NEW CHANNEL OPENED FOR FLOWING-BACK OF OVERSEAS RENMINBI ("RMB")

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The People's Bank of China ("**PBOC**") issued the *Administrative Measures on RMB Settlement in Relation to Foreign Direct Investment* on October 14, 2011 **("PBOC Measures").** The same day, The Ministry of Commerce ("**MOFCOM**") issued the *Notice on Relevant Issues on Cross-Border RMB Direct Investment* ("**MOFCOM Notice**"), the draft of which was published for public consultation on August 22 this year ("**Draft MOFCOM Notice**").

The issuance of these two regulations is another large gesture from China on RMB policies following its cross-border RMB trade settlement scheme and overseas RMB investment scheme. Pursuant to the *PBOC Circular on Clarification of Matters Relating to Cross-Border RMB Business* issued on June 3, 2011 ("**PBOC Circular 145**") and the *MOFCOM Circular on Matters Relating to Foreign Investment Administration Work* issued on February 25, 2011, approval of RMB-denominated foreign direct investments ("**FDI**"), on a case-by-case basis, began in early 2011. The two new regulations have unified the rules for such approval with the intention to further reduce pressure on China's increasing foreign exchange reserves and increase liquidation of overseas RMB by allowing its flowing back into China.

In general, the MOFCOM Notice focused on the approval of RMB-denominated FDI projects, while the PBOC Measures focused on the opening of RMB accounts for such projects and subsequent supervision of the use of such RMB funds. This alert summarizes the major issues relating to the two new regulations and their potential impact on foreign investment in China.

1. SOURCES OF OVERSEAS RMB

According to the MOFCOM Notice, the following types of RMB funds can be used in FDI projects:

1.1 RMB Payments from International Trade

In 2009, China introduced the cross-border RMB trade settlement scheme. In June 2010, the cross-border RMB trade settlement scheme was expanded from a limited scope of trade transactions, between five mainland cities and economies in the Association of Southeast Asian Nations, to transactions between 20 mainland cities or provinces and the rest of the world.

Due to promotion of the usage of RMB in international trade since early 2010, the Hong Kong RMB market has grown significantly, with RMB-denominated deposits reaching RMB 310bn (USD 48bn) by the end of 2010, representing a dramatic increase from RMB 62bn (USD9bn) just a year before[1]. Endorsement of RMB payments in international trade for FDI is therefore unsurprising.

1.2 Proceeds from Offshore Issuance of RMB-Denominated Bonds or Stocks

Beginning July 2010, Hong Kong banks were allowed to issue RMB bonds, commonly known as "Dim Sum Bonds". By the end of 2010, 50 offshore RMB-denominated bonds had been issued in Hong Kong raising RMB 35.7bn (USD5.5bn)[2]. Hui Xian REIT, the world's first RMB-denominated Real Estate Investment Trust sold outside of China, raised close to RMB 11.16bn (US 1.7 bn) in its initial public offering in Hong Kong. These two new regulations provide an important channel allowing RMB proceeds raised in Hong Kong to flow back into China.

1.3 RMB Profits or Proceeds from Existing FDI Projects

Reinvestment by foreign investors with post-tax RMB profits or RMB proceeds of equity transfer, capital reduction, liquidation, and advanced investment return from existing FDI projects, have long been encouraged by the Chinese government. Before the issuance of the two new regulations, this was the major form of RMB investment by foreign investors.

It should be noted that according to Article 12 and Article 13 of the PBOC Measures, foreign investment enterprises ("**FIE**") may remit RMB profits or proceeds to the offshore RMB accounts of foreign investors; Article 14 provides that foreign investors may also deposit such RMB profits or proceeds in a special RMB account for reinvestment.

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1 http://www.anz.com/.../AsiaSocietyRMBHandbook.pdf retrieved on Oct 24, 2011

2 Ditto

2. INFLUENCE ON FDI PROJECTS

According to both the PBOC Measures and the MOFCOM Notice, RMB-denominated FDI may take the form of a greenfield investment to establish a new FIE, a capital increase to an existing FIE, or an acquisition of equity interests of an existing FIE or purely domestic company. The PBOC Measures provide that a special RMB deposit account shall be opened for each type of the above-mentioned FDI, but no cash transactions are allowed through such special RMB account.

The following areas will be impacted by the two new regulations.

2.1 Foreign Invested RMB Fund

According to the PROC Measures and the MOFCOM Notice, equity investment vehicles (such as foreign invested investment companies), foreign invested venture capital investment companies, and foreign invested equity investment enterprises, can be capitalized in RMB. According to Article 15 of the PBOC Measures, it appears that foreign invested partnerships may also be capitalized in RMB, despite MOFCOM's lack of jurisdiction over such foreign invested partnerships.

Under the control of the *State Administration of Foreign Exchange Circular on Relevant Business Operation Issues concerning Improving the Administration of the Payment and Conversion of Foreign Exchange Capital of Foreign-invested Enterprises* dated and effective 29 August 2008 ("**SAFE Circular 142**"), foreign private equity funds have been unable to convert their foreign currency funds into RMB and this foreign exchange issue is a major obstacle for foreign private equity funds to carry out business in China. In this regard, there appears to be no practical solution, with the exception of the Shanghai pilot qualified foreign limited partner scheme, which allows certain qualified private equity funds to convert foreign exchange into RMB within a pre-fixed quota.

Pursuant to the two new regulations, foreign private equity funds may consider setting up RMB-denominated private equity funds using RMB profits from existing FDI projects or from proceeds gained by issuing RMB bonds or stocks in Hong Kong. Please note, however, the establishment of the above-mentioned RMB-denominated equity investment vehicles must be approved by the central level MOFCOM.

After the fund is set up, according to Article 15 of the PBOC Measures, the target company to be invested by the foreign RMB fund shall open a special RMB capital deposit account to receive the RMB capital contribution.

2.2 Investment in Real Estate Projects

The two new regulations do not prohibit investment of overseas RMB in real estate projects. Foreign invested real estate enterprises have been unable to borrow foreign debts since July 2007, pursuant the *Circular Concerning the Distribution of the List of the First Foreign-Funded Real Estate Projects Having Passed the Procedures for the Record of the Ministry of Commerce* issued by *the General Affairs Department of SAFE* on July 10, 2007. Article 17 of the PBOC Measures included cross-border RMB loans as foreign debt by providing that RMB loans shall also be taken into account within a FIE's foreign debt quota. Thus, the foreign debt restriction policy in the real estate sector will apply to cross-border RMB loans.

However, foreign invested real estate enterprises recorded with MOFCOM may consider financing their real estate projects in China with offshore RMB through capital increase. Such capital increase will still be subject to MOFCOM approval. Domestic real estate developers are unquestionably interested in financing overseas RMB by issuing RMB bonds or stocks in Hong Kong.

2.3 RMB-Denominated Cross-Border Acquisitions

It is worth noting that the PBOC Measures provide that in a typical cross-border acquisition, the Chinese seller may open a special RMB deposit account to receive RMB-denominated payment of the purchase price for such cross-border acquisition.

Previously, pursuant to the SAFE Circular 142, a Chinese seller must open a special asset transfer foreign exchange account to receive the purchase price in foreign currency. Because of the rapid increase of China's foreign exchange reserves, in practice it has been very difficult for Chinese sellers to convert foreign exchange into RMB, thereby forcing the parties of a cross-border acquisition to devote large amounts of time toward allocation of foreign exchange risks. Now, however, if the foreign investor holds sufficient RMB obtained in three ways as discussed above in Section 1, the parties may consider agreeing on RMB as the governing currency for the purchase price.

3. PROHIBITED USE OF RMB INVESTMENT

According to the MOFCOM Notice, cross-border RMB FDI into China must not be used to invest in securities or financial derivative products - directly or indirectly (except investment in the stock market as a foreign strategic investor), or to arrange entrustment loans (referring to inter-company financing arrangements with the participation of commercial banks).

The Draft MOFCOM Notice originally prohibited the use of overseas RMB to repay onshore or offshore debts. However, the official MOFCOM Notice removed such a restriction. This may simply be because MOFCOM does not want to intervene in the regulatory jurisdictions of PBOC and SAFE, and the MOFCOM Notice does not intend for repayment of onshore or offshore debts to be permitted.

4. RMB FOREIGN DEBTS

Under PBOC Circular 145, an FIE is no longer required to obtain PBOC approval prior to borrowing RMB loans. According to Article 17 of the PBOC Measures, an FIE may borrow RMB loans from its overseas shareholders, affiliates and financial institutions, but such loans shall be calculated together with foreign currency loans as its foreign debt, which cannot exceed the difference between its registered capital and total investment as approved by respective governmental authorities.

Under the current SAFE regulations, foreign debt borrowed by a Chinese company may not be used to repay its onshore and offshore RMB debts. As stated below, the PBOC Measures have not changed the existing FDI rules, which means this restriction should continue to apply.

Under the PBOC Measures, FIE borrowers may use their RMB income to repay such RMB loans directly through banks by providing certain documents (e.g. loan agreement, payment instruction, and tax clearance certification).

5. NEW PROCEDURES FOR RMB-DENOMINATED FDI PROJECTS

Neither the MOFCOM Notice nor the PBOC Measures attempt to change existing rules on the approval process with respect to the FDI projects. Article 3 of the PBOC Notice provides that RMB-denominated FDI projects must comply with existing Chinese FDI laws and regulations. Even for reinvestment of the FIEs formed in RMB-denominated investments, Article 3 of the MOFCOM Notice provides that it must comply with FDI laws, regulations or rules, as well as industrial policies on foreign investment, cross-border merger and acquisition security investigation rules, and anti-monopoly investigation rules. In addition, the following additional procedures are required:

5.1 MOFCOM Approval

Central MOFCOM approval is required for RMB investments into China under the following circumstances:

(a) the investment in RMB is RMB 300 million or more;

(b) the investment will be made into sectors of financing security, finance leasing, small amount credit loans or auction;

(c) the companies to be invested are foreign-invested investment companies, foreign-invested venture capital or equity investment enterprises; or

(d) the investment will be made into industries subject to government macro-control, such as cement, steel, electrolytic aluminium and ship building.

Other than the above, the current regulations governing allocation of approval authorities between central MOFCOM and its local counterparts continue to apply.

In addition to documents normally required in a FDI project, the following additional documents will be required by the competent MOFCOM local branches:

(a) proof or statement on the source of the RMB fund;

(b) statement discussing how the RMB fund will be used;

(c) Statement Form regarding the Cross-Border RMB Direct Investment (formulated by the MOFCOM); and

(d) where applying to change the currency of investment from foreign currency to RMB, a shareholder/board resolution and the amended joint venture contract and/or articles of association are also required.

5.2 PBOC Information Registration

Within 10 days upon receiving its business licence, an FIE formed in an RMB-denominated investment is required to register the company information with the local branches of PBOC. Where there is a change with the FIE's name, operation term, capital contribution method, or in case of a joint venture, the legal form or the JV partners, or in the event of any capital increase or reduction, equity transfer or swap, merger and acquisition or division, the FIE shall report to the PROC branch such changes within 15 days of the changes. Although the registration appears onerous, this repeals the requirement under an earlier PBOC notice in June this year that PBOC approval would be required for any RMB-denominated FDI projects.

5.3 SAFE's Roles

The PBOC Measures require Chinese banks to closely watch the direction RMB funds in RMB-denominated investments flow. They have not mentioned SAFE's roles in this scheme. Pursuant to the SAFE *Circular on Matters Concerning Regulating the Operation of Cross-Border RMB Capital Account Business* issued on April 7, 2011, Chinese banks are also subject to the supervision of SAFE when dealing with RMB FDI projects, for example, banks are required to file for recordal with SAFE any RMB account transactions relevant to FDI by entering relevant data in an online system controlled/shared with SAFE.

In addition, an FIE set up in a pure RMB-denominated FDI (i.e., where there is no involvement of foreign currency) is still required to do the foreign enterprise foreign exchange registration. The verification of the capital contribution to an FIE in RMB can only be done with relevant proof issued by SAFE.

In practice, it may take some time for PBOC and SAFE to consolidate the new rules with previous requirements and clarify SAFE's roles in this new FDI scheme.

6. CONCLUSION

Although the two new regulations were issued by the Chinese government to achieve various political and economic goals under current tough international financial circumstances, these latest regulations provide a new channel for foreign investment.

Notably, however, the Chinese government is allowing this in-flow of overseas RMB in the form of FDI under strict scrutiny. As usual, when a new set of rules are being established, there will always be problems with the interactions of different Chinese government departments and conflicts between the existing rules and the new rules. Considering the above information, and the anticipated appreciation of RMB in the near future, it may be difficult for foreign investors to decide whether to hold RMB and wait for its appreciation or to make investments now.

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