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The Legal Environment For Foreign Private Equity Firms In China

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Lawrence Zhan Zhang[*]

ABSTRACT

From a little-known, foreign concept to a critical component of the country's increasingly multi-layered capital markets, private equity in China has undergone tremendous development in the past decade. This Note first reviews the representative deals of major U.S. private equity firms (Bain Capital, Blackstone, Carlyle, KKR, TPG, Warburg Pincus, and the private equity arms of Goldman Sachs and Morgan Stanley) in China, and profiles leading Chinese private equity firms and their relationship with the U.S. firms. Then, the Note analyzes the evolving web of laws that regulates China's private equity industry, with special attention to the rise of RMB funds, and recent legal developments such as the Foreign-Invested Partnership ("FIP") regulation and the Qualified Foreign Limited Partners ("QFLP") program that many believe will lead to a level playing field for foreign and domestic firms. The thesis of this study is two-fold. First, the development of a legal framework for private equity in China is closely tied to the country's economic fundamentals. To date, private equity boomed in China largely in response to the unmet financial needs of small and medium-sized private companies and a financial system overly reliant on state-owned banks; going forward, the prosperity of foreign private equity firms in China will hinge on the country's gradual relaxation of its foreign exchange control and its plans for the renminbi to become a global currency. Second, private equity offers a unique lens for

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understanding China's legal system. In particular, this study examines the advantages and potential pitfalls of China's administrative rulemaking process, and the important yet controversial role of the government in a historic economic transformation.

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INTRODUCTION

2010 was a banner year for China's private equity industry. A mere decade ago, private equity was little known in China, and fund-raising was trivial. The industry saw meteoric growth through the decade, first led by American and other foreign private equity firms, with domestic firms entering the scene in late 2006 and rapidly catching up. From 2003 to 2010, the compound annual growth of China's private equity industry was 40%.[1] 2010 saw eighty-two new China-focused private equity funds that raised a total of $27.6 billion, and 363 new investments in the total amount of $10.3 billion.[2] In a series of new regulations and decisions, Chinese government at the national, provincial and municipal levels sent strong signals encouraging the country's private equity industry.

American private equity firms are pioneers and industry leaders in the world. Major American private equity firms, such as Bain Capital, Blackstone, Carlyle, KKR, TPG and Warburg Pincus set foot in China at the dawn of this century, when China was just entering the World Trade Organization, and when the Chinese regulatory regime was still largely underdeveloped. These players brought fresh and bold ideas into the fledging and tightly controlled capital markets in China.[3] Along with other types of financial institutions, such as investment banks, they spurred an array of broad-based legislation and rulemaking processes. A mere ten years later, these private equity firms find themselves in an

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1. Lefei Liu, President, Beijing Private Equity Association ("BPEA"), Keynote Address at the 2010 Global Private Equity Beijing Forum: Bentu Jijin Jiang Zhudao Zhongguo PE Shichang [Domestic Funds Will Lead China's Private Equity Market] (Nov. 14, 2010), http://www.pedaily.cn/Item/200447.aspx.

2. ZERO2IPO RESEARCH CENTER, 2010 STATISTICS FOR THE VENTURE CAPITAL AND PRIVATE EQUITY MARKETS IN CHINA 13, 16 (2010).

3. *See, e.g.*, Frederik Balfour & Xiang Ji, *Private Equity in China Comes of Age*, BUS. WK., July 24, 2007, *available at* http://www.businessweek.com/globalbiz/content/jul2007/gb20070724_300288.htm; Shaun Rein, *China's Private Equity Boom*, BUS. WK., July 16, 2008, *available at* http://www.businessweek.com/globalbiz/content/jul2008/gb20080716_744989.htm; Ellen Sheng, *The Go-Go World of Private Equity in China*, WALL ST. J. DEAL J. (Aug. 30, 2010, 2:07 PM), http://blogs.wsj.com/deals/2010/08/30/the-go-go-world-of-private-equity-in-china/; *Private Equity in China: Barbarians in Love*, ECONOMIST, Nov. 27, 2010, at 35.

increasingly intricate web of laws and regulations.[4]

American firms' overseas expansion tracks the recent private equity boom at home, roughly from 2002 to 2007.[5] During this period, the amounts invested in private equity increased substantially. However, in mid-2007, the credit crisis that started earlier in the mortgage markets spilled over to the junk bond and leveraged loan markets, and as a result, the entire leveraged finance market came to an abrupt halt.[6] As the markets at home recover gradually, major U.S. private equity funds have been proactively seeking to expand their foothold in China through ever-larger deals.[7]

Take a recent successful exit by TPG, a leading U.S. private equity firm, as an example. In June 2009, TPG sold its entire 17% stake in the Shenzhen Development Bank to Ping An Insurance[8] for about $2.28 billion, following a $150 million investment in the bank in 2004. The deal was recognized by the *Dow Jones Private Equity Analyst* as one of the "Top 5 Buyout-Backed Exits Via M&A" in 2009,[9] and is noteworthy in several ways. First, the 2004 TPG-Newbridge[10] investment in the Shenzhen Development Bank, after a two-year negotiation process, marked the first and only time that a Chinese national bank[11] became

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4. *See infra* Parts IV, V, and VI.

5. *See* Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 225 (2009).

6. DAVID P. STOWELL, AN INTRODUCTION TO INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY 291-92 (Academic Press 2010).

7. *See Private Equity in China: Barbarians in Love*, *supra* note 3, at 1.

8. Founded in 1988 and headquartered in Shenzhen, China. The Chairman of Ping An Insurance is Ma Mingzhe, a one-time chauffeur, self-made man and an avid advocate for diversified financial conglomerates in China. Ping An is currently China's second largest insurer, after China Life Insurance Co. *See* Rick Carew, *TPG Nears Sale of Stake in China Bank*, WALL ST. J., June 9, 2009, at C2.

9. DOW JONES PRIVATE EQUITY ANALYST, 2009 REVIEW & 2010 OUTLOOK 30 (2010). The deal was the only one from "emerging markets" listed among the twenty "Deals of the Year."

10. Newbridge was TPG's Asia investment arm at the time. *See* Carew, *supra* note 8, at C2.

11. Shenzhen Development Bank is one of the seventeen "joint-stock" Chinese banks that operate on national license, aside from the "big four" state-owned banks. As of the writing of this note, TPG remains the only foreign buyout firm to have gained approval from China's government to invest in a Chinese bank. In 2007, the China Banking Regulatory Commission ("CBRC") rejected Carlyle's bid to buy part of Chongqing City Commercial Bank. *See* Zijing Wu & Fox Hu, *TPG's Newbridge*

controlled by a foreign financial institution.[12] Second, the chief negotiator for TPG went on in December 2006 to create Bohai Fund,[13] the first Chinese private equity fund denominated in renminbi ("RMB").[14] Third, the acquirer, Ping An Insurance, is itself a beneficiary of foreign investments, notably by Goldman Sachs and Morgan Stanley in 1994, and by HSBC in 2002.[15] Fourth, despite spectacular return on this investment, TPG has reportedly had difficulties navigating the regulatory framework in China.[16]

An American private equity professional in the China market should not be surprised by these characteristics. Despite seemingly abundant opportunities to make money, the market is now seeing more and more highly competitive local firms, often spearheaded by people formerly trained in American institutions. More importantly, laws and regulations are developing very rapidly. This Note addresses these concerns by outlining the legal environment for foreign private equity funds in China, analyzing specific topics of interest, and discussing

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Raises $1.2 Billion in Ping An Stock Offering, BLOOMBERG (Sept. 3, 2010, 5:14 AM), http://www.bloomberg.com/news/2010-09-02/tpg-s-newbridge-seeking-1-16-billion-in-sale-of-ping-an-insurance-shares.html. The investment by a foreign financial institution in a Chinese bank is governed by the Jingwai Jinrong Jigou Touzi Rugu Zhongzi Jinrong Jigou Guanli Banfa [Administrative Measures of the Investment and Shareholding in Chinese-funded Financial Institutions by Foreign Financial Institutions] (promulgated by the China Banking Reg. Comm'n, Dec. 8, 2003, effective Dec. 31, 2003).

12. TPG assuaged China's banking regulators with an agreement for a five-year lockup on the stake. TPG furthered its control by appointing a former U.S. Treasury deputy secretary and CFO for Bank of America, Frank Newman, as chairman of the bank and has worked since the 2004 purchase to stack the bank's board with allies. *See* Brian Bremner, *The Great Bank Overhaul*, BUS. WK., Aug. 22, 2005, *available at* http://www.businessweek.com/magazine/content/05_34/b3948466.htm.

13. Luo Yan, *Ou Wei Shi Shei* [*Who Is Ou Wei*], HUANQIU QIYEJIA [GLOBAL ENTREPRENEUR], Dec. 20, 2007, *available at* www.gemag.com.cn/gemag/new/Picnew_content.asp?C_id=823. *See also infra* note 71 for a recent "exodus" of Chinese talents from Western to China-based private equity firms.

14. Renminbi (literally "people's currency") is the official currency in the People's Republic of China ("PRC"). The primary unit of renminbi is *yuan*.

15. Press Release, Ping An, HSBC to Increase Stake in Ping An by Acquisition of Shares from Goldman Sachs and Morgan Stanley (Apr. 9, 2005), http://www.pingan.com/about/en/news_70052.jsp.

16. *See* Daniel Inman, *Ping An to Invest in Shenzhen Development Bank*, BUS. WK., June 14, 2009, *available at* http://www.businessweek.com/globalbiz/content/jun2009/gb20090614_511195.htm.

potential legal developments and policy directions.

Part I paints the legal and business landscapes of private equity in the United States. Part II reviews representative investments of major U.S. private equity firms in China. Part III profiles leading Chinese private equity firms and their relationship with their U.S. counterparts. Part IV gives a general introduction to Chinese law, and analyzes the evolving web of laws of which a foreign private equity firm in China should be cognizant. Part V examines the Foreign-Invested Partnership ("FIP") regulation that came into effect in early 2010, and the race to set up RMB funds among foreign private equity funds. Part VI discusses the latest legal developments, including the Qualified Foreign Limited Partners ("QFLP") scheme and the Shanghai pilot program. The last part is the Conclusion.

I. BARBARIANS AT THE GATE: PRIVATE EQUITY IN THE UNITED STATES

The contours of private equity can be a little amorphous.[17] Some commentators view private equity as an asset class consisting of pools of actively managed capital organized to invest in privately held and certain public companies and securities.[18] Others have defined it based on different forms of investment strategies: leveraged buyout, growth capital, mezzanine capital, and venture capital.[19] This well accepted categorization, however, should be viewed with two caveats: first, for historical reasons (for instance, KKR's landmark buyout of RJR Nabisco in the late 1980s),[20] many people still see buyout funds as synonymous with private equity; second, venture capital is often treated as distinct from private equity because of its particular focus on early-stage, high-potential startup companies.

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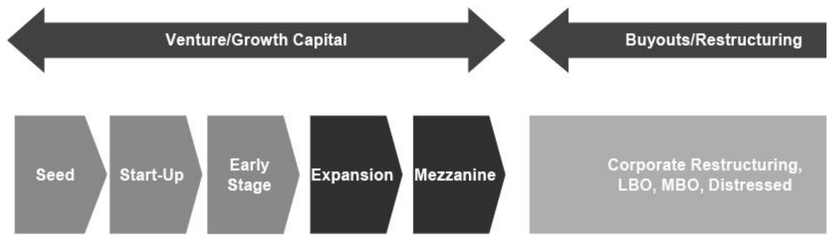
17. *See* Lloyd L. Drury, III, *Private Equity and The Heightened Fiduciary Duty of Disclosure*, 6 N.Y.U. J. L. & BUS. 33, 39 (2009).

18. MERRILL LYNCH ALTERNATIVE INVESTMENTS, PRIVATE EQUITY PRIMER 8 (2010).

19. STOWELL, *supra* note 6, at 283.

20. *See generally* GEORGE P. BAKER & GEORGE DAVID SMITH, THE NEW FINANCIAL CAPITALISTS: KKR AND THE CREATION OF CORPORATE VALUE (Cambridge Univ. Press 1998); BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO (Harper & Row 1990).

Figure 1
The Private Equity Spectrum



Source: MERRILL LYNCH ALTERNATIVE INVESTMENTS, PRIVATE EQUITY PRIMER 8 (2010).

Private equity funds are typically structured as pass-through entities, i.e. limited partnerships and limited liability companies that are transparent for tax purposes. Private equity funds typically raise money through private placements made pursuant to Regulation D ("Reg D," for accredited investors) or Regulation S ("Reg S," for non-U.S. investors) of the Securities Act of 1933 ("1933 Act"). The 1933 Act requires that every offer and sale of securities be registered with the Securities and Exchange Commission ("SEC") through the filing of a Registration Statement, including a disclosure document, known as a Prospectus, unless some exemption from registration is available under applicable law.[21] Reg D provides three exemptions: Rules 504 and 505 were promulgated on the basis of Section 3(b) of the 1933 Act, which authorizes the SEC to develop exemptions for offerings up to $5 million in amount when registration is not necessary to protect the public interest or investors; Rule 506, on the other hand, represents a nonexclusive safe harbor for the private offering exemption of Section 4(2).[22] Reg S provides safe harbors for off-shore distributions and resale of unregistered securities of U.S. and foreign issuers, when (1) offers are not made to persons in the United States; (2) the buyer is outside the United States or the seller reasonably believes him to be; (3) no direct selling effort is made in the United States; (4) the buyer is advised that interests may not be offered or sold in the United States or to U.S.

21. Securities Act of 1933 § 5, 15 U.S.C. § 77e (2006).
22. JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION 281 (Wolter Kluwer 6th ed. 2009).

persons without registration or exemption.[23]

Private equity funds are structured as capital-commitment funds, which are also known as drawdown funds. In other words, capital is committed up front and then called down over a period of years (usually one to eight) to fund investments, fees, expenses, etc. This stands in contrast with hedge funds, which are structured as "mark to market" vehicles that provide investors with redemption rights pursuant to periodic (daily, monthly, quarterly) net asset values for the fund. Private equity funds are illiquid: there is no right to redeem, and only a limited market for transferring interests. Investors receive cash flow from investments in the private equity funds by way of the distribution waterfall. However, the line between hedge funds and private equity funds has become blurrier, as many hedge funds are now creating hybrid funds with illiquid side pockets in addition to liquid classes.

The Investment Company Act of 1940 provides two exemptions to the registration requirement under the 1933 Act, namely Sections 3(c)(1) and 3(c)(7), which form the basis of the hedge fund industry.[24] Section 3(c)(1) exempts companies with fewer than 100 shareholders. Section 3(c)(7) exempts a company that is not making or proposing to make a public offering of its securities, and whose shareholders are "qualified purchasers" with a high net worth, which generally means individuals who own specified investments worth at least $5 million, or institutions that invest at least $25 million.[25] In the past, one of the more commonly used exemptions under the Investment Advisers Act of 1940 is the "private adviser exemption," which is available to investment advisers with fewer than fifteen clients, among other criteria.[26] The Dodd-Frank Act[27] eliminates the private adviser exemption, which will have the

23. *Id.* at 217-19.

24. COX, HILLMAN & LANGEVOORT, *supra* note 22, at 1116.

25. *Id.*

26. The private adviser exemption contained in Section 203(b)(3) of the Advisers Act exempts from registration an investment adviser that (i) had fewer than fifteen clients during the preceding twelve months; (ii) does not hold itself out to the public as an investment adviser, and (iii) does not serve as an investment adviser to a registered investment company or a business development company. *See* SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES, THE DODD-FRANK ACT: COMMENTARY AND INSIGHTS 37 (2010); HAL S. SCOTT, INTERNATIONAL FINANCE 799 (Foundation Press 17th ed. 2010).

27. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

effect of requiring a large number of currently unregistered advisers to register with the SEC.[28] Meanwhile, the Dodd-Frank Act directs the SEC to exempt from registration any investment adviser who advises only private funds with less than $150 million in assets under management in the United States.[29]

II. FAR EAST OR WILD WEST: U.S. PRIVATE EQUITY FIRMS IN CHINA

It is impossible to explain private equity-related legal issues in China without first painting a picture of the very lively business landscape. This part first presents a short biography of each of the leading American private equity firms in China: Bain Capital, Blackstone, Carlyle, KKR, TPG, Warburg Pincus, as well as the private equity arms of Goldman Sachs and Morgan Stanley, and then summarizes some distinctive characteristics of their investment activities, laying the groundwork for discussion of legal and regulatory issues in later parts of the Note.

BAIN CAPITAL

Bain's offices in Hong Kong and Shanghai are led by industry pioneers such as Jonathan Zhu[30] and Jingsheng Huang.[31] Bain's

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28. *Id.* § 403; *see also* SKADDEN, *supra* note 26, at 37.

29. Dodd-Frank Act § 408; *see also SEC Proposes Rules for the Registration of Hedge Funds and Other Private Fund Advisers*, PRIVATE EQUITY ALERT (Weil Gotshal, New York, NY), Nov. 30, 2010, at 2-3.

30. Jonathan Zhu is a native of China and served as CEO of Morgan Stanley China before joining Bain Capital in 2006. *See Jonathan Zhu*, BAIN CAPITAL, http://www.baincapital.com/team/TeamMember.aspx?id=102&viewType=ManagingDirectors (last visited Apr. 1, 2011). Calling himself an "accidental banker," he famously decided to go to law school while studying the poetry of Williams Wordsworth in a Ph.D. program at Cornell in the late 1980s. *See* Michael Schuman, *And for This He Read Poetry?*, TIME, Mar. 21, 2005, *available at* http://www.time.com/time/magazine/article/0,9171,1039694,00.html.

31. Jingsheng Huang received an M.B.A. from Harvard Business School and an M.A. from Stanford, and was a managing director of Softbank Asia Infrastructure Fund, or SAIF, before joining Bain Capital in 2005. Huang previously led SAIF's investments in UTStarcom (Nasdaq: UTSI) and Shanda Interactive Entertainment, Ltd. (Nasdaq: SNDA). Huang is an Independent Director of Shanda. *See Jingsheng Huang*, BAIN CAPITAL, http://www.baincapital.com/team/TeamMember.aspx?id=

representative deal in China was a $418 million purchase of a 12.8% stake in GOME, China's leading electronic appliance manufacturer.[32] Bain competed against KKR and Warburg Pincus to win the deal,[33] and nominated three nonexecutive directors, including Jonathan Zhu, to GOME's board.

Bain also invested in a series of less high-profile companies, including ASIMCO, Casda Biomaterials, GA PACK, Ideal Standard, JinSheng International, Sinomedia Holding Limited, SUNAC, and Suzhou HiPro Polymers.[34]

BLACKSTONE

Blackstone Greater China maintains offices in Hong Kong, Beijing, and Shanghai, led by Antony Leung, former Financial Secretary of Hong Kong SAR.[35] In May 2007, China Investment Corporation ("CIC"), China's then-fledgling sovereign wealth fund, bought a $3 billion stake in Blackstone, which subsequently raised $4.13 billion in its IPO in New York in June, the largest stock market listing in the United States since 2002. However, the investment proved to be a very poor one and came

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83&viewType=ManagingDirectors (last visited Apr. 1, 2011).

32. GOME was founded in 1987 by Huang Guangyu (1969-), a native of South China's Guangdong Province. Huang was arrested by Chinese police in November 2008 for alleged economic crimes. Once China' richest man (worth $6.3 billion in 2008), Huang was sentenced to fourteen years in prison and fined 800 million RMB in May 2010 by the Beijing Second Intermediate People's Court. Huang appealed, but the verdict was affirmed by the Beijing High People's Court in August 2010. The years of wrangling over control of GOME between imprisoned founder Huang Guangyu and his successor Chen Xiao ended with Chen's "honorable departure" on March 9, 2011. *See* Joe McDonald, *Huang Guangyu, Former Richest Man in China, Gets 14 Years in Jail*, HUFFINGTON POST (May 18, 2010, 5:32 AM), http://www.huffingtonpost.com/2010/05/18/huang-guangyu-former-rich_n_579810.html#.

33. Jackie Cheung & Rick Carew, *Bain Capital, China's GOME Forge Deal*, WALL ST. J., June 23, 2009, at B4.

34. *Investments*, BAIN CAPITAL ASIA, http://www.baincapitalasia.com/Investments (last visited Apr. 1, 2011).

35. *See Antony Leung*, BLACKSTONE, http://www.blackstone.com/cps/rde/xchg/bxcom/hs/firm_ourpeople_antony_leung.htm (last visited Apr. 1, 2011). Aside from Leung's official role, his marriage in July 2002 to Fu Mingxia, four-time Olympics champion ("Queen of Diving") and twenty-six years his junior, is a perennial talk of the town. For some background on Antony Leung's relationship with the PRC government, *see* Mark Landler, *A New Aide Prompts Talk of Beijing's Strength in Hong Kong*, N.Y. TIMES, Feb. 16, 2001, at A9.

under intense criticism domestically.[36]

Blackstone tested the waters in September 2007 by acquiring a 20% stake in China National BlueStar, a special chemical maker, from China National Chemical Corporation for $600 million. The transaction was approved by the National Development and Reform Commission ("NDRC") about four months later.[37]

More recently, in March 2010 Blackstone partnered with a consortium to invest $600 million in Dili Group, which owns Shouguang Agricultural Product Logistic Park, an agricultural-product trading center.[38]

CARLYLE

Among American private equity firms, Carlyle is one of the early movers, boasting "ten years of success in China."[39] The confidence is well founded; judging from the numbers, Carlyle is indeed the most active American private equity firm in China, investing $2.5 billion in

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36. Keith Bradsher, *China Faces Backlash at Home over Blackstone Investment*, N.Y. TIMES, Aug. 3, 2007, at C1.

37. *See China Approves Blackstone Investment in BlueStar*, REUTERS (Jan. 10, 2008, 6:43 AM), http://www.reuters.com/article/2008/01/10/us-blackstone-bluestar-idUSPEK28690120080110. NDRC is a macroeconomic management agency under China's State Council, which has broad administrative and planning control over the Chinese economy. Shan Fu, Senior Managing Partner in Blackstone's Beijing office, is a former official of the NDRC. *See* Shan Fu, BLACKSTONE, http://www.blackstone.com/cps/rde/xchg/bxcom/hs/firm_ourpeople_shan_fu.htm (last visited Apr. 1, 2011).

38. Shouguang, home to about one million people in the coastal province of Shandong, is known as China's "home of vegetables" for its year-round harvests. *See* Kennix Chim & George Chen, *Blackstone in $600 Million China Agricultural Deal*, REUTERS (Mar. 17, 2010, 9:20 AM), http://www.reuters.com/article/2010/03/17/us-blackstone-china-agricultural-idUSTRE62G24K20100317.

39. CARLYLE GROUP, 2008 ANNUAL REPORT 10 (2008). Leaders in Carlyle's China offices include Wayne Tsou and Xiang-Dong Yang, among others. Tsou earned his J.D. from Harvard Law School, an M.B.A. from Harvard Business School and an M.S. in electrical engineering from California Institute of Technology, and worked for Warburg Pincus from 1998 to 2004. *See Wayne Tsou*, CARLYLE GROUP, http://www.carlyle.com/Team/item5869.html (last visited Apr. 1, 2011). Yang received his B.A. in economics from Harvard University and M.B.A. from Harvard Business School. *See Xiang-Dong Yang*, CARLYLE GROUP, http://www.carlyle.com/team/item5713.html (last visited Apr. 1, 2011).

about fifty deals.[40] In April 2010, Carlyle completed raising $2.55 billion for its third Asia fund, the Carlyle Asia Partners III (CAP III).

Carlyle earned its glory the hard way.[41] Carlyle's attempted and eventually failed bid for Xugong Group, one of China's largest construction machinery manufacturers, was called by the Wall Street Journal "a deal that helped define the limitations of what foreign private equity investors could do in China."[42] Carlyle signed an ambitious deal to purchase an 85% stake in Xugong in October 2005.[43] On June 6, 2006, Xiang Wenbo, a senior executive[44] from one of Carlyle's bidding competitors, started a blog to disclose alleged "scandals" in the bidding process. Xiang rose to prominence by evoking nationalistic sentiments[45] and concerns over the country's national economic security when a large chunk of state-owned assets would suddenly change hands to foreign investors at a perceived low price. Two months later, a new and more

40. CARLYLE GROUP, 2009 ANNUAL REPORT 20 (2009). Carlyle founder David Rubenstein reasserted his confidence in the firm's investments in Asia during an interview with Alan Murray, Executive Editor of the Wall Street Journal Online. *See Executive Breakfast Series: David M. Rubenstein*, WALL ST. J. VIEWPOINTS (Mar. 18, 2010), http://online.wsj.com/ad/article/viewpoints-rubenstein.html.

41. In addition to the Xugong case, Carlyle also suffered setbacks in its attempts to invest in Guangdong Development Bank and Chongqing City Commercial Bank, among others. *See* Pan Hongxiu, *Kailei Zixing, Jianghu Yeyu Shinian Deng* [*Reflections of Carlyle: Ten Years in the Game*], ZHONGGUO QIYEJIA [CHINA ENTREPRENEUR], Apr. 2010, *available at* http://www.21cbh.com/HTML/2010-4-2/zNMDAwMDE3MTQzNw.html.

42. Dinny McMahon, *Carlyle Moves On from Xugong Shadow*, WALL ST. J. CHINA REAL TIME REPORT (Jan. 12, 2010, 3:56 AM), http://blogs.wsj.com/chinarealtime/2010/01/12/carlyle-moves-on-from-xugong-shadow/.

43. Rick Carew, *Will China Buy the World? The Beijing Debate*, WALL ST. J. CHINA REAL TIME REPORT (Mar. 10, 2009, 5:33 AM), http://blogs.wsj.com/chinarealtime/2009/03/10/will-china-buy-the-world-the-beijing-debate/.

44. Xiang was Vice Chairman (now President) of Sany Group, founded in 1989 and based in Changsha, Hunan Province in Central China. The company is currently undergoing rapid global expansion and has business relationships with approximately fifty countries. During a visit in December 2010 by Yang Jiechi, China's Foreign Minister, Xiang Wenbo presented the Foreign Minister with a model of the Sany Crawler Crane SCC4000 that was adopted by the Chilean government for the rescue of the thirty-three trapped miners. Press Release, Sany Group, Sany Welcomes Visit by Foreign Minister (Jan. 20, 2011), http://www.sanygroup.com/group/en-us/media/24527_for_news_text.htm.

45. Carew, *supra* note 43; Echo Zhou, *The Creator of "Created in China,"* THE LINK (China Europe International Business School, or CEIBS, Shanghai, China), Apr. 2009, *available at* http://www.ceibs.edu/link/latest/38900.shtml.

restrictive foreign M&A regulation was jointly promulgated by six government agencies.[46] Carlyle reduced its proposed stake to 45% in March 2007, and eventually gave up the proposal in July 2008.[47] The Xugong case offers fertile ground for studying the administrative rulemaking processes in China: namely, how they are affected by social pressure in a country where there is no representative democracy in the Western sense, and how they are shaped by the coordination and conflicts of interest between different government agencies.

Carlyle enjoyed successes in many other transactions. In November 2000, Carlyle invested $8 million in Ctrip, a leading online and offline hotel reservation and travel services provider in China.[48] In December 2003, Ctrip completed an IPO on Nasdaq ("CTRP"); and in 2004, Carlyle fully exited its investment in Ctrip.[49]

In December 2005, Carlyle signed an agreement with China Pacific Insurance Group Co. (CPIC Group) to participate in the injection of RMB 6.6 billion new capital into China Pacific Life Insurance Co. (CPIC Life), the country's third largest life insurer. The Carlyle partnership held a 25% stake (RMB 3.3 billion, or $410 million[50]) in CPIC Life after the injection.[51] CPIC Life subsequently underwent two IPOs, first in Shanghai in December 2007, and then in Hong Kong in

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46. *See* Foreign M&A Provisions, *infra* note 173.

47. Pan, *supra* note 41. Also note that China passed its first Property Law to formally protect private property during this period of time, when the ideological debate between the old and the new was in high tide. *See* Wuquan Fa [Property Law] (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007); Joseph Kahn, *China Backs Property Law, Buoying Middle Class*, N.Y. TIMES, Mar. 16, 2007, at A1.

48. *See* Liu Hongyan, *Kailei Zhongguo de Touzi Chuanqi* [*The Investment Legend of Carlyle China*], 21 SHIJI JINGJI BAODAO [21 CENTURY BUSINESS HERALD], Jan. 14, 2006, *available at* http://www.cye.com.cn/chuangyeketang/caifujinyan/20060114175137.htm.

49. *Id.*

50. All currency conversions in this note are based on then-current exchange rate between the dollar and the renminbi (yuan). The exchange rate was largely fixed at 1 dollar = 8.3 yuan from 1994 to July 21, 2005. From that day on, the yuan appreciated gradually for about 20%. As of the revising of this note (August 23, 2011), the exchange rate is 1 dollar = 6.3976 yuan.

51. Prudential Financial (United States) was a strategic investor in this transaction. Press Release, Carlyle, China Pacific Insurance (Group) Co. Joins with Carlyle to Inject a Total of RMB 6.6 Billion New Capital into China Pacific Life Insurance Co. (Dec. 19, 2005), http://www.carlyle.com/media%20room/news%20archive/2005/item6743.html.

December 2009, raising a total of RMB 30 billion, or $4.1 billion. In late 2010 and early 2011, Carlyle sold half of its stake in CPIC Life for approximately $2.67 billion.[52]

In addition to CPIC Life, three other Chinese portfolio companies of Carlyle – China Forestry, Concord Medical Services and Kaisa Group – successfully completed public offerings in Hong Kong and New York in 2009, raising a combined total of $3.8 billion.[53]

Figure 2
"Carlyle Group - Ten Years of Success in China."

Source: CARLYLE GROUP, 2008 ANNUAL REPORT 10 (2008)

52. Before the sellings occurred on December 30, 2010 and January 10, 2011, Carlyle owned 61% of CPIC Life's H shares (the shares of companies incorporated in mainland China that are traded on the Hong Kong Stock Exchange). Chen Huiying, *Kailei Zuobie Zhongguo Taibao, 5 Nian Jingzhuan 50 Yi Meiyuan* [*Carlyle Bids Farewell to CPIC Life, Netting $5 Billion in Five Years*], XIN SHI JI [CENTURY WEEKLY], Jan. 17, 2011, *available at* http://news.163.com/11/0118/04/6QLDO5HD00014AED.html.

53. CARLYLE GROUP, *supra* note 40, at 6. For a full list of Carlyle's portfolio companies in Asia, *see Asia Portfolio*, CARLYLE, http://www.carlyle.com/Geography/Asia/item8461.html (last visited Apr. 1, 2011).

KOHLBERG KRAVIS ROBERTS (KKR)

KKR's China endeavor is led by David Liu[54] and backed by KKR co-founder Henry Kravis.[55] In September 2007, KKR led a consortium that invested $450 million (of which KKR contributed $150 million)[56] in Tianrui Cement, a family enterprise and one of China's top ten cement producers. Later, KKR reportedly experienced serious trouble in terms of corporate governance with Tianrui's founder, Li Liufa.[57]

Then, in June 2009, KKR invested $150 million in Modern Dairy, a leading dairy farming company headquartered in Ma Anshan in China's central province of Anhui.[58] Modern Dairy is one of the largest operators of centralized large-scale dairy farms in China, and with KKR's investment, Modern Dairy targeted to construct another twenty to thirty large-scale farms in China as well as to pursue acquisitions.[59]

54. David Liu graduated from Columbia University as Class Salutatorian with a B.S. in Electrical Engineering. *See David Liu*, KKR, http://www.kkr.com/team/theteam.cfm?CategoryName=Investment%20Professionals-Private%20Equity%20and%20Asset%20Management&TitleSortOrder=LastName%20Asc&Pagenum=3 (last visited Apr. 1, 2011).

55. Henry Kravis had personally met with Liu Deshu, President of SinoChem, the parent company of Fast Eastern Leasing (now renamed Fast East Horizon) to discuss KKR's investment in the latter. Press Release, SinoChem, Liu Deshu Meets KKR Global CEO (Sept. 21, 2010), http://www.sinochem.com/tabid/871/InfoID/11462/frtid/790/Default.aspx. Kravis also spoke at the annual Global Private Equity Beijing Forum on November 10, 2008 (Chinese transcript available at http://finance.sina.com.cn/hy/20081110/10555487233.shtml).

56. Press Release, Kohlberg Kravis Roberts, KKR Leads US$450 Million Financing for Tianrui Cement (Sept. 17, 2007), http://www.kkr.com/releasedetail.cfm?ReleaseID=333004&KeepThis=true&TB_iframe=true&height=461&width=592 ("Tianrui Cement has also received commitments from the International Finance Corporation and an international banking syndicate led by JPMorgan for an additional US$335 million of USD and RMB long-term financing.").

57. *See* Tina Wang, *KKR's Concrete Lessons In China*, FORBES, July 9, 2009, *available at* http://www.forbes.com/2009/07/09/kkr-tianrui-cement-china-private-equity-asia.html ("By April 2008, Li Liufa was seen as running Tianrui Cement like his own fiefdom, say industry sources. A board meeting scheduled for that month in Henan was not held because Li did not show up, and this upset the head of KKR's China team, David Haifeng Liu, according to the former executive.").

58. Modern Dairy was founded in 2005 by former managers of Mengniu Dairy, China's largest liquid milk producer. *See* Cathy Chan, *KKR Said to Pay $150 Million for Stake in China's Modern Dairy*, BLOOMBERG (June 15, 2009, 6:00 AM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a1hRKK7enOLw.

59. Press Release, Kohlberg Kravis Roberts, Ma Anshan Modern Farming

Modern Dairy had its Hong Kong IPO in late 2010.[60]

TPG

TPG[61] has a long track record of investing in China. In addition to the Shenzhen Development Bank transaction mentioned earlier, another landmark deal was TPG's investment (with General Atlantic, another leading private equity firm) in Lenovo in 2005.[62] The private equity firms owned a combined 2.8% stake in Lenovo, began reducing their holdings in 2007, and eventually exited in fall 2010.[63]

TPG's investments in China[64] also include Yunnan Red Winery (March 2007, $14 million),[65] China Grand Automotive Services (three

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Receives Investment from KKR (June 15, 2009), http://www.kkr.com/releasedetail.cfm?ReleaseID=389500&KeepThis=true&TB_iframe=true&height=461&width=592. One reviewer of this note pointed out that "this is an extremely successful investment that distinguishes premier foreign funds from the "eat what's up to your mouth" domestic funds. When they invested in this company, it was still making a big loss and the cash flow was negative. A domestic private equity fund would hardly take such deal. Obviously, KKR foresaw the bright future of scaled modern farming that was beyond the tradition farming skill of China. And they have the global resources to help the company to grow big." E-mail from Hogan Chao, China First Capital, to Lawrence Zhan Zhang, Fordham Law School (Mar. 27, 2011, 02:56 EST) (on file with author).

60. *See* Fox Hu, *China Modern Diary May Raise $571 Million in IPO, Terms Show*, BLOOMBERG, (Nov. 11, 2010, 4:54 AM), http://www.businessweek.com/news/2010-11-11/china-modern-dairy-may-raise-571-million-in-ipo-terms-show.html.

61. TPG was founded as Texas Pacific Group in 1992, but later shortened its name to TPG. *See* Henny Sender, *"Sorry, Sir. Texas Pacific Group Isn't Here Anymore,"* WALL ST. J. DEAL J. (Mar. 1, 2007, 11:39 AM), http://blogs.wsj.com/deals/2007/03/01/sorry-sir-texas-pacific-group-isnt-here-anymore/.

62. Press Release, Lenovo, Lenovo Announces US$350 Million Strategic Investment from Leading Private Equity Firms (Mar. 31, 2005), http://www.lenovo.com/news/us/en/2005/04/investors.html.

63. Philip Lagerkranser & Mark Lee, *Lenovo Falls after TPG, General Atlantic Said to Exit*, BLOOMBERG (Nov. 16, 2010, 6:42 AM), http://www.businessweek.com/news/2010-11-16/lenovo-falls-after-tpg-general-atlantic-said-to-exit.html.

64. Unlike other private equity firms discussed here, which all disclose their portfolio companies, on its website, TPG provides no information other than the contact information for its fourteen global offices, adding to the difficulty of research.

65. *TPG Fund Makes First China Investment: Yunnan Wine*, REUTERS (Apr. 11, 2007, 3:25 AM), http://www.reuters.com/article/2007/04/11/tpg-china-idUSHKG31694620070411. Yunnan is a province in Southwest China.

investments from 2007 to 2010, for undisclosed amounts),[66] shoe retailer Daphne (May 2009, $80.5 million),[67] supermarket chain WuMart (August 2009, $120 million),[68] and casual sportswear manufacturer China Vogue (October 2010, $45 million),[69] among others.

TPG hired Mary Ma, former Chief Financial Officer of Lenovo, to head its China operations in September 2007.[70] Ma left TPG in early 2011 to start another fund, joining other mainland executives at Western buyout firms who have decided to strike out on their own.[71]

WARBURG PINCUS

Warburg Pincus currently has twenty-one portfolio companies in China,[72] covering a diverse range of business sectors. Notable

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66. Bei Hu, *TPG-Owned China Grand Auto Said to Plan $1 Billion Initial Public Offering*, BLOOMBERG (Apr. 15, 2010, 6:03 AM), http://www.bloomberg.com/news/2010-04-15/tpg-owned-china-grand-auto-said-to-plan-1-billion-initial-public-offering.html.

67. *TPG Invests In Chinese Shoe Retailer Daphne*, REUTERS (May 25, 2009, 11:50 PM), http://www.forbes.com/feeds/afx/2009/05/25/afx6462540.html.

68. *WuMart Sells Stake to TPG, Hony ahead of Possible Listing*, CHINA ECONOMIC REVIEW, Aug. 14, 2009, *available at* http://www.chinaeconomicreview.com/dailybriefing/2009_08_14/Wumart_sells_stake_to_TPG_Hony_ahead_of_possible_listing.html.

69. *TPG Invests $45M in China Sportswear Maker*, CHINA DAILY, Oct. 19, 2010, *available at* http://www.chinadaily.com.cn/business/2010-10/19/content_11430382.htm.

70. Ma worked for Lenovo for 17 years before joining TPG. Mark Kleinman, *TPG Hires Mary Ma for China Push*, TELEGRAPH, Sept. 7, 2007, *available at* http://www.telegraph.co.uk/finance/markets/2815270/TPG-hires-Mary-Ma-for-China-push.html; Carlos Tejada, *Business Savvy Propels Ma in China Market*, WALL ST. J., Jan. 13, 2009, *available at* http://online.wsj.com/article/SB123187470105578101.html.

71. Henny Sender, *TPG's Ma Joins Exodus of Chinese Talents from Western Buy-out Firms*, FIN. TIMES, Feb. 10, 2011, *available at* http://www.ftchinese.com/story/001036845/en. One reviewer of this note, an insider of the Chinese private equity industry, commented that "I think cultural conflicts and deal execution are the main issues. For instance, I heard that to invest in a hotpot chain, analysts at KKR need to produces a 30-page presentation just to explain what is hotpot to people in New York. Overnight conference call is regular but discussions are often trivial. Such low efficiency makes it difficult for foreign funds to compete with local ones. Chinese market is rapidly changing, you need to take quick action and lock in as much as possible today." E-mail from Hogan Chao, China First Capital, to Lawrence Zhan Zhang, Fordham Law School (Mar. 27, 2011, 02:56 EST) (on file with author).

72. *Portfolio Companies by Geography*, WARBURG PINCUS,

investments include: a 2005 investment in Harbin Pharmaceuticals, a leading domestic pharmaceutical company; a 2006 investment in 7 Day Inn, founded in Guangzhou, Guangdong Province and one of the leading budget hotel chains in China; and a 2006 investment in Greentown China, headquartered in Hangzhou, Zhejiang Province and one of the leading residential property developers focused on the country's urban middle class.

In addition to the six private equity firms discussed above, the private equity arms of Goldman Sachs and Morgan Stanley have also been quite active in China.

GOLDMAN SACHS PRIVATE EQUITY GROUP

Goldman Sachs bought a 4.9% stake in the Industrial and Commercial Bank of China ("ICBC") in April 2006 for $2.58 billion, ahead of the bank's Hong Kong IPO on October 10, 2006. In March 2009, Goldman Sachs committed to a new lockup in relation to its investment in ICBC.[73] In early June 2009, Goldman raised $1.9 billion by selling almost the entire stake that it was free to divest (20%) under the revised lockup agreement with ICBC.[74] Then, in September 2010, Goldman reduced its stake from 3.9% to 3.1% to raise $2.05 billion.[75]

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http://www.warburgpincus.com/portfolio/PortfolioBySubRegion.aspx (last visited Apr. 1, 2011).

73. Under then existing lockup, the ICBC shares held by Goldman Sachs would have become free in equal installments on April 28, 2009 and October 20, 2009. Under the new lockup, Goldman Sachs would not sell 80% of its ICBC shares at any time prior to April 28, 2010. Press Release, Goldman Sachs, ICBC and Goldman Sachs Announce New Share Lock-up Commitment and Reaffirm Strategic Cooperation (Mar. 25, 2009), http://www2.goldmansachs.com/our-firm/press/pressreleases/archived/2009/icbc-gs-commitment.html.

74. Bei Hu & Christine Harper, *Goldman Sachs Raises $1.91 Billion in ICBC Stock Sale*, BLOOMBERG (June 2, 2009, 5:24 AM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a4HY3.3hvmNM&refer=home.

75. Nisha Gopalan & Peter Stein, *Goldman Cutting Stake in China's ICBC*, WALL. ST. J., Sept. 30, 2010, at C2.

Figure 3
Offloading: Goldman Sachs' buying and selling of ICBC

Source: Nisha Gopalan & Peter Stein, *Goldman Cutting Stake in China's ICBC*, WALL. ST. J., Sept. 29, 2010.

Aside from its activities in the banking sector, Goldman led a consortium in June 2007 to acquire a majority stake in Shuanghui, a leading meat processing company based in Henan Province, Central China.[76] Like Carlyle, Goldman Sachs has had its own share of bad luck navigating China's regulatory labyrinth. In November 2006, Goldman proposed to buy a 10.71% stake for $96 million in Guangdong Midea, an electronic appliance giant, in which both Bain and Warburg Pincus have also invested. In August 2007, the deal was vetoed by the China Securities Regulatory Commission on the sole ground that the "price was too low," even though the deal had been approved by the Ministry of Commerce two months earlier.[77]

76. Goldman has gradually reduced its stake over the years, down to about 10% by the end of 2009. *Goldman Sachs HK Unit Ups China Shuanghui Stake 25% to 60.7%*, MARKETWATCH (June 17, 2007, 10:52 PM), http://www.marketwatch.com/story/goldman-sachs-hk-unit-ups-china-shuanghui-stake-25-to-607.

77. *See* Shu-Ching Jean Chen, *Too Good a Deal for Goldman Sachs*, FORBES, Aug. 30, 2007, *available at* http://www.forbes.com/2007/08/30/goldman-midea-china-markets-equity-cx_jc_markets2.html. In the time it took the deal to pass through the regulators, Midea's share price rose more than five times. The report indicates that TPG-Newbridge owns 16.68% of Midea. *Id.*

MORGAN STANLEY PRIVATE EQUITY ASIA ("MSPEA")

MSPEA is one of the leading private equity investors in Asia, having invested in the region for over fifteen years. Half of its twenty-four portfolio companies are in China, including such household names in China as Belle International, Hengan International, Mengniu Diary, Nanfu Battery, Paradise Retail, and Ping An Insurance (which acquired the entire 17% stake in Shenzhen Development Bank from TPG).[78]

Some noteworthy characteristics emerge from the "biographies" presented above. In the West, private equity firms often engage in leveraged buyouts, but they could almost never do so in China.[79] A typical private equity investment in China is a non-controlling stake of 15-40% in an operating company, with the money intended as growth capital.[80] The percentage of shares that a foreign private equity fund can acquire in Chinese companies is restricted by Chinese laws and regulations.[81] As we see from the foregoing discussion, investment amounts range from $8 million (investment in Ctrip.com by Carlyle in 2000) to $600 million (investments in National BlueStar and Shouguang Agriculture by Blackstone in 2007 and 2010, respectively), and even higher amounts are bound to emerge now that these firms have come onshore with their own RMB funds.

American private equity firms invest in a wide range of industries and regions in China. The top ten industries as ranked by investments are biotechnology/healthcare, cleaning technology, mechanical engineering, food & drinks, Internet, retail, real estate, agriculture & forestry, chemical engineering, and financial services.[82] In terms of regions, American firms no longer limit themselves to the relatively affluent coastal areas, as foreign capital used to do in the early days; rather, they have expanded into the vast inland and even western frontiers of China.

Carlyle has closed by far the most deals, followed by Warburg Pincus and Bain. TPG earned itself a big name through high-profile

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78. *Private Equity Portfolio*, MORGAN STANLEY, http://www.morganstanley.com/institutional/invest_management/private_equity/pe_asia/portfolio.html (last visited Apr. 1, 2011).

79. *See* Balfour & Ji, *supra* note 3.

80. *See Private Equity in China: Barbarians in Love, supra* note 3, at 35.

81. *See, e.g.*, Foreign Strategic Investment Measures, *infra* note 171; Foreign M&A Provisions, *infra* note 173.

82. ZERO2IPO RESEARCH CENTER, *supra* note 2, at 18.

investments in Lenovo and Shenzhen Development Bank. Blackstone and KKR each closed a small handful of mega-deals.[83] Many of these firms' portfolio companies are small and medium-sized private companies that are most in need of growth capital.

III. THE WORST OFFENDER OR A STRONG CONTENDER: DOMESTIC PLAYERS[84]

Thanks to supportive national economic policy, the unprecedented speed of global information flow, and their own aptitude, domestic Chinese private equity firms have transformed themselves from apprentices to equal players with spectacular swiftness.

China's first domestic private equity company with an RMB-denominated fund, Bohai, was founded only on December 30, 2006, with main shareholders such as BOC International, Tianjin Teda, National Social Security Fund ("NSSF"), and China Development Bank ("CDB").[85] Because it had no precedent, the company had to obtain special approval from China's State Council and the National Development and Reform Commission.[86] Even though the plan to found Bohai was approved as early as December 2005, it took the parties a full year to sort out the legal structure and relationships of this new entity.[87] Bohai is undeniably a product of experimentation and compromise; it is a "hybrid" of corporation and partnership, unlike its American counterparts, which are predominantly limited partnerships.[88]

This Note also surveys some other major Chinese private equity

83. This statement does not take into account Blackstone's RMB Fund, the Zhonghua Development Fund (established in August 2009 with the government of Shanghai Pudong New Area). *See Zhonghua Development Fund*, BLACKSTONE, http://www.blackstone.com/cps/rde/xchg/bxcom/hs/businesses_aam_newinitiatives_zhonghua.htm (last visited Apr. 1, 2011).

84. *See* Yang Wang, Book Note, *China Reexamined: The Worst Offender or a Strong Contender?*, 106 MICH. L. REV. 1143 (2008) (reviewing RANDALL PEERENBOOM, CHINA MODERNIZES: THREAT TO THE WEST OR MODEL FOR THE REST? (Oxford Univ. Press 2007)).

85. *See* Zhao Jianfei, *Bohai Jijin: PE Zhongguo Zao* [*Bohai Fund: PE Made in China*], CAIJING [CAIJING], Jan. 6, 2007, *available at* http://magazine.caijing.com.cn/2007-01-06/110066153.html.

86. *Id.*

87. *Id.*

88. *Id.*

firms, including CDH, Citic private equity, Hony, Hopu, and New Horizon. Headed by Dr. Shangzhi Wu[89], CDH is a spin-off from China International Capital Corporation ("CICC")[90] and was incorporated in Cayman Islands in May 2002. CDH has raised capital for four funds, enlisting investors such as Stanford Management Company (the manager of Stanford University's endowment), sovereign-wealth fund Government of Singapore Investment Corporation, and International Finance Corporation, a member of the World Bank Group.[91] Thanks to its inheritance from CICC, from 2002 to 2005 CDH partnered closely with Morgan Stanley and Goldman Sachs in a series of investments, and profited handsomely.[92] Under the leadership of Lefei Liu[93] and Dr.

89. Wu received his Ph.D. in mechanical engineering from MIT in 1991, and was a senior investment officer at the International Finance Corporation from 1991 to 1993. From 1995 to 2002, Wu worked for CICC, serving as the head of the direct investment department beginning in 1996. Wu became a managing director in 1999 and served as a member of CICC's management committee between 2000 and 2002. *See Shangzhi Wu*, FORBES, http://people.forbes.com/profile/shangzhi-wu/20595 (last visited Apr. 1, 2011).

90. CICC is China's premier investment bank. Morgan Stanley and China Construction Bank helped form CICC in 1995, but disputes with CICC's management over personnel, corporate culture, and CICC's dealings with other foreign banks meant that Morgan Stanley over time became a passive investor. After a three-year effort to offload its interest in CICC, in December 2010, Morgan Stanley received long-awaited approval from the Chinese government to sell its 34.3% stake in CICC, clearing the way for the U.S. investment bank to pursue a new securities joint venture in China. Its shares in CICC were sold to KKR, TPG, Government of Singapore Investment Corporation, and Great Eastern Holdings Ltd., an insurer controlled by Oversea-Chinese Banking Corporation. *See* Kevin Kingsbury & Joy C. Shaw, *Morgan Stanley's Sale of CICC Gets Approval*, WALL ST. J., Dec. 9, 2010, at C2. CICC is run by Levin Zhu, son of former Chinese premier Zhu Rongji. *See* Cathy Chan, *China Weatherman Zhu Loses Grip as Citic Weakens CICC's Perch*, BLOOMBERG (Feb. 25, 2008, 7:39 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=arQz8cVWo7Xo&refer=exclusive; David Barboza, *Deal Seen for Stake in China Investment Bank*, N.Y. TIMES, Feb. 24, 2010, *available at* http://www.nytimes.com/2010/02/24/business/global/24yuan.html.

91. *See CDH Investments*, ZERO2IPO, http://www.zero2ipo.com.hk/cvcf/article/sponsors/29865.html (last visited Apr. 1, 2011).

92. Investments with Morgan Stanley included Mengniu Diary, Paradise Retail, and Shanshui; investments with Goldman Sachs included Yurun Group, Focus Media, and Shuanghui. *See* Li Ling, *Dinghui Chuangtou cong "Bang Dakuan" dao "Dakuan"* [*CDH: From Gold Digger to Gold*], XIN CAIFU [NEW FORTUNE], Aug. 15, 2006, *available at* http://www.p5w.net/newfortune/caiji/200608/t463976.htm.

93. *See Lefei Liu*, CITIC PRIVATE EQUITY, http://www.citicpe.com/liu_le_fei-

Yibin Wu[94], Citic private equity was established in June 2008 with the approval of the NDRC. It is the strategic onshore private equity investment platform of Citic Group and Citic Securities, which owns 71% of Citic private equity.[95] Citic private equity currently manages an RMB fund, Mianyang Scientific City Fund, which has a size of RMB 9 billion ($1.37 billion).[96] Hony Capital was formerly the investment branch of Lenovo Group. Managed by John Zhao,[97] Hony has won equity commitments from Goldman Sachs, Temasek Holdings, the endowments of Stanford and Notre Dame universities, and has co-invested with TPG and Legend Holdings in WuMart in August 2009.[98] Hopu Fund was established by Fang Fenglei,[99] the former chairman of

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eng.php (last visited Apr. 1, 2011). Liu was the Chief Investment Officer of China Life Insurance Company before heading Citic private equity. He received a bachelor's degree in economics from Renmin University of China, and a masters' degree from the Chinese Academy of Social Science ("CASS"). His father is Liu Yunshan, a CPC (Communist Party of China) Pulitburo member and director of the CPC Central Publicity Department, who is seen as a strong contender for the Pulitburo Standing Committee in 2012. *See* Cheng Li, *China's Midterm Jockeying: Gearing Up for 2012, Part 1: Provincial Chiefs*, CHINA LEADERSHIP MONITOR, Feb. 15, 2010, *available at* http://www.hoover.org/publications/china-leadership-monitor/article/5330.

94. Wu has a Ph.D. from Harvard, and after heading up Asia-Pacific mergers and acquisitions as partner at McKinsey & Company, he went on to lead Lenovo's acquisition of IBM's PC division and oversee Legend Holdings, Lenovo's investment arm. *See Yibing Wu*, CITIC PRIVATE EQUITY, http://www.citicpe.com/wu_yi_bing-eng.php (last visited Apr. 1, 2011).

95. *See* Duan Xiaoyan, *Zhongxin Chanye Jijin: Zuida de Renminbi PE Shi Zenyang Liancheng de* [*Citic Private Equity: How was the Largest Renminbi PE Forged*], 21 SHIJI JINGJI BAODAO [21 CENTURY BUSINESS HERALD], Jan. 29, 2010, *available at* http://www.21cbh.com/HTML/2010-2-1/164536.html. Citic Group was founded in 1979 by Rong Yiren (1916-2005) who was seen as the epitome of "red capitalist" in China and who would later become China's Vice President (1993-98). *See* David Barboza, *Rong Yiren, a Chinese Billionaire, Dies at 89*, N.Y. TIMES, Oct. 28, 2005, at C14.

96. Jamil Anderlini, *Local Buy-out Firms Defy U.S. Groups in China*, FIN. TIMES, Feb. 8, 2010, *available at* http://www.ft.com/cms/s/0/13b1d6b2-14da-11df-8f1d-00144feab49a.html#axzz1KJkZTZ00.

97. Zhao holds an M.B.A. from Kellogg School of Management, Northwestern University. *See John Zhao*, HONY CAPITAL, http://www.honycapital.com/hony_en/manage/team.html (last visited Apr. 1, 2011).

98. *See Hony Capital*, CHINAVENTURE, http://i.data.chinaventure.com.cn/i/32/ (last visited Apr. 1, 2011).

99. Fang is regarded as the man responsible for convincing his former boss and mentor Wang Qishan (now China's Vice Premier, in charge of the economy) to adopt

Goldman Sachs' securities partnership in China, and is advised by Clark Randt, former United States Ambassador to China (2001-09) and former head of Shearman & Sterling's Asia practices.[100] New Horizon has created a $100 million fund in 2005, a $500 million fund in 2007, and a third fund in 2010. Its investors include JPMorgan Chase, Deutsche Bank and Temasek Holdings.[101]

For years, China's National Social Security Fund has been the largest limited partner in these domestic private equity funds, although its prominence may be matched or even surpassed in the future, as China relaxed the restrictions in mid-2010 for insurance funds to invest up to 5% of their asset in private equity.[102] The domestic private equity firms' often extremely strong political connections have generated both interest and controversy. On the one hand, the rise of private equity in China is an unmistakable response to the failure of state-owned banks in meeting the financial needs of small and medium-sized companies in the private sector, and support from the state certainly facilitates the acceptance of private equity within China's financial circles.[103] On the other hand, a number of authors have offered a more sobering assessment that these political connections are a reflection of fundamental flaws in China's economic development model, despite its veneer of a market economy

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the American investment banking model and establish CICC, a joint venture with Morgan Stanley, in 1995. *See* Jamil Anderlini & Sundeep Tucker, *The Rise of China's Ultimate Dealmaker*, FIN. TIMES, May 13, 2009, *available at* http://www.ft.com/cms/s/0/8efd3718-3fe6-11de-9ced-00144feabdc0.html#axzz1KJkZTZ00; Cathy Chan, *Goldman's Fang Makes First Private Equity Investment*, BLOOMBERG (Aug. 30, 2008, 1:06 AM), http://www.bloomberg.com/apps/news?sid=aOF3lVH7WqRE&pid=newsarchive.

100. Rick Carew, *Former Ambassador Randt Advises on Chinese Private Equity*, WALL ST. J. CHINA REAL TIME REPORT (Nov. 24, 2009, 7:02 AM), http://blogs.wsj.com/chinarealtime/2009/11/24/former-ambassador-randt-advises-on-chinese-private-equity/.

101. *China's New Horizon Capital Raises 1 Billion Yuan Fund*, REUTERS (Jan. 13, 2009, 5:03 AM), http://www.reuters.com/article/2009/01/13/newhorizon-fund-idUSPEK11978920090113. One of the founders of New Horizon was Winston Wen, son of the Chinese premier Wen Jiabao. According to an announcement made by New Horizon on October 17, 2010, Winston Wen was no longer with the firm.

102. *See infra* Part VI.

103. *See* Rick Carew, *China's 'Princelings' and the PE*, WALL ST. J. DEAL J. (Feb. 1, 2010, 12:22 PM), http://blogs.wsj.com/deals/2010/02/01/chinas-princelings-and-the-pe/.

and breathtaking growth rate in the past decades.[104]

IV. SYSTEM IN THE MAKING: THE EVOLVING WEB OF LAWS

The legal system of the People's Republic of China ("PRC") is in form much closer to the legal system of continental Europe than to the common law, but also contains substantial elements borrowed from the former Soviet Union and inherited from traditional Chinese law.[105] In the aftermath of the Cultural Revolution (1966-76), China was in legal shambles and had virtually no contemporary legislation, and had to start from scratch.[106]

To understand China's legal system, one must first understand China's political system. The PRC is in form a unitary, not a federalist state, and all power flows from the central government in Beijing; that is, local governments have only such power as the central government chooses to delegate to them (although in reality, local governments enjoy varying degrees of autonomy because of the limits of effective supervision).[107] The PRC rejects the notion of horizontal separation of powers between the executive, legislative and judicial branches of government. Constitutionally speaking, the National People's Congress ("NPC"), which is the legislature, sits at the apex of China's political power structure.[108] The approximately three thousand delegates of the NPC, who are elected for five-year terms, convene for merely ten days

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104. *See generally* Rick Carew, *Cadre Capitalism*, WALL ST. J., July 12, 2010 (reviewing RICHARD MCGREGOR, THE PARTY: THE SECRET WORLD OF CHINA'S COMMUNIST RULERS (Harper 2010)), *available at* http://online.wsj.com/article/SB10001424052748703580104575362120444628254.html; Rick Carew, *Raising the Red Flag on Red Capitalism*, WALL ST. J., Jan. 10, 2011 (reviewing CARL E. WALTER & FRASER J.T. HOWIE, RED CAPITALISM: THE FRAGILE FINANCIAL FOUNDATION OF CHINA'S EXTRAORDINARY RISE (John Wiley & Sons 2011)), *available at* http://online.wsj.com/article/SB10001424052748704030704576070981801479062.htm.

105. Donald C. Clarke, *The Chinese Legal System*, GEORGE WASHINGTON UNIVERSITY SCHOOL OF LAW (July 4, 2005), http://docs.law.gwu.edu/facweb/dclarke/public/ChineseLegalSystem.html.

106. Jerome A. Cohen, *China's Reform Era Legal Odyssey*, FAR E. ECON. REV., Dec. 2008, at 34.

107. Peter Howard Corne, *Creation and Application of Law in the PRC*, 50 AM. J. COMP. L. 369, 370 (2002).

108. In reality, that position is occupied by the CPC Pulitburo Standing Committee. *See* Clarke, *supra* note 105.

each year, while the NPC Standing Committee (which currently consists of 175 members) and its nine specialized committees work full time.[109]

The day-to-day work of the government is carried out by the State Council under the Premier.[110] The State Council is divided into various functional ministries and commissions. This bifurcation between the people's congress and the day-to-day government is then replicated at the provincial and municipal levels.[111]

The judiciary is not independent and is institutionally weak.[112] The Chief Justice of the People's Supreme Court[113] is not a member of the Politburo; by comparison, the head of the Ministry of Public Security is a member.[114] Many judges are either young or not well trained, although the situation is rapidly changing as new breeds of well-trained law graduates replenish the system.[115]

Before the Criminal Code was enacted in 1979, the Constitutional Law passed in 1954 was the only statute of the People's Republic of China in force for twenty-five years.[116] Massive legislation began only in the 1980s, and the rule of law has been gradually taking shape since then.[117]

Thanks to more than thirty years of reform oriented toward a market economy, Chinese economic and business laws have undergone a thorough transformation, and are more closely in line with norms in

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109. *See* CECC, *Legislative transparency of China's NPC*, CONGRESSIONAL-EXECUTIVE COMMISSION ON CHINA, http://www.cecc.gov/pages/virtualAcad/gov/legistransp.php (last visited Apr. 11, 2011).

110. *See* Clarke, *supra* note 105.

111. *Id.*

112. *See* Cohen, *supra* note 106, at 36.

113. The current Chief Justice Wang Shengjun was born in 1946 and holds a bachelor's degree in history. He does not have a law degree. The inadequacy of his educational background for the position of a country's Chief Justice should be viewed against the background that most people in his generation were deprived of the opportunity of higher education, due to destructive turmoils brought by the Cultural Revolution (1966-76). Justice Wang's profile is viewable at the official English website of the Supreme People's Court, http://en.chinacourt.org/.

114. *See* Cohen, *supra* note 106, at 37.

115. *Id.* at 38.

116. *See* Joan Liu, *Finding Chinese Law on the Internet*, NEW YORK UNIVERSITY SCHOOL OF LAW, http://www.nyulawglobal.org/globalex/China.htm (last visited Apr. 11, 2011).

117. *Id.*

advanced countries, compared with other branches of law.[118] Nonetheless, a Western-trained lawyer should note that although the country has decisively transitioned from a centrally planned economy to a market-oriented one, the state maintains a heavy presence in the economy, and the interconnection between politics and economics is much less subtle than what one would typically find in the West. There is scantly a literal or metaphorical firewall between politics and business like the one in the United States: the political and business elites in the United States are effectively separated by the 230-mile physical distance between Washington and New York, whereas in China, they rub elbows in the same town,[119] a fact that may be partially responsible for the inordinate expansion of Beijing. The government and the Party routinely wage campaigns against corruption,[120] which is among the top complaints of the Chinese people, only to see the situation getting worse and worse.[121]

In a simplified version of China's legislative hierarchy suitable for discussion in this Note, Chinese law has three levels.[122] On the top are "national laws" adopted by the NPC and promulgated by the President. On the second level are the "administrative regulations" adopted by the State Council.[123] On the third level are the "administrative rules"

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118. *See* Wang & Huang, *infra* note 127, at 1.

119. As an illustration, in 2009, the top six cities as ranked by number of global 500 companies were Tokyo (51), Paris (27), Beijing (26), New York (18), London (15) and Seoul (11). *Global 500 2009: Cities*, FORTUNE, http://money.cnn.com/magazines/fortune/global500/2009/cities/ (last visited Apr. 1, 2011).

120. *See* Dexter Roberts, *China's Ruling Party Vows to Root Out Corruption*, BUS. WK., Mar. 10, 2011, *available at* http://www.businessweek.com/magazine/content/11_12/b4220013645558.htm. A recent high-profile corruption case was the downfall of Liu Zhijun, former Minister of Railways, in February 2011. Liu had been overseeing the extraordinary development of high-speed railways in China, which has captured global attention. *See* Edward Wong, *China's Railway Minister Loses Post in Corruption Inquiry*, N.Y. TIMES, Feb. 12, 2011, at A8.

121. *See* Minxin Pei, *Corruption Threatens China's Future*, CARNEGIE ENDOWMENT FOR INT'L PEACE POLICY BRIEF, No. 55, Oct. 2007, *available at* http://carnegieendowment.org/2007/10/09/corruption-threatens-china-s-future/g4.

122. *See* Legislation Law (promulgated by the Nat'l People's Cong., Mar. 15, 2000, effective July 1, 2000) chs. 2, 3, and 4.

123. XIANFA art. 89, § 1 (1982) (amended 1988, 1993, 1999 and 2004) (China) (empowering the State Council to "adopt administrative measures, enact administrative rules and regulations and issue decisions and orders in accordance with the Constitution and the law.").

adopted by the ministries and commissions under the State Council.[124] Then, the same hierarchy is replicated down at the provincial and municipal levels, and because of China's unitary polity, national laws in principle trump provincial and local laws when conflict exists.[125]

The counsel who advises an American private equity firm doing business in China is likely to be concerned about the following laws, regulations and rules, all of which were made after 2005 (the dates of effectuation are in parentheses):

- National laws (adopted by the NPC and its Standing Committee):
  - Company Law (January 1, 2006)
  - Securities Law (January 1, 2006)
  - Partnership Enterprise Law (June 1, 2007)
  - Enterprise Bankruptcy Law (June 1, 2007)
  - Anti-Monopoly Law (August 1, 2008)
- Administrative regulations (adopted by the State Council):
  - Foreign Exchange Regulation (August 5, 2008)
  - Foreign-Invested Partnership ("FIP") Regulation (March 1, 2010)
- Administrative rules (adopted by ministries and commissions under the State Council):
  - The "2006 M&A Rules":
    - Administrative Measures on Strategic Investments in Listed Companies by Foreign Investors ("Foreign Strategic Investment Measures") (January 31, 2006)
    - Administrative Measures on the Takeover of Listed Companies (September 1, 2006)
    - Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors ("Foreign M&A Provisions") (September 8, 2006)
  - Foreign Investment Industrial Guidance Catalogue (December 1, 2007)

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124. *Id.* art. 90 (empowering ministries and commissions under the State Council to "issue orders, directives and regulations within the jurisdiction of their respective departments and in accordance with the law and the administrative rules and regulations, decisions and orders issued by the State Council.").

125. For an interesting (and many see as groundbreaking) case involving a conflict between national and provincial laws, *see* Jim Yardley, *A Judge Tests China's Court, Making History*, N.Y. TIMES, Nov. 28, 2005, at A1.

COMPANY LAW

The new Company Law[126] represents a complete revision of the old Company Law (adopted in 1993): out of 229 articles of the old Company Law, 46 were deleted and 137 were amended; in addition, 41 new articles were added.[127] The reform is intended to bring China's Company Law more closely in line with its counterparts in developed economies.[128]

The reform introduces several important measures to enhance managerial accountability, addressing board composition, the role and responsibilities of directors, the protection of minority shareholders, and shareholder remedies.[129] One significant development is the introduction of the derivative suit. The new Company Law sets out the circumstances under which the court may allow shareholders to bring derivative action[130] and the procedures for doing so.[131]

Chapter Eleven (Articles 192 to 198) of the new Company Law is titled "Branches of Foreign Companies," which specifies that "[t]he branch of a foreign company established within the territory of China does not have the status of a legal person. The foreign company shall bear civil liabilities for the business operation of its branches undertaken within the territory of China."[132] Direct foreign investment in China may be carried out in three forms: a wholly foreign owned enterprise,[133] a contractual joint venture,[134] or an equity joint venture.[135]

126. Gongsi Fa [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006).

127. Baoshu Wang & Hui Huang, *China's New Company Law and Securities Law: An Overview and Assessment*, 10 AUSTL. J. CORP. L. 1, 3-4 (2006).

128. *Id.* at 1.

129. *Id.* at 6-8.

130. Company Law art. 150.

131. *Id.* art. 152.

132. *Id.* art. 196.

133. Waizi Qiye Fa [Foreign-funded Enterprise Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 31, 2000, effective Oct. 31, 2000).

134. Zhongwai Hezuo Jingying Qiye Fa [Chinese-Foreign Contractual Joint Venture Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 31, 2000, effective Oct. 31, 2000).

135. Zhongwai Hezi Jingying Qiye Fa [Chinese-Foreign Equity Joint Venture Law] (promulgated by the Nat'l People's Cong., Mar. 15, 2001, effective Mar. 15, 2001).

SECURITIES LAW

The new Securities Law,[136] adopted at the same NPC session as the new Company Law, is significant in several aspects.[137] First, the new law opens the door for the development of financial derivatives,[138] and lays the foundation for the establishment of multi-level securities markets in China.[139] Second, the new law strengthens the regulation of the issuing and trading of securities to further promote investor protection.[140] Third, in order to enhance the efficacy of the regulatory regime, the new law gives regulators more powers to perform their duties.[141]

The new Securities Law increases the role of the exchanges as self-regulators by giving them the power to list and delist companies and temporarily suspend trading securities[142] according to China Securities Regulatory Commission ("CSRC") procedures, as well as formally defining the exchanges as self-regulatory organizations.[143] In 2009, the CSRC further solidified such changes in its administrative licensing procedural rules.[144]

PARTNERSHIP ENTERPRISE LAW

The amended Partnership Enterprise Law[145] is viewed as an important step towards a more pro-investment corporate law, because it significantly alters existing partnership rules and principles established under the original Partnership Law enacted in 1997.[146] The new Partnership Law made significant changes in several respects: (1)

136. Zhengquan Fa [Securities Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006).

137. Wang & Huang, *supra* note 127, at 9-10.

138. Securities Law art. 42, 142.

139. *Id.* art. 39.

140. *Id.* art. 67, 74, 134.

141. *Id.* art. 180.

142. *Id.* art. 55, 56.

143. *Id.* art. 102.

144. *See* SCOTT, *supra* note 26, at 1165.

145. Hehuo Qiye Fa [Partnership Enterprise Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007).

146. *Recent PRC Partnership Law Amendments: Domestic Changes Significant, Little Immediate Impact Seen on Foreign Private Equity Investment*, CHINA UPDATE (Morrison Foerster, San Francisco, CA), June 2007, at 1.

Limited liability partnership ("LLP"): under the old Partnership Law, only unlimited liability partnerships were permissible. The amended Partnership Law now permits investors to establish LLPs;[147] (2) Legal person partners: the old Partnership Law required partners to a partnership to be individuals. The amended Partnership Law allows both legal persons and individuals to invest in partnerships;[148] (3) Bankruptcy: it was previously unclear whether a partnership could be forced into bankruptcy under the old Partnership Law. The amended Partnership Law gives creditors of LLPs the option, when the partnership is unable to meet its obligations, either to apply to the people's court for bankruptcy liquidation, or to claim directly against the general partners;[149] (4) Pass-through taxation: the amended Partnership Law expressly exempts partnerships from paying income tax, and taxes the income to partners on a pass-through basis.[150] The adoption of the Partnership Law spurred the extraordinary development of China's private equity industry by encouraging more new firms to adopt the partnership structure, which is inherently more suitable for private equity investments.[151]

The amended Partnership Law specifies "The measures for the administration on the establishment of partnership enterprises by foreign enterprises or individuals shall be formulated by the State Council."[152] This is essentially a carve-out; the State Council only filled in this gap with its own rule three years later.[153]

ENTERPRISE BANKRUPTCY LAW

The Enterprise Bankruptcy Law,[154] adopted at the same NPC session as the Partnership Enterprise Law, makes China the first Asian

147. Partnership Enterprise Law art. 2.

148. *Id.* art. 2.

149. *Id.* art. 92.

150. *Id.* art. 6.

151. *See* Joel H. Rothstein, *RMB Funds: The Evolving Role of Foreign Investors and Fund Managers in China*, PH PERSPECTIVES (Paul Hastings, Los Angeles, CA), Jan. 2010, at 1.

152. Partnership Enterprise Law art. 108.

153. *See* FIP Regulation, *infra* note 167.

154. Qiye Pochan Fa [Enterprise Bankruptcy Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007).

country to adopt an American-style bankruptcy system.[155] In contrast to the old regime, under which liquidation is the sole bankruptcy mechanism, the new law, for the first time, shifts its focus to corporate reorganization and introduces many concepts primarily borrowed from Chapter Eleven of the U.S. Bankruptcy Code.[156] The new law also entitles foreign owners and creditors for the first time in modern Chinese history to assert rights to assets they own in China.[157]

ANTI-MONOPOLY LAW

Adopted after a near thirteen-year drafting process, the Anti-Monopoly Law[158] is China's first comprehensive antitrust legislation, and has been hailed as a milestone in China's march towards a market economy.[159] The difficulty in drafting, adjudication and enforcement of this law is partly because the ideas behind anti-monopoly are inherently at odds with traditional Chinese culture that tends to be more tolerant of concentration of power, although this is too simplistic a statement that apparently does not do justice to the full complexity of this issue.[160]

The foregoing discussion shows that the country's most basic economic laws – Company Law, Securities Law, Partnership Enterprise Law, Enterprise Bankruptcy Law, and Anti-Monopoly Law – were not enacted until after 2005 (although the old Company Law and Securities Law were made in 1993 and 1998, respectively, they were completely revised in 2005). By contrast, in the United States, the Sherman Antitrust Act was passed in 1890, and the major securities laws were enacted in 1933 and 1934. The notion of "rule of law" is relatively new to the Chinese who have been living in a Confucian, relationship-based

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155. Shu-Ching Jean Chen, *China's Bankruptcy Big Bang*, FORBES, June 12, 2007, *available at* http://www.forbes.com/2007/06/12/china-bankruptcy-law-face-markets-cx_jc_0612autofacescan01.html.

156. David Patrick Eich & Chuan Li, *Private Equity Investments in China: Impact of Recent Legal Reforms*, VENTURE CAPITAL REVIEW, Issue 18, Winter 2007, at 35-36.

157. Enterprise Bankruptcy Law art. 5.

158. Fan Longduan Fa [Anti-Monopoly Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 30, 2007, effective Aug. 1, 2008).

159. Wentong Zheng, *China's Anti-Monopoly Law – One Year Down*, ANTITRUST AND COMPETITION POLICY BLOG (Oct. 6, 2009), http://lawprofessors.typepad.com/antitrustprof_blog/2009/10/chinas-antimonopoly-lawone-year-down.html.

160. *Id.*

system for two thousand years.[161]

FOREIGN EXCHANGE REGULATION

On August 5, 2008, the State Council adopted the second amendment of the Foreign Exchange Regulation.[162] The Regulation adopts a more balanced control mechanism for both the inflow and the outflow of foreign exchanges in China, and tightens supervision of the cross-border capital flows.[163] The old foreign exchange rules, first issued by the State Council in January 1996 and subsequently amended in January 1997, laid out the fundamental foreign exchange policy and legal framework in China, and specified that the RMB is freely convertible for current account transactions, whereas any conversion between RMB and foreign currencies for any capital account transactions require State Administration of Foreign Exchange ("SAFE") approval or registration.[164] Because of the shortage of foreign currencies at that time, the old rules maintained a strict control on the outflow of foreign currencies but adopted a flexible approach to facilitate their inflow.[165]

Because of the rapidly growing size of China's foreign exchange reserves, the new rules tighten restrictions on currency inflow and relax the approach to outflow, even though the fundamental foreign exchange administration framework established by the old rules remains unchanged.[166]

FOREIGN INVESTED-PARTNERSHIP ("FIP") REGULATION

The FIP Regulation[167] has been a long time in coming. Eagerly

161. KENNETH LIEBERTHAL, GOVERNING CHINA: FROM REVOLUTION THROUGH REFORM 4 (W.W. Norton 2nd ed. 2004).

162. Waihui Guanli Tiaoli [Regulation on Foreign Exchange Administration] (promulgated by the St. Council, Aug. 5, 2008, effective Aug. 5, 2008) [hereinafter Foreign Exchange Regulation].

163. David Dai, *China Adopts a More Balanced Foreign Exchange Control*, CHINA LAW ALERT (MWE China Law Offices, Shanghai, China), Nov. 2008, at 1.

164. *Id.*

165. *Id.*

166. *Id.*

167. Waiguo Qiye huo Geren zai Zhongguo Jingnei Sheli Hehuo Qiye Guanli Banfa [Administrative Measures on the Establishment of Partnership Enterprise by Foreign Enterprises or Individuals in China] (promulgated by the St. Council, Nov. 25, 2009,

anticipated by foreign investors and attorneys as early as in 2007, it was not enacted by the State Council until August 19, 2009, and another three months went by before the Premier promulgated the Regulation. The FIP Regulation represents an important step toward a national-law level framework permitting foreign investors to utilize a PRC partnership structure to form onshore RMB private equity funds,[168] and triggered prompt actions from foreign private equity firms like Carlyle.[169] Like the Partnership Law that came into effect on June 1, 2007, the FIP Regulation contains a prominent carve-out: "[i]n the event China has other provisions for the establishment of partnership enterprises by foreign enterprises or individuals in China *with investment as the main business*, it should be subject to those provisions" (emphasis added).[170]

THE "2006 M&A RULES"

The "2006 M&A Rules" refer to three rules: Administrative Measures on Strategic Investments in Listed Companies by Foreign Investors ("Foreign Strategic Investment Measures"),[171] Administrative Measures on the Takeover of Listed Companies,[172] and Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors

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effective Mar. 1, 2010) [hereinafter FIP Regulation].

168. *See Draft Foreign-Invested Partnership Regulation – New Possibilities for Global Funds in China?* CHINA MATTERS (Paul Hastings, Los Angeles, CA), Sept. 2009, at 3.

169. *See* Rick Carew & Dinny McMahon, *Carlyle Joins With Beijing to Launch a New Fund*, WALL ST. J., Jan. 12, 2010, *available at* http://online.wsj.com/article/SB10001424052748704055104574653132375745034.html?mod=WSJ_Bonds_RIGHTMoreInMarkets.

170. FIP Regulation art. 14. Private equity firms likely belong to the category of enterprises "with investments as the main business."

171. Waiguo Touzizhe dui Shangshi Gongsi Zhanlve Touzi Guanli Banfa [Administrative Measures on Strategic Investments in Listed Companies by Foreign Investors] (promulgated by the Ministry of Com., the China Sec. Reg. Comm'n, the State Admin. of Tax'n, the State Admin. for Indus. & Com., and the State Admin. of Foreign Exch., Dec. 31, 2005, effective Jan. 31, 2006) [hereinafter Foreign Strategic Investment Measures].

172. Shangshi Gongsi Shougou Guanli Banfa [Administrative Measures on the Takeover of Listed Companies] (promulgated by the China Sec. Reg. Comm'n, July 31, 2006, effective Sept. 1, 2006) (amended Aug. 27, 2008).

("Foreign M&A Provisions," commonly known as "Circular 10").[173] Circular 10 arrived at the height of the national debate on Carlyle's planned 85% investment in Xugong Group, a construction machinery manufacturer, and it probably caused Carlyle to drop the bid in the end.[174] To the dismay of China's small and medium-sized private companies that had experienced great difficulty securing loans from state-owned banks, Circular 10 also effectively sealed off an important overseas funding channel for them,[175] the "red chip" model.[176]

It is crucial to understand the roles and responsibilities of the key government agencies that enact and enforce these rules: the Ministry of Commerce ("MOFCOM") supervises and approves foreign investments; the National Development and Reform Commission ("NDRC") approves foreign investment project application; the State-owned Assets Supervision and Administration Commission ("SASAC") approves and supervises state-owned targets; the China Securities Regulatory Commission ("CSRC") approves and supervises listed companies; the State Administration for Industry and Commerce ("SAIC") is responsible for registration and administration; the State Administration

173. Guanyu Waiguo Touzizhe Binggou Jingnei Qiye de Guiding [Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors] (promulgated by the Ministry of Com., the State-owned Assets Supervision & Admin. Comm'n, the State Admin. of Tax'n, the State Admin. for Indus. & Com., the China Sec. Reg. Comm'n, and the State Admin. of Foreign Exch., Aug. 8, 2006, effective Sept. 8, 2006) (amended June 22, 2009) [hereinafter Foreign M&A Provisions].

174. *See* McMahon, *supra* note 42.

175. *See* Foreign M&A Provisions, *supra* note 173, art. 11 ("If any domestic company, enterprise or natural person merges its affiliated domestic company in the name of a company legally established or controlled by the aforesaid domestic company, enterprise or natural person in foreign countries or regions, it shall be subject to the approval of the MOFCOM"); art. 40 ("Where a special purpose company is to be listed overseas, the listing shall be approved by the securities regulatory authority under the State Council").

176. In a typical red chip model, a Chinese private company sets up a Special Purpose Vehicle ("SPV") in a overseas tax haven like the Cayman Islands or the British Virgin Islands, receives foreign private equity and/or venture capital investment, merges the original company into that SPV and possibly does an IPO in an overseas stock exchange. The very onerous and unpredictable approval procedures imposed by Circular 10 made it very difficult for Chinese private company to complete a red chip fundraising in subsequent years. *See, e.g.*, Feng Yuding, *Hongchou Shangshi Zai Yu Shihaowen Konghuang* [*The Red Chip Model Meets Circular 10 Scare Again*], SHANGWU ZHOUKAN [BUSINESS WATCH MAGAZINE], Apr. 25, 2007, *available at* http://finance.sina.com.cn/stock/t/20070425/14593540249.shtml.

of Foreign Exchange ("SAFE") manages and monitors foreign exchange transactions; the State Administration of Taxation ("SAT") oversees tax registration and collection; and other industry-specific regulators.[177] The effectiveness of China's administrative rulemaking critically depends on the coordination among these government agencies, whose interests and ideologies could conflict and thwart the policy objectives.

FOREIGN INVESTMENT INDUSTRIAL GUIDANCE CATALOGUE

Last but not least is the Foreign Investment Industrial Guidance Catalogue, which divides all potential foreign investments into three categories: *Encouraged*, *Restricted*, and *Prohibited* (unlisted industry sectors are deemed to fall into the *Permitted* category).[178] The categorization is meant to fulfill policy objectives such as upgrading industrial structure, enhancing resource conservation and environmental protection, addressing trade surplus and the rapid increase of foreign exchange reserves, balancing regional development, and protecting national economic security by applying a "cautiously open" policy to foreign investment in certain sectors.[179]

V. ON THE RISE: THE RMB FUND

The RMB fund has been hailed as the "next opportunity" by international private equity investors desiring to compete in China.[180] With the rise of China-based institutional investors and the massive increase in domestic liquidity, international private equity investors are finding it increasingly difficult to compete with domestic players for

177. Alex Yong Hao, Founding Director of the Chinese Business Lawyers Association ("CBLA"), lecture at the Inaugural Seminar of CBLA: China M&A, Joint Ventures, and Strategic Alliances (June 11, 2009) (on file with author).

178. Waishang Touzi Chanye Zhidao Mulu [Foreign Investment Industrial Guidance Catalogue] (promulgated by the Nat'l Dev. & Reform Comm'n, and the Ministry of Com., Oct. 31, 2007, effective Dec. 1, 2007). The 2007 edition of the Catalogue supersedes previous editions (2004, 2002, 1997, 1995). Our very own profession, legal service, belongs in the "Restricted" category.

179. Thomas Y. Man, Yan Zeng & Jing (Jean) Sun, *Foreign Investment Industry Catalogue: New Revisions & Alignment with National Development Strategy*, CHINA LAW & PRACTICE, Dec. 2007/Jan. 2008, at 17. The authors are attorneys at Orrick, Herrington & Sutcliffe LLP. *Id.*

180. Rothstein, *supra* note 151, at 1.

deals. Foreign private equity firms believe that Chinese laws governing foreign investment put them at a competitive disadvantage to domestic investors with RMB funding sources.[181] In recent years, governmental regulations have made it increasingly difficult for Chinese companies to establish offshore ownership structures.[182] Therefore, foreign investors have to come onshore and become subject to a complex and burdensome foreign investment regulatory regime, under which a foreign investor generally must set up a special legal entity, called a foreign-invested enterprise ("FIE").[183] Foreign investors view RMB funds as an opportunity to avoid the complexities associated with making each investment as a FIE, and to tap the ever-growing pool of Chinese individual and institutional investors.[184]

In August 2009, Blackstone signed an agreement with the government of Shanghai Pudong New Area to establish the firm's first regional private equity fund denominated in renminbi, planning to raise RMB 5 billion, or $732 million. According to the firm, the Blackstone Zhonghua Development Investment Fund "will make priority investments in the Shanghai Pudong New Area, a major focal point for the Chinese government's plans to develop a leading international finance and shipping center in the region as well as in other regions in China."[185] It was reported that China's National Social Securities Fund committed up to 40% of Blackstone's total target size, or RMB 2 billion ($293 million).[186] If true, this would represent the first investment by the NSSF in an RMB-denominated foreign fund, which would be subject to special permission from the State Council.

Pursuant to the effectuation of the FIP Regulation as of March 1,

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181. *Id.*

182. *See supra* notes 175, 176. These offshore structures previously provided convenient platforms for international private equity investments. *Id.*

183. Rothstein, *supra* note 151, at 1.

184. *Id.* *See also China RMB Funds: The Far East is Closer than You Think*, PILLSBURY CLIENT ALERT (Pillsbury, New York, NY), Mar. 3, 2009, at 1-2.

185. *Zhonghua Development Fund*, *supra* note 83.

186. George Chen & Megan Davies, *Blackstone Nails Down Some Commitments to China Fund*, REUTERS (Feb. 25, 2010, 11:43 PM), http://www.reuters.com/article/2010/02/26/us-blackstone-china-idUSTRE61P0T220100226. As discussed earlier, NSSF has long been the biggest limited partner in China's private equity industry, having contributed to China's largest private equity funds such as Bohai, CDH, Citic private equity, Hony, among others. *Supra* note 85.

2010, all new RMB funds will most likely adopt the FIP structure.[187] The Chinese limited partnership form is attractive because it shares a number of features with limited partnership vehicles from other jurisdictions, such as operational flexibility (including flexibility on the timing and amounts of capital contributions and profit allocations) and pass-through tax treatment.[188] While the establishment of a foreign-invested enterprise in the form of a wholly foreign-owned enterprise, an equity joint venture or a contractual joint venture is subject to prior approval from the Ministry of Commerce, the FIP Regulation only requires registration with appropriate provincial or local branches of the State Administration of Industry and Commerce.[189] In January 2010, SAIC issued compatible provisions, which went into effect on March 1, 2010, to further regulate the registration procedures with respect to foreign-invested partnerships.[190]

The promulgation of the FIP Regulation was an important first step in making FIPs a reality, and Carlyle clearly took the message to heart. In January 2010, Carlyle partnered with a subsidiary company of the Beijing municipal government to raise its first RMB fund, in the amount of RMB 5 billion, or $732 million.[191] Then, on February 24, 2010,

187. *See* FIP Regulation, *supra* note 167.

188. Rothstein, *supra* note 151, at 2.

189. John V. Grobowski & Yiqiang Li, *Administrative Measures for the Establishment of Partnership Enterprises in China by Foreign Enterprises or Individuals*, FAEGRE & BENSON CLIENT ALERTS (Faegre & Bensen, Minneapolis, MN), Jan. 1, 2010, at 2.

190. Waishang Touzi Hehuo Qiye Dengji Guanli Guiding [Administrative Provisions on the Registration of Foreign-invested Partnership Enterprises] (promulgated by the State Admin. for Indus. & Com., Jan. 29, 2010, effective Mar. 1, 2010); Guanyu Zuohao "Waiguo Qiye huo Geren zai Zhongguo Jingnei Sheli Hehuo Qiye Guanli Banfa" Guanche Shishi Gongzuo de Tongzhi [Notice on Doing a Good Job in the Implementation of the Foreign-Invested Partnership Regulation] (issued by the State Admin. for Indus. & Com., Feb. 10, 2010). *See also* Fang Jian, *SAIC Issues Rules on the Registration of Foreign-invested Partnerships*, LINKLATERS CHINA NEWS (Linklaters, London, UK), Feb. 5, 2010; *RMB Private Equity Funds in Foreign-Invested Partnerships*, CHINA MATTERS (Paul Hastings, Los Angeles, CA), Mar. 2010.

191. Carew & McMahon, *supra* note 169. However, partnering with a government entity is not a panacea; recently, Carlyle failed to convince the CBRC in its proposed investment in the Beijing Rural Commercial Bank, despite strong support from its partner (the subsidiary company of the Beijing municipal government), repeating its setback in the Chongqing City Commercial Bank. *See* Wu & Hu, *supra* note 11; Chen, *supra* note 52.

Carlyle teamed up with Shanghai conglomerate Fosun Group[192] to establish a $100 million jointly held private equity fund based in China and denominated in renminbi.[193] This is reportedly the first business license granted to a FIP with primary business in private equity investment, after the FIP Regulation took effect.

In the wake of pioneering moves by Blackstone and Carlyle, TPG made even bigger splashes in August 2010, announcing that it was partnering with two of China's largest cities, Shanghai and Chongqing, to raise nearly $1.5 billion and create its first two RMB funds.[194]

VI. NEW OUTLOOK: THE DECADE AHEAD

2010 was an eventful and exciting year for China's private equity industry, and some industry leaders see it as marking the beginning of a new era, the coming of age of the domestic Chinese private equity companies.[195] Such optimism is well founded, although it must also be qualified.

Several developments on the domestic front are noteworthy: (1) ChiNext and exit strategy. ChiNext, launched in October 2009, is the Shenzhen Exchange's Nasdaq-style second stock exchange. Because it is easier and faster for small and medium-sized private companies to be listed on ChiNext, ChiNext has proven to be an important alternative for private equity fund exit strategies.[196] (2) Insurance funds as the new limited partner. The China Insurance Regulatory Commission issued the Interim Measures for Equity Investment with Insurance Funds on September 5, 2010, opening the door for Chinese insurance companies to invest up to 5% of their total assets in private equity funds.[197] (3)

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192. Fosun Group is one of the nation's largest privately held companies, with more than $10 billion in assets. FOSUN INTERNATIONAL, http://www.fosun.com/en/.

193. James T. Areddy & Joy C. Shaw, *Carlyle, Fosun Set Global Ambitions for Partnership*, MARKETWATCH (Feb. 24, 2010, 02:37 PM), http://www.marketwatch.com/story/carlyle-fosun-set-global-ambitions-2010-02-24.

194. David Barboza, *TPG to Create Chinese Currency Funds*, N.Y. TIMES, Aug. 24, 2010, at B3.

195. *See* Liu, *supra* note 1.

196. *Id.* Note that in 2010, 96% (or 160 out of 167 cases) of the private equity exits in the Chinese market occurred through IPO. *See* ZERO2IPO RESEARCH CENTER, *supra* note 2, at 21.

197. Baoxian Zijin Touzi Guquan Zanxing Guanli Banfa [Interim Measures for

Fund of Funds ("FoF"). China's first RMB Fund of Funds, Guochuang FoF, was launched on December 28, 2010. Guochuang FoF was jointly set up by CDB Capital (a subsidiary of China Development Bank) and Suzhou Ventures Group.[198] The initial size of Guochuang FoF is RMB 15 billion. Guochuang FoF consists of Guochuang Kaiyuan, a private equity FoF with the initial size of RMB 10 billion, and Guochuang Yuanhe, a venture capital FoF with the initial size of RMB 5 billion.[199]

A nationwide legal framework for private equity is gradually taking shape, and in a series of recent rulemaking such as the FIP Regulation and the QFLP Program, the authorities seem to be making a conscious effort to level the playing field for foreign and domestic private equity firms.

SUPPORTIVE LAWS AND POLICIES

After the FIP Regulation came into effect in March 2010, the State Council continued the momentum by issuing a slew of opinions and decisions that together proved to be a big boon for private equity.[200] From April to October 2010, the State Council issued Several Opinions on Better Utilizing Foreign Investment,[201] Several Opinions on Encouraging and Guiding the Healthy Development of Private Investment,[202] Opinions on Promoting Enterprise Merger and

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Equity Investment with Insurance Funds] (promulgated by the China Ins. Reg. Comm'n, July 31, 2010, effective July 31, 2010). As mentioned in Part III, before this new rule the National Social Security Fund has been the biggest limited partner for private equity funds in the country.

198. Hu Rongping, *Guokai Jinrong Dazao 600 Yi Guochuang Mujijin* [*CDB Capital Forges 60 Billion Guochuang FoF*], JINGJI GUANCHA BAO [THE ECONOMIC OBSERVER], Dec. 29, 2010, *available at* http://www.eeo.com.cn/finance/banking/2010/12/29/190262.shtml.

199. *Id.*

200. See *supra* notes 122-24 for the administrative legislation power vested in the State Council and its ministries and commissions by the Constitution and the Legislation Law.

201. Guanyu Jinyibu Zuohao Liyong Waizi Gongzuo de Ruogan Yijian [Several Opinions on Better Utilizing Foreign Investment] (issued by the St. Council, Apr. 6, 2010).

202. Guanyu Guli he Yindao Minjian Touzi Jiankang Fazhan de Ruogan Yijian [Several Opinions on Encouraging and Guiding the Healthy Development of Private Investment] (issued by the St. Council, May 7, 2010).

Restructuring,[203] and Decision on Accelerating the Cultivation and Development of Strategic New Industries.[204] All these opinions and decisions highlighted "private equity" as an important component of China's capital markets and beneficial to the national economy.

These provisions were implemented in the Notice on the Division of Work among Departments, which was issued by the General Office of the State Council and further carried out by the ministries, commissions, and agencies under the State Council.[205] For instance, the Ministry of Commerce's Notice on Decentralizing the Examination and Approval Power for Foreign Investment aims to decentralize, simplify and streamline the approval procedures for foreign investors.[206]

On January 31, 2011, the National Development and Reform Commission issued the Notice on Further Regulating the Development and Filing of Equity Investment Enterprises in Pilot Areas.[207] The Notice provides much-needed guidance on the regulation of RMB private equity funds, and may mark the beginning of a centrally administered regulatory framework for such funds.[208] Its three most important provisions are: (1) Registration with the NDRC: subject to limited exceptions, any equity investment enterprises with registered capital of more than RMB 500 million and more than one investor must register with the NDRC if formed in a Pilot Area;[209] (2) Fundraising: an

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203. Guanyu Cujin Qiye Jianbing Chongzu de Yijian [Opinions on Promoting Enterprise Merger and Restructuring] (issued by the St. Council, Aug. 28, 2010).

204. Guanyu Jiakuai Peiyu he Fazhan Zhanlvexing Xinxing Chanye de Jueding [Decision on Accelerating the Cultivation and Development of Strategic New Industries] (issued by the St. Council, Oct. 10, 2010).

205. Guanche Luoshi Guowuyuan "Guanyu Jinyibu Zuohao Liyong Waizi Gongzuo de Ruogan Yijian" Bumen Fengong Fang'an [Notice on the Division of Work among Departments to Implement the "Several Opinions on Better Utilizing Foreign Investment"] (issued by Gen. Office of the St. Council, Aug. 18, 2010).

206. Guanyu Xiafang Waishang Touzi Shenpi Quanxian Youguan Wenti de Tongzhi [Notice on Decentralizing the Examination and Approval Power for Foreign Investment] (issued by the Ministry of Com., June 10, 2010).

207. Guanyu Jinyibu Guifan Shidian Diqu Guquan Touzi Qiye Fazhan he Bei'an Guanli Gongzuo de Tongzhi [Notice on Further Regulating the Development and Filing of Equity Investment Enterprises in Pilot Areas] (issued by the Nat'l Dev. & Reform Comm'n, Jan. 31, 2011) [hereinafter NDRC Notice on Equity Investment].

208. John R. Fadely, Helen Jiang & Catherine Yang, *NDRC Notice Regarding RMB Funds Provides Guidance on the Regulation of China's Domestic Private Equity Industry*, ASIA ALERT (Weil Gotshal, New York, NY), Mar. 2011.

209. The Pilot Areas include Beijing, Tianjin, Shanghai, Jiangsu, Zhejiang and

equity investment enterprise may raise capital only through a private placement to investors that are capable of assessing and bearing the risks of an investment in the equity investment enterprise;[210] (3) Investment restrictions: equity investment enterprises must be established in accordance with applicable PRC laws and may invest only in shares and equity interests that are not publicly traded.[211]

QUALIFIED FOREIGN LIMITED PARTNERS AND THE SHANGHAI PILOT PROGRAM

The QFLP has been long expected, and the announcement came in November 2010 that Shanghai, Beijing and Tianjin had been granted special status to accept QFLP as private equity investors.[212] Under the QFLP, each of the cities will have its own foreign quota for the amount allowed to be converted from foreign to domestic currency for the purpose of private equity funds.[213] The QFLP allows foreign investors to bring in foreign capital to convert into domestic currency, but the amount must not be more than 50% of the ultimate size of the fund.[214]

The QFLP parallels the QFII (Qualified Foreign Institutional Investors)[215], a program that was launched in 2002 to allow licensed foreign investors to buy and sell *A shares* in China's mainland stock exchanges in Shanghai and Shenzhen. Both QFLP and QFII are avenues for foreign investors to participate in the Chinese market, under China's capital control regime.[216]

Hubei. *See* NDRC Notice on Equity Investment, *supra* note 207, art. 5.

210. *Id.*, art. 1.

211. *Id.*

212. *The Floodgate: Three Cities to Test the QFLP Scheme*, ASIA PRIVATE EQUITY REV. GREATER CHINA EDITION, Dec. 2010, *available at* http://www.asiape.com/apergc/apergc_issues/apergc1012.html.

213. *Id.*

214. *Id.*

215. As of June 2010, 96 foreign entities have been approved as QFIIs. Sixteen of them are from the United States, including Harvard, Yale, Columbia and Stanford universities. *See QFII Directory*, CHINA SECURITIES REGULATORY COMMISSION, http://www.csrc.gov.cn/pub/zjhpublic/G00306208/201006/t20100610_181348.htm (last visited Apr. 1, 2011).

216. Liu Xue & Wang He, *Shanghai Shuaixian Kaifang Waishang Touzi PE Zhengce, Renminbi Zibenxiang Kaifang Zai Maibu* [*Shanghai Takes the Lead in Opening Policies for Foreign Private Equity Investment, Renminbi Capital Account Liberalization Makes Another Stride*], XINHUA [XINHUA], Jan. 12, 2011.

In early January 2011, the Shanghai Municipal Financial Services Office,[217] Shanghai Municipal Commission of Commerce and the Shanghai Municipal Administration for Industry and Commerce jointly issued the Implementation Measures on Pilot Program of Foreign-Invested Equity Investment Enterprises in Shanghai ("Pilot Measures").[218] Under the Pilot Program, qualified foreign investors can apply to convert foreign currency into renminbi, which they can directly invest in private equity funds based in Shanghai. The program would allow the investors to bypass China's tough restrictions on bringing funds into the country for financial investments — limits that are part of China's capital control regime.[219]

The governing body of the Pilot Program is the Joint Conference for Pilot Program of Equity-Investment Foreign Invested Enterprises ("Joint Conference"), which is composed of various working units that represent interests of the Shanghai government and the State.[220] The State Administration of Foreign Exchange has enlisted its Shanghai branch, the Shanghai SAFE, to control matters arising from foreign exchange issues when the Pilot Measures are implemented.[221] SAFE's presence suggests that investments made by funds formed under the Pilot Measures may still have to be approved by and reported to SAFE.[222]

QFLP and the Shanghai Pilot Program are considered major policy

217. Dr. Fang Xinghai directs the Shanghai Municipal Financial Services Office. Fang holds a B.S. in economics (1986) from Tsinghua University, and a Ph.D. in economics (1993) from Stanford University. Fang worked for the World Bank for five years, before returning to China to work for the China Construction Bank (1998-2000), the Galaxy Securities (2000-01), the Shanghai Stock Exchange (2001-05), and the Shanghai Financial Services Office since 2005. *See Fang Xinghai*, CHINA VITAE, http://www.chinavitae.com/biography/Fang_Xinghai (last visited Apr. 1, 2011).

218. Guanyu Benshi Kaizhan Waishang Touzi Guquan Touzi Qiye Shidian Gongzuo de Shishi Banfa [Implementation Measures on Pilot Program of Foreign-Invested Equity Investment Enterprises in Shanghai] (promulgated by the Shanghai Mun. Fin. Serv. Office, the Shanghai Mun. Comm'n of Com., and the Shanghai Mun. Admin. for Ind. & Com., Dec. 24, 2010, effective Jan. 24, 2011) [hereinafter Pilot Measures].

219. Dinny McMahon, *Shanghai Loosens Rules for Foreigners in Private Equity*, WALL ST. J., Jan. 13, 2011, at C2.

220. Pilot Measures art. 4.

221. *Id.*

222. *The Breakthrough*, ASIA PRIVATE EQUITY REV. GREATER CHINA EDITION, Feb. 2011, *available at* http://www.asiape.com/apergc/apergc_issues/apergc1102.html.

breakthroughs because of China's longstanding capital control, which is implemented by the SAFE. China has long maintained a fully convertible current account and a selectively convertible capital account that favors liberalizing long-term capital flows while restricting short-term capital flows.[223] For instance, SAFE's "Circular 142" prohibits the conversion of foreign exchange into renminbi for equity investment purposes.[224] The new measures portend simplification of the process and relaxation of certain restrictions, but the actual effect may depend on many variables.

Private equity has undergone significant growth in China in the past ten years, and the momentum is likely to continue in the new decade. A nationwide legal framework governing private equity is now on the horizon. The FIP Regulation that came into effect in March 2010 made it easier for foreign private equity firms to set up RMB funds and directly tap into local resources,[225] and the QFLP pilot program in Shanghai in January 2011 marks the beginning of a new era in which China welcomes foreign investors to enter its vast private equity market under established rules.[226] These new legal developments will likely foster a level playing field for foreign and domestic private equity firms. Domestic firms have turned from apprentices into real competitors, attracting top talents from foreign firms.[227] The game just got more interesting.

CONCLUSION

Observing China's fledging private equity industry is intellectually

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223. China has been reluctant to make its capital account fully convertible because its financial system is still immature. China's current account has been fully convertible since 1996. *See* Foreign Exchange Regulation, *supra* note 162, art. 5 ("The state imposes no restrictions on international payments and transfers of current account transactions.").

224. Guanyu Wanshan Waishang Touzi Qiye Waihui Zibenjin Zhifu Jiehui Guanli Youguan Yewu Caozuo Wenti de Tongzhi [Notice on Relevant Operational Issues Concerning Improving the Administration of the Payment and Settlement of Foreign Exchange Capital of Foreign-funded Enterprises] (issued by the State Admin. of Foreign Exch., Aug. 29, 2008) art. 3.

225. *See* Rothstein, *supra* note 151, at 1.

226. *See The Breakthrough*, *supra* note 222.

227. *See* Sender, *supra* note 71.

stimulating. Private equity was little known in China merely ten years ago, but now it has firmly established itself as part of the country's increasingly multi-layered capital markets. This study of the brief legal and financial history of the Chinese private equity industry has two broad implications.

First, the development of a legal framework for private equity in China is closely tied with the country's economic fundamentals.[228] Private equity boomed because there was a gap to fill in China's financial system, which had long been dominated by the country's state-owned banks. A large number of entrepreneurial, private companies with high growth potential flourished in reaction to the country's liberalization policies, but many have experienced great difficulties securing funds from state-owned banks.[229] Chinese savers, who want better returns on their investments, and entrepreneurs, who need capital, are keen on bypassing the big banks. Over time, the government also realized the significance of weaning the country's economy off an overdependence on bank lending.[230] Private equity came just in time.

In the future, the prosperity of foreign private equity firms in China will continue to hinge on the country's economic circumstances and policies, and in particular, policies regarding the renminbi. Foreign private equity firms will stay competitive in China only if they tap the ever-growing pool of wealthy Chinese individuals and institutional investors, and achieve flexibility on the timing and amount of capital contributions and profit allocation through their own RMB funds.[231] Therefore, foreign private equity firms will benefit from a Chinese economic policy that gradually loosens foreign exchange control and in the long term makes the country's capital account fully convertible. A fully convertible capital account is a prerequisite for the renminbi to become a global currency, which seems to be China's long-term goal.[232]

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228. The legal and economic histories of other countries have shown the same. In the United States, for example, the Securities Act of 1933 came in the aftermath of the stock market crash of 1929 and during the ensuing Great Depression, and Regulation D (discussed in Part I) was a response to conditions of the 1970s that made it unnecessarily difficult for small businesses to raise capital. *See* COX, HILLMAN & LANGEVOORT, *supra* note 22, at 281.

229. *See Private Equity in China: Barbarians in Love*, *supra* note 3.

230. *See* McMahon, *supra* note 219, at C2.

231. *See* Rothstein, *supra* note 151, at 2.

232. *See* Lingling Wei, *New Move to Make Yuan a Global Currency*, WALL ST. J., Jan. 12, 2011, at A1 (quoting remarks from Li Xiaojing, general manager of Bank of

Then again, only a global currency is compatible with the "going-out" plan now championed by leading Chinese enterprises, state-owned or privately-held. This was clearly in the mind of China's central bankers[233] when the bank issued its very first Public Notice of 2011 to promulgate the Administrative Measures for the Pilot RMB Settlement of Outward Direct Investment.[234] Around the same time, Bank of China's New York branch launched renminbi trading in the United States for the first time, expanding the nascent offshore renminbi market that began last year in Hong Kong.[235] Commentators see these as solid steps toward a more convertible Chinese currency.[236]

Second, private equity offers a unique lens for understanding China's legal system. As this Note examines, administrative legislation and rulemaking[237] have played a pivotal role in the development of China's private equity industry, and more recently, in leveling the playing field for foreign and domestic private equity firms. The effective rulemaking by the State Council and its ministries and commissions is a key source of strength at the current stage of China's economic development. In fact, it is tempting to think that this system

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China's New York branch that "we're preparing for the day when renminbi becomes fully convertible."); David Barboza, *In China, Tentative Steps Toward Global Currency*, N.Y. TIMES, Feb. 11, 2011, at B1 (quoting remarks from Robert A. Mundell, a Nobel laureate economist, that "the renminbi was already a regional currency in Southeast Asia, where China had become the dominant trading partner of many countries.").

233. Some officials at the People's Bank of China have substantial overseas experiences. Yi Gang, Deputy Governor of the PBOC, received his Ph.D. in economics from the University of Illinois in 1986, and became a tenured Associate Professor at Indiana University in 1992. Yi returned to teach at Peking University in 1994, joined the PBOC in 1997 and rose through the ranks at the central bank. He had been in charge of China's monetary policy and foreign exchange administration. *See Yi Gang*, PEOPLE'S BANK OF CHINA, http://www.pbc.gov.cn/publish/english/1011/index.html (last visited Apr. 1, 2011). A younger official, Li Bo, now head of the PBOC's Monetary Policy Department II (overseeing the globalization of renminbi), graduated from Renmin University of China, received his Ph.D. in economics from Stanford and J.D. from Harvard Law School, and has worked at Davis Polk & Wardwell LLP.

234. Jingwai Zhijie Touzi Renminbi Jiesuan Shidian Guanli Banfa [Administrative Measures for the Pilot RMB Settlement of Outward Direct Investment] (promulgated by the People's Bank of China, Jan. 6, 2011, effective Jan. 6, 2011).

235. Wei, *supra* note 232, at A1.

236. *See, e.g.*, Barboza, *supra* note 232, at B1.

237. Such powers are granted by the Constitution to the State Council and its ministries and commissions. *See supra* notes 123 and 124.

possesses some of the advantages typically associated with the common law system – flexibility and nimbleness – only that those who assigned such attributes to the system are not the judges, but government officials. The officials who made and implemented the recent private equity-friendly rules have been credited with their responsiveness and adeptness at fine-tuning, or, in the words of the late Deng Xiaoping (1904 - 1997), "crossing the river by feeling the stones."[238]

The administrative rulemaking system is at its best when the ministries and commissions under the State Council coordinate with each other to carry out stated policy objectives. Conversely, in cases where lack of communication, or worse, conflicts of interest arise among various agencies, a confusing patchwork of laws and regulations ensues.[239] Because of the experimental nature of China's economic reform, such inefficiencies are not at all uncommon. Inter-agency conflicts of interest run the gamut from mostly monetary to largely ideological. For example, as the 2006 M&A Rules[240] demonstrate, the struggle between economic liberalism and protectionism has been a perennial hot button, and constantly redefines the boundaries of what foreign private equity firms (as well as other financial institutions) can and cannot do in China.[241]

Looking beyond administrative legislation and rulemaking, we encounter a more fundamental question of the Chinese legal system. Like other East Asian countries during their economic takeoffs, the Chinese system vests enormous discretion in the administrative agencies that make and implement the regulatory schemes.[242] Unlike Japan, which adopted a democratic polity after Word War II, or South Korea, which transformed itself into a democracy in late 1980s, the inherent lack of checks and balances in China's current political system continues to breed abuse of power and other "systemic risk," to borrow the term from finance.[243]

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238. *See, e.g.*, *Cong "Mozhe Shitou Guohe" Dao Gaige "Dingceng Sheji"* [*From "Crossing the River by Feeling the Stones" to Reforming "Top-Floor Design"*], DIYI CAIJING RIBAO [CHINA BUSINESS NETWORK], Mar. 9, 2011, *available at* http://money.163.com/11/0309/06/6UMDKE4T00252G50.html.

239. *See* Corne, *supra* note 107, at 370.

240. *See supra* notes 171 to 173.

241. *See* McMahon, *supra* note 42.

242. John Ohnesorge, *Chinese Administrative Law in the Northeast Asia Mirror*, 16 TRANSNAT'L L. & CONTEMP. PROBS, 103, 111 (2006).

243. *See* Pei, *supra* note 121, at 5-6.

As discussed in Part IV, the polity of the People's Republic of China rejects the notion of horizontal separation of powers between the executive, legislative and judicial branches of the government.[244] China's legislature, the National People's Congress, only makes the country's basic laws.[245] Even the country's most basic economic laws have not been enacted until very recently, and "rule of law" in the Western sense is a new notion to the Chinese who have been living in a Confucian, relationship-based system for two thousand years.[246] Although the Chinese Constitution also confers supervisory power to the People's Congress,[247] in reality, the institutional infrastructure supporting the exercise of such power is very limited.[248] For one thing, the NPC is not a professionalized representative body, and its three thousand or so delegates only convene for ten days each year.

The Chinese judiciary is not independent and is institutionally weak.[249] Under current circumstances, it is unrealistic to expect the Chinese judiciary to play the kind of role as their U.S. counterparts and move the society forward with landmark decisions, although some scholars, drawing lessons from the Japanese courts, have advocated for the Chinese courts to play a more openly political role in major social conflicts.[250]

Many scholars see a political system lacking checks and balances as responsible for some of China's most troubling problems, such as widespread government corruption, and the ever-widening income disparity among different social and political groups.[251] Recently, private equity has been under intense criticism for being a tool of enriching the country's political establishment, so much so that people

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244. *See* Clarke, *supra* note 105.

245. XIANFA art. 62 § 3 (1982) (amended Apr. 12, 1988, Mar. 29, 1993, Mar. 15, 1999, Mar. 14, 2004) (China).

246. *See* LIEBERTHAL, *supra* note 161, at 4.

247. PRC STATE COUNCIL, WHITE PAPER: BUILDING OF POLITICAL DEMOCRACY IN CHINA (2005), Ch. 3, *available at* http://news.xinhuanet.com/english/2005-10/19/content_3645750.htm.

248. For an interesting discussion, *see* Guobin Zhu, *Constitutional Review in China: An Unaccomplished Project or a Mirage?* 43 SUFFOLK U. L. REV. 625 (2010) (arguing that the Chinese "constitutional review" system vests the reviewing power in the legislature instead of courts).

249. *See* Cohen, *supra* note 106, at 36.

250. *See* Frank K. Upham, *Reflections on the Rule of Law in China*, 6 NAT'L TAIWAN U. L. Rev. (forthcoming Sept. 2011).

251. *See* Pei, *supra* note 121, at 5.

now joke that "PE" stands for "princes' enterprise."[252] This new development is worrying because it breeds injustice, inequality and social instability,[253] and undermines the foundation of a "neutral government" that some argue has been at the helm of China's reform in the past three decades.[254]

How the Chinese legal system may evolve is obviously beyond the scope of this Note. However, private equity provides a captivating lens for making fresh discoveries about contemporary China. Along with the whole set of presumptions of the market economy (e.g., equal participation, transparency, rule of law) that it is embedded in, private equity is becoming a new force in shaping China's economic, legal and political future.

252. *See* Carew, *supra* note 103.

253. *See, e.g.*, Carl F. Minzner, *Xinfang: An Alternative to Formal Chinese Legal Institutions*, 42 STAN. J. INT'L L. 103 (2006); Katherine Wilhelm, *Rethinking Property Rights in Urban China*, 9 UCLA J. INT'L L. & FOREIGN AFF. 227 (2004).

254. *See* Yang Yao, *The End of the Beijing Consensus*, FOREIGN AFF., Feb. 2, 2010, at 1, *available at* http://www.foreignaffairs.com/articles/65947/the-end-of-the-beijing-consensus. Professor Yao is Deputy Dean of the National School of Development and Director of the China Center for Economic Research at Peking University. According to Professor Yao, "China has for three decades been ruled by a *disinterested* government – a detached, unbiased regime that takes a *neutral* stance when conflicts of interest arise among different social and political groups. This does not mean that Beijing has been devoid of self-interest. On the contrary, the state is often predatory toward citizens, but its predation is 'identity-blind' in the sense that Beijing does not generally care about the social and political status of its chosen prey – unlike many governments elsewhere that act to protect and enrich *specific* social or political groups. As a consequence, the Chinese government has been more likely than other authoritarian regimes to adopt growth-enhancing policies." (emphasis added). *Id*.

APPENDIX: ACRONYMS FOR CHINESE PROPER NAMES

Because the literal translations of China-related entity names tend to be long, they are often shortened to their acronyms. Over time, these acronyms entered the lexicon of English-speaking financial professionals, lawyers and academics alike. Many of these acronyms became an integral part of these entities' logos, and are used far more often than the original translations (just like the way American private equity firm TPG changed its official name from the original "Texas Pacific Group" to a nondescript, non-geographic, TPG in 2003). Listed below are the names that have appeared in the Note.

GOVERNMENT ENTITIES

- People's Republic of China (PRC)
- National People's Congress (NPC)
- Communist Party of China (CPC), or Chinese Communist Party (CCP)
- National Development and Reform Commission (NDRC)
- State-owned Assets Supervision and Administration Commission (SASAC)
- People's Bank of China (PBOC, sometimes PBoC)
- State Administration of Foreign Exchange (SAFE)
- China Securities Regulatory Commission (CSRC)
- China Banking Regulatory Commission (CBRC)
- China Insurance Regulatory Commission (CIRC)
- Ministry of Commerce (MOFCOM)
- State Administration for Industry and Commerce (SAIC)
    - Administration for Industry and Commerce (AIC) at provincial and local levels
- State Administration of Taxation (SAT)
- National Social Security Fund (NSSF)

COMPANIES

- Industrial and Commercial Bank of China (ICBC)
- Bank of China (BOC)

- China Construction Bank (CCB)
- Agricultural Bank of China (ABC)
- China Development Bank (CDB)
- China Investment Corporation (CIC)
- China International Capital Corporation (CICC)
- China International Trust and Investment Company (CITIC)
- China Pacific Insurance Company (CPIC)
- Shenzhen Development Bank (SDB)

OTHERS

- State-Owned Enterprises (SOE)
- State-Owned Banks (SOB)
- Foreign Invested Enterprise (FIE)
- Foreign Invested Partnership (FIP)
- Qualified Foreign Limited Partners (QFLP)
- Qualified Foreign Institutional Investors (QFII)