RMB Funds in China

An analysis prepared by Edward Epstein and Kim Tung

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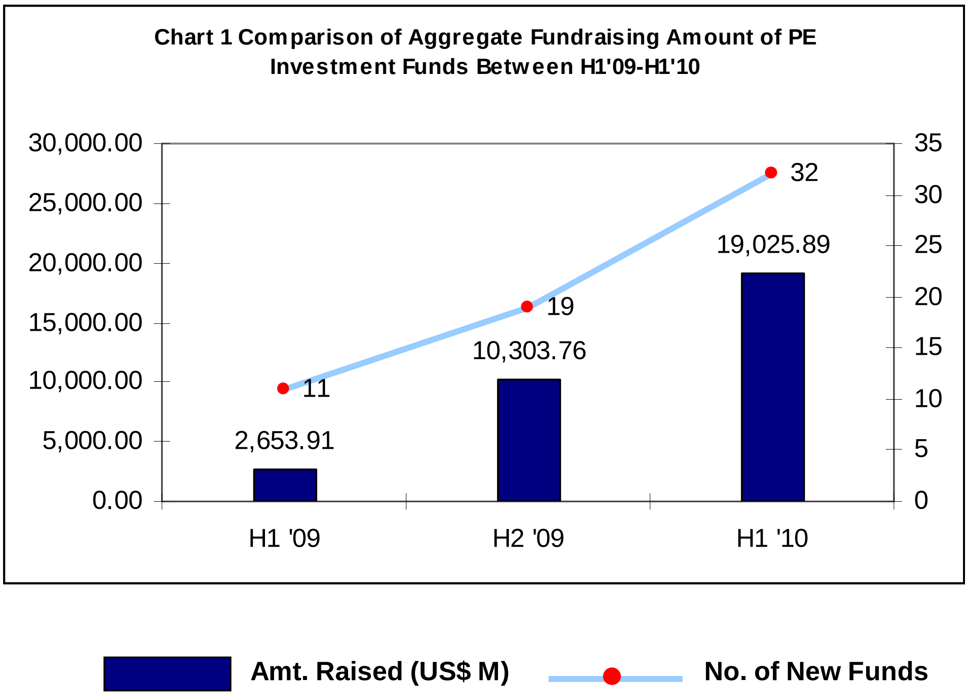
Despite the global financial crisis, China remains one of the favorite investment destinations for global investors. According to China's National Bureau of Statistics (NBS), China's economic growth (GDP) accelerated to 10.7 percent year on year in the fourth quarter of 2009, and China's GDP continued to increase to 11.1 percent in the second quarter of 2010. Moreover, while the global market is suffering a lack of liquidity, China RMB investors are both liquid and hungry to make investments.

This is reflected in the increase of new RMB funds in China over the last year (Charts 1, 2 and 3). The number of funds raised in the first half of 2010 reached 32, which is the highest number since 2007. The number of funds raised soared by 68.4% and 190.9% from the second half of 2009 and the first half of 2009 respectively. Moreover, the amount raised by these funds on the aggregate has increased significantly from the second half of 2009. Following this trend, the number of RMB investments has increased over time (Chart 4).

Current Framework of RMB Funds

RMB funds are not new in China. In 2003, China's Ministry of Commerce (MOC) issued the first regulation regarding Foreign Invested Venture Capital Enterprises (FIVCE), which created the preliminary framework for RMB funds. The first RMB industrial investment fund approved by the National Development and Reform Commission (NDRC) was established in 2005. In late 2008, the State Council of China issued the *Several Opinions on Providing Financial Support for Economic Development,* which paved the way for a codification of the private equity (PE) industry in China and the regulation of PE investment funds. In June 2009, the NDRC confirmed that the draft of the



Source: Zero2IPO Research Center - www.zero2ipo.com.cn

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Administrative Rules of Private Equity Investment Funds has been completed, and submitted to the State Council for approval. Moreover, since 2008, Beijing, Shanghai and Tianjin have all promulgated local policies to promote the development of the RMB funds business. Most recently, in October 2010, to further promote Shanghai's RMB fund market the central government approved in principle Shanghai's Qualified Foreign Limited Partner (QFLP) pilot program.

China's economic growth and the development of RMB funds in China, combined with the global economic situation, have resulted in many foreign fund managers seriously considering the possibility of setting up RMB funds in China, which can raise funds from China local investors and facilitate investments in the Chinese market, with the result that some foreign fund managers have recently succeeded in setting up RMB funds. However, since laws and practices in this area are developing rapidly and largely ad hoc, many fund managers have been confused by the types and structures of RMB funds and the requirements to access to them.

The current framework for RMB funds in China has developed piecemeal based on various regulations issued at different times, which has resulted in structures and practices that lack logical consistency. There are four main forms of RMB funds currently used in practice, which form the subject of this analysis.

1. Industrial investment funds (IIF) which are subject to special approval from the NDRC and the State Council

IIFs are usually established by government-back investors (combined with private investors) or based on multi-lateral treaties and mainly use a corporate structure. Since the Bohai IIF established in 2005, there have been dozens of IIFs approved but most of these IIFs were not successful. In October 2009, the NDRC and the Ministry of Finance (MOF) newly approved 20 new IIFs focusing on high-tech industries. The total investment in these IIFs is RMB9.2 billion, in which central and local governments contributed RMB2.2 billion, and the balance will be raised from private investors.

2. Venture capital enterprises (VCE) which are subject to specific administrative rules applicable to domestic VCEs and FIVCEs

VCEs and FIVCEs are established under special regulations and can take the form of

Chart 2 Distribution of Newly Raised PE Funds in H1 2010 (By No. of New Funds Raised)

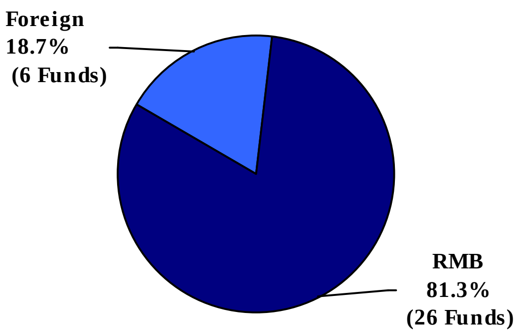
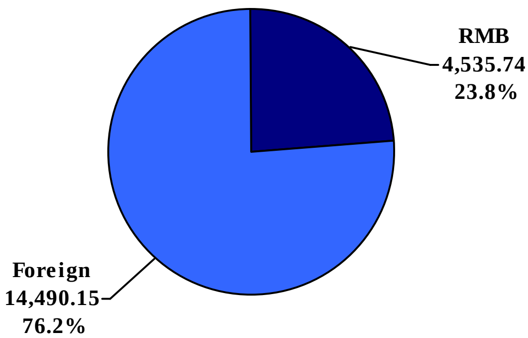


Chart 3 Distribution of Newly Raised PE Funds in H1 2010 (By Amount Raised, US$M)



Source: Zoro2IPO Research Center - www.zeroipo.com.cn

either pure RMB funds or sino-foreign RMB funds under a corporate or partnership structure (for FIVCEs, the regulation establishes a quasi-limited-partnership structure). By using VCEs, fund managers can raise funds from both offshore and onshore investors and establish onshore RMB-denominated funds. Some qualified VCEs and FIVCEs can also enjoy certain incentive policies including tax benefits. The limitations of VCEs and FIVCEs are that, the legal structures of these funds are limited by the regulations, which are very inflexible, and that FIVCEs can, in principle, only invest into high-tech or new-tech companies.

3. Equity investment funds (PE Funds) which are currently formed under local policies using a corporate or partnership structure

National rules on PE funds are still under discussion but local governments, such as in Beijing, Shanghai and Tianjin, have for a short

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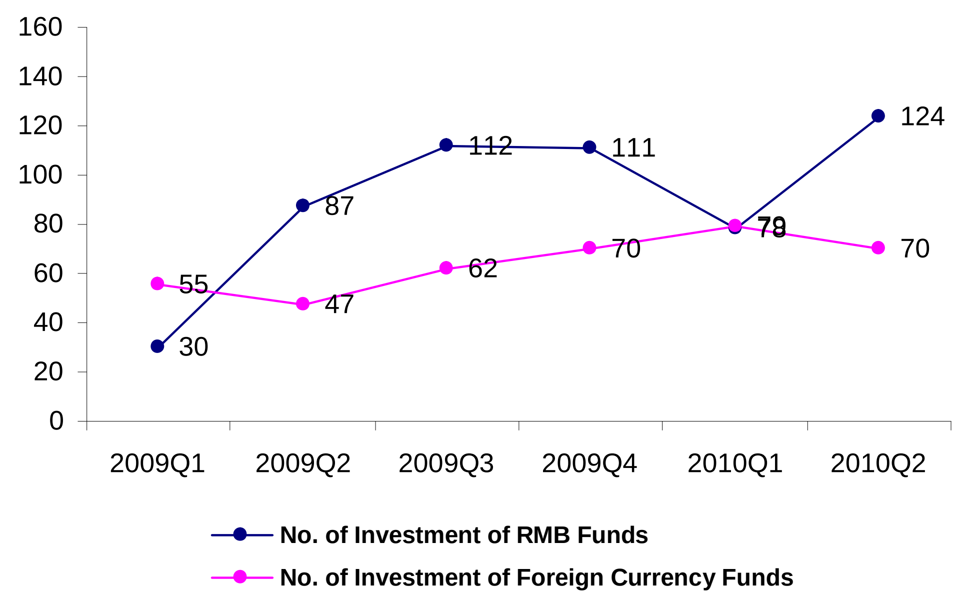
while begun to explore practical ways to develop PE funds in their jurisdictions.

For example, since August 2008, the Shanghai government has allowed PE fund enterprises, which can be structured in the form of limited companies, limited partnerships or foreign invested enterprises. These PE funds must have a registered capital of at least RMB 100 million, all of which shall be contributed in cash. Under the limited partnership structure, the partners of the PE funds enjoy pass-through taxation, among which the general partners bear unlimited liability and are subject to corporate income tax of 25% or a progressive individual income tax of up to 35%. The limited partners enjoy limited liability and are subject to corporate income tax at a rate of 25% or the individual income tax at a rate of 20%.

PE fund enterprises are allowed to be established in several cities in China and those PE funds are also allowed to make investments in many industries, but investors still face many practical problems. According to the current regulations, these PE fund enterprises can only make equity investments, which means they can only hold equity interests of portfolio companies but cannot provide debt financing or directly hold assets by themselves. Also, the corporate structure is not tax-efficient because the dividends distributed by the portfolio companies are subject to 25% enterprise income tax at the PE fund level, while the partnership structure has difficulties when the portfolio companies get listed and the funds exit. Moreover, foreign investors have to face more restrictions on direct investment, foreign exchange and tax treatments when participating PE funds in China.

In order to encourage the engagement of PE funds by foreign investors, local governments are actively seeking incentive policies from the central government. For example, the government of Shanghai Pudong New Area issued some pilot rules in June 2009 to allow foreign investors to set up onshore fund management enterprises (FEIMC) as WFOEs or Sino-foreign joint venture companies in Pudong, which have the business scope of fund management services and can be used to manage RMB funds in China. By contributing at least US$2 million as registered capital in these FEIMCs, foreign PEs may set up an onshore vehicle to raise and manage RMB funds in China, which will be used to pioneer the development of foreign-managed RMB funds. At the end of October 2009, the government of Shanghai Pudong New Area reached an arrangement with SAFE that, FEIMCs will receive an automatic waiver to convert foreign currency into RMB for investment in their own RMB funds. This waiver was previously up to 1% of aggregate capital commitments of the RMB fund as a whole, but as discussed further below, the limit of this waiver recently increased to 5%.

Chart 4 Quarter-on-quarter Comparison of Investment Deals of RMB and Foreign Currency Funds (Q1'09-Q2'10)



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Pioneers of China's Developing Private Equity Industry

Encouraged by local incentive policies and the trend of promoting onshore PE development, many well-known foreign PEs have begun to explore the possibility of setting up RMB funds in China, and some have become pioneers in this development. In 2009, the Blackstone Group, First Eastern Financial Investment Group, CLSA Asia-Pacific Markets, Prax Capital, Draper Fisher Jurvetson, among others, established FEIMCs in Pudong Shanghai and have or are in the process of setting up RMB funds.

One success story is Prax Capital (Prax). Prax was among the first firms granted approval to manage RMB denominated funds by the Shanghai Pudong New Area Government. Prax then announced that it successfully raised its first RMB denominated real estate fund and its first RMB denominated growth capital fund, each with commitments of RMB 600 million (approx. US$ 88million). Significantly, despite the perceived difficulties in domestic fundraising, Prax's two RMB funds have been launched and fully subscribed by Chinese domestic investors, thus indicating that there is a keen level of interest in investing in private equity among Chinese investors.

"The Carlyle Group and...Fosun sucessfully formed...[an FIP] RMB fund in Shanghai..."

Another pioneer is the Blackstone Group (Blackstone) which in late 2009 formally launched its RMB Fund in Shanghai. Blackstone signed a preliminary agreement with Lujiazui Financial Development Co., a government-backed company. The fund is called the Blackstone Zhonghua Development Investment Fund, and it aims to raise five billion yuan (approx. US$732.5 million) and focus mostly on investments in Shanghai as well as neighboring areas in the Yangtze River Delta. Blackstone also later announced that it signed its first domestic Chinese investor for its RMB fund.

The Carlyle Group and a Chinese domestic company, Fosun, successfully formed the first RMB fund in Shanghai under the new measures for foreign-invested partnerships that became effective on March 1, 2010.

Other well known names in the private equity / venture capital industry reported to have established or are in the process of establishing RMB Funds include: KKR, Hony Capital, CDH Investments, FountainVest, SAIF, Capital Land and CITIC Trust, and Bohai Industrial Investment Fund Management.

New Measures Boost Foreign PEs Interest in Forming RMB Funds

(a) Foreign Invested Partnership Measures

The momentum for foreign PEs to form RMB funds further increased when the long awaited *Administrative Measures on the Establishment of Partnership Enterprises by Foreign Enterprises or Individuals* (Partnership Measures), published by the State Council went into effect on March 1, 2010. The Partnership Measures are widely recognized as a new form of doing business in China and a new step to encourage foreign investment. According to the Partnership Measures, foreign investors may form wholly-owned foreign-invested partnerships (FIP) or Sino-foreign owned FIPs, or join existing domestic partnerships which will be converted into FIPs. The Partnership Measures state that FIPs which mainly engage in the investment business shall comply with "other relevant rules", which indicates that China may adopt special rules in the future on foreign-invested PE funds which use a FIP as their investment vehicle. The local governments of Beijing, Shanghai and Tianjin are considering the issuance of more detailed rules concerning foreign-invested PE funds based on the Partnership Measures, which may resolve this uncertainty at the local level and provide more practical ways for FIPs to engage in the PE funds business.

Prior to the Partnership Measures, some argued that the measures will allow FIPs to engage in the investment business immediately

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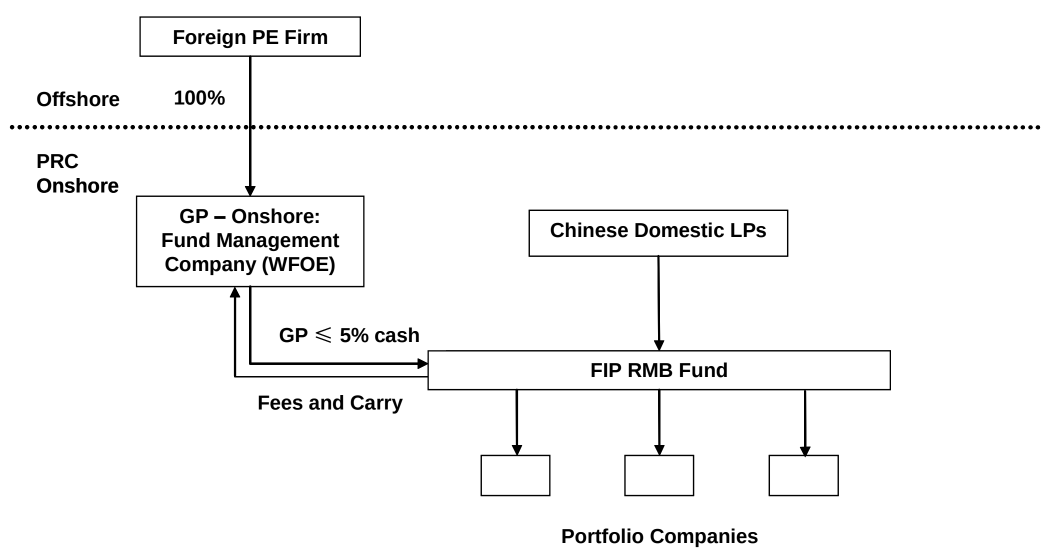
until further detailed restrictions are provided, while some others believed that foreign investors need to wait for further detailed rules. However, the successful formation of the FIP RMB fund by Carlyle and Fosun immediately after the effectiveness of the Partnership Measures has at least answered this question for now in Shanghai.

Carlyle's RMB Fund is a general partnership with Fosun and not a limited partnership structure, which most foreign PEs prefer. Carlyle's fund is reported to be the first FIP to be granted a business license with its primary business in private equity investments. Despite

designed to attract quality foreign limited partners, such as overseas institutional investors, to invest in RMB funds by: (1) removing the restrictions on foreign exchange in hopes of creating a free foreign exchange settlement when QFLPs make investments in RMB funds and when they remit returns and the principal aboard; and (2) allowing RMB funds invested by QFLPs to enjoy the same treatment as that of domestic funds with regards to investment approval. Whether Shanghai's pilot program will resolve these issues remains to be seen, but our understanding of recent practices and forthcoming legislation and policies is encouraging.

Chart 5 Basic Pudong FIP RMB Fund Structure



the absence of further rules (as required under Article 14 of the Partnership Measures), SAIC appears to have taken the view that the administration of industry and commerce authorities (AICs) at the provincial level have the authority to register private equity funds formed as FIPs.

(b) Shanghai's QFLP Pilot Program for Foreign PEs

To further promote Shanghai's foreign PE industry, the central government approved in principle Shanghai's *Pilot Program of Foreign Capital Participating in RMB Equity Investment* (QFLP pilot program) in mid-October of 2010. No formal rules and regulations for the pilot program have been published yet and it is anticipated that the rules and regulations will be published by late this year or early 2011. In its draft form, the QFLP pilot program was

First, the automatic waiver afforded to FEIMCs in Shanghai to convert foreign currency into RMB for investment in one's own RMB fund, that was previously up to 1%, has recently been increased to a maximum of 5% of the aggregate capital commitments of the RMB fund as a whole.

Second, the FEIMC may be the general partner of an RMB fund and may convert its foreign currency into RMB once the fund has been established.

Third, if a limited partnership RMB Fund has only domestic Chinese limited partners and the foreign capital contribution of the general partner(s) of the fund does not exceed 5%, the fund will be deemed a pure RMB fund and should be afforded the same advantages of a pure domestic RMB fund.

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Fourth, if the foreign limited partner is a QFLP, then the foreign limited partner should be allowed to convert its foreign currency into RMB to invest into the RMB fund. The QFLP pilot program should broadly follow the QFII model with respect to the foreign exchange administration and quota system. Foreign investors that meet certain qualifications should be able to apply for a foreign exchange conversion quota under the program. In particular, with the quota, the RMB fund will be able to convert the capital contributed by a foreign partner in foreign currency into RMB for investment purposes, and later to purchase the foreign exchange back when repatriating capital. It appears that a fund invested by QFLP(s) and foreign GP(s) will be recognized as a pure RMB fund so long as the total foreign capital contribution is no more than US$100 million or 50% of the aggregate size of the fund. To be a QFLP, it appears that a foreign investor, among other conditions, should have its own capital of no less than US$500 million and at least a total of US$5 billion in assets during a prescribed period of time. Of course, it remains to be seen if such rules will be promulgated and how they will be implemented.

"...the central government approved in principle Shanghai's...QFLP pilot program..."

Given the current legal framework and recent developments, a simple foreign invested GP/LP RMB fund in Pudong Shanghai may possibly take the structure in Chart 5.

The structure in Chart 5 is just a basic structure and will change depending on the circumstances of each situation and the rules and regulations that are ultimately published by the Shanghai government.

Foreign Investment Restrictions for FIPs

The Partnership Measures are not clear on the foreign investment restrictions for FIPs, but after the adoption of the Partnership Measures, SAIC issued the *Administrative Regulations for the Registration of Foreign-Invested Partnership Enterprises (Circular 47)* on January 29, 2010 and *the Circular Concerning the Improvement of the Implementation of the Administrative Measures for the Establishment of Partnership Enterprises by Foreign Entities or Individuals in China (Circular 31)* on February 10, 2010. These two circulars require that: (1) investments by Investment FIPs (an FIP fund that invests into portfolio companies) must comply with the laws, regulations and rules governing foreign investment, and (2) for any project subject to NDRC's approval for foreign investment, the Investment FIP must apply for and obtain NDRC's approval before its investment. Circular 31 also requires the provincial AICs to review MOC and/or NDRC approvals during the course of registering an Investment FIP's reinvestment in China.

However, it is believed that the foreign investment restrictions and foreign investment approvals that are applicable to general Investment FIPs may not be applicable to foreign managed RMB funds using the limited partnership structure, and given recent developments, this belief is becoming more of a reality in Shanghai. This limited partnership fund structure (as discussed above) entails the formation of an FEIMC in places like the Shanghai Pudong New Area. The FEIMC or the subsidiary of the FEIMC may then act as the general partner together with other domestic limited partners to form a limited liability partnership under the PRC Partnership Law. Also, foreign restrictions may not apply to this RMB fund structure because it may be considered a pure RMB fund.

In addition, Tianjin appears to have also found a current solution for the foreign investment restrictions. In Tianjin, a WFOE is deemed by the local authorities to be a PRC domestic entity and may act as a general partner or limited partner in an RMB fund. Such an RMB fund has been recognized as a domestic partnership, and significantly, this Tianjin RMB fund has been permitted to invest in traditionally restricted or prohibited categories, such as real estate, on the same footing as a domestic Chinese RMB fund. However, such an RMB fund could ultimately face a higher level of

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regulatory scrutiny. Moreover, the foreign investors in such funds have thus far only contributed services or onshore RMB profits to fund its general partner commitments. In one recent case, a WFOE was allowed to use its onshore RMB profits to fund its obligations as a limited partner under this type of Tianjin fund.

Foreign Exchange Restriction for FIP Funds

At this time, unless under the Shanghai rules or the QFLP pilot program, a foreign fund manager may most likely be disappointed if it is seeking to use a FIP to manage foreign and RMB commingled funds. Restrictions under SAFE Circular 142 prohibiting the conversion of foreign money into RMB for equity investment purposes remain unchanged. Neither Circular 47 nor Circular 31 allows an FIP to convert its foreign capital into RMB for investment purposes. Under Circular 47, foreign partners who intend to make contributions in RMB cash must obtain SAFE's prior approval with respect to its reinvestment of its onshore RMB profits or other lawful RMB income. However, given Shanghai's recent developments, these restrictions appear to be relaxing in favor of foreign PEs.

"Despite these uncertainties...well known players...have formed RMB funds..."

4. Trust investment plans (TIP) formed by qualified trust investment companies

China enacted its Trust Law in 2001. Although any individual or legal person can act as a trustee, in practice, qualified trust investment companies (TIC), as non-bank financial institutions, are the only entities which are qualified to establish commercial trust plans and sell to unit holders. In 2007, the central government issued several regulations to standardize the regulation of TIC business and clarify the requirements for establishing commercial trust plans. Since then, the TIP has become one of the most important vehicles for RMB funds. Currently, there generally are three types of trust plans which can be used:

(1) The TIC establishes a TIP to raise funds from unit holders and then makes equity investments in or loans to portfolio companies. Dividends, revenues from sales of equity, and loan interest will be used to make distributions to unit holders;
(2) The TIC establishes a TIP to raise funds from unit holders and then acquires and holds the pooled assets. The revenues from the sale, lease or operation of these assets will be used to make distributions to the unit holders; and
(3) The TIC establishes an assets TIP for portfolio companies focusing on specific assets and then sells the preferred beneficiary interests of these assets to unit holders, under which the funds raised will be used to fund the portfolio companies, and the revenues generated by the underlying assets will be used to make distributions to the unit holders.

These TIPs are all pure RMB funds and usually are only open to Chinese investors. Therefore, at this time, both foreign general partners and limited partners cannot engage in these plans. However, foreign PEs' onshore subsidiaries can provide paid management services to these RMB funds. Foreign PEs may also establish hybrid fund structures to raise funds from domestic and foreign investors side by side to engage indirectly in the target projects so that foreign limited partners can also indirectly invest in the same projects.

China's Real Estate Investment Trusts (REITs)

One of the most useful functions for TIPs is pooling funds for real estate investment. TIPs established for real estate investment are often referred to as "Quasi-REITs". The central government has been drafting rules to regulate REITs. Several central government departments including China Banking Regulatory Commission (CBRC) and China Securities Regulatory Commission (CSRC) are drafting their own REIT rules, which they hope to be adopted by the State Council. The CBRC's version of a REIT is a debt financing product, under which the owner of the real estate will

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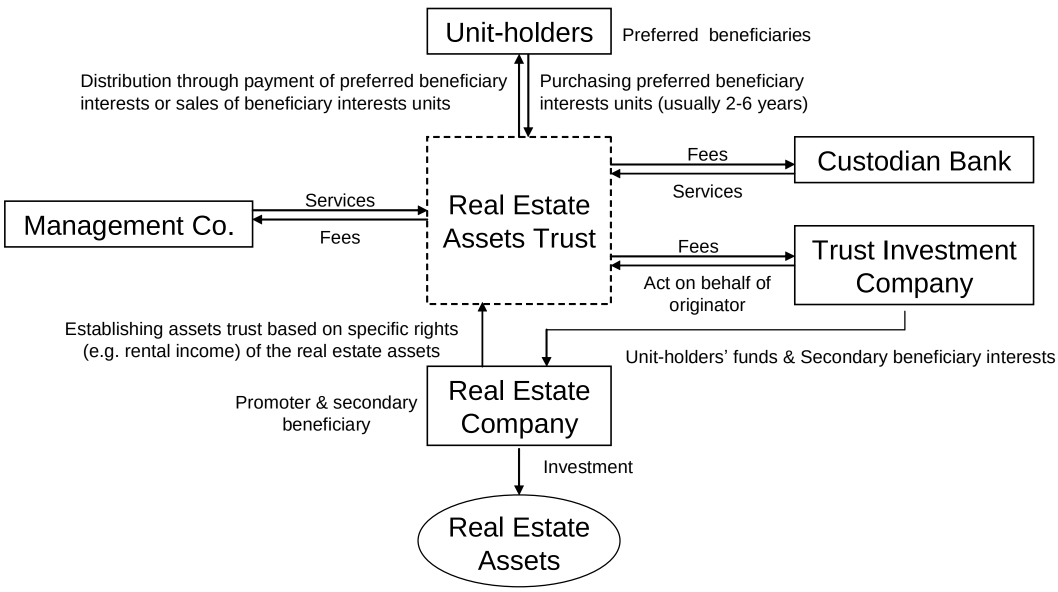
Example of General Quasi-REIT Structure



not transfer title to investors and will only assign the beneficiary interests to the investor, which is similar to the third type of TIP described above. These REIT products will not be listed but may be traded in inter-bank market. The CSRC's proposed REIT, however, is more like a US-style REIT under which the title of the real estate assets is transferred and the products can be publicly traded. The CRBC's draft of the REIT rules (80 clauses) were published for comments in December 2008.

It has been suggested that the central government will first adopt the CBRC's proposed REIT structure and then later adopt the CSRC's proposed REIT structure. To move the CBRC structure forward, the People's Bank of China (PBOC) and CBRC have jointly drafted the *Administrative Measures on the Pilot Program for Collective Investment Trusts for Real Estate*, and the PBOC has also drafted the *Administrative Measures on Issuing Real Estate Trust Beneficiary Certificates on the Inter-bank Market* to set out the legal framework for products under the CBRC REIT structure. It has been reported that the measures do not contemplate having properties under development for entrustment but contemplates to have only completed properties that are generating income. Properties eligible for entrustment include both residential and commercial properties, and it appears that multiple properties may be entrusted under a single trust arrangement. As far as we are aware, neither measure has been officially promulgated, and apparently a second set of measures are being circulated to other authorities and institutions for consultation.

Several cities including Beijing, Tianjin, Shanghai and Shenzhen are competing to join the pilot program formulated by CBRC/PBOC, and it appears that Shanghai may soon be the first city in China to launch a non-listed REIT. It was reported in May 2010 that a proposal drawn up by four Shanghai based enterprises, including listed companies Shanghai Jinqiao Export Processing Zone Development Co. Ltd. and Shanghai Lujiazui Finance & Trade Zone Development Co. Ltd., has been reviewed by the relevant regulatory bodies and submitted to the State Council for approval. According to the proposal, the REITs will debut in the form of beneficiary securities in compliance with proposed regulations by PBOC. Industrial and commercial properties under the management of the four enterprises in Shanghai will be included in the investment pool. The beneficiary securities are rumored to be similar in structure to bond issues. Owners of real estate properties will entrust a trustee to manage the assets and issue REITs on the interbank bond market. REIT investors will enjoy preferential rights in receiving a fixed income from a total return within the duration of the securities, while remaining profits will be left to the owners of the properties.

Of course, proponents of the CSRC structure continue to push and suggest solutions which in their opinion would better satisfy the needs of the market. Some fund management

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Well known PE/ VCs reported to have formed or forming RMB funds:

The Blackstone Group

The Carlyle Group / Fosun

First Eastern Financial Investment Group

CLSA Asia-Pacific Markets

Prax Capital

Draper Fisher Jurvetson

KKR

Hony Capital

CDH Investments

FountainVest

SAIF

Capital Land and CITIC Trust

Bohai Industrial Investment Fund Management

companies and securities companies regulated by the CSRC have prepared preliminary proposals for REIT products that presumably will be traded on the stock exchanges.

No matter which REIT structure is ultimately adopted, the introduction of REITs may provide a viable alternative fund raising vehicle for real estate financing in China.

Conclusion

After many years of hearing footsteps on the stairs, it seems that foreign participation in RMB funds is finally becoming a reality in the PE, VC and real estate industries. The advantages of RMB funds are clear: they can make investments without foreign exchange controls, they can raise funds from local investors, including high net worth individuals, onshore companies, government fund of funds (FOF), insurance companies and social security funds, and they can speed up the transactions because they are not weighed down by the baggage of foreign investment approvals. There are also disadvantages: the legal structure is still unclear and foreign participation is still limited, as is liquidity and exit strategies. Moreover, the lack of mature local limited partners and their expectations of high yields are limiting the development of RMB funds. Despite these uncertainties, several well known players in the PE/VC industry have formed RMB funds, and the rapid development of China's economy and the need for increasingly diverse financing tools will ensure that RMB funds will play an increasing role in the near future.

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Firm Overview

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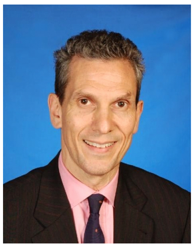
Contacts & Attorney Biographies



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Edward Epstein focuses on mergers and acquisitions, real estate development and investment, antitrust issues and foreign direct investment, particularly in the manufacturing sector. With more than twenty years of legal experience in China, Mr. Epstein has counseled numerous multinational companies and become a sought-after expert on Chinese law. He has extensive experience in handling real estate matters, complex land acquisition projects, and advising clients on how their business structures can comply with China's regulatory requirements. He has also advised real estate developers and investors on how to finance investments with RMB fund structures.

Mr. Epstein has been highly ranked by both Chambers Asia and Asia Pacific Legal 500 as a leading lawyer in corporate/mergers and acquisitions, and real estate in China, and he is also recognized as one of the leading lawyers in Asia by Asia Law - Leading Lawyers in the areas of real estate, mergers and acquisitions, general corporate practice, and labor and employment law.

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Olivia Lee has more than 20 years of experience providing professional legal services and advice on general corporate and commercial transactions, mergers and acquisitions, corporate finance, capital markets transactions, securities transactions, establishment and listing of investment funds, and debt restructurings in Hong Kong, Asia, North America, and Europe, with significant experience in China. Ms. Lee has advised various multinational companies and private equity funds on their direct investments and mergers and acquisitions in various industries of China. She has also assisted many companies based in China and Hong Kong in overseas listings, financing, mergers and acquisitions, as well as international tax planning. She is fluent in English, Mandarin Chinese and Cantonese.

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Revised November 2010
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