China's new foreign exchange controls create fresh concerns

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Background

Foreign investors and other parties transacting with Chinese counterparts who were still digesting the events of the last two years during which China appeared to be moving towards a more inward-looking approach, with the promulgation of, among others, the *People's Republic of China Counter-Terrorism Law*, the *People's Republic of China National Security Law* and more recently the *People's Republic of China Cybersecurity Law*, are now facing a new set of challenges.

China has recently imposed a series of foreign exchange controls which affect all deals done involving currency outflows from China, notably outbound investments by Chinese buyers.

Current account v capital account transactions

China divides transactions involving a cross-border element into:

- current account transactions which are liberalized and only require proof to be provided to the remitting and converting or receiving bank in China that there is a genuine and lawful underlying transaction; and
- capital account transactions which are still restricted and more strictly regulated.

Why has China imposed the new controls?

There is currently a heightened sensitivity in China in relation to outflows of capital, with the authorities having very recently issued a series of policies to restrict these. This suggests that Chinese individuals and companies may have been trying to shift their money out of China in significant amounts in recent years as the growth curve and future growth prospects for the Chinese economy have weakened. Amongst other methods, it is known that one such route for shifting assets overseas involved fake transactions conducted via Hong Kong using dummy companies, e.g. setting up a shell company in Hong Kong and invoicing exports to China that were never delivered. It is not clear to what extent these structures were more motivated by individuals seeking to repatriate funds overseas as opposed to corporates.

Leaving aside the issue of the underlying fraud, these would constitute current account transactions. Eventually the Chinese authorities became aware of this through discrepancies in the relevant records, leading to increased scrutiny with regard to capital outflow transactions.

More recently concerns have been raised about questionable outbound transactions being used by Chinese companies and individuals to shift assets overseas. These, on the other hand, are capital account transactions. They are particularly sensitive and significant to China's regulators because of the potential to shift large amounts overseas in a single transaction.

What do the new policies say?

China issued a series of policies introducing the new procedures in the period running up to the end of 2016, through pronouncements by various government agencies, rather than hard law.

In November 2016, the central planning body and key outbound investment approval agency, the National Development and Reform Commission ("**NDRC**") issued an internal note on restricting certain outbound capital account transactions. These are scheduled to expire in September 2017. Based on such NDRC note, up to the end of September 2017, the following categories of outbound transactions will, in particular, be targeted by the Chinese authorities and will not be granted approvals to proceed in principle unless otherwise specifically permitted by the relevant authorities (based on criteria which are not in the public domain):

- outbound investments in real estate made by State-owned enterprises with a Chinese investment amount of USD 1 billion or more;
- overseas investments involving an extra-large Chinese investment amount exceeding USD 10 billion;
- outbound transactions outside the core business of the company involving an amount of USD 1 billion or more;
- outbound investments directly made by limited partnerships;
- foreign direct investment involving an acquisition of 10% or less of the shares in an overseas listed company;
- investments in offshore targets that have an asset value that is larger than the Chinese acquirer;
- investments in offshore targets where the investing entity is a newly-established vehicle; or
- transactions involving domestic capital participation in the delisting of overseas listed Chinese enterprises.

In addition, outbound investments made by Chinese enterprises with a high asset-liability ratio and low net assets yield will be monitored closely as well.

It has been widely reported that on 28 November 2016, the Shanghai Branch of the State Administration of Foreign Exchange ("**SAFE**") held an internal meeting with regard to the administration of cross-border receipts and payments. It was reported that as a result of this and the internal guidance to banks issued on the back of this, any single purchase or payment of foreign exchange and RMB/foreign currency disbursement in an amount equivalent to or greater than USD 5 million for capital account transactions must be first reported to the Beijing SAFE as a large transaction.

Such transactions may now only be carried out once the relevant authorities, including the People's Bank of China ("**PBOC**"), SAFE, NDRC, Ministry of Commerce ("**MOFCOM**") and so forth, have completed an authenticity and compliance review of the transaction and granted approval therefor. If the transaction amount exceeds USD 50 million (inclusive), a stricter level of scrutiny applies, involving direct monitoring by central SAFE in the system and a review. Shanghai SAFE also emphasized that transactions <u>must not be split up</u> into smaller components in order to circumvent large amount transaction reporting.

On 6 December 2016, NDRC, MOFCOM, PBOC and SAFE jointly held a press release responding to the media inquiries regarding outbound investment administration. Based on the official responses during the press release, going forwards, the Chinese authorities will pay particular attention to the following outbound investment transactions, meaning such investments will to subject to greater administrative scrutiny as compared to others:

- large investments in business outside the core business of the Chinese investor;
- outbound investments made by limited partnerships;
- investment in offshore targets that have asset values that are larger than the Chinese acquirers;
- the investing entity is a newly established vehicle [without any substantial operations]; and
- “irrational” overseas investments in certain industries, specifically real estate, hotels, film, entertainment and sports clubs.

Conclusion

In general, what is clear from anecdotal and our experience with actual client transactions is that payments out of China on outbound transactions are being subjected to far greater scrutiny as compared to say 6 months or a year ago. Summarising all the policy pronouncements so far, the levels of scrutiny on any outbound capital account transactions will depend on:

- the amount of money that is being transferred overseas;
- the industry sector of the target;
- the country to which the payment will be transferred; and
- the profile of the Chinese investor (e.g. newly established SPV and/or acting outside its core business).

The new procedures are somewhat opaque. Timing for completing the regulatory procedures for outbound direct investments is highly uncertain at present until we see the first few cases go through the new system, bearing in mind much of this is very recent in nature. Extra time needs to be factored into payment deadlines for all transactions involving outbound payments from China, as the new approval process is likely to cause delays of up to several months in our estimation. Even the approval of the transfer of small amounts of money (less than USD 10 million) may take up to one month.

In addition, based on our enquiries with local banks, currently PBOC grants an unofficial "quota" to each bank requiring the total capital outflow amount processed by the specific bank per month to be within the "quota" limits. This "quota" would apply to all capital outflows from China, even including payments under current account transactions (e.g. cross-border trading transactions) which, as noted above, are less highly regulated than capital account transactions. Transactions at month end are likely to be pushed into the next month due to quotas being used up. Good relationships with the relevant authorities and government officials will likely be crucial for getting larger transactions approved in a timely fashion, and we expect that many more interactions will be needed to explain the rationale of certain transactions to regulators.

Application documents for outbound approvals should include facts and evidence as to the genuine nature and business rationale for transactions (e.g. why is the target selling the asset and how the acquisition fits into the Chinese acquirer's strategy), so that any concerns in this regard from the regulatory stakeholders can be addressed at an early stage.

China will also be well aware of the cases where fraud was not involved but where Chinese companies going outbound (particularly but not exclusively State-owned Enterprises) overpaid or made overseas investments that did not stack up commercially: it may also be using the new reviews and controls to bring order to the market and to weed these out in the process, thereby preventing State-owned assets from being dissipated in ill-thought-through overseas forays.

This is clearly an area to watch as the new reviews are rolled out: we understand that the new policies create uncertainty and concerns for many transaction counterparties, particularly sellers to Chinese buyers. We are available to talk through the issues and share our experiences. We remain, however, firmly of the view that this is not in any way the 'end of the outbound trend' as some have predicted: we take the view that this is only a "bump in the road" and that where there is a genuine outbound deal that makes business and strategic sense, it will still get approval/record filing and the deal will get done, even if the timetable stretches out somewhat.

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