

# Topics in Chinese Law

AN O'MELVENY & MYERS LLP RESEARCH REPORT

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## RMB Funds: Update and Trends

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**B**ecause of the inconvertibility of the Chinese Renminbi currency ("RMB") and various other regulatory constraints, there have historically been two separate universes of private equity deals in China: domestic deals denominated in RMB, and foreign deals using offshore holding companies that invest in Chinese operating subsidiaries. However, a series of changes to Chinese regulations, culminating in the implementation of the *Regulations on Mergers and Acquisitions of Domestic Companies by Foreign Investors* (commonly known as the "M&A Rules") in September 2006, have made it very difficult to restructure a Chinese domestic company into an offshore holding structure (to facilitate offshore investments into such domestic companies) and all offshore investments by foreign investors since then have involved only Chinese companies that were already held by way of an offshore holding company. On the other hand, with the massive increase in China's domestic liquidity, continued growth of the Chinese economy, and policy support from central government to spur domestic investment, foreign investors are increasingly looking at the attractiveness of the domestic deal flow and

the desirability of setting up an onshore investments platform (that is, a "RMB Fund") in order to facilitate such onshore deal-making.

There have always been plenty of domestic private equity investors operating in China historically that made RMB-denominated investments, including wealthy individuals, domestic corporations and other government-backed institutions. Even before 2006, both Chinese target companies and domestic investors knew that foreign investors typically require the establishment of an offshore holding company as a condition to their investment, a process that was cumbersome, time consuming and often resulted in operational inconveniences to the target company. Even if a foreign investor was willing to invest directly into a Chinese domestic company, such investment would still require government approvals and the application process for approval can be slow, often presenting uncertainty to the parties. Thus, there are many domestic deals where the only investors being considered are



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domestic investors who can act quickly because they do not require government approvals to invest.

By forcing all foreign investment into Chinese companies through onshore structures, foreign investors are pushed to compete directly against traditional onshore investors. Historically foreign investors have been attractive to Chinese companies because the foreign presence increases the reputation and credibility of the company, perhaps by improving the overall management level and corporate governance, and better positions the company for a public listing. Foreign investors often offer a better valuation or at least have the ability to write sizeable checks for Chinese companies that have grown too big to seek purely local investors. Now that both foreign and domestic investors need to consummate their investments via onshore structures, the decision criteria for many Chinese entrepreneurs is whether the intangible benefits from accepting money from a foreign investor outweighs the operational costs involved in becoming a foreign-invested Chinese company. Even though such structures do not directly facilitate offshore public market exits, this may not be viewed by local entrepreneurs as a particular hindrance, since both offshore public listings for RMB Funds and foreign direct investments that do not have offshore listing vehicles will both require central government approval under the current regulatory framework. In this regard, setting up a RMB Fund may offer the foreign investor a platform that lessens the cost to the entrepreneur while also easing and speeding up the investment process to the foreign investor.

### What are RMB Funds?

The term "RMB Funds" commonly refers to pooled investment vehicles that are formed in China and

denominated in RMB. Some RMB Funds may include foreign funding sources. We generally see three types of legal structures in the market that are referred to as RMB Funds:

- (i) "Industrial Funds" ( “产业基金” ), which are formed pursuant to special approval from the National Development and Reform Committee (or their applicable local counterparts, "NDRC"),
- (ii) "Venture Capital Investment Enterprises" ( “创业投资企业” or "VCIE") that are formed under the 2003 *Administrative Measures on Foreign Invested Venture Capital Investment Enterprise* ("FIVCIE Rules") with approval from the Ministry of Commerce (or their applicable local counterparts, "Mofcom") or under the 2005 *Interim Provisions on Administration of Venture Capital Investment Enterprises*, depending on whether the VCIE contains foreign funding, and
- (iii) "Equity Investment Funds" ( “股权投资企业” , or "EIF") that are currently formed under various guidelines and circulars published by local authorities. Examples of such circulars include the *Notice on Issuing the Opinion on Facilitating the Development of Private Equity Fund Industry* published by certain Beijing authorities in January 2009. It is believed that NDRC is on track to publish national-level guidelines for the formation and operation of EIFs during fall of 2009 (see below discussion).

For the purposes of this article, we will focus only on the forms of RMB Funds that involve a significant participation level from foreign fund sponsors - namely FIVCIEs and foreign-related EIFs.

## 24-Months Ago and Now

When O'Melveny last published an article on RMB Funds in February 2007, the concept of an onshore funding vehicle was a novelty and an interesting theory. The number of such funds in the market was small with varying degrees of test operations. Although we still see that some RMB Funds being set up today are small (approx \$10 million to \$15 million in commitment) in comparison to offshore funds, there are also sizeable \$100+ million funds being set up to facilitate real investment plans (see Table 1 below). Indeed, it is generally understood that there are over 400 purely-domestic RMB funds and at least 40 FIVCIEs in operation as of May 2009.

	Feb. 2007	Since Feb 2007*
No. of Industrial Funds	1	9
No. of FIVCIEs	6	>30
(total amt)	~ \$150M	> \$1.5B
(avg.size)	~ \$25M	~ \$50M
No. of foreign-related EIFs	0	> 10

\* source: O'Melveny research; information as of May 2009

## Why a RMB Fund?

There is simply no one single reason or catalyst that explains the explosion in popularity of RMB Funds. Quite simply, different foreign fund sponsors are setting up RMB Funds for different reasons.

First, a foreign-invested RMB Fund can in theory make an investment into Chinese companies without obtaining prior Chinese government approvals, which should allow it to move just as quickly as a domestic investor. Therefore, a foreign investor that has a RMB Fund should have the competitive advantage of being able to access both domestic and offshore deal flow.

Second, RMB Funds should be able to convert foreign exchange faster (or otherwise hold onto and redeploy its

RMB cash) than can be done under a straight onshore investment from abroad. In some situations, a RMB Fund-invested company can take the form of a purely domestic limited liability company, making A-share exits for such investee more easily achieved.

Third, some foreign fund sponsors are setting up their RMB Funds in order to do onshore fundraising from local investors. Chinese investors generally need special approval from various Chinese government agencies in order to invest in offshore US dollar-denominated private funds, so having a RMB Fund would give the onshore investors the ability to invest in offshore fund managers. In addition, we have seen a dramatic increase in the number of Chinese institutions (with greater available capital) that are now permitted to invest in private equity funds. The most notable onshore investors are the various local government guidance funds, securities firms and insurance companies, and the National Social Security Fund. The growth in onshore money specifically up for grabs to foreign fund sponsors with a vehicle that can legally accept RMB commitments is often a driving consideration for the foreign sponsor to proceed with setting up a RMB Fund. The well-documented growth of high net worth Chinese individuals is also a contributing source of available onshore capital, and these investors are often particularly well-suited to support the fundraising needs of smaller fund sponsors.

Another significant reason that some sponsors set up their RMB Funds is the clarity in treatment of such vehicles under the complex web of Chinese laws and regulations. If properly structured, RMB Funds can be treated as tax pass through entities so that the investors are only taxed on their pro rata share of investments while the fund itself is not subject to

Chinese income taxes. In relation to currency conversion by the State Administration for Foreign Exchange ("SAFE"), RMB Funds are treated no less favorably than cross-border investors are treated in certain other jurisdictions typically associated with investments into China, do not require conversion for recycled RMB, and can repatriate their capital to investors as and when they dispose of portfolio companies. RMB Funds in theory should also be able to negotiate far better shareholder rights and protections than their offshore counterparts, thus boosting the level of deal structuring that better approximates the rights that are available in offshore deals.

However, foreign fund sponsors should tread cautiously when evaluating whether to set up a RMB Fund. While a RMB Fund may be a useful "tool" to have for the fund sponsors' toolbox, these are ultimately onshore vehicles and, like all Chinese entities, require much more administrative maintenance than a typical offshore entity in, for example, the Cayman Islands. Operational pitfalls do exist for such onshore entities. RMB Funds are also not limitless in their scope of investments – for example, they can not be used to facilitate trades in public equity (i.e., the fund will not be able to invest in so-called onshore "PIPE" deals via such structures) and capital committed to RMB Funds generally cannot be used to fund offshore investments.

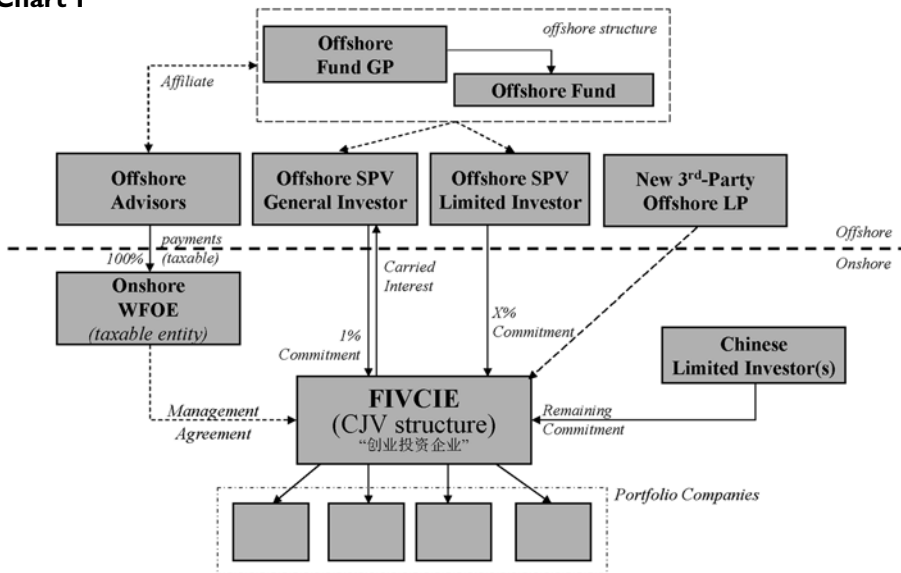
In summary, foreign fund sponsors should check with their counsel to understand which of the RMB Fund's attributes and benefits are reasonably achievable and are more difficult to attain in practice. Many such benefits are subject to local interpretation, and setting up the RMB Fund in a jurisdiction that is not familiar with them often results in greater administrative difficulty and diminished benefits for the fund sponsor.

## RMB Fund Attributes -- FIVCIE

So what are the requirements to set up a RMB Fund? Since the promulgation of the FIVCIE Rules in 2003, the FIVCIE became a RMB Fund structure available to foreign investors. The structure and related fund entities are similar to a typical offshore private equity fund structure, can accept investments from multiple foreign and domestic investors via one or more closings, is tax pass through, and has a business license to conduct equity investments with foreign funds. Chart 1 sets forth the basic organizational form of the FIVCIE structure - a non-legal person cooperative joint venture - although we have worked on or seen more than a handful of permutations of this form, usually to cater to the specific needs and investor dynamics of the foreign fund sponsor. In March 2009, Mofcom delegated the approval authority for the establishment and modification of FIVCIEs smaller than \$100 million to selected sub-national authorities, thereby making the structuring of the FIVCIE dramatically quicker and easier.

Depending on local government's familiarity and other factors, the FIVCIE can make investments in domestic companies without the need for prior government approvals as long as the target companies are in the "encouraged" or "permitted" categories of foreign investment. Only a filing of a report with the local government is required according to published guidance. This gives a FIVCIE the ability to compete with domestic investors on deal execution speed. Secondly, unlike most foreign-invested companies, FIVCIEs can repatriate initial contributed capital as well as all profits back to their investors as and when the FIVCIE disposes of its portfolio investments. When domestic or foreign fundraising is involved, a FIVCIE can also

Chart I



facilitate carried interest payments to the fund sponsor. Furthermore, in some cases a FIVCIE's target company has been permitted to remain as a domestic limited liability company, thus minimizing the disruption to the target company's operations and making it easier for the target to take the foreign money.

On the downside, FIVCIEs are required to primarily invest in private portfolio companies in either high- or new-technology industries; a FIVCIE with a general investment mandate in all industries is not contemplated by the FIVCIE Rules. In addition, FIVCIEs generally are not permitted to borrow (although this restriction is marked for change in the 2006 draft amendments to the FIVCIE Rules), and the SAFE procedures applicable to FIVCIEs deploying their original US dollar capital in the startup stage can be onerous in practice. In order to obtain the tax pass through treatment for the FIVCIE, the fund is usually structured as a "non-legal person cooperative joint venture." This means there needs to be at least one Chinese investor in the FIVCIE with commitments of at least US\$1 million. Of course, accepting Chinese investors is often a driver behind setting up the RMB Fund for many foreign fund sponsors anyway.

It may also be possible, although with more difficulty, to set up the RMB Fund as a "non-legal person wholly-foreign owned enterprise." Under this method, the RMB Fund would be completely funded and owned by foreign investors. Such a wholly foreign-owned RMB Funds would continue to be subject to the investment restrictions, but it would benefit from being treated as a local Chinese entity in many respects by China's regulatory authorities and also receive tax pass through treatment.

In summary, the FIVCIE possesses many beneficial deal-making attributes. However, foreign fund sponsors should work with their RMB Fund counsel to understand which of these benefits are easily achieved and which will require some level of additional structuring and/or discussions with local Chinese authorities in order to be realized.

**RMB Fund Attributes -- Equity Investment Funds**

The FIVCIE's shortcomings have caused some fund sponsors to seek out alternative RMB Fund structures. In recent years, the concept of a "pure" RMB Fund - i.e. a RMB Fund that is entirely domestically funded

and therefore not subject to foreign investment restrictions or any deal-level approvals - has been viewed as a possible alternative. Such "pure" RMB Funds usually adopt the EIF's business scope and structure, and permit greater flexibility for its fund sponsor and fund investors to dictate their internal governance. The EIFs will not be subject to the catalogue for foreign investment (because there is no foreign funding), are not limited to investing in the "high tech" sector, are already funded in RMB so would not require any currency conversion, generally do not need special government approval to consummate deals, and generally offer the promise of simpler structures and tax pass through treatment, among other benefits. The downside of course is that there is currently no EIF form that can accept foreign funding directly, an often prohibitive restriction that currently limits its use by any foreign fund sponsor that is required to deploy capital through their offshore funds. However, the powerful combination of favorable deal-making advantages makes the EIF a tempting structure for any China-based fund sponsor to create alongside their offshore funds in so-called *onshore-offshore parallel structures* (i.e. the structure adopted by Hony Capital and CDH Capital with the support of funding from the National Social Security Fund).

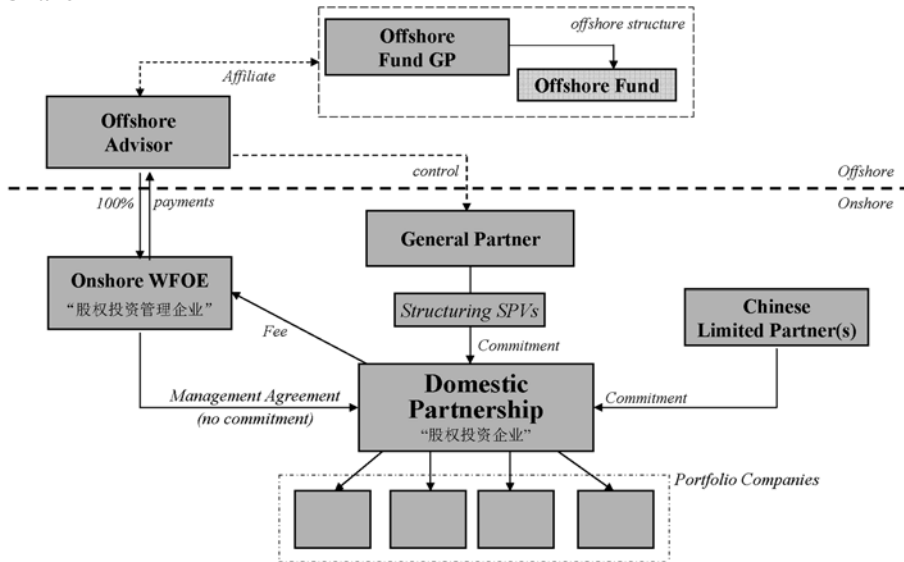
Chart 2 shows a diagram of one common EIF structure set up in the form of a domestic partnership. As is the case for FIVCIE, there are at least half a dozen structuring variations for the EIF and foreign fund sponsors should consult with their RMB Fund counsel to discuss the structure that best achieves the fund sponsor's goals.

There are very few national-level regulations or guidelines that discuss the appropriate set up and operation of an EIF. Most of the EIFs to date have been established pursuant to

regulations promulgated by applicable provincial or local-level authorities. A case in point for such local regulation would be the *Provisional Measures for the Administration of Registration and Filing by Equity investment funds and Equity investment fund Management Companies (Enterprises) in Tianjin*<sup>1</sup>, issued by the Tianjin Development and Reform Commission (plus other local authorities) in November 2008, or the *Notice on Industrial and Commercial Registration and other Matters by Equity Investment Enterprises in Shanghai*<sup>2</sup> issued by the Shanghai Financial Services Office (plus other local authorities) in August 2008.<sup>3</sup> It is also commonly known in the industry that the NDRC is currently working on draft measures that address the organization structure, operating scope, fundraising process, and other elements of an EIF. However, it is unclear whether such measures will be issued, or to what extent it would be supported by the other regulatory agencies (specifically SAFE) so as to meaningfully alter the model of operation of EIFs.

For the time being, EIFs set up under local regulations can only provide the foreign fund sponsor with a medium to manage a domestically-raised RMB Fund -- typically in partnership form in order to best mirror the allocation of rights and cash flows between the fund sponsor (as general partner) and the investors (as limited partners) that commonly exist for offshore fund structures - but the foreign investor/fund sponsor will not be able to directly channel its offshore funding through the EIF in order to consummate deals for its offshore funds. It is possible of course for the offshore funds of the foreign investor to co-invest alongside the EIF on a pure deal basis, but it is difficult for such co-investment scheme to be formally locked in and as such

Chart 2



presents potential conflicts of interest and structuring issues for the parties involved. Fund sponsors who are interested in setting up an EIF should consult with their fund counsel to ensure the conflicts that are presented by it are permissible under its fund governance documents.

## Trends

Chinese onshore fund vehicles are inevitably a novelty relative to the tried and tested offshore fund model. The recent popularity in such vehicles have been driven by a confluence of factors, some of which may diminish in importance as the world climbs out of the financial crisis and the Chinese investment climate turns from economic stimulus to control of hot money. Any foreign fund sponsor contemplating onshore deal-making should consult with their counsel and make their decision based on an evaluation of the trends in the industry and how certain issues may play out 12 or 24-months down the road rather than take a static view of the Chinese legal regime. While no one can foresee the future, certain regulatory policies and macroeconomic trends are clearly visible that may materially affect this industry:

1. Onshore fundraising is becoming a real possibility. Government-backed guidance funds and national-level institutions have been increasingly entering the investment space as limited partners since early 2008. We expect this trend to continue. While many national champion brands are more interested in being general partners than limited partners, foreign fund sponsors that have established track records should be able, in the near future, to partner with onshore limited partners to create a more "Chinese" reputation for the foreign fund sponsor. Likewise, reputable local fund sponsors that target smaller deals should be able to tap solely into the local fundraising space without going into the offshore fundraising market to raise sub-\$100 million funds, which should be considered a real possibility in the immediate 18 to 24-month horizon.
2. Competition among different local jurisdictions will spur further policy support for RMB Funds. During the past 12 months, various local Chinese governments have given increasing attention to the promotion of the private equity

industry in their jurisdiction. Building a robust RMB Fund regime has been a mantra of many key Chinese investment areas (including Beijing, Shanghai, Tianjin, Suzhou, and Chongqing), each of which have issued local support policies and operating guidelines in relation to RMB Funds operating in their area. Although Tianjin was the early leader (stemming from their experiences with the Bohai Industrial Fund), we should expect that such competition among local governments will continue for the intermediate term horizon. Regulations are changing fast, and previous inexperience by local authorities has given way to sophisticated local guidance funds and regulators. Development in such jurisdictions for new regulation and breakthrough operational efficiencies for RMB Funds has meant that the experiences by RMB Fund sponsors over a year ago may already be outdated, and likewise current experiences may not be applicable by next year. As local Chinese approval authorities further tweak their processes to draw foreign fund sponsors to their jurisdiction, foreign fund sponsors should benefit.

3. Increased scrutiny by national-level regulators. The current private placement rules in China in connection with raising capital for RMB Funds are generally considered loose. While there are the expected prohibitions against misrepresentations, specific details on how the fundraising process should be run and what can or cannot be done during the fundraise is unclear. As more and more foreign fund sponsors look to onshore LPs for fundraising, it is reasonable to expect that national level regulators will give increasing

regulatory scrutiny over the medium of communication, the promises of the fund sponsor to the fund investors, and exact characteristics of the RMB Fund product. For example, the requirement for information memorandums and risk disclosure documentation often created for offshore funds is starkly absent in many onshore fundraisings. Likewise, other than the expected NDRC guidelines for the formation and operation of EIFs, the existence of regulations from other national-level regulators (e.g., the China Securities Regulatory Commission) in relation to RMB Funds and private placement fundraisings also currently does not exist. Foreign fund sponsors should expect further developments from such regulators.

4. Foreign investment restrictions and the popularity of purely-domestic RMB Funds. Virtually every national sovereign in the world maintains an ability to block investments that may pose a threat to the national interests of that sovereign. From Australian mining assets to American shipping ports, certain assets will continue to be subject to higher nationalist protections than others. China is no different in this regard when it comes to the enforcement of the foreign investment catalogue. While it is unlikely for there to be significant changes to the investment restriction policies in the near future, it has been discussed whether RMB Funds that contain only a small contribution from foreigners would be treated as a domestic entity for capital deployment and investment consummation. Any such movement will likely be slow and complicated at first, and so should be viewed more as a longer

term development, but global investors who manage permanent capital (or semi-permanent capital) may want to monitor developments in this space. Indeed there have already been some pilot cases in the market for foreign-funded entities to be treated as purely local entities for many purposes under PRC law, including acting as the general partner of domestic partnerships.

## Conclusion

Setting up a RMB Fund is not a panacea. A RMB Fund by its nature has certain difficulties and inefficiencies. It is also not yet feasible for a RMB Fund to be run in tandem with an offshore foreign currency fund in such a way that the two funds are effectively merged as one fund. This is because China's foreign currency rules do not currently permit an outflow of capital from China to be used to subsidize losses of an offshore investment fund, should the offshore fund lose money while the RMB Fund makes money.

As Chinese entrepreneurs seeking foreign private equity investment have come to appreciate, the considerable enthusiasm of international investors for China has not diminished their fundamental concern about path to investment. Foreign fund sponsors will not rush in the front door without knowing how these RMB Fund vehicles will operate and the potential hassles that may be involved in setting them up or reaping their supposed benefits. One hopes that the regulatory authorities responsible for developing and implementing China's foreign-invested RMB Fund laws will come to value the role of foreign private capital and appreciate the needs of financial investors to achieve investment operations that provide them with both efficiencies and attractive returns relative to investing

elsewhere in the world. There is certainly a basis for optimism that they will do so. The movements that are afoot at various regulatory authorities all point to a rapid movement in the legal framework that support the RMB Fund as a platform for future investments in China.

Although the current RMB Fund regimes are still nascent, they nonetheless represent a tremendous step forward in policy from just a couple of years ago, and more and more foreign investors are finding them as sufficiently acceptable platform on which to do deals. Yet like many significant regulatory reforms in China in the past, further changes will likely come in a piecemeal fashion - early adoption and trial measures by various local jurisdictions followed by national level guidelines - which ensure that the legal framework will continue to be tricky to navigate for foreign fund sponsors, and many of the bumps on the road to operations can be minimized if one proceeds with diligence and foresight.

## Endnotes:

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1. “天津股权投资基金和股权投资基金管理公司（企业）登记备案管理试行办法”
2. “关于本市股权投资企业工商登记等事项的通知”
3. The Shanghai Pudong authorities recently issues on June 10, 2009, the *Provisional Measures of Shanghai Pudong New Area for the Establishment of Foreign-Invested Equity Investment Management Enterprises* ( “浦东新区设立外商投资股权投资管理企业试行办法” ) pursuant to which foreign fund sponsors are permitted, among other things, to create wholly-foreign owned enterprises that are fully engaged in providing management services to EIFs. While the measures do not address the issue of whether foreign-funded EIFs are now permitted, O'Melveny considers this an announcement as an "initial step" that paves the way for future EIF local guidelines and central level regulations for foreign fund sponsors.



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