

New SAFE Circular Re-Opens Door for Venture Capital and Private Equity Investment

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The State Administration of Foreign Exchange (the “SAFE”) promulgated *Circular on Issues Relating to Foreign Exchange Administration of Equity Financings and Return Investments by Domestic Residents through Offshore Special Purpose Vehicles* (“Circular 75” or the “Circular”) on October 21, 2005, which legalizes, and further regulates, the offshore holding company structure favored by private enterprises in their offshore fundraising activities with a view toward channeling foreign venture capital and private equity investments back into China’s private sector. Circular 75 took effect on November 1, 2005.

Background

Prior to the promulgation of Circular 75, the SAFE had successively issued Circulars 11¹ and 29² on January 24, 2005 and April 8, 2005, respectively (collectively, the “Previous Circulars”), which have since become household names in foreign investment circles in China. While they appeared to be aimed at curtailing corruption in the disposition of state-owned assets and strengthening the enforcement of China’s personal income tax laws, the Previous Circulars have put a de facto freeze on the fundraising activities of private enterprises in China. Under the Previous Circulars, any PRC resident who wishes to hold equity interests in an offshore entity must apply for approval by the SAFE, which approval, being a requirement for the establishment of a domestic operating subsidiary of such offshore entity, has never or rarely been granted. For the bulk of 2005 venture capital and private equity investment into China dwindled and statistics have shown that foreign direct investment was adversely affected as a significant portion of it is through venture financing using the offshore holding company structure. Circular 75 came after numerous exchanges between various government agencies (the SAFE, in particular) and researcher, commentators and practitioners and represent a constructive step taken by the government in correcting the over-inclusiveness of the Previous Circulars and providing a legal channel for private individuals and enterprises in China to raise funding from overseas investors.

Circular 75 is said to be an achievement of legislative sponsors’ efforts to reinvigorate China domestic individuals’ offshore investment by superseding Circular 11 and Circular 29. The changes in Circular 75 offer a critical

¹ *Circular on Issues Relating to Improving the Administration of Foreign Exchange in Mergers and Acquisitions by Foreign Investors* (国家外汇管理局关于完善外资并购外汇管理有关问题的通知) promulgated on January 24, 2005 by SAFE.

² *Circular on Issues Relating to Registration by Domestic Individual Residents of Offshore investment and the Foreign Exchange Registration of Mergers and Acquisitions Involving Foreign Investors*(国家外汇管理局关于境内居民个人境外投资登记及外资并购外汇登记有关问题的通知) promulgated on April 8, 2005 by SAFE.

improvement as of domestic individuals will be allowed officially and practically to do offshore investment and invest their earnings from the offshore investment back to China. This article will summarize (i) the procedures for PRC individuals to follow in order to raise funding from offshore investors through an offshore special purpose vehicle and (ii) certain significant characteristics of Circular 75 as well as its limitations.

Major Provisions

The core provision of Circular 75 is that it specifically permits domestic residents to establish or control offshore special purpose vehicles (“Offshore SPVs”) for the limited purposes of equity financing and return investment (i.e. investment of proceeds from such financing in the subsidiaries of such SPVs in China). We will examine the different elements of such core provisions as follows.

Who are Domestic Residents?

Under the Circular, domestic residents consist of domestic resident legal persons and domestic resident natural persons. Domestic resident legal person was defined under Circular 75 as an enterprise or institutional legal person or any other economic organization that is legally established in the People’s Republic of China (“PRC” or “China”). Given that *the Regulations on the Administration of Foreign Exchange for Overseas Investments* already expressly permits domestic enterprises to engage in overseas investment and that the vast majority of the beneficiaries of Circular 75 will likely choose to establish, control or invest in offshore entities as individuals for a number of reasons, we will examine the Circular as it applies to individuals instead of legal persons. A “domestic resident natural person” (hereinafter referred to as a “Domestic Individual”) is defined as either (i) a natural person who holds a resident identification certificate, passport or other lawful PRC identity document, or (ii) a natural person who, for reasons of economic interest, habitually resides in China but is not a PRC national.

Even though the term “domestic resident” appears in the Previous Circulars, Circular 75, for the first time, expressly defines the ambit of domestic resident natural persons by including both Chinese citizens and foreigners habitually residing in China. However, the term “habitually reside” still remains ambiguous without more definitive requirements for length or history of residence, such as those used in determining the taxable income of foreigners residing in China. What is clear is that PRC citizens residing outside China are domestic residents for the purposes of the Circular.

Who are the authorities in charge of registration?

SAFE branches and the foreign exchange administration departments in the provinces, autonomous regions and municipalities directly under central government where the Domestic Individuals reside, as well as the SAFE branches

in Shenzhen, Dalian, Qingdao, Xiamen and Ningbo (each, a “SAFE Branch”) are authorized to receive the registration application of the Domestic Individuals who intend to establish or control Offshore SPVs and any amendment thereafter to the registration documents if there is any.

What constitutes “control”?

Under Circular 75, “control” of an Offshore SPV or a domestic enterprise means obtaining the rights to manage, receive earnings from, or perform decision-making with respect to the affairs of, an Offshore SPV or a domestic enterprise, by way of acquisition, trust, proxy shareholding, voting rights, redemption of equity interest, issuance of convertible debt, etc. This rather broad definition encompasses many of the provisional arrangements currently in use which were adopted in response to the Previous Circulars.

What constitutes “equity financing” and “return investment”?

For any offshore investment by Domestic Individuals to be permitted under Circular 75, it has to satisfy two important conditions: (i) that the purpose of the Offshore SPV has to be equity financing and (ii) that the proceeds from such equity financing have to be for return investment. The Circular further specifies that equity financing will include convertible debt financing but does not further explain what qualifies as equity financing or convertible debt financing. Such terms, while widely used by industry practitioners, can have differing meanings. For instance, preferred stock with broad redemption rights and fixed return rates can be more similar to debt than to equity. It is implied in the Circular (and consistent with the notion of SPV) that the offshore financing will be on the basis of the equity interests held by the Domestic Individuals in domestic enterprises or the assets of domestic enterprises controlled by such Domestic Individuals.

Return investment refers to direct investment activities conducted by Domestic Individuals through an Offshore SPV, which may include the following: (i) the purchase or exchange of equity interests in domestic enterprises; (ii) the establishment of new foreign-invested enterprises (“FIEs”) to purchase or control domestic assets; (iii) the purchase of domestic assets and the subsequent investment of such assets in a newly established FIE; and (iv) increase of the registered capital of domestic enterprises. In other words, proceeds from the offshore financing must be invested back into China.

How to register an offshore investment?

Domestic Individuals who intend to establish or control an Offshore SPV must submit certain application documents to a competent SAFE Branch for the offshore investment foreign exchange registration (“Offshore Registration”). The application documents include: (i) a written application providing a details of the domestic enterprise or enterprises, the equity structure of the Offshore SPV and the planned

offshore financing arrangements; (ii) the identification documents of the Domestic Individuals; (iii) the business plan for the offshore financing; (iv) the examination and approval documents for offshore investment issued by the Ministry of Commerce or its provincial level branches (“MOC Approval”) and verification of source of foreign exchange in the case of domestic legal persons; (v) the *Foreign Exchange Registration Form of Offshore Investment by Domestic Individuals* (“Registration Form”) completed by Domestic Individuals; and (vi) other authentication documents. It should be noted that information on the direct and indirect shareholding of Domestic Individuals in the Offshore SPV is required on the application form.

Given that the MOC Approval requirement only applies to domestic legal persons, consistent with the fact that the *Regulations on Approving Matters involving Offshore Investment in way of Establishing Enterprises*³ applies only to domestic enterprises, it appears that offshore investment registration by Domestic Individuals will only involve SAFE and not the Ministry of Commerce. What may be relevant is the *Administrative Licensing Law*⁴, which must be observed by all governmental agencies, including SAFE.

When and how should Offshore Registration be amended?

In following situations, Domestic Individuals must amend their Offshore Registration with respect to any change to their rights in the net assets or equity interests in the Offshore SPV: (a) at the completion of investing assets or equity interests in a domestic enterprise into an Offshore SPV and/or the subsequent completion of equity financing involving the Offshore SPV, and (b) upon a material change in the Offshore SPV that does not involve any return investment, such as an increase or decrease in capital, a transfer or exchange of shares, a business combination or divestment, long term equity or debt investment or extension of guarantees.

For any change involving return investment described in (a) above, the Domestic Individual must submit the following documents: (i) a written application providing a detailed description of any changes in the shareholders and equity of the domestic enterprise and the Offshore SPV and the methods for valuing the assets or equity of the domestic enterprise and the Offshore SPV; (ii) the Registration Form completed by the Domestic Individual; (iii) the examination and approval documents or registration certificates regarding the Return Investment issued by the MOC or its local branches (“Return Investment Approval”); (iv) where state-owned assets are involved, confirmation documents issued by the State-owned Assets Supervision and Administration Commission or its local branches regarding the value of the

³ Issued by the Ministry of Commerce on October 1, 2004 and became effective on the same day.

⁴ Effective from July 1, 2004. Article 42 provide that government agencies should make their decisions within 20 days since they accept the application and such period may be extended for another 10 days subject to the approval of the chief in case of complicated circumstances.

assets or equity of the domestic enterprise; (v) the registration document and business license of the Offshore SPV; and (vi) other authentication documents.

It should be noted that the regulation governing the issuance of the Return Investment Approval in the case of contributing equity interests in a domestic enterprise into an offshore entity in exchange for shares in the offshore entity (or a “share swap”) is still in the process of being drafted. In absence of such approval, return investment will have to take the form of an asset transfer for the time being.

What are the requirements on capital flow?

Upon completion of offshore financing, proceeds from the financing may be remitted back into China in accordance with the business plan of the Offshore SPV. After the completion of Offshore Registration and any required amendments thereto, funds may be repatriated to the Offshore SPV in the form of profits, dividends, liquidation distribution, payment for transfer of shares and reduction of capital. Any receipt of foreign exchange by Domestic Individuals from the Offshore SPV through profit or dividend distribution or a change in capital must be remitted back into China within 180 days of receipt of such funds.

Observations

Legalizing Offshore SPV Structure

The most significant aspect of Circular 75 is permitting PRC residents to establish, control and hold shares in offshore holding companies for the purpose of conducting offshore fundraising, which reopens the door for domestic entrepreneurs and overseas venture capital and private equity investors which was effectively closed by the Previous Circulars. The Circular quietly recognizes the legitimacy of such offshore holding company structure and further regulates, or at least provides guidelines for regulating, such practice. The positive tone of the Circular is also evident in Article 8, which retroactively grants SPVs established prior to November 1, 2005 an extension period to bring them into compliance with the Circular. It is encouraging to see that the SAFE, as a governmental agency, can heed public sentiments regarding specific areas of legislation and take concrete steps in remedying past oversight and lack of sophistication. While the Circular is imperfect in numerous areas, its positive effects will nevertheless be long-lasting ones.

Narrowly Defined Scope

It must be noted that the scope of applicability of Circular 75 is narrowly defined. In order to be able to register his or her equity interests in an offshore entity, the PRC resident must indicate and substantiate the purpose of the application to the SAFE as for offshore equity financing and return investment, which mean at least part of the proceeds from the financing must be channeled back into China. It is doubtful that a straightforward acquisition of a PRC entity by an offshore SPV (either in

cash or through share exchange) will be approved. On its face, the Circular is a stringent one: it even requires a business plan for the stated financing purpose. However, this requirement can be implemented and enforced remains to be seen. By definition, an offshore SPV must be formed first in order for the financing to be consummated. It will be interesting to know whether the approval will be subsequently nullified if the proposed financing does not materialize.

Burdensome Monitoring and Filing Requirements

The Circular provides for a number of monitoring and filing requirements which appear excessive yet may at times be difficult to implement or enforce. The Circular provides that any major changes relating to the offshore SPV must be filed with the SAFE within 30 days of such changes. “Major changes” include increase or decrease of capital (hopefully it means issued capital), transfer or exchange of equity interests, business combinations or separations, incurrence of long-term equity or debt investments (the term “long-term equity investment” is not defined in the Circular) and extensions of third-party guarantees. Such provisions in Circular 75 appear to aim at extending control over PRC residents and their equity interests and rights to distribution arising from such equity interests; however, if actually implemented and enforced, such requirements would impose substantial burden on the PRC residents, on the one hand, and dampen investor interest in the SPV, on the other hand. For example, a successful offshore SPV will, by definition, have an increasing number of shareholders, many of which will not be subject to Circular 75 (or any other PRC law or regulation, for that matter). Imagine how much work will be involved if all “major changes” will have to be reported by the PRC resident shareholders in the SPV. By the same token, non-PRC resident shareholders in the SPV will likely raise issues with their PRC resident counterparts disclosing information relating to an offshore private entity to the Chinese government.

Foreign Exchange Control Measures

Similar to the monitoring and filing requirement, the Circular also imposes seemingly stringent requirements on the flow of foreign exchange. Article 4 provides that proceeds, or portions of the proceeds, from the offshore financing must be remitted into China according to the plan for the use of proceeds contained in the business plan for the financing. In addition, the Circular provides that all profits, dividends and other distribution from disposition of equity in the offshore SPV received by the PRC resident shareholders must be repatriated to China within 180 days of receipt. While stringent on their face, it is questionable how effectively such provisions can be enforced. That being said, it should be noted that Article 4 represents an improvement from a draft version of the Circular which effectively provided that all proceeds from the offshore financing be invested into China. At a minimum, the current Article 4 recognizes an offshore SPV may have operating subsidiaries outside China and may enter into various commercial transactions offshore. There is a slight indication that the Chinese government (or at least the

SAFE) may have started to realize that an offshore entity, by definition, is beyond its control.

Looking Ahead

It is said that Circular 75 was designed remove the de facto freeze on venture capital and private equity activities in China as well as potential overseas listings. In preparation for the anticipated possible mass applications by PRC resident individuals and enterprises planning for offshore financing, the SAFE has already trained officials in local branches on how to understand and implement Circular 75. Nonetheless, given its limitations and the lack of coordination among different governmental agencies involved in the same process, such as the Ministry of Commerce and the State Administration for Taxation, it remains to be seen whether Circular 75 will be successfully and timely implemented by the SAFE.