

## China Alert - New SAFE Circular Changes the Rules on Company Financings and Round-Tripping Investments via Overseas Special Purpose Companies

The State Administration of Foreign Exchange ("SAFE") promulgated the *State Administration of Foreign Exchange Circular on Issuing the Operational Rules concerning Foreign Exchange Administration of Company Financings and Round Tripping Investments via Overseas Special Purpose Companies by Residents in China [Huifa (2011) No. 19]* ("**Circular 19**") on May 17, 2011. Circular 19 further clarifies issues concerning the implementation and application of the *State Administration of Foreign Exchange Circular on Relevant Issues concerning the Foreign Exchange Administration of Residents in China Engaging in Financing and in Round-tripping Investment via Overseas Special Purpose Companies* (No. 75 [2005] of the State Administration of Foreign Exchange, hereunder referred to as "**Circular 75**") and simplifies the operational procedures for Circular 75. Circular 19 will take effect on July 1, 2011.

### 1. BACKGROUND

Prior to the promulgation of Circular 19, on May 29, 2007 SAFE had issued *Circular of the General Affairs Department of the State Administration of Foreign Exchange on Issuing the Operational Rules for the State Administration of Foreign Exchange Administration of Company Financings and Round-tripping Investments via Overseas Special Purpose Companies [Huizongfa (2007) No. 106]* ("**Circular 106**") to clarify certain issues relating to the practical operation and application of Circular 75. However Circular 106 was never publicly promulgated, and was intended to be used as internal SAFE guidance for the implementation of Circular 75. This note summarises the changes to Circular 75 and Circular 106 as well as to other related foreign exchange rules brought about by Circular 19.

### 2. STRUCTURE OF CIRCULAR 19

Circular 19 covers the following three types of activities requiring foreign exchange registration:

- (a) foreign exchange registration in relation to special purpose vehicles ("**SPVs**") established by PRC-resident individuals (Section 1 of Circular 19);
- (b) foreign exchange registration in relation to newly-established foreign-invested enterprises ("**FIEs**") (Section 2 of Circular 19); and

- (c) foreign exchange registration in relation to overseas direct investments by entities in China (Section 3 of Circular 19). Notably where an outbound investment SPV originally not caught by Circular 75 applies to make an inbound investment in China, it then comes within the scope of regulation under Section 1 of Circular 19 as a round-tripping investment through an offshore SPV.

### 3. FOREIGN EXCHANGE REGISTRATION IN RELATION TO SPVS ESTABLISHED BY INDIVIDUAL PRC RESIDENTS

#### 3.1 General structure

Section 1 of Circular 19, which deals with foreign exchange registration in relation to SPVs established by PRC resident individuals covers the following areas:

- (a) Initial registration;
- (b) Changes to registered particulars;
- (c) Registration in relation to the establishment of SPVs, mergers and acquisitions by SPVs involving enterprises in China
- (d) Approval for recording income streams received by PRC resident individuals due to capital structure changes;
- (e) Cancellation of registration; and
- (f) Retrospective registration.

Unlike under Circular 106, the foreign exchange registration of SPVs receiving an injection of interests in overseas entities by PRC residents is not specifically addressed in Circular 19. In addition, the repatriation of funds and account-opening processes provided under Circular 106 are replaced by the approval for recording income received by PRC-resident individuals from capital changes. This makes the process for dealing with foreign exchange income from capital changes relating to SPVs consistent with that relating to other capital account income streams. The provisions on cancellation of registration are new. A comparison between Circular 106 and Circular 19 in respect of the documentary requirements for items (a), (b), (c) and (f) above is attached as Annex 1.

#### 3.2 Reiterating the PRC-Resident Individuals

Circular 19 repeats the definition of PRC-resident individuals/natural persons provided in Circular 106. In addition to natural persons who hold Chinese resident identity

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cards, passports or other lawful identity certificates, PRC-resident individuals also captures "natural persons who do not have any lawful identity documents issued by China but habitually reside in China due to economic interests". These mainly fall into the following three categories:

- (a) Natural persons who have permanent accommodation available inside China, who leave such accommodation due to reasons such as overseas trips, study, medical treatment, work and requirements imposed by rights of abode in foreign countries, but will return to the permanent accommodation after the reasons mentioned above have disappeared;
- (b) Natural persons who hold the domestic (Chinese) interests in enterprises in China; or
- (c) Natural persons who previously held the domestic (Chinese) interests in enterprises in China, and still are the ultimate owner of such interests although the underlying interests have been transformed into foreign-owned interests.

Paragraph (a) of the test in particular seems to be aimed at foreigners who own or lease property in China, whilst (b) and (c) appear to capture Chinese nationals who are entrepreneurs with ongoing interests in enterprises in China who now hold foreign passports, but in the case of (b) may still be registered as the PRC (domestic) shareholder in an enterprise in China. Item (c) seems to capture individuals who were PRC shareholders in an enterprise in China, but have since modified their status to foreign shareholder (presumably on obtaining a foreign passport) perhaps through a layer of offshore investment vehicles. This may be an attempt to prevent PRC individuals claiming they are exempt from registration simply by obtaining a foreign passport whether or not they re-register as a foreign investor in the PRC entity.

### 3.3 Major Changes Relating to the Initial Registration

#### (a) 3-year Operation Requirement Eliminated

Though Circular 75 is silent on the issue, Circular 106 requires the underlying domestic enterprise in which a PRC resident has equity interests or which he/she controls to have been operating for at least three years before the individual PRC resident can apply for SPV foreign exchange registration. Circular 19 de facto eliminates this requirement by accepting applications for initial registration of an overseas SPV while the PRC enterprise has yet to be established. This enlarges the pool of Chinese start-up companies in which foreign investors can make overseas investments where SAFE registration is an investor requirement.

#### (b) Timing for Initial Registration Clarified

Circular 75 requires initial SAFE registration by the individual to be carried out prior to the establishment of the SPV.

Section 1 of Circular 19 provides that an application for registration may be submitted after the SPV is established, but material capital or equity changes including financings, equity changes or round-tripping investments are only allowed to take place after completion of SAFE registration.

Based on our previous experience before the issue of Circular 19, SAFE normally required the SPV's incorporation documents to be submitted as part of the initial registration process. Thus it remains to be seen, whether in the course of implementation of Circular 19, SAFE will modify its operational requirements and start to accept registration applications before the SPV is established.

### 3.4 Change of Registration - Burdens Reduced

Under Circular 75 and Circular 106, all material changes including capital increases or decreases, equity transfers or share swaps, mergers or splits, long-term equity or debt investments, or the granting of foreign-related security needed to be registered or record-filed within 30 days of the occurrence of the event in question.

Under Circular 19, amendment registration or record-filing is only required for material capital changes relating to the SPV, such as the SPV's financing plan changes, the establishment, or gaining of indirect control of an overseas company. The registration of all other changes can be carried out in a single combined filing during in the annual inspection of the FIE invested by the SPV. This is a positive development and will significantly reduce the burden on PRC-resident individuals in terms of avoiding the need for frequent applications to amend or record-file changes. However amendment registration must be carried out before a PRC resident receives funds in China from an SPV resulting from capital changes.

### 3.5 Retrospective Registration - Application Scope Further Expanded

Though Circular 75 did address the issue, the permitted scope of retrospective registration was narrowly defined as "any PRC residents or PRC legal entities that have established or gained control of SPVs and which have also completed a round-tripping investment prior to the promulgation of Circular 75 must carry out retrospective foreign exchange registration prior to March 31, 2006."

Circular 106 removes the deadline for retrospective registration by providing that an application for retrospective registration can be carried out after March 31, 2006 provided that the enterprise which is the object of the round-tripping investment ("**PRC Enterprise**") has not made any payments, such as profits, dividends, liquidation dividends, transfers of equity interest consideration, capital reduction proceeds, payments of principal and interest in relation to shareholders loans and the like to the offshore SPV during the period between April 21 2005 (the effective date of Circular 75) and

the date of application. If any of these types of payments has already been made, SAFE will only carry out retrospective registration after the PRC Enterprise and the actual controller have paid the fine for foreign exchange evasion in accordance with relevant stipulations on foreign exchange (i.e. 30% of the sums involved, based on the *Foreign Exchange Administrative Regulations* promulgated by the State Council and as revised on August 5, 2008).

Circular 19 clearly provides that retrospective registration applies to applications submitted by any PRC resident that has established or gained control of a SPV where that SPV has undergone material capital or equity changes (such as carrying out an offshore fundraising, share transfer or round-tripping investment back into China and so forth) prior to the application date. In the same way as Circular 106, it also provides that retrospective registration can only be carried out after payment of the fine for evading foreign exchange has been made.

Compared with Circular 75 and Circular 106, Circular 19 appears to have expanded the scope of retrospective registration application by allowing this not just in cases involving SPVs where a round-tripping investment has been completed, but also in cases where the SPV has been established but has not undergone certain capital-related changes (or even where it has, as long as the corresponding fine is paid). Furthermore, the required application materials include, among other things, a special audit report stating whether the PRC Enterprise has made any payments to the SPV during the period between April 21, 2005 and the date of application, which is not required under Circular 106.

#### 4. LINK WITH OVERSEAS INVESTMENT FOREIGN EXCHANGE REGISTRATION

Unlike Circular 106, Circular 19 distinguishes between foreign exchange registration of SPVs established by PRC-resident individuals and those established by PRC-resident entities. The former are covered by a separate regime under Section 1 of Circular 19, but the latter are now covered under the current overseas investment registration regime set out in Section 3 of Circular 19. This seems to be logical and sensible.

From our reading of Circular 19, the major difference between the two appears to be that the former does not require project approval from the Ministry of Commerce, but the latter will require such approval. In addition, the retrospective registration requirement (discussed above) only applies to the former but not to the latter.

#### 5. LINK WITH FIE FOREIGN EXCHANGE REGISTRATION

Circular 19 also attempts to link SPV foreign exchange registration with the foreign exchange registration system applicable to FIEs generally, by including the following notable changes to the previous rules in Section 2 of Circular 19.

First, foreign exchange registration for the establishment of FIEs or mergers/acquisitions of enterprises in China involving SPVs (within the statutory definition) is referenced in Section 2 of Circular 19, but is considered as an exception to the general foreign exchange registration rules applicable to FIE establishment or mergers/acquisitions of enterprises in China by foreign investors.

Second, when a FIE applies for a foreign exchange registration certificate, SAFE local branches are required to include a remark about whether or not the FIE is a "SPV round-tripping investment" in its internal foreign direct investment foreign exchange administration system.

Third, if an FIE is established by a SPV (within the definition under Circular 19 above), any further changes to its foreign exchange registration certificate will require the submission of the SPV foreign exchange registration. Previously, this was not required (SAFE would, however, have checked internally whether SPV registration had been carried out).

Section 2 of Circular 19 also combines the foreign exchange registration procedures for foreign-invested real estate enterprises ("**FIREEs**") with those applicable to FIEs generally. The requirement for minimum total investment for a FIREE of no less than US\$10 million (with the registered capital being no less than 50% of the total investment (i.e. the 1:1 debt-equity ratio as prescribed under Circular 171<sup>1</sup>)) remains unchanged.

#### 6. CONCLUSION

Although the title of Circular 19 appears on the face of it to be solely concerned with the foreign exchange administration of company financings and round tripping investments via SPVs by PRC residents, in fact Circular 19's scope is much wider, covering foreign exchange registration in relation to newly-established FIEs and overseas direct investments by PRC entities. Because of the broad definition of "PRC resident", it also potentially captures many foreigners who are long-term residents in China, but query how easy it will be enforce against such foreigners in practice (who have ready access to

<sup>1</sup> *The Opinions on the Administration of Foreign Investors in Accessing the Real Estate Market* as promulgated by the Ministry of Construction, the Ministry of Commerce, the National Reform and Development Commission, the People's Bank of China, the State Administration for Industry and Commerce, and SAFE on 11 July 2006.

offshore funds and bank accounts and hence can easily circumvent the need to convert RMB into foreign exchange). It also remains to be seen whether local SAFEs actually agree to register foreign shareholders in SPVs under Circular 19, as in our experience they have refused to do so in the past.

It is clearly stated that Circular 19 shall supersede the *Operational Rules concerning Foreign Exchange Administration of Capital Item (2009 version)* with respect to any foreign exchange registration or approval matters concerning FIEs to the extent of any inconsistency between the two. Nonetheless, it does not specify the exact relationship between the Circular 19 and Circular 106, hence it is not clear how other differences between the two circulars should be addressed, although presumably the usual rule of interpretation that the "new replaces the old" still holds good.

Perhaps the main positive developments brought about by Circular 19 are rationalisation of the overall regime, simplification of the burdens on individual PRC residents in terms of notifying certain changes and opening up the gates for another "wave" of retrospective regularisation of non-registered SPVs engaging in round-tripping investments in China. However given the fact that heavy fines will have to be paid where payments have already been made in order to secure SAFE registration, some of the previous defaulters may hesitate before making a move in this direction, especially if the money involved has already been spent or re-deployed elsewhere.

*Please refer to the separate document for the comparison between Circular 106 and Circular 19 in respect of documentary requirements.*

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