Howard Chao, Walker Wallace and Yi Zhang

Introduction

Over a period of only a few short years, a very significant private equity industry has developed in China. Beginning in the early 2000s, a gradual trickle and then a flood of venture and growth capital investors from Silicon Valley, New York, London and various parts of Asia entered the China market. In the early years, there was little domestic Chinese investor competition, and the domestic Chinese capital markets were still in a fledgling state. Chinese policymakers had no experience with financial investors and made no distinctions between them and the corporate investors (they were much more familiar with the latter). Chinese corporate law was not developed to support the requirements of financial investors. The Chinese laws and regulations providing legal vehicles for foreign investors¹ were originally established to regulate foreign corporate investors in China.

Because of the restrictions and inadequacies of the Chinese domestic legal regime, foreign private equity investors traditionally held their China investments through offshore holding companies (typically in the Cayman Islands, the British Virgin Islands or Hong Kong) owned by founders or management. The holding company would in turn own operating FIEs in China. This structure enabled all shareholder arrangements between private equity investors and founders/management to be documented at the offshore holding company level, allowing for the usual investor protections such as preferred shares, put and call options, rights of first offer/refusal and exits, all without the need for Chinese government approvals. This structure was well-suited for the eventual wave of Chinese IPOs in the U.S. and Hong Kong, since it was much easier to list an offshore company in the U.S. and Hong Kong, than a Chinese domestic company.

Indeed, in cases where the proposed foreign investment was in a sector prohibited to foreign investment, a practice of using “captive” Chinese domestic operating companies developed to circumvent sector restrictions. The domestic operating company would conduct the business in the sensitive sector with a proper license and would be owned by one or more trusted Chinese nationals, perhaps the founder or a relative of the founder. This operating company would in turn be controlled through contractual arrangements by the foreign-owned WFOE and would pay most of its revenues to the WFOE through a servicing agreement. The Chinese government turned a blind eye to these so-called “VIE” arrangements² and eventually many of the most successful offshore IPOs were structured in this fashion.

According to the data published by ChinaVenture,³ from January 1, 1988 to September 30, 2010 there were 3,373 private equity investments in China with an aggregate investment amount of US\$115.482 billion. Based on our firm's research discussed below, in calendar 2010 there were 347 IPOs in China on the three domestic boards, and of these companies approximately 40% had significant VC/PE ownership (mostly domestic) at the time of IPO.

¹ These vehicles are called foreign invested enterprises (“FIEs”) and include equity joint ventures (“EJVs”), co-operative joint ventures (“CJVs”) and wholly foreign owned enterprises (“WFOEs”).

² “VIE”, or “Variable Interest Entity”, is a financial accounting term discussed by FASB Interpretation No. 46, Consolidation of Variable Interest Entities. Captive structures in China are designed to meet this standard so that the results of the captive company may be consolidated with, and treated as part of, the foreign-owned WFOE group for financial accounting purposes.

³ See <http://cvsource.chinaventure.com.cn/listfinancing.action>.

In looking back at this period of unfettered investments by foreign private equity investors, several things are noteworthy. First, foreign private equity investors were filling a financing need not met by the Chinese domestic financial system. A significant transfer of know-how to China also occurred, resulting in a strong pool of private equity professionals (many of them Chinese nationals) who now operate in China.

Second, many Chinese enterprise owners were able to convert their PRC owned domestic businesses to “foreign-owned” businesses by setting up an offshore holding company (often held jointly with international private equity investors) and using such holding company to purchase their businesses in China (a so-called “round trip investment” or “red-chip restructuring”). In this way Chinese enterprise owners were able to largely escape the jurisdictional reach of the Chinese government for monitoring, foreign exchange and tax collection purposes. Profits of the operating company in China could be repatriated to the offshore holding company, and once there, could be further repatriated to other offshore holding companies. This achieved permanent deferral from tax as a result because current Chinese individual income tax laws do not yet contain anti-deferral provisions for offshore entities owned by Chinese individuals. Compare this to the situation of pure domestic Chinese companies where the owners had no legitimate means to move their profits offshore. In addition, if a large capital appreciation was realized on the sale of the offshore holding company shares, that gain was also not taxable in China.⁴ And just as importantly, no Chinese approval was required to transfer the offshore holding company shares, unlike in the case of transfers of interests in FIEs in China.

Third, since these private equity-backed companies were all structured as offshore holding companies, their natural exit was an offshore IPO or trade sale, not a domestic exit. Indeed, a significant number of the U.S. and Hong Kong IPOs of Chinese companies were private equity-backed companies. This was not a sustainable approach in the long term, however, since at the same time China was also accumulating a substantial base of domestic capital and reinforcing the growth of its own domestic capital markets.

It was therefore not surprising that the Chinese government started to restrict the offshoring of Chinese companies and their financings, beginning around 2005.

Circular 75

The first Chinese agency to regulate round trip investments was the State Administration of Foreign Exchange (“SAFE”). After some early regulatory missteps, in October 2005 SAFE issued Circular No. 75 (“Circular 75”), requiring Chinese residents to register with the local SAFE branch before establishing or controlling⁵ any offshore special purpose company with assets or equity in a Chinese company for the purpose of an offshore equity financing. Chinese residents who had already set up such offshore companies prior to Circular 75 were also required to register under Circular 75. The term “Chinese resident” under Circular 75 theoretically includes PRC nationals and non-PRC nationals who habitually live in China for economic reasons. Failure to comply with Circular 75 could result in the Chinese subsidiary being prohibited from engaging in foreign exchange transactions (and, possibly, from distributing dividends out of China), as well as liability under Chinese laws for violation of foreign

⁴ This treatment is now at risk under *The Notice on Strengthening the Management of Enterprise Income Tax Collection of Proceeds from Equity Transfers by Non-resident Enterprises* issued by the PRC State Administration of Taxation in December 2009 (Guoshuihan [2009] 698).

⁵ “Control” is interpreted broadly to include the right to receive economic proceeds of the onshore venture.

exchange rules. In effect, the Chinese subsidiary would not be able to engage in ordinary operational activities.

Since then, SAFE has, pursuant to its internal guideline, expanded the definition of round trip investment by requiring Circular 75 registration of greenfield investments by offshore companies established or controlled by a Chinese resident in which no pre-existing domestic company or asset is involved. Essentially, any offshore financing and subsequent onshore investment by an offshore company established or controlled by a Chinese resident is subject to Circular 75 registration.

In practice, the SAFE regulations have significantly complicated offshore restructurings that typically need to be carried out in preparation for a venture capital or private equity investment and, thus, potential issues relating to SAFE registration usually warrant careful consideration by investors before making an investment. Nonetheless, the process for making a SAFE registration has become somewhat more predictable since Circular 75's initial promulgation in 2005 and the SAFE registration generally is not, at least not in and of itself, a block on potential transactions. Indeed, specialized agents dealing with SAFE registrations have become common in China after Circular 75 came into effect. Recently, however, SAFE has apparently tightened the review and approval of Circular 75 registration applications because of concerns over the influx of "hot money" and pressure for RMB appreciation.

The M&A Rules

After Circular 75 was promulgated, in August 2006, six Chinese ministries, including the Ministry of Commerce ("MOFCOM") and SAFE, jointly issued amended regulations on mergers and acquisitions of domestic companies by foreign investors (the "M&A Rules") which put a further brake on round trip investments. Under the M&A Rules, central government approvals (as opposed to provincial or local approvals) were for the first time required for all round trip investments regardless of the size of the transaction.

When the M&A Rules were enacted, many were concerned about whether this new rule would stop the flow of new private equity-backed companies and IPO candidates. It all hinged on how liberal the central government would be in approving round trip investments. The worst fears of investors have actually turned out to be true. Since the M&A Rules went into effect, virtually no round trip restructurings have been approved under the rules. This has put a stop to many reorganizations of Chinese companies into offshore holding company structures, thereby dramatically reducing the future pipeline of deals for private equity investors.

Such effective prohibition on round trip investments was further confirmed by a "Foreign Investment Examination and Approval Management Guidance Handbook" published by MOFCOM on December 23, 2008, under which MOFCOM states that it currently will consider approval of a round trip investment only under two limited circumstances: (i) if the offshore acquirer is a listed company or (ii) if the formation of the offshore acquirer has been duly approved and the offshore acquirer has begun actual operations and will use its profits for the round trip investment. While this suggests that MOFCOM is now open to considering reverse merger (or back-door listing) transactions by listed companies, as well as business consolidation acquisitions by approved offshore operating companies, these two limited exceptions are not very meaningful to private equity and venture capital investors. Apart from these two exceptions, the vast majority of round trip investments falling under the M&A Rules will continue to be prohibited by MOFCOM.

How do Circular 75 and M&A Rules affect venture capital and private equity investments in China?

The restructuring difficulties imposed by Circular 75 and the M&A Rules have not stopped offshore financings and listings of Chinese companies. The number of offshore financing deals and offshore Chinese IPOs since 2007 has still been very high. Nonetheless, most such deals have involved companies that were restructured prior to September 8, 2006 when the M&A Rules went into effect.

Many companies organized or restructured after September 8, 2006 have explored and used various alternative structures to address the difficulties imposed by the M&A Rules on round trip investments, including, for example, using variations of the VIE structure or JV structure. However, such alternative structures are generally highly specific to each company's unique circumstances and, being generally untested, carry additional risks and uncertainties.

It is always possible that the Chinese government may start permitting round trip investments again. This would be in part due to political considerations – for example to allow Hong Kong to continue to function as an international financial centre for China. However, it is also possible that a more restrictive regime could be put in place, and approval by the Chinese central government of round trip investments will continue to be effectively withheld.

The Growth of Domestic Capital and Private Equity Industry

Around the time restrictions were put in place against round trip investments, conditions also matured for the development of a strong domestic Chinese private equity industry. With the rapid growth of China's economy, tremendous amounts of capital have been accumulated by wealthy entrepreneurs, companies and the banking system. Government policymakers have come to realize that a vibrant Chinese private equity industry can be an important supplement to more traditional sources of financing for growth enterprises and can improve the governance and management of companies. A large number of government-sponsored and funded domestic private equity funds were established⁶ that made direct investments in domestic companies without the intermediation of an offshore holding company.

Such domestic investors enjoyed several inherent advantages over their offshore competitors. First, domestic RMB funds have benefited from the abundance of local capital, often provided by the local or central government, financial institutions, companies and wealthy individuals.

Second, by investing directly in Chinese companies, rather than trying to invert them into an offshore holding company structure, such investors did not have to deal with Circular 75 or the M&A Rules, nor the related delays and complications.

Third, because pure domestic investors generally do not require Chinese government approvals for M&A transactions, whereas offshore investors do, these domestic private equity funds had the advantage of speed. They could close a deal very quickly whereas an offshore investor might require several months of foreign investment approval waiting time in order to close a deal.

Further, once an offshore investor invests in a Chinese company, that Chinese company generally becomes an FIE. This means that all significant changes relating to this company, including transfers of equity, new investors, amendments to its articles and increases in capital,

⁶ Between 2006 and 2008, a total of 10 "industrial funds" were approved by the National Development and Reform Commission with an aggregate commitment of over US\$20 billion. Many other local government funded investment funds have also been established.

would all need to be approved by MOFCOM or its local counterpart. This can be potentially off-putting to a Chinese target company and another reason why it may prefer a domestic investor.

Finally, as Chinese domestic stock exchanges developed and trading multiples skyrocketed, increasing numbers of Chinese companies began to choose a domestic listing, rather than an offshore one. Since the reopening of the Chinese domestic IPO market in early 2009⁷, a total of 190 companies have been listed on the various Chinese domestic stock exchanges for a total of US\$44,816 million raised. The ChiNext (创业板) in Shenzhen was established in early 2010 and appears to have been a significant success with over 100 companies listed since then. In recent months, the price earnings multiples of Chinese listed companies have averaged in the range of 18.65 to 46.01, well in excess of Hong Kong and the U.S. All of this again argued in favor of domestic investors, since most offshore investors with their offshore structures preferred offshore listings.

Of course, international private equity funds continued to hold strong attractions for many Chinese companies. Their stronger management, experience, network of relationships, particular sector expertise and other value-add benefits continued to cause many Chinese companies to welcome offshore private equity investors. At the same time, many offshore private equity investors felt pressure to explore onshore investing by creating an onshore investment vehicle with as many of the attributes as possible of a pure domestic investor. Thus, some offshore private equity funds set up so-called foreign-invested venture capital investment enterprises (“FIVCEs”), a form of Renminbi fund vehicle with foreign investment.⁸ These FIVCEs receive a somewhat mixed treatment under Chinese law and for some purposes are treated like domestic investors, but for others receive foreign investor treatment. The situation is further complicated by the fact that they receive different treatment across different regions in China depending on the attitude of the local government.

Possible Onshore Investment Structures for Foreign Investors

With the development of the onshore deal market, many foreign private equity investors are now looking for ways to structure at least some of their investments into China in the form of direct onshore investments - with the intention of an eventual onshore exit - instead of investing in an offshore holding company owned by founders or management. The structure of these deals, however, depends on the nature of the entity making the investment. There are several possibilities:

1. the investor could be a true offshore entity;
2. the investor could be an FIE;
3. the investor could be an FIVCIE; or
4. the investor could be one of the new foreign invested limited partnerships.

The rules for each classes of investors are different. It is worth noting that many international investment funds have now begun to make onshore investments into China using these various approaches, with the expectation that the portfolio company will eventually do an onshore listing or other exit.

⁷ Prior to this time there was a Chinese government imposed moratorium in place on new domestic Chinese IPOs in order to permit a restructuring of the shareholdings of state-controlled listed companies so that so-called “legal person shares” could be freely tradable.

⁸ See discussion below.

Offshore Entity Investors

If the investor is an offshore entity, then any Chinese company in which it directly invests (assuming total foreign investment in that entity is at least 25%) automatically becomes an FIE and the investment must be approved by MOFCOM or its local counterpart.⁹ Typically the portfolio company form used would be a Sino-foreign joint venture, since this is the normal corporate form used when there are both foreign and domestic investors. There are two forms of Sino-foreign joint ventures, “equity joint ventures” and “cooperative joint ventures”, each of which is governed by a distinct statute and implementing regulations. While it is beyond the scope of this paper to go into detail about the differences between these legal forms, suffice it to say that equity joint ventures are more common and generally require the investors to be treated *pari passu* with respect to ownership percentages, distributions and control rights. Cooperative joint ventures are a little less common, more flexible in their structuring and may be harder to obtain approval for.

The key challenges for a foreign investor using a Sino-foreign joint venture structure are that they are subject to PRC laws and regulations and that such laws and regulations are fairly rigid in how a joint venture can be structured. No shares in the joint venture are issued, but instead each investor has a percentage of the joint venture’s registered capital. There is no provision in Chinese law authorizing the issuance of preferred shares or the equivalent for such a joint venture. All transfers of registered capital need the consent of all existing shareholders and the approval of the relevant government authorities. Thus, put/call options are hard to implement. Each investor has statutory veto rights over a specified list of actions, and all amendments to the joint venture contract and articles require each investor to consent. There is also no provision in Chinese law authorizing joint ventures to repurchase the registered capital from their investors. Obviously, this list of restrictions does not permit the use of standard offshore investment structures and documentation. In addition, all documents must be drafted in Chinese and submitted to the government authorities in Chinese for approval, although English versions can also be used by the parties. The governing law on all joint venture contracts must be Chinese law, although the parties may choose arbitration in an offshore location such as Hong Kong for dispute resolution.

In the face of these many restrictions, how can foreign investors accustomed to offshore structures operate in China? Some foreign investors have used side agreements with the founders to obtain special rights which are difficult to accommodate in the statutory documents of the company, such as anti-dilution adjustments and put options. It is possible to structure such special rights as an obligation given by the founders (i.e. the other shareholders of the target company) to the investors, instead of an obligation of the target company. For example, the founders might agree to transfer a portion of their registered capital to the investors for *de minimis* price or to purchase the registered capital held by the investor for a specified price under certain circumstances. However, there is uncertainty as to whether such side agreements are enforceable. While it is a private arrangement among the shareholders, the relevant Chinese laws and regulations specifically provide that inter-shareholder issues of a Chinese joint venture should be provided in the joint venture contracts subject to government approval and that any other agreements not consistent with the approved joint venture contracts are not enforceable. In any case, since any sale or transfer of registered capital requires the consent of the relevant government authorities, enforcement of such rights also requires the

⁹ If the percentage is less than 25%, it may still be an FIE, but it may not be entitled to all the “benefits” enjoyed by a typical FIE. Following recent changes in the tax laws, the “benefits” enjoyed by an FIE have become quite limited. One significant remaining benefit is an FIE’s ability to borrow foreign debt to the extent of the difference between its total investment amount and registered capital.

cooperation of the government authorities. In general, due to the weaker Chinese legal system and simpler documentation which is customary in China, the agreements for direct onshore investments offer less investor protection than standard offshore documentation.

Investing Through an Ordinary FIE

Foreign investors which already own an FIE with RMB funds might consider using the FIE as an investment vehicle. Generally speaking, unlike a direct onshore investment by a true offshore entity, such investment would not change the domestic nature of the target company; in other words, if the target company was originally a domestic limited liability company before the investment, it would not become an FIE by virtue the investment by the FIE. Further, under relevant PRC laws, so long as the business of the target company is not in a restricted or prohibited industry, such investment does not require any prior governmental approval, but only a recordal of the investment with relevant authorities on completion.¹⁰

Compared with the direct onshore investment by a true offshore entity, investing through an FIE offers the investor greater flexibility to structure the investment and its rights.

First, while there is no concept of preferred shares or the equivalent for a domestic limited liability company (similar to FIEs), the relevant laws and regulations are less rigid in respect of its legal documentation as compared with Sino-foreign joint ventures. For example, any transfer of the equity interest in a Sino-foreign joint venture is subject to the consent of the other non-transferring equity holders; in comparison, while a transfer of the equity interest of a domestic limited liability company is also subject to a priority purchase right of the other shareholders, if a non-transferring shareholder does not exercise its priority purchase right and does not affirmatively deliver its consent within a certain period, it would be deemed to have agreed to such transfer.

Second, the applicable branch of the State Administration for Industry and Commerce (“SAIC”), not MOFCOM, is the only governmental body that would review the investment documentation, reducing approval risk in the transaction. Theoretically, SAIC’s sole function is to register the transaction, and not review transaction terms, but whether the investment documentation can be easily registered depends in part upon the sophistication of the reviewing officials. In some cases, reviewing officials who do not have sufficient experience with international style documentation may have difficulty accepting provisions which are different from Chinese domestic boilerplate and may refuse to accept registration.

However, using FIEs for onshore investments also has downsides. For example, the sale of such investments attracts a 25% enterprise income tax (to the extent not offset against other losses) and gains cannot be immediately repatriated outside of China. In addition, a certain amount of cash will be trapped in such FIEs, and therefore, such model may be better suited to an evergreen style of investing as a permanent capital base.

Investments by FIVCIEs

To encourage investments by foreign private equity venture capital funds in high tech industries, in 2001 China promulgated the FIVCIE rules, pursuant to which a foreign investor can establish an FIVCIE engaged in the business of making equity investments in China and providing

¹⁰ It should be noted that most FIEs do not have a business license to engage purely in investment activities. Inasmuch, it is desirable to have at least some operational business activities to stay clear of business scope violations. Alternatively, an entity known as a Chinese holding company could be established with a business license expressly allowing investments, but this entity comes with other downsides in terms of approval of downstream investments and onerous set-up requirements.

consultancy services. The establishment of an FIVCIE and the investments by an FIVCIE are regulated by the FIVCIE Regulation Rules promulgated on March 31, 2003.

An FIVCIE is prohibited from making equity investments in “prohibited industries” and is required to obtain approval from a provincial branch of MOFCOM for any investment in “restricted industries”. In comparison, an equity investment in encouraged or permitted industries would only require a “recordal” with the applicable MOFCOM authority before the completion of the investment, and the applicable MOFCOM authority is obligated to issue an FIE establishment approval certificate to the target company within fifteen days.

As compared with “Investments through an Ordinary FIE”, investment by a FIVCIE would generally change the corporate nature of the target company and convert the target company into an FIE. Furthermore, since currently all US Dollars contributed by the foreign investors to a FIVCIE generally cannot be converted to RMB by the FIVCIE, investment by FIVCIEs must typically take the form of hard currency. This leaves investee companies to convert investment proceeds to RMB¹¹ and makes FIVCIEs less attractive as investors as compared with investors who have RMB funds. However, that being said, there have been many exceptions to these requirements in practice because certain localities have sought to allow FIVCIEs to convert specified amounts of US Dollars at the FIVCIE level. The improvement of these mechanics continues to be a hot topic as various local regulators continue to lobby for currency conversion reforms, and MOFCOM is considering yet another iteration of the FIVCIE Regulation Rules.

Investments by Foreign-Invested Limited Partnerships

China did not allow foreign companies or individuals to set up foreign-invested limited partnerships (“FIPs”) until March 31, 2010 when the Administrative Measures on Formation of Partnership Enterprises in China by Foreign Enterprises or Individuals (the “FIP Regulations”) became effective. Whereas the formation of FIEs and FIVCIEs requires prior approval from the Ministry of Commerce or its local counterpart, the formation of an FIP theoretically only needs to be registered with SAIC. However, in practice, since the fund business scope is such a sensitive matter, the approval of another authority such as the local finance office is typically required, as is implicit approval from local MOFCOM authorities.

Under the FIP Regulations and related implementing rules, FIPs are allowed to make investments in other PRC entities. However, the regulations and rules are not very clear as to how the investments should be made. It appears that the treatment of such investments will depend on the nature of the FIP involved. If the FIP’s main business is to hold investments in other PRC entities, the rules applicable to investments by FIEs may be applicable. In all cases, the investments must comply with the general PRC laws and regulations governing foreign investments.

In addition, FIPs are the subject of locally supported “pilot policies” designed to allow currency conversion from US\$ into RMB at the FIP level. Some expect that such currency policies will start to be rolled out in early 2011. This will solve the currency problem faced by newly formed FIVCIEs, but will not eliminate the problem of having FIP investments undergo FIE approval procedures.

¹¹ Under current SAFE regulations an FIE can only convert US Dollar proceeds into RMB piecemeal by providing the qualified evidence of the use of the proceeds (such as bona fide third party contracts, etc.) to the local banks.

Restructuring an Offshore Holding Company to Become an Onshore Structure

Since 2009, there has been a trend of so called “red-chip structures” being migrated or “unwound” into onshore structures in preparation for an onshore listing, whereby all the shareholders of the offshore holding company become the equity holders of the operating subsidiary of the offshore holding company in China. In the past one year period, there have been at least ten domestic companies so restructured which have submitted applications for onshore listing with the China Securities Regulation Commission (“CSRC”), eight of which were approved and went public successfully.

This restructuring process is generally permitted under PRC laws. The primary PRC governmental approvals for the restructuring are the standard governmental approvals required for converting a WFOE into a Sino-foreign joint venture or a domestic limited liability company and, later on, converting it into a joint stock company. However, there are several major issues that need to be considered in relation to the restructuring process.

First, the restructuring requires the offshore shareholders to pay additional cash in order to obtain shares in the onshore operating subsidiary. In many cases, the parties have valued the shares of the onshore operating subsidiary based on its registered capital, which considerably understates the company’s fair value so as to lower the total amount the offshore shareholders are required to pay. While the likelihood of a tax challenge by the governmental authorities currently appears low, the possibility of potential tax liability cannot be wholly discounted. Further, such acquisition of equity in the onshore operating subsidiary at a low price (which is the tax basis for such equity) as a substitute for original equity held in the offshore holding company creates a potential “inside-outside” tax basis problem for the foreign investors, who paid a much higher price for the equity in the offshore holding company.

Second, after dissolving the offshore holding structure, it would be very difficult under current PRC laws for the parties to reestablish the offshore holding structure later on if the domestic company was unable to achieve onshore listing. Since an onshore listing requires prior approval by the CSRC on the basis of a final structure, as opposed to restructuring happening at the moment of the listing, an onshore migration involves higher uncertainty as compared with an offshore listing.

Third, it can be difficult to move offshore holding companies onshore where they use “captive” structures to circumvent sector restrictions. PRC law practitioners generally believe that use of such structures by domestic companies with foreign ownership will not be accepted by the CSRC. The captive company probably will be required to be the listing vehicle, and depending on whether it is in a restricted or prohibited industry, the restructuring process might require the redemption of part or all of the foreign investor owned equity.

Listing on a PRC Domestic Exchange

China currently has two stock exchanges: the Shanghai Stock Exchange and the Shenzhen Stock Exchange. The Shanghai Stock Exchange has only one board: the Main Board, whereas the Shenzhen Stock Exchange has three boards: the Main Board, the Small and Median Sized Enterprises Board and ChiNext.¹² A foreign invested entity can be listed on any of these boards provided it meets the required criteria and obtains the necessary approvals.

¹² There have been no new IPOs on the Shenzhen Stock Exchange’s Main Board since September 2000.

Conversion of Limited Liability Companies

One listing criterion is that the listing vehicle must be a company limited by shares. Under the PRC Company Law, companies fall under two categories: limited liability companies (“LLCs”) and companies limited by shares (“CLSs”). As most FIEs are LLCs, they must be converted into foreign invested CLSs before they can be listed.

Conversion of a foreign invested LLC to a foreign invested CLS requires the approval of MOFCOM or its local counterpart. Under rules issued by MOFCOM, one requirement for such conversion is that the LLC must have made profits in each of the three years immediately prior to the conversion.¹³ As this is not always easy to satisfy, one option for foreign investors when investing in a domestic company is to convert the domestic company directly to a foreign invested CLS (as opposed to a foreign invested LLC) prior to their investment. As such conversion is from a domestic LLC to a foreign invested CLS, the three year profitability test would not apply.¹⁴

A theoretical concern often raised in connection with converting an LLC to a CLS is that the regulations governing such conversion impose a three-year lock-up on the shareholders of the LLC at the time of conversion. However, many legal commentators believe that the three-year lock-up under these regulations has been superseded by changes to China’s Company Law, which require only a one-year lock-up on promoters for a CLS. Extensive anecdotal evidence would indicate that Chinese government departments are acting consistent with this more lenient approach.

Listing Requirements

The listing requirements which a company needs to satisfy in China are analogous to those in Hong Kong and many other jurisdictions. Some of the key requirements are described in the chart below. In addition, a listing candidate must demonstrate that it has appropriate corporate governance structures and compliance measures in place.

	Shanghai/Shenzhen Stock Exchange	ChiNext
Operating history	At least 3 years. Where a limited liability company is converted into a company limited by shares, credit is given for the operating history of the limited liability company.	
Post-IPO capitalization	No less than RMB50 million ¹⁵	No less than RMB30 million
Profitability	<p>The listing candidate must meet <u>both</u> of the following tests:</p> <ol style="list-style-type: none"> 1. have been profitable for the past 3 fiscal years and have accumulated net profits of at least RMB30 million for such period after deducting any non-recurring gains; <u>and</u> 2. have accumulated net cash flow of over RMB50 million for the most recent 3 fiscal years or have accumulated operating revenue of over RMB300 million for such period. 	<p>The listing candidate must meet <u>either</u> of the following tests:</p> <ol style="list-style-type: none"> 1. have been profitable for the past 2 fiscal years and have accumulated net profits of at least RMB10 million for such period; <u>or</u> 2. have revenues of at least RMB50 million and net profits of at least RMB5 million for the last fiscal year and a growth rate of at least 30% in its revenue for the last 2 fiscal years.

¹³ We understand that, in practice, this rule is sometimes waived.

¹⁴ We understand that, in practice, straight conversion from a domestic LLC to a foreign invested CLS does not happen often.

¹⁵ This is an exchange requirement. The CSRC only requires post-IPO capitalization of RMB30 million.

	Shanghai/Shenzhen Stock Exchange	ChiNext
Pre-IPO assets	Must have positive retained earnings; <u>and</u> Intangible assets constitute less than 20% of net assets (excluding rights such as land use rights and mining rights)	No less than RMB20 million net assets and positive retained earnings
Continuity of business	The core business, board composition and management must have remained substantially unchanged over the last 3 years.	The core business, board composition and management must have remained substantially unchanged over the last 3 years.
Continuity of control	The <i>de facto</i> controlling party must have remained unchanged for the last 3 years.	The <i>de facto</i> controlling party must have remained unchanged for the last 2 years.
Public float	Public float after IPO must be at least 25%, except where registered capital is not less than RMB400 million, in which case public float must be at least 10%.	

Listing Process and Timing

On paper, the process to list a company on a Chinese stock exchange is not much different from listing a company in many offshore jurisdictions. The issuer must meet certain requirements (as described above). It must be sponsored by licensed investment banks and represented by other professionals, such as accountants and lawyers. It must prepare a prospectus and other required documents. Finally it must apply to CSRC for approval of the listing.

In practice, however, the PRC listing process has been criticized for its lack of transparency and predictability. Companies often have to wait a long time to obtain the required approvals even after they have submitted all the required documents and complied with all the required procedures. One primary reason seems to be that the CSRC is subject to political and policy influence and often has to make decisions based on concerns that are not necessarily related to the companies applying for listing approval.

Timing is also affected by a *de facto* quota on the number of companies that can list at any given time. Listing candidates must be supported in the listing process by two qualified “sponsor representatives” from the underwriter. Sponsor representatives can only advance one candidate at a time for listing on a given exchange, and partly as a result of the rigorous requirements for qualification, there are relatively small numbers of sponsor representatives in even the biggest securities companies.¹⁶ It is understood that this bottleneck is sometimes exacerbated by securities companies’ aggressive marketing efforts, often resulting in a backlog of IPO candidates queued up for listing with a given securities company.

As a result of these factors, although a company could theoretically complete an IPO within six months after its first application to the CSRC, it is not unheard of for companies to wait more than a year. Timing can be further affected by government policy. There are several cases in recent years where the government has imposed a moratorium for long periods of time on all listings as a result of economic conditions or shifts in policy. One recent example was the

¹⁶ As of September 2010, there were 1509 qualified representatives across 71 securities companies in China. CITIC Securities, one of the most successful underwriters of domestic IPOs had only 81 qualified representatives.

moratorium on new IPOs from May 25, 2005 to June 2, 2006 in connection with the “share reforms” to make so-called legal person shares tradable.¹⁷

Shareholders Agreements

The CSRC has a well-known antipathy towards shareholders agreements. Inasmuch, it is generally understood that the CSRC will refuse to consider the listing of any company that has a shareholders agreement in place, even if there is provision for the agreement to automatically terminate immediately prior to listing. There are a number of reasons typically given for the CSRC’s stance. Not the least, the CSRC is apparently unsympathetic to the need for any special minority protection in the lead up to listing. At its most cynical, the CSRC is said to believe that financial investors are mostly focused on cashing out in connection with an IPO and are not necessarily helpful to the long-term health of listed companies post-IPO. A less cynical reason sometimes ascribed to the CSRC is that minority protections provided at law are sufficient to protect minority shareholders in a CLS and that shareholders agreements unnecessarily complicate the job of evaluating listing candidates.

Even without this CSRC bias, there could be a steep price to pay for the normal package of protective provisions usually included in a shareholders agreement. Under Chinese securities law, a shareholder with veto rights could be viewed as a control party. Since controlling parties at the time of IPO are subject to a three year lock-up on their shares, a financial investor would typically want to bend over backwards to avoid falling into this category.

As a result of these issues, it is common practice to terminate all shareholders agreements in respect of a listing candidate before submitting an application to the CSRC. Parties will sometimes agree that the terms of the original shareholders agreement should come back into effect if the listing application is ultimately withdrawn, but it is understood that this may be difficult to enforce. Further, given the amount of time that is often required to qualify for listing after a candidate submits its application to the CSRC, the lack of normal investor protections during this period can be a serious issue. There are a number of ways to mitigate this risk, but they typically are case dependent and will vary from transaction to transaction.

Lock-ups

Lock-up requirements applicable to Chinese companies are more stringent than for companies listed in other jurisdictions. As compared to the U.S., where lock-ups are driven by marketing concerns, rather than any legal requirement, and Hong Kong, where a 6-month lock-up applies to pre-IPO shareholders, shares in a Chinese listed company could be locked up for several years. For fund investors, such lock-ups can mean extended risk exposure even after a listing and may be an important consideration when evaluating an investment. Although there are mechanisms that have been used to try to circumvent China’s onerous lock-up requirements, such work-arounds typically require a steep discount as a cost of disposing of lock-up shares.

¹⁷ When state-owned enterprises were first listed in China, a typical approach was to create an SOE holding company on top of the SOE listco to be listed. The holding company would retain a majority of the shares in the SOE listco after the IPO and such shares were generally referred to as “legal person” shares. In order to attract investors to buy the IPO shares and reduce market volatility, the legal person shares were not allowed to be traded on the stock exchange, which was why they were also called “non-tradable” shares. In 2005, the Chinese government carried out the “share reform” consisting of (i) allowing the legal person shares to be tradable pursuant to an agreed schedule and (ii) providing agreed compensation to the public shareholders (in the form of receiving free shares and/or cash from the legal person shareholders or the listco).

Set forth below is a table describing lock-up requirements that are more likely to be relevant to financial investors.

	Shanghai/Shenzhen Stock Exchange	ChiNext
Promoters of foreign-invested share company	3 years after establishment of the CLS ¹⁸	
Promoters of domestic share company	1 year after establishment of the CLS	
Pre-IPO investors	If shares subscribed for within 12 months prior to publication date of prospectus, lock-up is 3 years after AIC registration of newly issued shares. ¹⁹	If shares subscribed for within 6 months before CSRC officially accepted issuer's IPO application, then lock-up is 3 years after AIC registration of newly issued shares. Even if three-year lock-up expires, the pre-IPO subscriber can only transfer a maximum of 50% of such shares within 24 months after the IPO.
Investors acquiring secondary shares from control party within 12 months prior to IPO	3 years after transfer ¹⁹	
Minority shareholders at IPO	1 year after IPO	
Control parties at IPO	<ol style="list-style-type: none"> 3 years after IPO Reduced to 1 year after IPO, if approved by stock exchange and (i) the transfer is to an affiliate; or (ii) under the rules for Shenzhen listed companies, where transfer is necessary to save a company in serious difficulties. 	<ol style="list-style-type: none"> 3 years after IPO Reduced to 1 year after IPO if approved by stock exchange and the transfer is to an affiliate.

¹⁸ This is required by a 1995 regulation adopted before the current version of the PRC Company Law. In the past, this 3-year lock-up has been treated as applicable to any shareholder in a joint venture at the time of its conversion to a foreign-invested share company. In recent practice, regulators appear to be disregarding this requirement, and we understand that MOFCOM is considering amendments to the 1995 regulation.

¹⁹ This requirement was deleted in the latest version of the listing rules for Shanghai and Shenzhen Stock Exchanges. However, in practice, CSRC still requires a 3-year lock-up period.

Listing of VC/PE Backed Companies

It is worth noting that in recent years a large number of domestic IPOs in China have been for companies backed by venture capital and private equity funds, most of which are domestically owned. The following table sets forth the results of research by O'Melveny & Myers into domestic VC/PE backed IPOs:²⁰

	VC/PE Backed Domestic IPOs in China 2010 Calendar Year			
	No. of IPOs	No. of VC/PE-backed IPOs	% of IPOs VC/PE-backed	Average size of VC/PE-backed IPOs (RMB)
Shenzhen Growth Equity Board (ChiNext)	117	62	53%	Rmb 863.6 million
Shenzhen Small Medium Enterprise Board	204	70	34%	Rmb 916 million
Shanghai Main Board	26	8	31%	Rmb 2.698 billion
Total	347	140	40%	Rmb 994.7 million

Listing of foreign-invested CLSs was historically considered more difficult than listings of pure domestic companies. In recent years, however, as part of the drive to make Chinese stock exchanges more "international", more and more foreign invested CLSs have been able to obtain IPO approvals. According to Wind Info, as of April 2010, there were 84 A-share listed companies which had at least one foreign shareholder among their top three shareholders, and 154 A-share listed companies which had at least one foreign shareholder among their top 10 shareholders, accounting for approximately 5% and 10%, respectively, of all the A-share listed companies in China.²¹

Costs of Domestic Listing

It seems inevitable that PRC markets will continue to grow in popularity as a destination for Chinese companies to secure capital. While the current high multiples commanded by Chinese markets may not continue forever, for a Chinese entrepreneur whose business is located in China, who may or may not speak English and for whom securing a U.S. visa or Hong Kong travel permit may be a hassle, Shanghai and Shenzhen are likely to seem more accessible. Local investment banks, accountants and lawyers will work hard to feed this trend, and legal impediments to setting up red chip structures will discourage consideration of offshore markets as a viable alternative. As a natural outcome, like other places in the world, Chinese domestic companies will be more likely to list on Chinese domestic stock markets.

However, notwithstanding the significant built-in advantages that are likely to accrue to domestic listings, there are a number of strategic issues that a company (and its investors) may want to consider before rushing to a domestic listing. For fast growing companies, especially in capital intensive industries, the need for continued financing may not end with an IPO. This could be a problem for a domestically listed company as there are significant barriers to raising additional funds from the public after an IPO. Not the least, a follow-on offering would have to re-queue up for CSRC approval, which can take more than a year and is subject to numerous uncertainties.

²⁰ We only counted companies with more than five percent VC/PE ownership as VC/PE-backed.

²¹ Up to now, all the companies listed in China have also been incorporated in China. It is believed that, in the near future, China will allow foreign incorporated companies to be listed in China.

Further, unlike in other jurisdictions, it has proven difficult for Chinese companies to issue convertible bonds or other innovative financial instruments to help with the marketing of a follow-on issuance.

In addition, for companies with an international business where acquisitions may be an important part of their expansion strategy, an overseas IPO can be a source of acquisition currency. For example, a company publicly listed in the U.S. might use its shares to acquire a promising technology start-up. While it is theoretically possible that a company listed in Shenzhen or Shanghai could issue shares to pay for an overseas acquisition, the practical reality is that the bureaucratic red tape would be prohibitive for all but the largest of state-backed companies.

Finally, for foreign investors, domestic exit also creates an issue in the form of additional tax drag on returns (i.e., a 10% withholding tax on capital gains). For certain investors this may not be much of an issue if they are able to offset such taxes against other tax liabilities. For example, many U.S. investors may be able to take tax credits for income tax paid in China. However, for investors like European funds or U.S. funds with tax exempt LPs, such tax drag may be a material issue.

Choices, Choices

For international private equity investors, the landscape we have described above is complex and perplexing. Investors will need to make many difficult choices, and the best decisions will depend on a combination of factors and will change over time as the Chinese regulatory regime evolves. Despite the uncertainties, several clear trends are emerging.

First, large Chinese LPs are becoming important sources of funding. International PE sponsors need to decide whether such LPs can or should become part of their investor base, and if so, how to work them into their overall fund structure.

Second, China's domestic financial infrastructure, including PE activity, is growing both in terms of size and sophistication. Onshore investors are playing an increasingly important role in China's PE marketplace, and international PE funds may need to become as "domestic" as possible, and quickly. However, not all opportunities will be domestic companies. Some Chinese companies are already structured in such a way, or they are in such sectors, that the natural exit is an offshore listing or sale.

Third, the domestic capital markets are becoming a viable exit option, despite their less transparent regulatory regime, the uncertainties of the listing process and the volatility of the market. Even if international investors do not prefer a domestic exit, they need to address the reality that many Chinese companies do.

All of this argues for flexibility in how an investor structures its China investment vehicles and makes its investments in China to preserve the maximum optionality in raising funds, making investments and achieving exits. For larger investors, this means establishing both offshore and onshore vehicles and learning how to structure deals in a manner adapted to the peculiarities of Chinese law. And in many cases it will be necessary to make a call early on as to whether the exit will be offshore and onshore, since that will determine the investment structure. And as Chinese law and the marketplace change in the coming years, and as the control over RMB conversion is further liberalized, some of these structures will need to change, again.

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