

VENTURE CAPITAL INVESTMENT IN THE INDIAN MARKET

*Background Note for the Presentation made by **Sajai Singh**, Partner, J. Sagar Associates
on Venture Capital Investing In Asia,
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This Background Note attempts to put together a document listing some high level issues that affect the venture business in India. While there are several issues, the scope of this document is restricted to the structure of the above meeting. And it may be read as such. For more information and clarifications, Sajai Singh is available at the communication address and numbers provided at the end of this Note.

While venture capital and private equity funding may be considered a new phenomenon in India, the sector itself has seen its share of highs and lows. In the late nineties, India seemed to be the ‘flavor of the day’ for its IT brainpower, with venture capital being pumped into the country. The dot com downfall in 2001-2002 burst the bubble, and venture capitalists were more tentative in investing in Indian undertakings. However, after two years of consolidation in 2003 and 2004, the Indian economy followed an upward spiral in 2005. As investors watched the surge in the Indian stock markets in 2005, the persons monitoring developments on this front most closely seemed to be the venture capitalists. The booming markets merely confirmed their belief that India was indeed one of the most attractive destinations for their funds to yield high returns. While the major markets of United States, Europe and Israel have witnessed a growth in venture capital funding, China and India are clearly the emerging markets where both venture capitalists and private equity players are expected to park their funds¹. Various studies and analyses published over the past 18-24 months have projected India to be the fastest growing economy over the next few decades. A recent study conducted by Deutsche Bank Research projects the annual growth of GDP in India to be around 5.5% until 2020, while countries like the U.S., Canada and France are projected to have growths of only 3.1%, 2.4% and 2.3%, respectively, for the same period².

The typical venture capitalists ‘venturing’ into India today consist of successful global venture capitalists, high net-worth individuals and private investors, all of whom are looking to cash in on India’s vibrant markets. 2005 witnessed over 68 investments in India with a total funding of US\$ 1.8 billion. Major investors have included reputed venture capitalists such as Newbridge Capital, ChrysCapital, Warburg Pincus, Temasek and General Atlantic, among others³. As could be expected, the IT-ITES⁴ sector continues to lead other sectors in terms of investment. The other sectors that have attracted significant investment include manufacturing, healthcare and life sciences. As of December 2005, the total venture capital investment portfolio in India was estimated to be at US\$ 4.3 billion (see below). The total number of venture capital firms in India has increased from 2003 and 2004, and these firms now employ over 290 professionals (see below).

¹ “Robust Fund Raising and Liquidity Prices in 2005, Along With Global Investing, Forecast Renewed Vigor For Venture Capital in 2006”, by Ernst & Young.

² As per the survey, the other growth centers are expected to be Malaysia at 5.4%, China at 5.2% and Thailand at 4.5%. See Strategic Review 2006 published by the National Association of Software and Service Companies (Nasscom).

³ Each of these venture capital investors have invested between US\$ 50-100 million in various sectors. For a detailed account of the key deals in 2005, please refer to Strategic Review 2006, published by Nasscom. <http://www.nasscom.org>

⁴ Information Technology and Information Technology enabled business services.

Top Sectors Attracting Private Equity Funding in India⁵

Sector	No. of Deals	Value (US \$ Million)
IT-ITES	33	422.90
Manufacturing	23	331.45
Healthcare and Life sciences	13	201.24
Banking and Financial Services	6	146.70
Textiles	12	146.50

Venture Capital/ Private Equity Industry Profile⁶

	2000	2001	2002	2003	2004	2005
Number of VC Firms	81	77	78	81	86	89
Estimated VC Professionals	278	267	270	278	289	292
Investment during the year (US\$ Million)	850	1135	1050	865	1363	665
Investment portfolio as of December 31, 2006	1587	2343	3188	3120	4739	4304

Some basics on India and the Indian Legal System

Before considering the manner in which venture capitalists usually like to structure their transactions in India, it is imperative that the investor understands India and the Indian legal system. A country with over a billion people, India has found its English speaking human capital is a major asset. India has always been English speaking due to the fact that it was a British colony until 1947. In addition to the English language, India inherited its legal system from the British, and as is the case with most commonwealth countries, India follows the English Common Law system. Numerous laws enacted during the British rule continue to remain in force to this day. Today, India is a federation of 28 States and 7 Union Territories. Unlike its US counterpart, the Indian justice system consists of a unitary system at both the State and Federal level. States are divided into districts and within each, a District or Sessions Judge is head of the judiciary. The District and Session Courts comprise the lowest level of courts and are trial courts of original jurisdiction, applying both Federal and State laws. An appeal from these courts would go to the High Court of the State. Above the State High Courts is the Supreme Court of India, situated in New Delhi, which is the highest court of justice in the country.

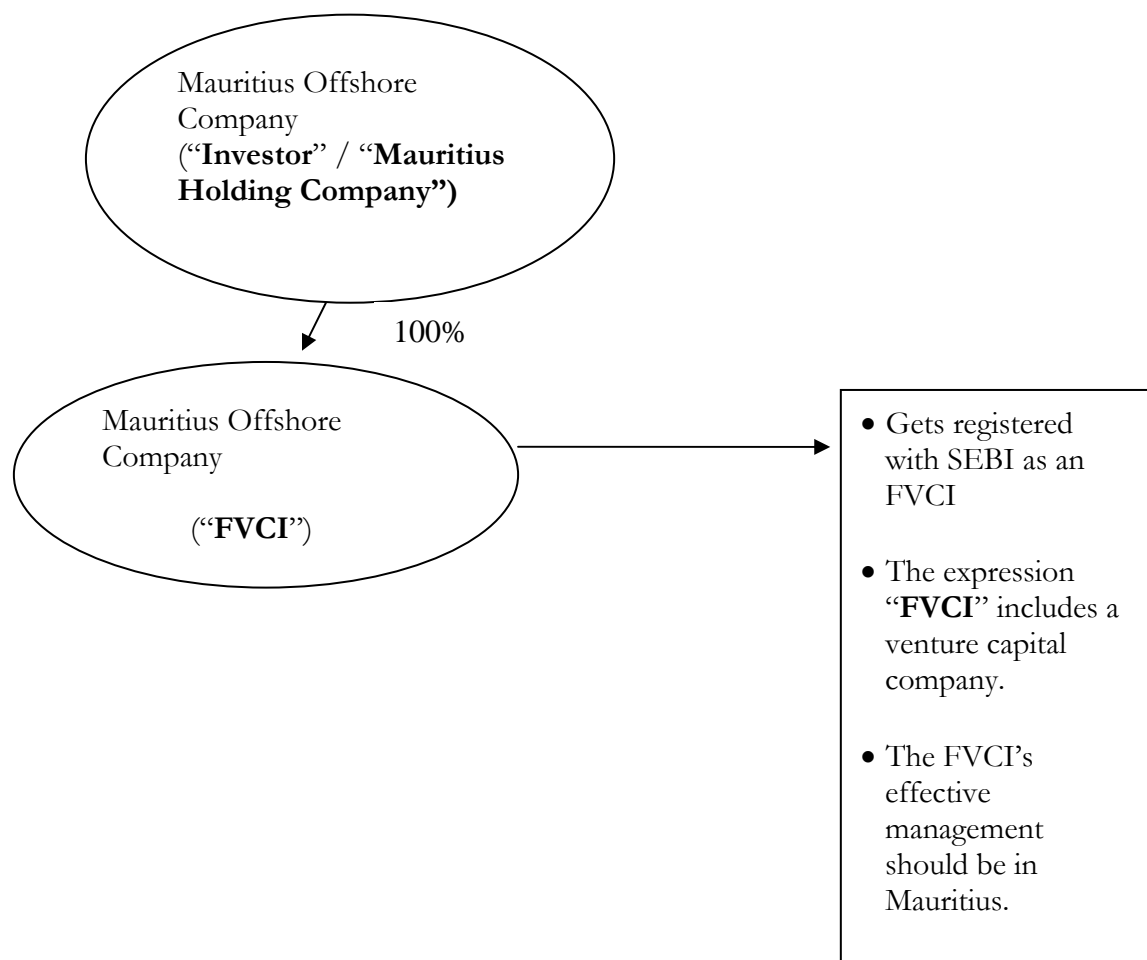
⁵ Strategic Review 2006 published by the National Association of Software and Service Companies (Nasscom).
<http://www.nasscom.org>

⁶ Strategic Review 2006 published by the National Association of Software and Service Companies (Nasscom).
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To most Western visitors to India, the legal, business and administrative system does not seem foreign as a result of a common heritage of British rule. Combine this with the famous Indian hospitality, which generally makes every visitor feel welcome. The only negative aspect of this hospitality is that Indians find it hard to say ‘no’, which is important for visitors to know when trying to negotiate with Indians.

Most laws that govern venture capital investment are Federal laws and the relevant authorities/regulators are the Foreign Investment Promotion Board⁷, the Reserve Bank of India⁸ (‘RBI’) and the Securities and Exchange Board of India⁹ (the ‘SEBI’). This paper will describe the structures typically used for investments in India. Before we understand the role of each authority, it is important to understand the structure for investments into India.

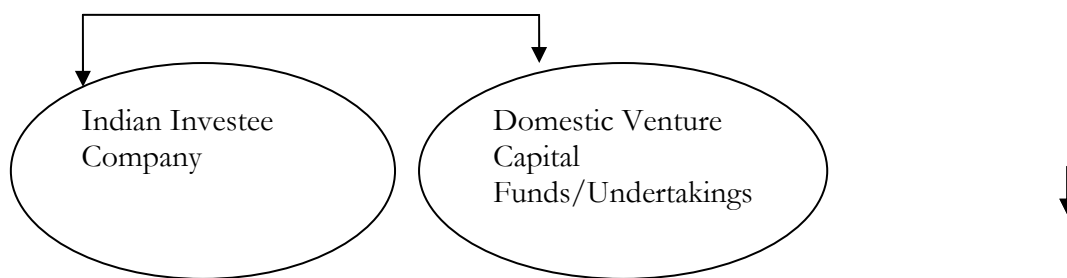
Typical Venture Capital Structure



⁷ The Foreign Investment Promotion Board or the FIPB is a body under the Department of Economic Affairs, Ministry of Finance, Government of India. The main function of the FIPB is to consider and recommend certain restricted Foreign Direct Investments ('FDI'). It may be noted that the Government of India has opened up most sectors to foreign investment, however, foreign investment is prohibited in certain sectors such as atomic energy, lottery business, gambling and betting business and agriculture, and foreign investment is restricted in certain other sectors such as retail trading, real estate, print media, broadcasting, defense and insurance.

⁸ The RBI is the Central Bank of the country and performs a number of functions such as formulating and implementing monetary policy, prescribing the broad parameters of banking operations within which the banking and financial systems are to function, overlooking and regulating the foreign exchange market, and issuing currency.

⁹ The SEBI is the Indian counterpart to the Securities Exchange Commission in the U.S. and its main function is that of regulating and developing the securities market in India and of protecting the interests of investors in securities.



Regulatory Framework

An FVCI (or Foreign Venture Capital Investor) is an investor incorporated or established outside India which proposes to make investments either in domestic Venture Capital Funds ('VCFs') or Venture Capital Undertakings¹⁰ ('VCUs') in India (defined to mean a domestic unlisted Indian Company) and which is registered under the Foreign Venture Capital Investor Regulations, 2000 ('FVCI Regulations'). Although foreign private equity players and offshore VCFs can invest in India directly under the Foreign Direct Investment Scheme (the 'FDI Scheme')¹¹, the SEBI grants certain benefits to those investors who register themselves under the FVCI Regulations (which benefits will be elaborated upon later in this paper). While considering an FVCI application, the SEBI does review the applicant's track record, professional competence, financial soundness, experience, general reputation, whether the applicant is regulated by an appropriate foreign regulatory authority or is an income tax payer, amongst other factors. The SEBI then forwards its approval to the RBI, which then grants its approval.

¹⁰ Under the Venture Capital Funds Regulations, 1996 that govern the functioning of domestic venture capital fund, a 'VCU' means a domestic company (i) whose shares are not listed on a recognized stock exchange in India; and (b) which is engaged in the business of providing services, production or manufacture of articles or things and does not include such activities or sectors which are specified by the Federal Government. The current list includes Non Banking Financial Services, Gold Financing and certain other prohibited sectors mentioned in footnote 7.

¹¹ An investor investing under the FDI Scheme would be bound by certain restrictions, including investment limits and caps under each business area. The FDI Scheme is regulated by the regulations issued under the Foreign Exchange Management Act, 1999.

Although, certain restrictions are placed on the manner in which an FVCI may use its funds¹², it has the option of using all of its funds to invest in a domestic VCF, which can in turn invest up to two-thirds of its funds in unlisted companies. While the FDI Scheme does not apply to FVCIs, an investment by an FVCI in a listed company or in a special purpose vehicle (an 'SPV') that does not fall under the definition of a VCU or a VCF would qualify as an investment under the FDI Scheme, which would be subject to the sectoral caps and other limitations on investment that apply under the FDI Scheme for investments, unless special permission is obtained from the RBI for investing beyond the sectoral caps or waiving any of the other limitations under the FDI Scheme.

Benefits of Registering under the FVCI Regulations

While registration under the FVCI Regulations is not compulsory, the Indian Government has sought to make this registration attractive by conferring certain benefits upon those institutions that have registered, including:

1. Other than a registered FVCI investment, all other non-resident investments are subject to a condition that subsequent investments require the Government's approval, where the non-resident has an existing joint venture, technology transfer agreement or trademark agreement in the same field in India.
2. FVCIs are exempt from the usual practice of valuing the shares on the basis of their listed price or on the basis of their net asset value (in the case of an unlisted company) in any investment or M&A transaction¹³. This exemption also helps when an FVCI is looking to exit its investment from an unlisted company. In such a situation, instead of paying a price based on the net asset value of the investee company, it could pay the negotiated price¹⁴.
3. The provisions of the SEBI (Substantial Acquisitions of Shares and Takeover) Regulations, 1997 ('Takeover Code') do not apply to shares transferred from an FVCI to the promoters of the company or to the company itself, if effected in accordance with a pre-existing agreement between the FVCI and the promoters of the company. This ensures that in the event the

¹² All investments to be made by foreign venture capital investors are subject to the following conditions:

- (i) the investor must disclose its investment strategy to the SEBI
- (ii) an FVCI can invest all of its funds in a domestic VCF
- (iii) an FVCI would have to make its investments in the following manner:
 - (a) At least 66.67% (two thirds) of its funds would have to be invested in unlisted equity shares or equity linked instruments of VCUs.
 - (b) The remaining 33.33% could be invested as follows:
 - Subscription in the initial public offering of a VCU whose shares are proposed to be listed;
 - In debt or debt-related securities of a VCU in which the FVCI has already made an investment by way of equity;
 - By way of a preferential allotment of equity shares of a listed company, subject to a lock-up period of one year;
 - Investment by subscription or purchase in the equity shares or equity-linked securities of a financially weak listed company or industrial listed company.
 - Investment by subscription or purchase in an SPV.

¹³ The Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India)(Amendment) Regulations, 2000 states that the FVCI may acquire by purchase or otherwise or sell shares/convertible debentures/units or any other investment held by it in the VCUs or VCFs or schemes/funds set up by the VCFs at a price that is mutually acceptable to the buyer and the seller/issuer. See Suranya Aiyar, Senior Associate, J. Sagar Associates in "Foreign Investment in India" (unpublished).

¹⁴ The valuation guidelines used for determining the value of the transferred shares in this case would not be applicable to such a sale and as a result, the sale could be at any price that the parties may mutually agree upon.

promoters decide to buy back the shares from the FVCI, they will not be required to comply with the public offering requirements of the Takeover Code, which would otherwise require that an offer be made to the other shareholders of the company for up to twenty percent (20%) of the outstanding share capital.

4. The shares acquired by a FVCI in an unlisted company are not subject to the one year lock-up period upon the Initial Public Offering ('IPO') of the shares of the company¹⁵. Thus, the FVCI would be able to exit its investment in such a company after the listing of the shares without having to wait for the completion of the lock-up period.
5. FVCIs registered with the SEBI are 'Qualified Institutional Buyers' in the SEBI (Disclosure and Investor Protection) Guidelines, 2000 ('DIP Guidelines'). As a result, they are eligible to participate in the primary issuance process, meaning that they would be able to subscribe for the securities in an IPO under the typical book-building process.

In addition to the benefits listed above, an FVCI is also entitled to various benefits under taxation laws in India. Before we analyze tax advantages, it is important to understand the various business organizations available in India in which investors can invest.

Business Organizations in India

Companies, partnerships and sole proprietorships are the main forms of business organizations that are prevalent in India. The Companies Act, 1956, governs companies and the Indian Partnership Act, 1932, governs partnerships. As there is no law specifically governing the manner in which sole proprietorships operate, they are the easiest organizations to set up and require minimal legal documentation. However, since the risk of a sole proprietorship lies solely with the founding person, such form is not usually favored. A partnership is not generally favored as a means of doing business on a large scale, since the liability of partners is unlimited. The concept of Limited Liability Partnerships has not yet been adopted in India¹⁶. Companies are thus the preferred mode of conducting business in India.

Companies in India are of two types – public and private. These companies can have limited or unlimited liability for their members. Further, liability of members can be limited by shares¹⁷ or by guarantee¹⁸. There are two types of shares under Indian Company Law – equity shares (common stock) that have voting rights and preference shares (preferred stock) that carry a preferential right as regards the dividend payable to their holders as well as a preferential right in regard to payment of capital on winding up or liquidation.

Private Companies

¹⁵ The DIP Guidelines prescribe that the entire pre-issue share capital of a company undertaking an IPO owned by a promoter is to be locked-up for a period of at least one year. A minimum thereafter has to be kept locked-up for two more years.

¹⁶ Recently, however, the Ministry of Company Affairs, Government of India provided a concept paper on Limited Liability Partnerships. The concept paper is only the first step to the introduction of a bill in the Parliament and is aimed at provoking critical examination of the provisions contained in this paper by all chambers of commerce, business organizations, professional bodies, academics and persons connected with corporate sector.

¹⁷ Where the liability of the members is limited to the unpaid value on the shares held by them.

¹⁸ Where the liability of the members is a pre-determined amount.

A private company is one which, by its Articles of Association¹⁹, restricts the number of its members to 50 and which imposes restrictions on the transfer of its shares. Further, a private company prohibits an invitation to the public to subscribe for shares in or debentures of the company as well as any sort of invitation or acceptance of deposits from persons other than its members, directors or their relatives. The minimum paid up capital that such a company must have is Rs. 100,000²⁰.

Public Companies

A public company is one which is not a private company and which has a minimum paid-up share capital of at least Rs. 500,000²¹. A public company cannot impose restrictions on the manner in which its shares are transferred and is not prohibited from inviting the public to subscribe to any shares of the company. A private company that is a subsidiary of a public company is also deemed to be a public company.

Tax Issues

Domestic VCFs and Investors

Indian VCFs are entitled to tax benefits under Section 10(23FB) of the Income Tax Act, 1961 ('Tax Act'). Any income earned by an SEBI registered VCF²² (established either in the form of a trust or a company) set up to raise funds for investment in a VCU is exempt from tax.

Foreign Venture Capital Investor

With regard to a FVCI registered with the SEBI, while there is no specific exemption, the exemption under Section 10(23FB) applies to a 'venture capital company' registered with the SEBI, and the definition of a 'company' under section 2(17) of the Tax Act includes any body corporate incorporated under the laws of a country other than India. The income of the FVCI continues to be tax exempt even after the shares of the Indian investee company in which the FVCI has made the initial investment are subsequently listed on a recognized stock exchange in India. However, Section 10(23FB) has to be read with in conjunction with Section 115U which provides, *inter alia*, that notwithstanding anything contained in any other provisions of the Tax Act, any income received by a person out of investments made in a FVCI will be subject to tax in the same manner as if it were the income received by the investor had he made the investment directly in the Indian investee company. This means that any income earned by a VCF by way of dividend, interest or capital gains, upon distribution, would continue to retain its original character in the hands of the investors. Under the Tax Act, dividends declared by an Indian company are exempt from tax in the hands of the shareholders and the company distributing dividends is required to pay an additional dividend distribution tax at the rate of 12.5%. There is a capital gains tax applicable in the hands of the domestic investors, which varies between 10% and 30% (exclusive of any surcharge and cess²³) depending on the status of the investor (individual or corporate);

¹⁹ Bylaws or governing documents.

²⁰ Approximately US\$ 2,300.

²¹ Approximately US\$ 11,400.

²² Domestic VCFs are governed and regulated by the Venture Capital Funds Regulations, 1996.

²³ Cess is a levy that is required to be paid, under a fiscal statute, for a specified purpose like R&D, education, etc. as the Government determines. It is a tax on the total tax payable.

the nature of capital gains (long-term for above 12 months or short term); and the type of investment (listed or unlisted). In case of non-resident investors, the tax rate could be as high as 40% (exclusive of surcharge).

Double Tax Avoidance Agreements

In this context, it becomes important for an FVCI to structure its investment in a tax efficient manner. One manner in which taxation may be avoided or minimized is by relying on section 90(2) of the Tax Act, which provides for relief from double taxation. A non-resident investor from a country with which India has a tax treaty has an option of being taxed under the Double Taxation Avoidance Agreement ('DTAA') or the Tax Act, whichever is more beneficial. Therefore, a non-resident investor might elect the DTAA if the treaty is more favorable, in which case the provisions under Sections 10(23FB) and 115U would not be applicable. However, note that if the FVCI opts to be taxed under the DTAA and it has a permanent establishment in India, its Indian income would not be tax-free²⁴.

The Mauritius & Singapore Involvement

The common investment route adopted by venture capitalists is to incorporate an offshore company in a country with which India has a favorable tax-treaty. This also provides protection against the annual revisions to the Tax Act. When incorporating an offshore entity, care should be taken to structure operations so as to minimize the risks of denial of treaty benefits.

Mauritius has traditionally been the most favored jurisdiction for incorporation to invest in India. A company incorporated in Mauritius becomes a tax resident of Mauritius, and thus is subject to the DTAA between India and Mauritius. Under the India-Mauritius DTAA, any capital gains earned by a resident of Mauritius are exempt from tax in India. Further, the business profits of a Mauritius offshore company are taxable at an effective tax rate of only 3%²⁵. Most investors who come into India via Mauritius do not have any substantive business in Mauritius and are incorporated there only to take advantage of the DTAA. While the tax haven status of Mauritius has recently come into question, the Supreme Court has upheld the tax treaty and hence Mauritius continues to be a favorable tax saving jurisdiction²⁶. Further, the Indian Authority For Advance Ruling, in a ruling²⁷ dated March 22, 2001, held that the gains made from the sale of shares by a private equity fund (a venture capital fund would be treated likewise) upon exit would not be regarded as capital gains but as business profits. Although, technically, this ruling is binding only on the applicant, it is indicative of the views of the Indian tax

²⁴ Berjis Desai, Managing Partner, J. Sagar Associates, "Tax-free foreign venture capital investment", *International Financial Law Review*, 2002

²⁵ This is due to a system of deemed tax credit of 80%.

²⁶ Over the past few years, India's tax authorities have been less tolerant of the manner in which foreign institutional investors ('FII') have avoided being taxed by routing their investments through Mauritius. In some cases certificates of residence produced by Mauritius-incorporated FIIs were not automatically recognized and, in others, such FIIs were being asked to pay tax as if they were resident in India. To clear any confusion in this regard, the Government of India, acting through the Central Board of Direct Taxes ('CBDT') issued a circular in which it declared that a Mauritius certificate of residence should be treated as sufficient evidence of corporate and beneficial residence of a company or FII. This circular was challenged before the High Court of Delhi, which quashed the circular on the ground that the CBDT did not possess the necessary authority to pass such a circular. When the matter came up for hearing before the Supreme Court, the Supreme Court upheld the government's decision and reversed the Delhi High Court's order to quash the circular. It ruled that the government's power to enter into double tax avoidance agreements included the power to issue interpretations of these agreements, as was the case when the circular was issued. The Supreme Court went on to hold that such interpretive circulars or notifications would be valid even when they were inconsistent with the provisions of the tax statute.

²⁷ In the reference of TCW/ICICI India Private Limited Equity Fund LLC, Mauritius,

authorities. Thus, it is possible that the gains made by the FVCI upon exit from an Indian investee company may be treated as business profits and not as capital gains in India, even though the Government of Mauritius may treat them as capital gains.

With the controversies on investments through Mauritius moving to the forefront and with the signing of the India-Singapore Comprehensive Economic Cooperation Agreement (CECA) on June 29, 2005²⁸, Singapore may soon become the destination of choice for investors. While investment through Mauritius used their Mauritian entities like shell, conduit or post-box operations just to avail themselves of the tax incentives, it will be somewhat different in Singapore. Investors would need to establish full business presence in Singapore, not just a shell, conduit or post-box operation. Further, there has been a drop in the withholding tax imposed by Singapore on royalties and fee for technical services from 15 % to 10 %.

By situating an offshore entity in a favorable treaty location, investors are developing ingenious methods of avoiding the shell, conduit or post-box operation allegation and the applicability of Section 115U and its pass through effect. Specifically in Mauritius, investors set up another company as a holding company. To take the example of a Mauritius based FVCI ('Investor'), a second Mauritius company ('Holding Company') would be incorporated and this Holding Company would hold the shares of the Investor. Accordingly, even if the Investor is held liable to pay Indian tax on business profits, the Mauritius Holding Company can rely upon the provisions of the Indo-Mauritius DTAA and pay no tax on the business profits made by the Investor. Thus, the venture capitalist will hold 100% of the equity of the Holding Company which, in turn, will hold 100% equity in the Mauritius FVCI, which will invest in various Indian investee companies.

The India Investment

Typically, in India, venture capital investment in a company is structured such that the venture capitalist gets a combination of equity shares as well as preference shares in the company. The preference shares are usually convertible into equity shares at a later point in time upon the occurrence of certain triggering events. Issuance of preference shares ensures that the venture capitalist gets preference over the other shareholders in the event of the winding up or liquidation of the company, while the issuance of the equity shares grants the venture capitalist voting rights at shareholder meetings. The manner in which the investment is made into the company, however, varies from deal to deal and may be done as one investment or in different tranches. When venture capitalists opt for more than one round of

²⁸ By way of this agreement, Singapore and India have improved their existing 1994 Double Tax Avoidance Agreement (DTAA). The main improvement to the DTAA is that tax residents now enjoy capital gains tax exemption status on investments in India. However, a tax resident is not entitled to the capital gains exemption if its affairs are arranged primarily to take advantage of the benefits of the DTAA. In addition, a shell/conduit company with little or no business operations or with no real and continuous business activities in Singapore is not eligible for the capital gains tax exemption. For the purpose of capital gains tax exemption, a company is not a shell company if:

1. It is listed on recognized stock exchange of the Contracting State
2. Its total annual expenditure on operations in the residence State is equal to or more than Sing\$200,000 or Indian Rs. 50,00,000 in the respective Contracting State, as the case may be, in the immediately preceding period of 24 months from the date the gains arise.

The capital gains tax exemption regime of a country is an important consideration for investors and this exemption, which was previously only available to Mauritius. <http://www.fta.gov.sg>.

investment, the subsequent rounds of investment are often contingent upon the company reaching certain milestones.

Leaving aside commercial considerations, investors are often more comfortable investing in a private company because of the significant input they can have in the operations of such a company. Investors in private companies have the option of entering into shareholders agreements with the other shareholders to ensure that they have input in the affairs of the company²⁹ and to make sure that certain restrictions are placed on the transfer of shares to protect their investment from dilution. It may be advisable, depending upon confidentiality concerns, for the terms of such shareholders agreement to be incorporated into the Articles of Association of the company since in the event of a conflict between the terms of any shareholders agreement and the Articles of Association, the Articles of Association would govern.

Typically, the investor obtains management and control rights in the company by incorporating positive as well as negative rights into the Articles of Association. A positive right would be the entering into of a voting agreement with the other shareholders of the company so that the other shareholders would vote in the same manner as the investor with respect to certain matters. A negative right would be one where the investor has the right to veto certain decisions of the Board. It should be understood that although voting agreements are used in India, their validity has not yet been tested in a court of law.

The investor may also protect the value of its investment by incorporating ratchet rights and anti-dilution provisions that enable it to make up for the price differential between the shares issued to it and the shares issued by the company to a second investor in a future round of financing by the issue of additional shares to the investor.

Exit options are also often incorporated into the Articles of Association. The most common exit option is an IPO, however, certain enabling tag along/drag along rights facilitating an exit may also be provided for.

While, in general, venture capital investment concepts common overseas are available in India, there are some unique provisions of law, which should be verified by local counsel prior to any investment. These range from the non-enforceability of a post employment restrictive covenant to the lack of the 'employment-at-will' concept in India. Also, the various types of securities, which the investor may be used to purchasing in its local jurisdiction, may not be available in India. In addition, Indian company law does not allow telephonic board meetings. Elaborated below are two key concepts, which we often find are of concern to overseas investors.

The practice of having Registration Rights Agreements has not yet gained recognition in India. In India, the decision to issue shares of the company to the public is taken by the Board of Directors of the company and they are not permitted to be contractually bound to make this decision in any particular manner. Further, the shares to be offered are taken on a pro-rata basis from the shareholders. While a

²⁹ Typically, venture capitalists obtain the right to elect one or more directors to the Board of Directors of the company, the right to maintain their percentage of share ownership in future rounds of financing from other parties, and the right to have the final decision on certain matters.

provision for registration could be contractually provided for with the shareholders, to date such a provision has not been tested in a court of law in India.

Another issue where venture capitalists have to tread carefully is in not being construed as 'promoters' of the company. The SEBI, through the DIP Guidelines, has stipulated lock-up requirements on shares of promoters to ensure that the promoters or persons who are controlling the company continue to hold some minimum percentage in the company after the public offering. A promoter is defined as being a person (or persons) who is in over-all control of the company or who is instrumental in the formulation of a plan or program pursuant to which the securities are offered to the public, and those named in the prospectus as promoters(s). This definition, however, is an inclusive one and it would really depend upon the manner in which the SEBI would interpret the actions of a company and the key individuals/ entities associated with it. To avoid being construed as promoters, investors often resort to the inclusion of certain clauses in the investment documentation, which provide that the investor is not to be considered as a promoter of the company. However, this is another issue that has not yet been challenged in the Indian courts.

Conclusion

Ever since economic liberalization started in India in 1991, policymakers have steadily opened up the economy to foreign investment, attracting global players to compete and tap the large potential in the domestic market. India's progressive foreign trade policy has been implemented through a combination of fiscal reform, liberalization of trade and investment policies and rational exchange controls. This combined with strong fundamentals comprising a favorable demographic profile, human capital, trade openness, increasing urbanization and rising consumer spending has made India one of the fastest growing markets in the world.

The spiraling growth in the economy has led to a similar rise in the funding provided by venture capitalists. Apart from a few sectors like non-banking financial services, gold financing and activities not permitted under the industrial policy of the Government of India, investors can invest their funds in most other sectors. And if investors can get used to the heat and dust of India, it continues to be a country that offers great investment opportunities to foreign investors.

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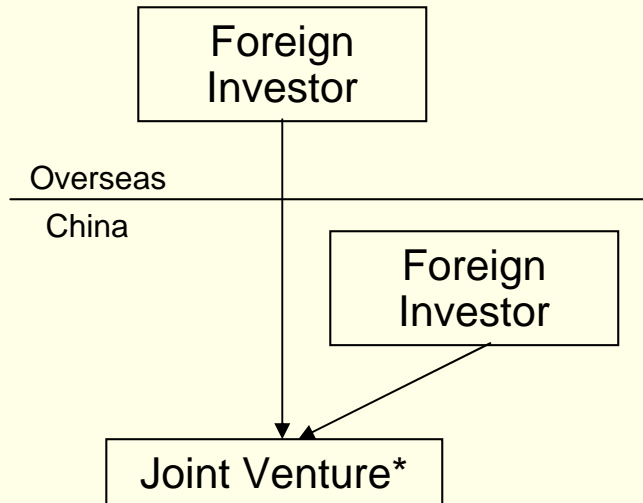
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Financing Business Activities in China

- Foreign Direct Investment vs. Venture Capital/Private Equity Financing
 - long-term strategic investment vs. short-term financial investment
- Equity financing vs. Debt financing
 - increasing registered capital vs. granting loans

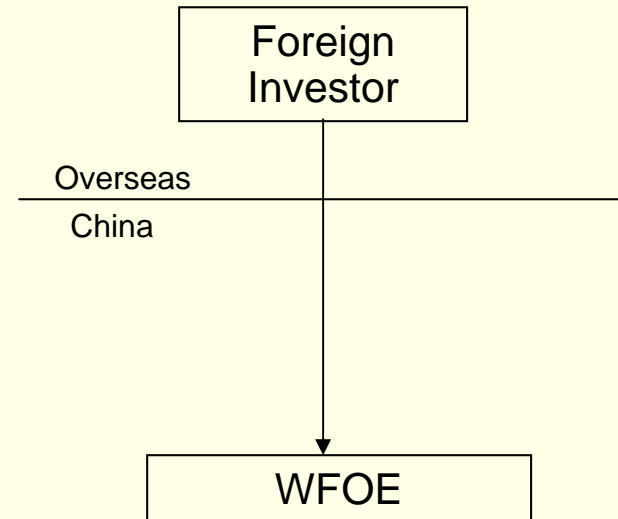
Foreign Direct Investments

- Sino-Foreign Joint Venture



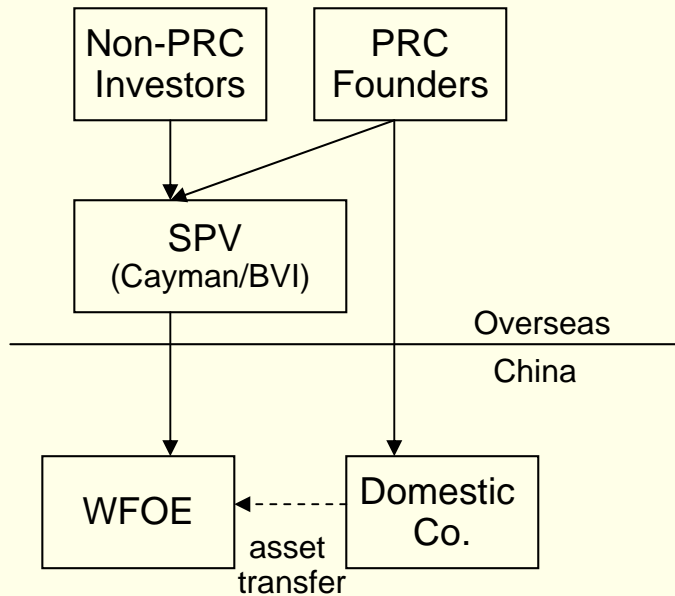
vs.

- Wholly Foreign-Owned Enterprise (WFOE)

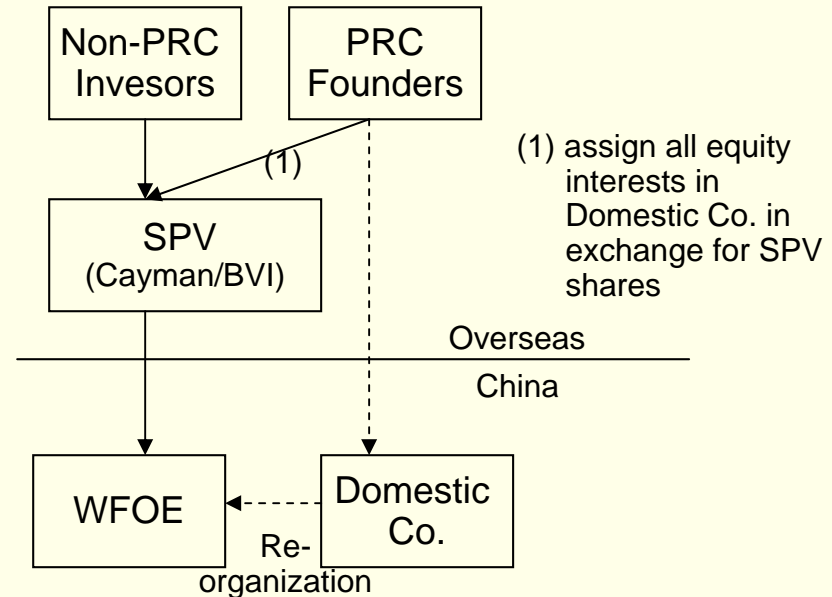


Venture Capital/Private Equity Financing

- Investing in unrestricted industries* – *asset injection*



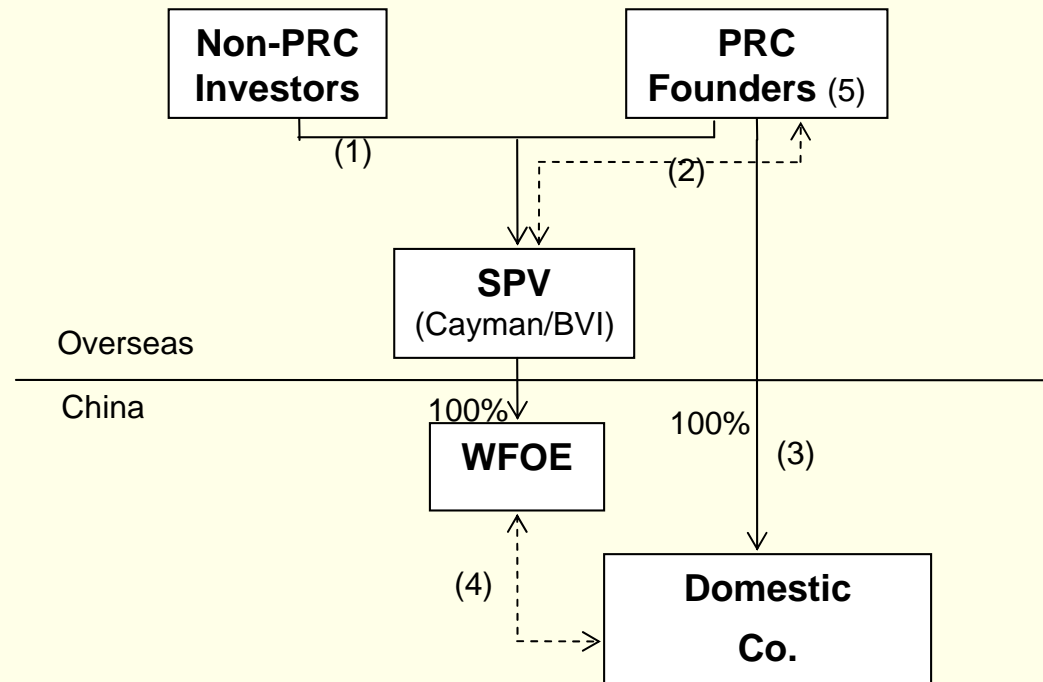
- Investing in unrestricted industries – *share swap*



*For example, software development industry.

Venture Capital/Private Equity Financing

- Investing in restricted industries*



*For example, wireless value-added services.

Venture Capital/Private Equity Financing

- **Notes:**

- (1) Investment can be made in the form of debt or equity.
- (2) SPV grants a loan to the founders. As collateral to secure the repayment of the loan, the founders pledges all their equity interests in Domestic Co. to SPV.
- (3) The loan proceeds are used as capital contribution to Domestic Co.
- (4) WFOE and Domestic Co. enter into a series of contractual financial and operations control arrangements so that the revenues of Domestic Co. can be flowed through WFOE to SPV.
- (5) PRC founders are required to register with local SAFE branch before establishing or investing in SPV. Any subsequent shareholding change in SPV or transactions resulting in change of control of Domestic Co. also requires SAFE registration, according to Circular 75.

Particular Issues Concerning Onshore Debt Financing

- Lending funds to a Chinese domestic entity is considered as a capital account transaction subject to compulsory foreign exchange registration
- A foreign investment enterprise (regardless of JV or WFOE) may not borrow money in excess of a debt-equity ratio as required under PRC law.
- SAFE* advance approval is required for Chinese domestic entities (excluding foreign investment enterprises) to create security interests for benefit of foreign creditors.
- Not easy to perfect and enforce security interests created over onshore borrower's or its guarantor's assets:
 - ❖ Security interests created over equipment, real property, patent rights and public traded securities are registrable with the relevant government agencies, but securities interests created over equity interests in non-public companies are not registrable.
 - ❖ Enforcement of security interests in China has to go through Chinese courts, which is less reliable than other common law jurisdictions.

* SAFE stands for the State Administration of Foreign Exchange or any of its local branches.

Repatriation of Profit and Investment

- China restricts free flow of foreign exchanges under capital account:
 - ❖ equity financing and debt financing considered as capital account activities
 - ❖ SAFE advance approval required for repatriation of capital investments and repayment of foreign loan principals
 - ❖ repatriation of profits earned by a foreign investment enterprise to its foreign investors **NOT** a capital account transaction, and **NOT** require prior SAFE approvals
 - ❖ repatriation of loan interests **NOT** a capital account transaction, and **NOT** require prior SAFE approvals

Circulars 11 & 29 vs. Circular 75

- Circulars 11 and 29

- ❖ expressly required SAFE's approval in order for Chinese residents to (a) directly or indirectly establish or obtain control of a foreign company or (b) to exchange domestic assets or equity interest for stock or assets of a foreign company
- ❖ required approvals from SAFE headquarter
- ❖ lacked details on procedural and documentation requirements in obtaining SAFE approvals

- Circular 75

- ❖ only requires Chinese residents to register with SAFE in order for them to (a) directly or indirectly establish or obtain control of a foreign company or (b) to exchange domestic assets or equity interest for stock or assets of a foreign company
- ❖ Requires registration with local SAFE branches
- ❖ provides more detailed guidance as to how to carry out the requisite registrations, with substantial disclosure requirements

美富律师事务所

Investments and Exits in China

**American Bar Association Annual Meeting
Venture Investing in Asia
Honolulu, Hawaii, August 6, 2006**

PRESENTATION OVERVIEW

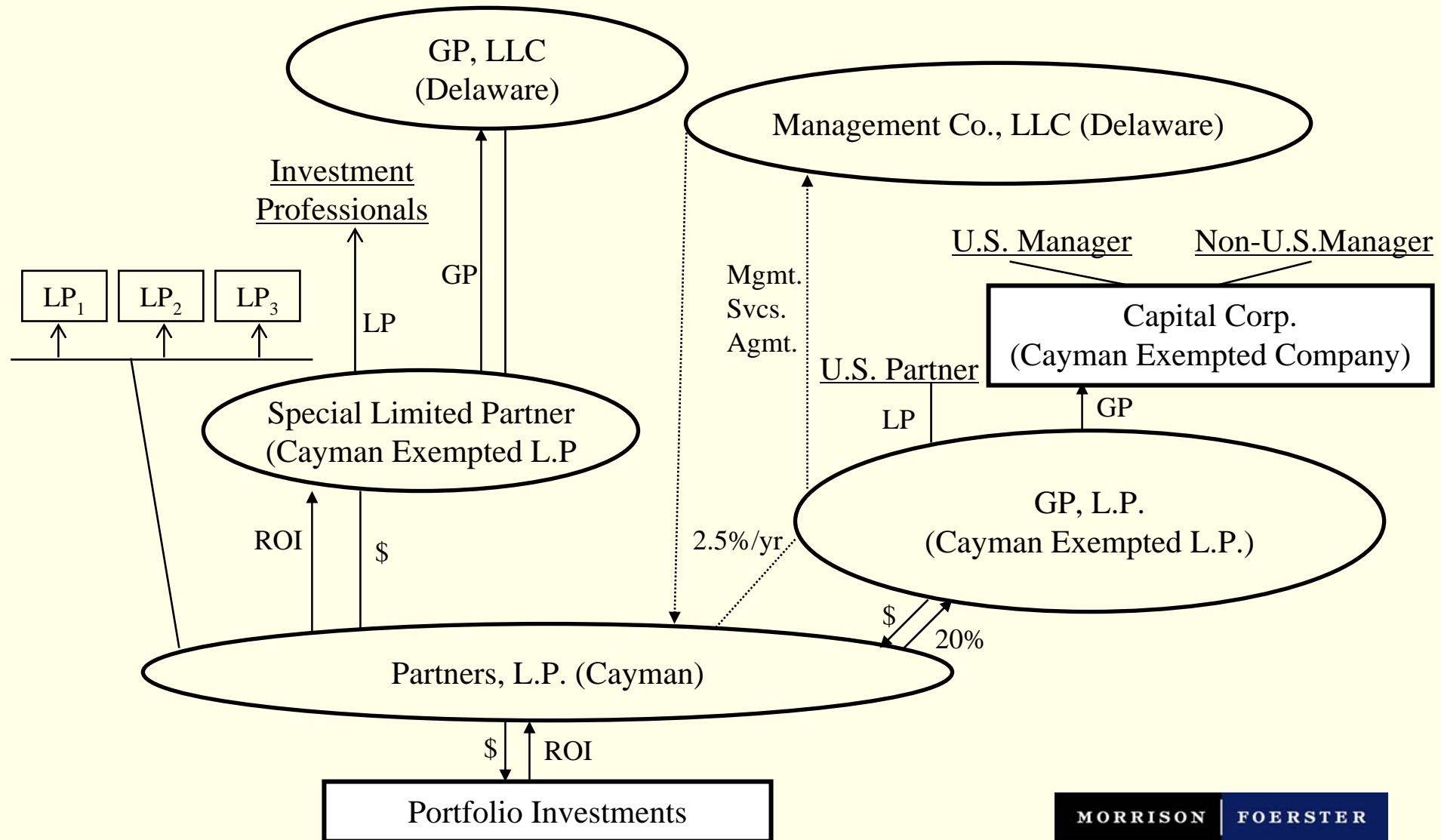
Part I Fund Formation

- Fund Structures
- Fund Terms & Conditions

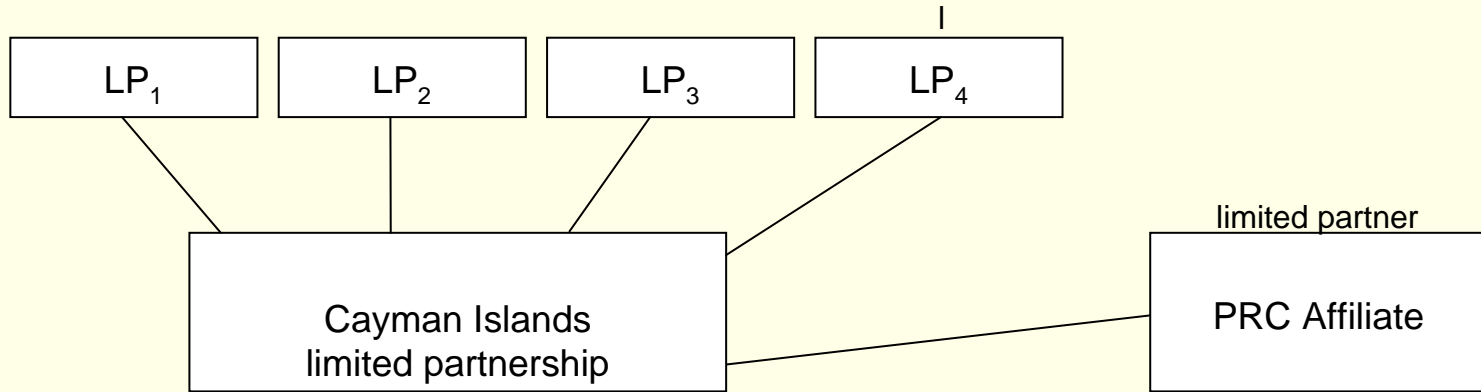
Part II Portfolio Investments

- Basic PE Financing Structures
- Legal Structuring Issues
- Deal Process Issues
- Due Diligence Issues
- Representative PE Deal Terms
- Buyouts and Investments in Domestic Targets

Fund Structures — Offshore Limited Partnership

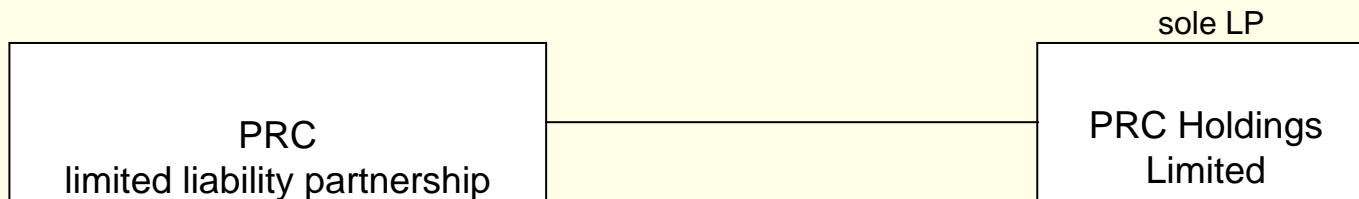


Fund Structures — Parallel Funds



Offshore

Onshore



Fund Structures — Parallel Funds

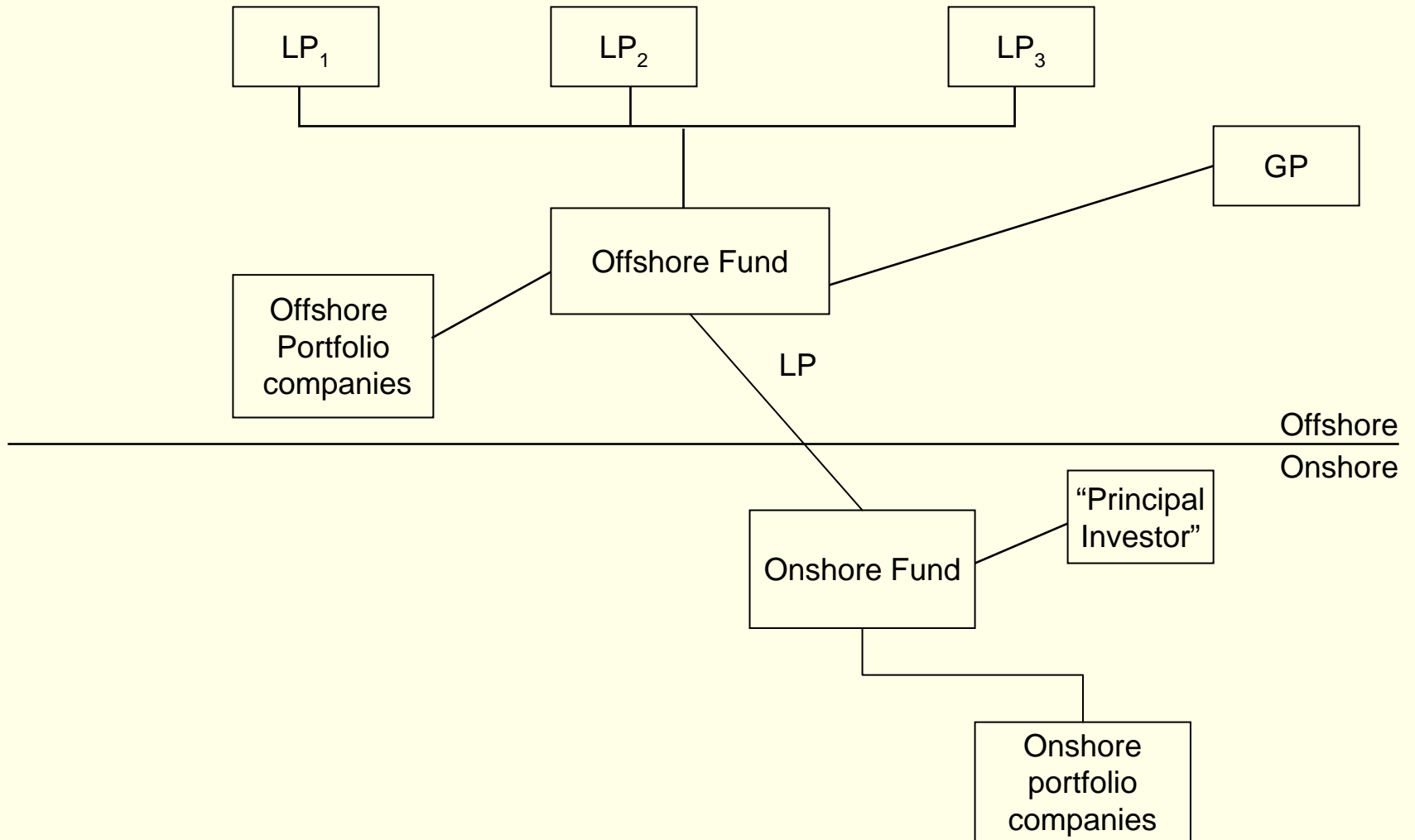
FIVCE regulations promulgated by MOFCOM in 2003 rarely used to date --- Softbank/Tianjin; Infinity-CSVC

Parallel fund structure can facilitate investment in restricted industries under Foreign Investment Catalogue

Key to Parallel fund structure is use of offshore affiliate of PRC Sponsor which allows for adjustments between offshore Cayman fund and onshore PRC fund

Adjustments can be made between onshore and offshore funds by adjusting capital calls and distributions among investments

Fund Structures — Tiered Structure



Fund Terms & Conditions — Key Issues

I. Formation and Operation

- GP commitment
- Co-investment by principals of GP entity for their own account
- Most Favored Nation treatment of LPs
- Co-Investment rights
- ERISA and UBTI issues
- Islamic finance/Sharia compliance issues
- Drawdown procedures
- Default provisions
- Timing of successor funds
- Payment of placement agency fees

Fund Terms & Conditions — Key Issues

(Continued)

II. Fees and Expenses

- Management fees
- Transaction fees (buyout segment)
- Organization expenses
- Operating expenses

III. Distributions and Profit Sharing

- Carried interest formulas
- Distribution waterfall
- Preferred returns
- Catch-up once preferred return is met
- GP Clawback

Fund Terms & Conditions — Key Issues

(Continued)

IV. Governance

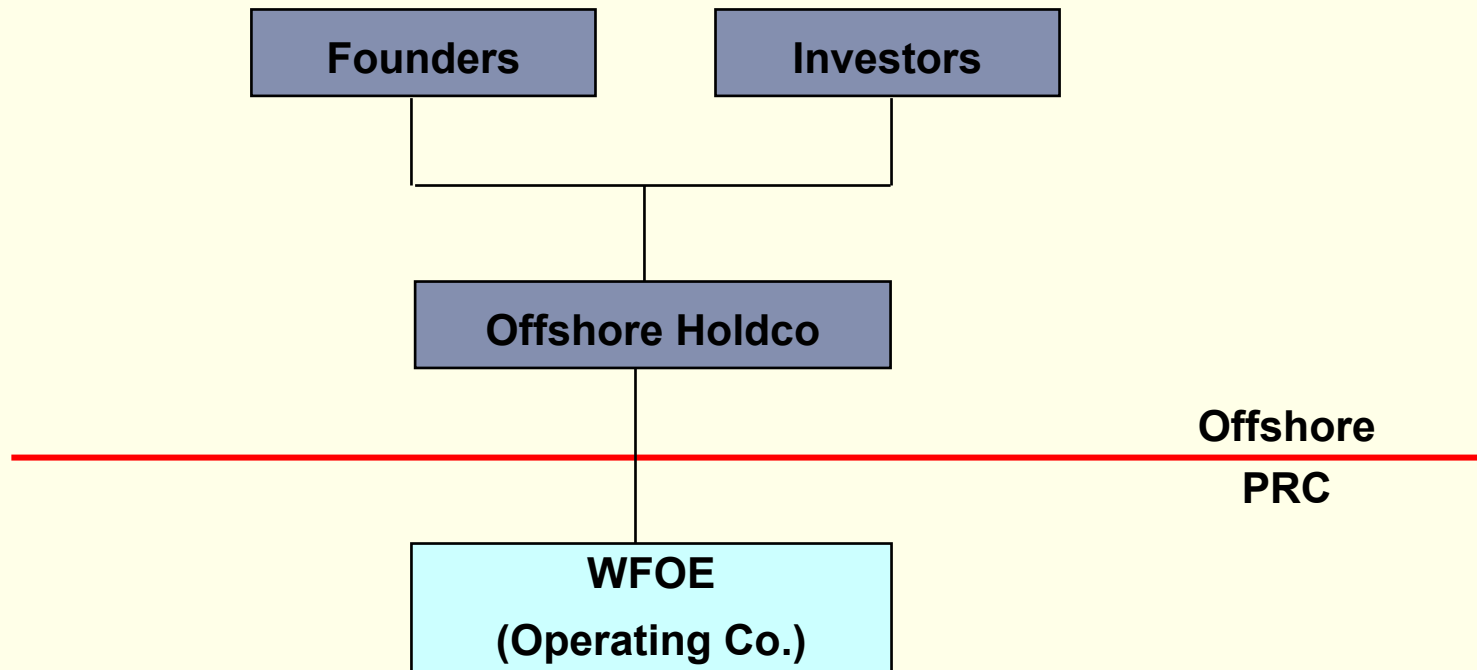
- Advisory Boards
- Indemnification
- Key-person clauses
- Transfer of LP Interests

Part II Portfolio Investments

- Basic PE Financing Structures
- Legal Structuring Issues
- Recent Foreign Exchange Issues
- Deal Process Issues
- Due Diligence Issues
- Representative PE Deal Terms
- Buyouts and Investments in Domestic Targets

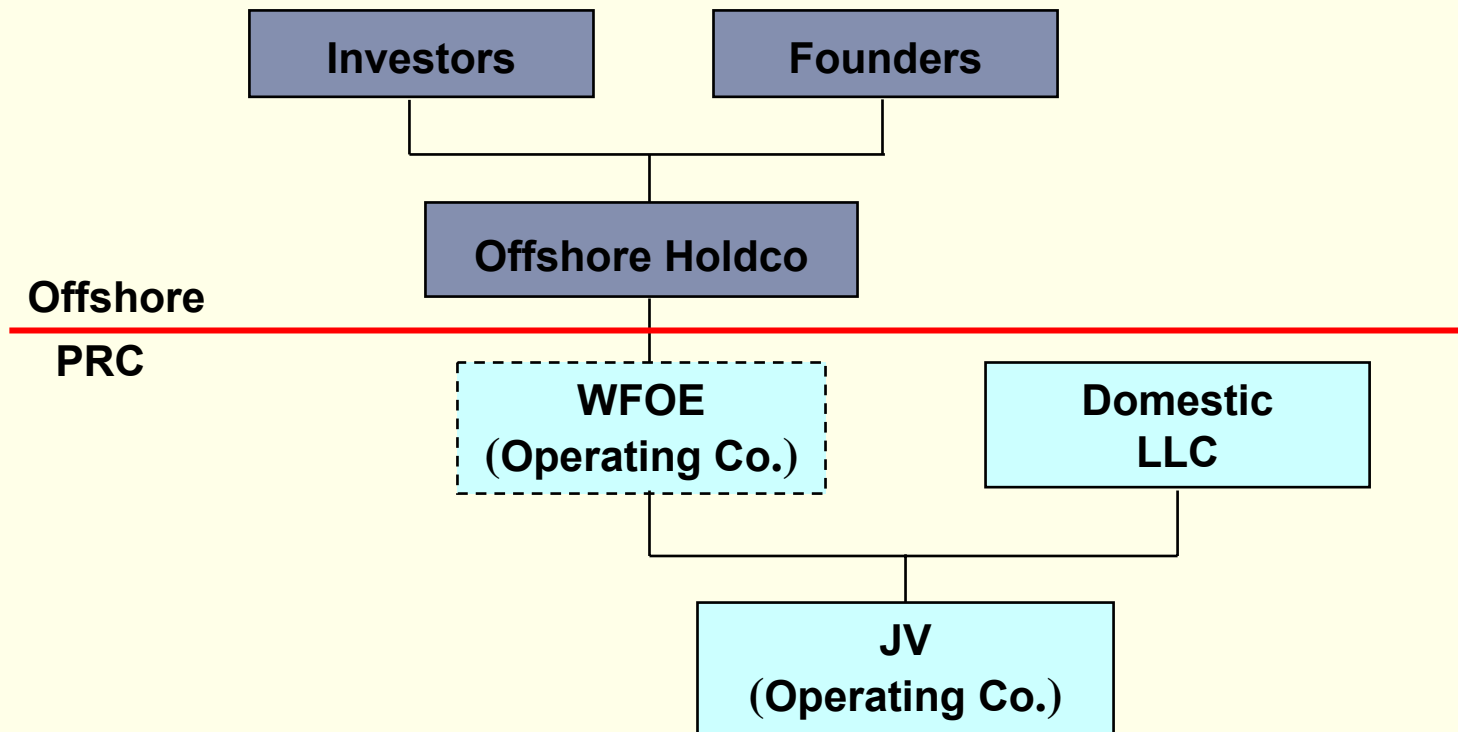
Basic PE Financing Structures

- Basic Deal Structure
 - Permitted Industry



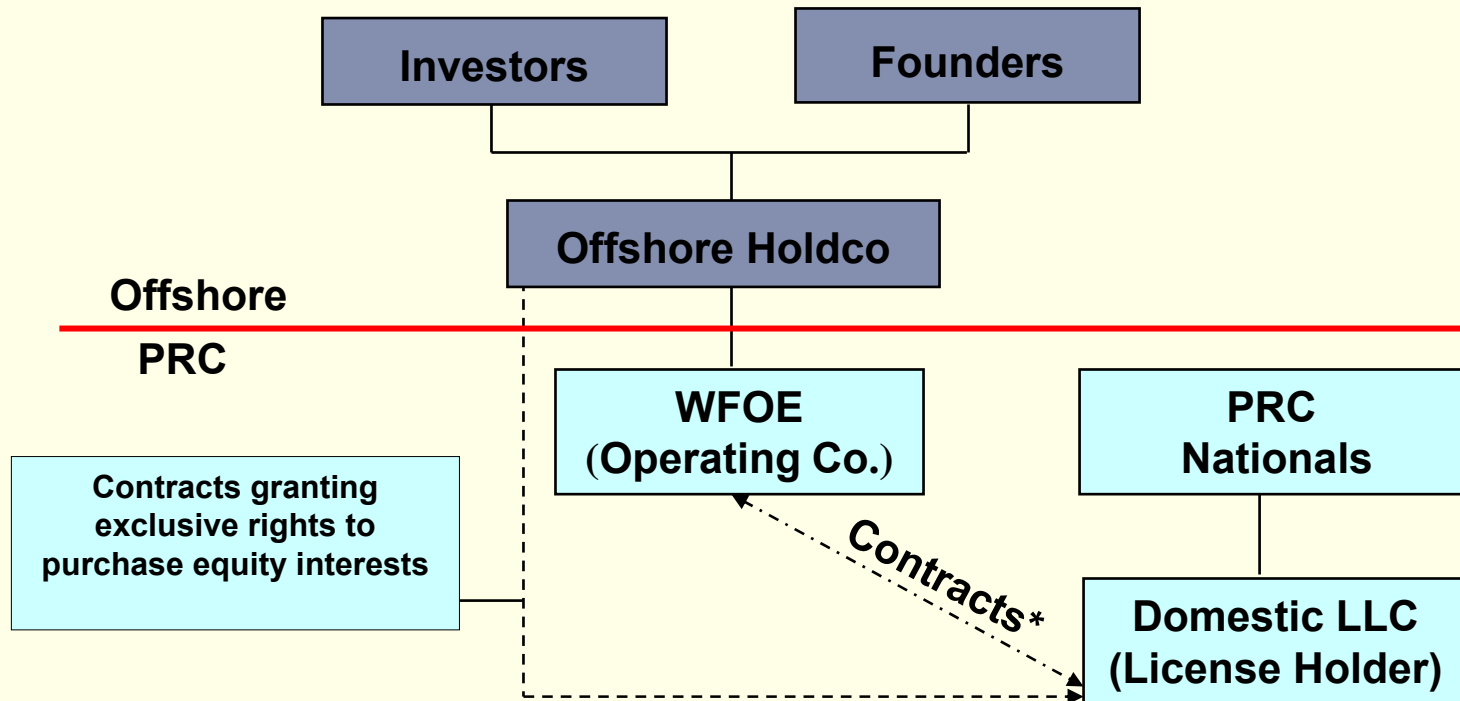
Basic PE Financing Structures (Continued)

- Basic Deal Structure – Variation 1
 - Partially Restricted Industry



Basic PE Financing Structures (Continued)

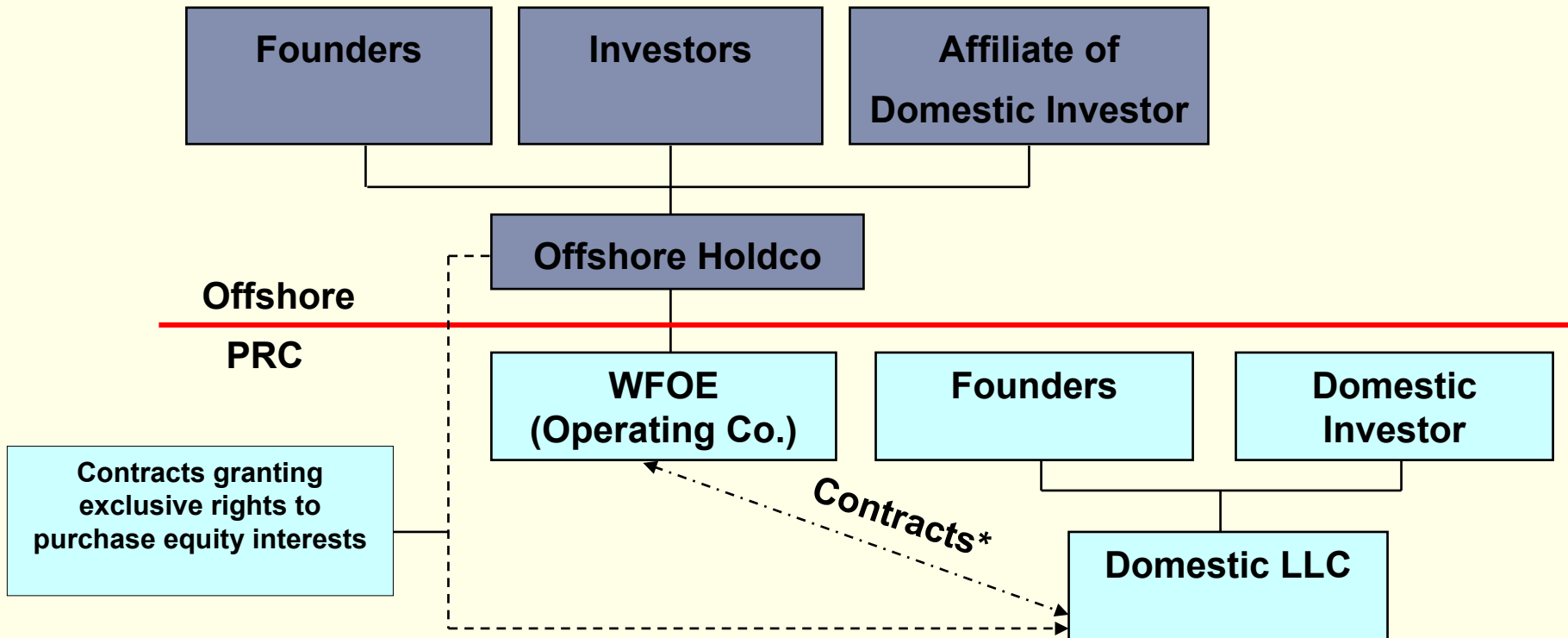
- Basic Deal Structure – Variation 2
 - Prohibited Industry



* These contractual arrangements relate to such matters as the provision of services, software licenses, equipment leases, etc., in exchange for fees.

Basic PE Financing Structures (Continued)

- Basic Deal Structure – Variation 3
 - Parallel Investments



* These contractual arrangements relate to such matters as the provision of services, software licenses, equipment leases, etc., in exchange for fees.

Legal Structuring Issues

- Examples: Baidu.com, Focus Media, Hurray!, Linktone, KongZhong, eLong, Ctrip, Shanda, 51job, NetEase, SINA, Sohu.
- Implementing the 2-level offshore/onshore structure almost always requires restructuring of domestic entities.
- Different ownership structures at different levels may cause misalignment of interests.
- Restrictions in certain industries require contractual arrangements for certain important assets (e.g. ICP license, advertising license, HR services license, Internet business operations license).

Legal Structuring Issues

(Continued)

- Foreign exchange restrictions may cause problems for restructuring and co-investment by domestic investors.
- The 2-level structure implies a lack of direct control over operating assets in PRC (especially assets linked by contractual arrangement).
- Control provisions in offshore documentation may not be easily enforceable in PRC.
- Differences between international corporate governance standards and PRC standards.
- The 2-level structure and contractual arrangements raise consolidation issues with respect to “variable interest entities” that should be addressed to facilitate eventual exit via IPO or sale to strategic buyer.

Deal Process Issues

- Complexity
 - Multiple jurisdictions
 - Multiple parties
 - Multiple time zones
 - Multiple locations
 - Multiple counsels

Deal Process Issues

(continued)

- Roles of Counsel
 - International Counsel – documentation, offshore corporate work, onshore and offshore due diligence, process manager
 - Offshore jurisdiction counsel – basic corporate secretarial, jurisdiction review of constitutional and deal documents, legal opinion
 - PRC Counsel – restructuring, PRC due diligence, regulatory and legal opinion work

Deal Process Issues

(continued)

- Unrealistic Timing Expectations
 - Investee lack of sophistication
 - Investor lack of attention to legal structuring matters
 - Re-defining of Term Sheet
 - General gaming
 - Desire to close before basic conditions satisfied

Deal Process Issues

(continued)

- Cultural Issues
 - “Get the money in and see what happens” mindset
 - Unrealistic expectations of fees and responsibilities of counsel
 - Lack of transparency in due diligence and disclosure process
 - Inattention to compliance with laws and regulations (probably due to imperfection in PRC legal system and enforcement problems)
- Timelines

Due Diligence Issues

- Proper PRC licenses, properly held
- IP chain of title secured
- Lack of basic corporate maintenance
- Compliance with tax and social fund requirements
- Founder loans
- Shares held “in trust” for others
- Founder affiliated companies

Due Diligence Issues

(Continued)

- Obtaining Quality Diligence Information
- Expect the Unexpected

Representative PE Deal Terms

- Valuation; Investment Amount
 - Mostly early stage investments (Series A and B)
 - Entrepreneurs have high valuation expectations
 - Down rounds less frequent
 - Investment amounts traditionally small (in the \$1M to \$10M range), but growing in past 12 months

Representative PE Deal Terms

(Continued)

- Liquidation Preference
 - Often multiple liquidation preference (1x – 3x purchase price)
 - Often senior to previous rounds
 - Often participating without cap
 - Some use of IRR as basis for calculation
 - Deemed liquidation (trade sale)
- Dividends
 - Cumulative dividends not prevalent

Representative PE Deal Terms (Continued)

- Anti-dilution Provisions
 - Frequently full ratchet adjustment
 - Investors often demand performance based adjustment, or “valuation ratchet”
- Redemption Right
 - Most investors require redemption right
 - Around 5-year timeframe
 - Common use of liquidation preference as redemption price

Representative PE Deal Terms (Continued)

- Voting Rights
 - Preferred shares vote together with all shareholders on as-converted basis
 - Class veto rights broad and intrusive on operations
 - Extensive protective provisions and veto rights at both offshore holding company level and PRC operating company level

Representative PE Deal Terms

(Continued)

- Board Representation
 - Usually consistent with shareholding
 - Investors becoming more demanding of board control
 - Control over audit and compensation committees

Representative PE Deal Terms

(Continued)

- Transfer Restrictions
 - Right of first refusal and co-sale right
 - Absolute prohibition on transfer (1 – 4 years)
- Reach up to founders' holding companies
- Drag-Along Right
 - Some investors demand right of forced sale
 - Valuation multiples or IRR as criteria for forced sale for exit

Representative PE Deal Terms (Continued)

- Registration Rights
 - Customary registration rights imported from U.S. style transactions
 - Increasing inclusion of equivalent rights in connection with regional listings (e.g. Hong Kong)

Representative PE Deal Terms

(Continued)

- General Trends
 - Improvement in valuation
 - Investors using tranches to disburse funds, focusing on regulatory and performance milestones
 - Investors demanding more certainty in performance and returns
 - Investors becoming more involved in operations of portfolio companies and requiring more extensive protective provisions

Representative PE Deal Terms (Continued)

- Shift toward regional listings and trade sales
- Increase in exits via U.S. listings and trade sales to U.S. strategic buyers in certain industries — Internet, in particular

Buyouts and Investments in Domestic Targets

- **Acquisitions of different types of Chinese targets are subject to different regulatory regimes**
- **Foreign-invested Enterprises (“FIEs”)** (外商投资企业)
- **Limited Liability Companies** (有限责任公司)
- **Joint Stock Companies** (股份有限公司)
 - Non-listed Joint Stock Companies (非上市的股份有限公司)
 - Listed Joint Stock Companies (上市股份有限公司)
- **State-owned Enterprises (“SOEs”)** (国有企业)

Buyouts and Investments in Domestic Targets

(Continued)

Type of Target	Offshore	FIE	Private Enterprise	SOE	Listed SOE
Government Review and Approval Authority	SAFE SAT	MOFCOM SAIC SAFE SAT	MOFCOM SAIC SAFE SAT	SASAC MOFCOM NDRC SAIC SAFE SAT	SASAC MOFCOM CSRC NDRC SAIC SAFE SAT
Primary Regulations	Circular No. 11 & No. 29	2003 M&A Provisions	QFII	SOE Acquisition Rules	SOE Acquisition Rules
	2003 M&A Provisions	FIE Equity	2003 M&A Provisions		Listed SOE Circular
		FIE Merger & Division Rules			Listed Co. Measures
Degree of Difficulty	Low				High

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November 2005

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SAFE CIRCULAR 75¹

The dust is beginning to settle on the effect and fate of SAFE Circular 11 and Circular 29, at least for the time being. On October 21, 2005, SAFE issued the long awaited new circular on “Relevant Issues Concerning Foreign Exchange Control on Domestic Residents’ Corporate Financing and Roundtrip Investment Through Offshore Special Purpose Vehicles” (“Circular 75”),² effective November 1, 2005. At the same time Circular 11 and Circular 29 will cease to be implemented.

On October 23, 2005, SAFE also issued a news release about the issuance of its Circular 75 (the “SAFE News Release”). In the SAFE News Release, SAFE makes it clear that the efforts by Chinese private companies and high technology companies to obtain offshore financing are being encouraged by China’s national policies. Circular 75 confirms that the use of offshore special purpose vehicles (“SPV”) as holding companies for PRC investments are permitted as long as proper foreign exchange registrations are made with SAFE.

We believe that this is a positive development for venture capital, private equity and other foreign investors, although it is still too early to assess the long term effect this new circular will have on PRC companies seeking to obtain offshore equity financing through offshore SPVs.

This Special Note summarizes the key provisions of Circular 75 and what they may mean for investors.

Offshore Equity Financing by PRC Companies Via SPVs Officially Sanctioned by SAFE

In Circular 75, SAFE has substantially altered its position on offshore equity financing by PRC residents by way of offshore SPVs. In Circular 11 and Circular 29, SAFE was perceived by the market as attempting to control and curtail the gradual expansion of the quiet and yet widely known practice of “hui cheng” or “roundtrip” investment. This is the process of PRC residents effectively moving ownership and control of PRC-based assets to an offshore holding company by transferring those assets to a wholly foreign-owned enterprise that is held by the offshore SPV, usually a company established in the Cayman Islands or BVI. The SPV is used as a vehicle to obtain financing to facilitate the operation of the assets and expansion of the business. In contrast, in Circular 75, and in the SAFE News Release, in

¹ This Special Note is a follow-on note to a memorandum we prepared on the two previous circulars issued by China’s State Administration of Foreign Exchange (“SAFE”), commonly referred to as Circular 11 and Circular 29. The previous memorandum can be found at <http://www.mof.com/news/updates/files/update02036.html>.

² Text of Circular 75 can be found at <http://www.safe.gov.cn/law/law586.htm>

particular, SAFE now describes the practice of PRC residents obtaining offshore equity financing through establishing SPVs and roundtrip investments in PRC companies as part of the development of the private sector that will be “encouraged, supported and guided.”

This change of tone on the part of SAFE is significant and should be welcome news to PRC residents whose PRC domestic companies are actively seeking offshore equity financing. Circular 75 is also a positive signal to foreign private equity funds and venture capital funds, whose investment plans in China’s fast-growing enterprises run by entrepreneurs were largely put on hold since the beginning of 2005 by the promulgation of Circular 11 and Circular 29, due to vagueness of regulation, lack of articulated procedure for obtaining SAFE approvals, and uncertainty of the future direction of offshore equity financing by PRC companies via SPVs.

Multiple Approvals No Longer Needed

Before Circular 75, Circular 11 expressly required SAFE’s approval in order for any PRC resident to directly or indirectly establish or obtain control of a foreign company. SAFE’s approval was also required for any PRC resident to exchange domestic assets or equity interest for stock or assets of a foreign company. Such approvals, however, have only rarely been given.

In a major change of position, SAFE now only requires PRC residents to register with SAFE rather than obtain SAFE’s approval. This appears to more effectively reflect its role as managing foreign exchange activities rather than investment control.

Multiple Foreign Exchange Registrations Will Require Detailed Disclosure by Relevant Parties

Circular 75 is not all good news, however. While effectively revoking the perceived ban on PRC residents obtaining offshore equity financing via SPVs, Circular 75 requires multiple foreign exchange registrations entailing detailed disclosure by the relevant parties involved in the specified offshore equity financing transactions. These required registrations include:

1. The Initial Foreign Exchange Registration by PRC Residents

Under Article 2, before establishing (or gaining control of) an offshore SPV for the purpose of offshore equity financing, a PRC resident (whether a resident individual or a legal person) must file at least six required documents with local SAFE for foreign exchange registration in connection with the proposed offshore investment (the “Offshore Investment FX Registration”).

Of the six documents required for such registration, Document #1 requires the disclosure of (i) information about the domestic PRC company, (ii) the equity structure of the proposed SPV, and (iii) the arrangement for the offshore financing. If the PRC resident is a resident individual, Document # 5 requires basic information of the PRC resident and additional information

of the offshore SPV as listed in the form attached to Circular 75 (the “Attached Form”).

In addition, the PRC legal person (a company, usually) must also submit two approval certificates (i) concerning the source of foreign exchange capital (assets), and (ii) the proposed offshore investment. Presumably, the first certificate is to be obtained from local SAFE, and the second certificate is to be obtained from the Ministry of Commerce (“MOFCOM”) or its local counterparts. Among the documents that are required for the foreign exchange registrations, obtaining these two approval certificates may be more time consuming and unpredictable than getting the other documents. There is a strong presumption that once having obtained these approvals, SAFE would not use this process or other administrative means to reject and deny otherwise legitimate application by PRC residents to establish an offshore SPV.

SAFE completes the Offshore Investment FX Registration by a domestic resident by affixing a SAFE business chop on the application once it has verified the application documents submitted to SAFE.

2. The Amendment to the Foreign Exchange Registration by PRC Residents

Under Article 3, when a PRC resident contributes to the SPV the assets or equity interest in a PRC company, or when the PRC resident undertakes an offshore equity financing after contributing the assets or equity interest to the SPV, the PRC resident is to file another set of six documents to amend the Offshore Investment FX Registration. These documents show how the PRC resident’s equity in the SPV has changed.

Document #1 requires the disclosure of (i) information of the change of equity interest in the domestic PRC company and in the SPV, and (ii) the method for the determination of price for the assets and equity interest in the PRC company and in the SPV. If the PRC resident is a resident individual, Document # 2 requires basic information of the PRC resident and, the additional information of the offshore SPV as listed in the Attached Form.

In addition, the PRC resident must also submit one approval certificate for the roundtrip investment by the SPV from competent PRC authorities in charge of foreign investment. We assume that this certificate is the approval certificate obtained from MOFCOM or its local counterparts.

Finally, if any state-owned asset is involved, confirmation document by the state-owned asset administration concerning the value of the assets or equity interest of the relevant PRC company must be obtained first, and then submitted to SAFE for verification.

3. Foreign Exchange Control Formalities of Foreign Investment or Foreign Debt by PRC Companies

Under Article 5, when a SPV makes roundtrip investments or provides shareholder loans to a PRC company using the funds obtained from the

offshore financing, the relevant PRC company must handle foreign exchange registration formalities in accordance with effective PRC laws and regulations.

4. Amendment to Foreign Exchange Registration by PRC Residents for Material Changes

In addition to the registration requirement under Article 2, Article 3, and Article 5, Article 7 of Circular 75 imposes yet another requirement for a PRC resident to amend the foreign exchange registration whenever material events occur that affect the capital structure of the SPV which does not involve a roundtrip investment. These events may include an increase or decrease of capital, transfer or swap of equity interest, consolidation or a split, long term equity or debt investment, or guarantee provided for a third party. The amendment to registration must be done within 30 days of the occurrence of the material event.

Transfer of Funds from SPV Back to China

After the completion of the offshore equity financing, the PRC resident may repatriate the capital that has been raised back to China, in accordance with the original business plan. It is important to note that no specific time is given for when this is to occur.

Foreign currencies obtained from profit, dividends and from sale of equity interest in a SPV, however, must be remitted back to China within 180 days of receipt thereof.

Key Terms Defined

Circular 75 provides fairly detailed definitions for four principal terms: (1) special purpose vehicle, (ii) roundtrip investment (“*???*”), (iii) domestic residents, and (iv) control.

Of particular interest is the definition of special purpose vehicle, which is defined as “an offshore enterprise directly established by or under the indirect control of a domestic resident legal person or a domestic resident individual using his or her assets, or equity interest held, in a domestic enterprise, for the purpose of offshore equity financing (including convertible debt financing).” This definition makes it clear that if the SPV is not established for the purpose of offshore equity financing, then Circular 75 will not be applicable.

It should be noted that a "domestic resident individual" includes both a resident with a PRC passport/identification card, and an individual, who although does not have a legal status in the PRC, but who for economic reasons, "habitually" resides in the PRC.

“Roundtrip investment” and “control” are both broadly defined to capture the common arrangements or schemes for the offshore SPV to invest in domestic companies, and for the domestic PRC resident to control the SPV.

Retroactive Registration

For PRC residents who established (or obtained control of) an offshore SPV before November 1, 2005, and who completed the roundtrip investment, but have not carried out the required foreign exchange registration for offshore investment, Circular 75 requires that they carry out the retroactive registration with a local SAFE before March 31, 2006. After the PRC resident has completed the retroactive foreign exchange registration, local SAFE can handle the foreign investment or foreign debt registration for the relevant PRC company.

Conclusion

At this point, the published text of Circular 75 and the SAFE News Release are the only information available with regard to Circular 75. It is likely that Circular 75 may be further clarified by SAFE, whether through written documentation to be issued later, through oral discussions or comments by officials from SAFE or its local branches, or more importantly, through implementation by SAFE in connection with actual transactions. Additionally, MOFCOM and other Chinese government ministries or departments may issue regulations that will shed more light on Circular 75.

While the market will be watching how Circular 75 is implemented, it nonetheless provides significant hope that SAFE is now moving in a direction that will permit a return to greater ease in establishing the types of legal structures and permitted the kind of financing that has been critical for the development of venture and private equity financed companies operating in China.