

# SAFE Issues Revamped Rules on Round-Tripping Investments by PRC Residents: But Will SAFE Circular 37 Make any Difference?

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The State Administration of Foreign Exchange ("**SAFE**") issued the *Relevant Foreign Exchange Administration Issues on People's Republic of China Residents Investing, Raising Finance Overseas and Engaging in Round-tripping Investment through Special Purpose Vehicles [Huifa No. 37]* on 4 July 2014 ("**Circular 37**"). Circular 37 took effect on the same date. Circular 37 replaces the *Relevant Issues on People's Republic of China Residents Engaging in Financing and Round-tripping Investments through Overseas Special Purpose Vehicles [Huifa No. 75]* ("**Circular 75**") which was also issued by SAFE almost ten years ago on 21 October 2005.

## Background

In order to assess the impact of Circular 37, it is helpful to understand the background which led to the issue of Circular 75 back in 2005. Private Chinese entrepreneurial activity was increasingly robust after the turn of the century, particularly in the Internet and new technology sectors which led to the listing of the People's Republic of China ("**PRC**") tech champions on primarily the New York Stock Exchange and NASDAQ. Sina.com, NetEase Inc. and Sohu.com were the early pioneers in the early part of the millennia and around 2005, Tencent, Baidu and Ctrip.com were next in line. These giants (including Alibaba, which is on target to become one of the largest if not the largest technology listing in history surpassing that of Facebook Inc.) were initially start-ups which had sought offshore venture capital and private equity funding through offshore holding structures. Because the funding and investment vehicles were usually based offshore for tax, options for offshore exits and reasons associated with the difficulty of replicating a standard set of investor's rights (dividend preference, liquidation preference and so forth) under PRC law, particularly in the Cayman Islands, the British Virgin Islands and Hong Kong, the PRC authorities were not able to directly monitor and regulate the activities of these offshore funding and investment vehicles.

Against this backdrop, SAFE issued two circulars which were intended to create a regulatory framework for the industry, but which had the unintended effect of temporarily shutting down the use of offshore funding and investment vehicles for venture capital transactions. These two circulars were the *Relevant Issues in Improving the Administration of Foreign Exchange of Mergers and Acquisitions by Foreign Investors* issued on 24 January 2005 [Huifa [2005] No. 11] ("**Circular 11**"). It was followed on 8 April 2005 by the *Circular on Several Issues on Registration of Overseas Investments by PRC Resident Individuals and Foreign Exchange Registration of Mergers and Acquisitions by Foreign Investors [Huifa [2005] No. 29]* ("**Circular 29**"). Both Circular 11 and Circular 29 preceded Circular 75 and when they were issued in early and mid-2005, both were heavily criticised for not setting out the requirements and processes clearly. The uncertainties with the processes involved posed significant hurdles and risks to PRC domestic companies seeking offshore funding. It effectively put a halt to any transaction involving PRC residents seeking to raise funds from foreign investors through offshore entities.

Following intense pressure from the investment community, Circular 75 was then issued by SAFE in late 2005 to replace both Circular 11 and Circular 29. Its net effect was to clarify some, but not all of the 'grey areas' of Circular 11 and Circular 29. Although the processes and requirements set out in Circular 75 added another layer of compliance burden, it at least brought about some level of certainty that offshore funding transactions by PRC resident entrepreneurs involving 'round-tripping' investments back into China were feasible. Upon the promulgation of Circular 75, both Circular 11 and Circular 29 were repealed.

Circular 75 has, for almost a decade, been the centrepiece of regulatory concerns for PRC resident entrepreneurs and investors in any transaction involving the setting up of offshore entities for fund raising purposes and the use of such funds in the PRC. These structures are prevalent in venture capital type

transactions particularly in the Internet, telecommunications and technology sectors which have and are still generally off-limits to foreign investors. A registration as required under Circular 75 is a must-have in almost all venture capital deals which target a future listing, particularly on the Hong Kong Stock Exchange. PRC legal opinions are almost always required to cover compliance with Circular 75 to the extent feasible (it is frequently hard to get a clean opinion in this regard).

Fast forward to today, the issuance of Circular 37 to replace Circular 75 is therefore seen as a significant regulatory development in this space and its implications need to be considered carefully by the investment community and advisors alike. We set out below the key differences between Circular 37 and Circular 75<sup>1</sup>.

### **Definition of Special Purpose Vehicle and Use of Offshore Assets**

Under Circular 37, a "special purpose vehicle" ("**SPV**") refers to an offshore enterprise directly established or indirectly controlled by PRC residents (including PRC institutions and PRC individual residents) using the assets or rights and interests which they lawfully own in an enterprise in China (an enterprise in China shall hereafter be defined as a "**PRC Enterprise**"), or the assets or rights and interests which they lawfully own offshore, for the purpose of engaging in investment or financing activities. This definition is consistent with Circular 75 but there is an added provision allowing offshore assets to be used in establishing or controlling the SPV (underlined above). The added scope is likely due to the loosening up of the controls on PRC residents keeping their assets offshore, which can therefore be injected into the SPV.

The ability to use offshore assets is reiterated under Section 3 of Circular 37, which states that where a PRC resident uses its offshore assets to be injected into the SPV, the application should be made to the SAFE branch in the place in which the PRC resident is registered or in which his/her household registration (戶

籍) is filed. The household registration is normally based on where the household registration of the parents are filed, and it is very difficult to change one's household registration location, although there are currently proposals to revamp this system altogether. The use of offshore assets is a step in the right direction. In our experience, SAFE authorities have always required ownership of onshore assets (usually in the form of the PRC resident's shareholding in a PRC Enterprise) as a pre-condition to any registration under Circular 75. There seems to be no obvious reason for excluding offshore assets.

Furthermore, Circular 37 expands the types of activities which the SPV can conduct. Under Circular 75, the SPV was limited to "offshore equity financing" (股权融资) type activities but under Circular 37, it can now engage in investment as well as financing (投融资) activities. The allowance for the SPV to conduct investment activities is consistent with the PRC government's drive to open up outbound investment channels to PRC residents. There has always been uncertainty as to PRC nationals owning shares or securities in an offshore entity and the expanded scope of activities for a SPV suggests that this is now possible under Circular 37. However, this is limited to the circumstances as provided under Circular 37 and Section 4 of Circular 37 is a reminder that registration of the SPV does not serve as evidence that the investment and financing acts comply with the requirements from the other industry departments in charge of outbound investments – further discussed below.

### **Definition of Round-Tripping Investment**

The definition of "round-tripping investment" under Circular 37 is broader as it refers to the direct investment activities conducted by PRC residents through a SPV, either directly or indirectly, including establishing foreign invested enterprises ("**FIEs**") or projects in China by way of new establishment, merger and acquisition and so forth, and obtaining rights and interests therein such as ownership, control, operating and management rights and so forth.

By contrast, "round-tripping investments" are referred to under Circular 75 as direct domestic investment activities carried out by PRC residents through SPVs, including, but not limited to, the following methods: purchasing or swapping the equity interests held by Chinese parties in enterprises in China, establishing FIEs in China and, through such enterprises,

<sup>1</sup> Please refer to our note entitled "[The PRC State Administration of Foreign Exchange \("SAFE"\) Issues Circular No. 75 – a new chapter begins?](#)" dated November 2005 for a more detailed examination of Circular 75 attaching an English translation of Circular 75.



purchasing or, through contract, controlling assets in China, purchasing assets in China through contract and using such assets to establish a FIE, or using such assets to increase the [registered] capital of an enterprise in China.

In our experience, certain SAFE authorities have interpreted "round-tripping investment" strictly whereby "including, but not limited to" has been read as "namely". The result was that if the type of "round-tripping investment" did not fall squarely under the examples provided under Circular 75, SAFE would reject the application. Without specifying examples of a "round-tripping investment", the definition under Circular 37 is therefore broader and will hopefully allow investments which do not fall squarely under Circular 75 to be registered with SAFE.

### SAFE Registration Branch

According to Section 3 of Circular 37, where a PRC resident makes a capital contribution using its onshore assets and interests, it must file the application to register with the local SAFE branch having jurisdiction over its place of registration or with the local SAFE branch having jurisdiction over the area where his/her/its assets or interests in the PRC Enterprise are located. This is a different concept compared to Circular 75 which required the application be made to the place where the PRC resident is located (which in practice, is where his/her household registration (户籍) is filed).

In our experience, local SAFE branches in different locations often interpret the regulations and requirements differently from each other. According to our inquiries with the SAFE authorities in Beijing and Shanghai, given that Circular 37 has only been recently issued, it has yet to be fully implemented. Applications are still being considered pursuant to Circular 75 and are therefore made to the SAFE branch where the PRC resident is located.

Therefore, it may now be possible under Circular 37 to 'cherry pick' which SAFE branch entity to make the application with by moving the assets and interests to a location which has less stringent requirements. However, this has to be balanced with the commercial and practical implications of relocating the assets. Even moving a company across administrative regions within the same municipality poses challenges in terms of timing and cooperation.

### Timing of Application and Documentation Requirements

Circular 75 required the application to be made prior to the PRC resident establishing or gaining Control<sup>2</sup> of the SPV. Circular 37 on the other hand requires that the registration with the relevant SAFE branch be completed prior to the PRC resident using its/his/her onshore or offshore assets to make the capital contribution to the SPV. The difference between gaining Control and making a capital contribution may not be material given that contributing capital into the SPV is encompassed in the definition of Control under Circular 75, but note the comment below on whether this affects the timing for the establishment of the SPV.

Documentation wise, both Circular 37 and Circular 75 require the proper forms, approvals, identification and incorporation documents to be provided. Circular 37 explicitly requires resolutions and documents evidencing ownership of the relevant assets and interests to be provided which were not required under Circular 75. However, in practice, these were commonly required by the authorities under Circular 75 by virtue of the catch all provision of any 'other documents evidencing the authenticity of the transaction'. Circular 37 also has a similar catch all clause which is commonly seen in PRC legislation. The catch all provision essentially gives the relevant SAFE authority the discretion to interpret the regulations as they see fit on a case by case basis and to add back in anything that may have been overlooked by the drafters of the legislation.

One document explicitly required under Circular 37 is the SPV registration documents and materials evidencing the shareholding of the PRC resident or its/his/her status as actual Controlling party (i.e. register of shareholders). This is a key difference from Circular

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<sup>2</sup> The term "Control" is defined under Circular 75 as referring to "PRC residents using acquisitions, trusts, nominee arrangements, voting rights, rights of repurchase, convertible bonds and such like methods to obtain rights to operate, rights to benefits or decision-making rights in relation to an SPC or an enterprise in China". Under Circular 37, the definition of "Control" is in essence similar to Circular 75, and refers to the "obtaining by PRC residents of operating rights, rights of profits or decision-making rights in relation to an SPV through acquisitions, trusts, holding as a nominee on behalf of others, [granting of] voting rights, repurchases, convertible bonds or other such similar methods".

75, as it suggests that the PRC resident could become a Controlling party *prior to application to SAFE*, whereas Circular 75 requires the application to be made *prior to Controlling the SPV*. Notwithstanding both interpretations, in our experience, some local SAFE branches have taken the extreme view of interpreting Circular 75 as requiring registration to be completed prior to the establishment of the SPV in which the PRC residents will hold direct shareholdings. It remains to be seen how SAFE will interpret Circular 37, but the requirement to apply prior to making a "capital contribution" (出资) could certainly be interpreted as encompassing shareholding ownership, which would be consistent with existing practice. Another interpretation will be to allow the establishment of the SPV, but limit the contributions of the PRC resident to registration and incorporation fees or contributions (and not making any material capital contributions).

### Registration of Employee Incentive Plans

Employee incentive plans form a key part of the way in which early stage companies motivate their staff. This is especially the case for privately-held start-ups which often struggle with bank financing and cash flow in the early stages. Prospective employees and candidates may forgo immediate cash rewards for a longer term windfall when the company lists in the foreseeable future (usually on a five to seven year time horizon). Apart from the potential monetary upside, participating and contributing to the success of the company is also rewarding and attractive to the best candidates. Therefore, employees are often offered shares as part of an employee incentive plan which helps incentivise the employees to work as a team with senior management and the founding shareholders.

Under Circular 75, there was no express recognition that employee incentive plans were registerable, which left a gap as to how employee incentive plans of the SPVs (which in most cases, will be the listing vehicle) were to be dealt with. In our experience, some SAFE authorities did recognise the importance of employees being granted shares in the SPV and allowed the shares reserved for employee incentive plans to be reflected in the registration made pursuant to Circular 75. Others refused to reflect any shares reserved for employee incentive plans altogether. Companies and their advisors devised various ways to address the uncertainties by using nominee and trust structures, but the broad definition of control has always left a doubt

hanging over whether offshore equity incentive plans were compliant with Circular 75.

A welcome change under Circular 37 is that Section 6 allows non-listed SPVs<sup>3</sup> to register employee incentive plans of the PRC Enterprise which it directly or indirectly controls. Section 6 lists the documents required to be submitted which include application forms, evidence of the SPV's foreign exchange registration certificate, and evidence of the employment or labour service relationship between the employees and the PRC Enterprise. Predictably, there is also the catch-all provision of 'any other materials required by SAFE'.

### Offshore Lending

Section 10 of Circular 37 further states that a PRC Enterprise which is directly or indirectly controlled by a PRC resident(s) may, on the basis of a genuine and reasonable need, lend money to an already registered SPV in accordance with the relevant provisions. PRC Enterprises are only permitted to operate within their approved business scope and in order to conduct lending activities, its business scope will need to expressly include lending particularly in this instance where the loan is made to the offshore SPV. This has led to entrustment loans through banks (commonly known as 'back to back' loans) so it remains to be seen how this provision will be implemented. This gives rise to a classic Chinese regulatory conflict where the rules and interpretations issued by the People's Bank of China and the PRC Supreme People's Court<sup>4</sup> clearly outlaw inter-company lending, but SAFE seems to be endorsing it. This leaves a rather unclear and unsatisfactory position at law.

<sup>3</sup> Listed offshore entities which offer equity incentive plans to employees of their subsidiaries in the PRC are subject to a separate registration procedure under the *Circular on the Foreign Exchange Administration of Domestic Individuals Participating in Foreign Listed Companies' Employee Share Incentive Plans* issued by SAFE effective 20 February 2012. Please refer to our client note entitled "[New Rules on Employee Share Plans for Foreign Listed Companies in China: Are They Finally Ready to Take Off?](#)".

<sup>4</sup> See Articles 2 and 21 of the *General Rules for Loans* issued by the People's Bank of China effective 1 August 1996 and *Reply to Questions regarding Adjudication of Inter-company Lending Agreements where the Lender has not Received the Agreed Loan Interest* issued by the Supreme People's Court on 25 March 1996.

## Hints of a Regulator's Crackdown?

This possibility of inter-departmental conflict is hinted at again in Section 4 of Circular 37, where it states that the fact of SAFE regulation does not mean the underlying investment is compliant from the perspective of the department in charge of the industry, a possible oblique reference to leaving room for a Ministry of Industry and Information Technology ("**MIIT**") crack down on the so-called Variable Interest Entity ("**VIE**") structure. This is basically a workaround to circumvent foreign investment restrictions by using contractual means to control and extract profits from a domestic capital entity holding the relevant permits, frequently used in the telecoms and Internet industries<sup>5</sup>.

In short, SAFE registration is not to be set up as a defence against or a free pass vis-à-vis other regulators. Under Circular 75, our experience has been that whilst SAFE is aware of the common use of the VIE structure in venture capital and private equity investments of a "round-tripping" nature, it has taken the diplomatic approach by not referring to the VIE structure in both Circular 75 and Circular 37. The definition of control is in essence mirroring the VIE concept (operating rights, rights of profits or decision-making rights) but it relates to the SPV and not the PRC enterprise. In practice, based on our experience, it is common for SAFE to request that references to VIE and the contractual arrangements which form the VIE structure be removed altogether from the transaction documents in order for it to accept the registration under Circular 75. It remains to be seen if this attitude will change under Circular 37 but until the other heavyweights such as the MIIT or Ministry of Commerce weigh in on this subject with some degree of clarity, it is unlikely that SAFE will lead on this controversial issue.

## REMEDIAL FILINGS

Circular 75 imposed a deadline (31 March 2006) for registrations to be completed retrospectively where SPVs and round-tripping investments had been made prior to the promulgation of Circular 75. Considering Circular 75 took effect in November 2005 and given its

uncertainties, unsurprisingly, many PRC residents were not able to comply with the deadline. Due to the tight timeline, SAFE was at that time inundated with applications and many PRC residents and offshore investors were left frustrated with the registration process. Since then, PRC residents who did not comply with the deadline have received mixed responses when they tried to apply for registration after the deadline. Certain SAFE branch authorities rejected these applications whilst others imposed discretionary fines in approving the application for registration.

SAFE may have learnt from this experience, as Section 12 of Circular 37 states that prior to the implementation of Circular 37, if a PRC resident had already contributed assets within China or overseas to a SPV but had not carried out the proper foreign exchange registration, the PRC resident must issue a letter of explanation explaining the reasons for failing to register and SAFE will carry out remedial registration as well as impose fines accordingly. Unfortunately, no indication is given of the scope of fines which may be imposed. Nonetheless, this is a positive development as it expressly allows PRC residents to complete remedial filings without a specified deadline.

## CONCLUSION

Overall, Circular 37 is a positive and welcome development. It allows PRC residents to use their offshore assets for investment and expressly allows registration of shares issued under employee incentive plans. However, there is otherwise little in the way of substantive change or simplification of the time-consuming and involved registration processes compared to the prior regime under Circular 75. It represents incremental rather than fundamental change. Under the new Circular 37 regime, SAFE is still imposing a strict registration requirement for round-tripping investments by PRC residents through SPVs and, more importantly, the procedures and documentation are largely the same. The positive effects are, therefore, very limited. Notwithstanding, a key barometer will be to see how the local SAFE branch authorities interpret Circular 37 on the ground. Hopefully, they will use their discretion to simplify the registration process to encourage more innovation and investment in the private sector, which is a key pillar in China's shift towards reducing dependence on the manufacturing sector and moving towards an innovation-based services economy. Examining the principles conveyed by Circular 37, we understand that

<sup>5</sup> Please refer to our note entitled "[China VIE structure for foreign investment under attack from multiple directions: Will it emerge \(relatively\) unscathed or is its very survival threatened?](#)" dated January 2012 for a detailed examination of the Variable Interest Entity structure.

SAFE's focus is gradually shifting from strictly controlling PRC residents' offshore activities to overseeing their activities from a more macro perspective (i.e. monitoring and collecting useful information from the offshore investment and financings by PRC residents). On this basis, we understand that there may be less of a requirement to register each layer of offshore shareholdings (it is quite common to have a Hong Kong entity establishing for tax advantages in between the Cayman Islands or British Virgin Islands entity and the PRC entities). Hopefully, it will be possible to consolidate the offshore shareholdings as opposed to the current practice of registering each layer of shareholding.

As touched on above, based on our inquiries with SAFE authorities in Beijing and Shanghai, as of date, Circular 37 has not been fully implemented as the authorities are undergoing internal sessions to implement Circular 37. The authorities have explained that until Circular 37 is fully implemented, Circular 75 will still be relied upon in when reviewing the applications. Given the significance of Circular 37 to venture capital and private equity fundraising particularly in the Internet, telecommunications and new technology space, investors and founder entrepreneurs alike will be well advised to monitor the developments on the ground closely.

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