

SAFE amends regime in regulating roundtrip investments

The State Administration of Foreign Exchange has just issued Circular 37 to introduce important changes to the regime governing roundtrip investments. The changes clarify the application of the regime and simplify administrative procedures, and are aimed to encourage Chinese enterprises to "go abroad" and facilitate domestic residents in seeking financing in the global market. This briefing compares the new regulatory requirements with the old, and discusses the impact brought about by the change.

Background

Chinese enterprises have always shown a keen interest in offshore restructuring as it provides the flexibility of tapping funds with less Chinese regulatory interference. Accordingly, Chinese enterprises have long used roundtrip investments as a common avenue to seek overseas private equity financing or public offerings.

In order to regulate roundtrip investments, various ministries in China have issued important regulations in the last decade, most notably Circular 75 whereby the State Administration of Foreign Exchange (SAFE) imposed stringent measures in 2005 over the formation of special purpose vehicles (SPVs) by domestic residents, their transfer of assets and equity to the SPVs and remittance of profits back to China. The *Provisions on Takeover of Domestic Enterprises by Foreign Investors (M&A Rules)* issued by the Ministry of Commerce (MOC) in 2006 further required roundtrip investments to be approved by the central government.

Over the years, the above restrictions have made the implementation of roundtrip investments difficult. The conservative approach taken by SAFE (both at central and local levels) in implementing Circular 75 had rendered the registration procedures into a *de facto* approval requirement. With a view to remove the stagnancy and to facilitate domestic residents in seeking financing in the global market so as to support the State policy of "going abroad", SAFE has released a clearer and more flexible rule on 14 July 2014 to regulate roundtrip investments. The new rule, namely the *Notice on Issues Relating to the Administration of Foreign Exchange in Offshore Fund-raising and Investments and Roundtrip Investments Conducted via Offshore Special Purpose Vehicles by Onshore Residents* (Hui Fa [2014] No.37), (Circular 37), further comprises operational guidelines to clarify the scope of regulatory supervision and to streamline administrative procedures.

Key changes introduced by Circular 37

Circular 37 took effect as from 4 July 2014 to replace Circular 75 in its entirety. The changes introduced by Circular 37 are significant in that they have expanded and clarified key definitions and procedures that have an important bearing on roundtrip investments. The main differences between the two circulars (which are underlined) and our observations of their impact of the changes are set out below.

Aspects	Circular 37	Outgoing Circular 75
Definition of "onshore individual residents"	Chinese citizens with Chinese identity cards, <u>military identity cards or armed police identity cards</u> , or offshore individuals without any of these identity cards but who habitually reside in China due to economic relationships.	Individuals holding legal identification documents of the PRC, including identity cards or passports, etc., and individuals who do not have legitimate PRC identity but habitually reside in China due to economic relationships
Definition of "SPVs"	Offshore enterprises directly established or indirectly controlled by onshore residents (including both onshore <u>institutions</u> and onshore <u>individual residents</u>), using assets or interests in onshore enterprises <u>or offshore assets or interests</u> in their legitimate possession for the purpose of <u>investment and/or</u> fund-raising.	Offshore enterprises directly established or indirectly controlled by onshore legal person residents or onshore natural person residents, using assets or interests in onshore enterprises in their possession for the purpose of offshore equity fund-raising (including fund raising via convertible bonds).
<p>Observations:</p> <p>Under the new definition, an onshore resident can now use its offshore assets or interests to establish or control an SPV. Therefore, an onshore resident is no longer required to have any onshore assets or enterprise before it is able to file for SAFE registration under Circular 37. That said, how SAFE defines "legitimately-owned offshore assets or interests" in practice is yet to be observed.</p> <p>Further, adding "investment" to the purposes of the SPVs appears to fill the previous regulatory vacuum regarding outbound investments by onshore individual residents. Previously, in an outbound investment context, SAFE would usually only effect foreign exchange conversion and cross-border remittance of funds by an onshore resident after the outbound investment is approved by the National Development and Reform Commission and the Ministry of Commerce, but the outbound investment regimes previously only addressed outbound investments by onshore legal persons and not individuals. This revision in Circular 37 may provide a legitimate channel for an onshore individual resident to make outbound investment by completing the requisite SAFE registrations going forward.</p>		
Definition of "roundtrip investment"	Direct investment activities onshore by onshore residents via the SPVs (directly or indirectly) <u>i.e., to establish foreign-invested enterprises or projects by way of new establishment or acquisition and to obtain the right of ownership, right of control, right of management and other rights and interests.</u>	Direct investment activities onshore conducted by onshore residents via SPVs, which activities include, without limitation, to acquire or swap a PRC shareholder's shareholding in an onshore enterprise, to establish a foreign-invested entity and purchase (or control via contractual arrangements) onshore assets through such foreign-invested entity, and to purchase onshore assets via contractual arrangements and establish a foreign-invested entity (or subscribe for capital increase in a domestic entity) using such purchased onshore assets.
<p>Observations:</p> <p>This simplified definition offers more certainty on the scope of a roundtrip investment, and makes it clear that roundtrip investment by way of "VIE structures" are captured under the SAFE registration requirements.</p>		

Aspects	Circular 37	Outgoing Circular 75
Legitimate source of funding	Apart from offshore equity fund-raising, funding may also be sourced from (i) onshore enterprises that are directly or indirectly controlled by the onshore resident so long as such funding is based on true and reasonable needs, and (ii) from an onshore resident using its onshore or offshore assets or interests legitimately owned by such onshore resident. Specifically, an onshore resident may use the foreign exchange it has purchased legitimately onshore if there is a true and reasonable need for the SPV's establishment, share redemption or privatization, etc.	The only legitimate source of funding for SPVs was offshore equity fund raising.
Registrability of equity incentive plans	For equity incentive plans granted by an SPV to the onshore resident directors, supervisors, senior management and other employees of the onshore enterprises directly or indirectly controlled by such SPV, the relevant onshore residents <u>may</u> conduct their SAFE registrations prior to exercising their rights under the equity incentive plans.	Silent on equity incentive plans granted by SPVs to the onshore resident employees of its onshore enterprises. Hence, it has been difficult for onshore residents to remit funds offshore when participating or exercising rights under such plans.
<p>Observations:</p> <p>The availability of SAFE registration under such circumstances would facilitate the adoption of equity incentive plans by Chinese companies with an offshore structure.</p>		
Timing to apply for registration of the SPV with the local SAFE	Before capital contribution is made to the SPV.	Before the establishment or acquisition of control of the SPV
<p>Observations:</p> <p>It now appears that Circular 37 allows for the registration to be conducted <u>after</u> the establishment of the SPV. In practice, even under the Circular 75 regime, onshore residents typically did not conduct registration until the SPV proposes to make an onshore investment or raise funding from offshore. Such change in Circular 37 seems to be in line with such practice.</p>		
Filing of amendment registration	Filing must be made " <u>promptly after the onshore resident has effected a capital increase, capital reduction, share transfer or exchange, merger, division and other material changes</u> ".	An amendment registration was required <u>within 30 days</u> after a material change took place with respect to <u>the SPV</u> .
<p>Observations:</p> <p>In addition to softening the 30-day registration timeline, on a literal reading, such change also seems to indicate that a third party's investment into such an SPV may not necessarily require SAFE registration if such investment does not constitute a capital increase or share transfer on part of the onshore resident.</p>		
Remittance of profits into China	The requirement under Circular 75 has been removed	Onshore residents must remit any profit, dividends or proceeds received from share capital changes in the SPVs within 180 days of receipt.

Aspects	Circular 37	Outgoing Circular 75
Possibility of supplemental registration	Procedurally possible for those onshore residents who have contributed their onshore or offshore assets or interests to its offshore SPV but had failed to register with SAFE.	The window for making applications for supplementary registrations under the Circular 75 regime had been largely closed in practice.
<p><u>Observations:</u></p> <p>This indicates that SAFE may be opening the door for supplementary registrations for applicants that had not filed for SAFE registration timely.</p>		

Conclusion

Circular 37 has introduced some significant revisions to its predecessor Circular 75. It expands the definition of SPVs, and allows Chinese residents to set up SPVs using either its onshore or offshore assets. Chinese individuals may now even purchase foreign exchange onshore to engage in direct outbound investment. These relaxations are likely to facilitate an increased flow of funds in and outside of China, and could encourage Chinese companies and individuals to participate in the global financial market.

However, as SAFE has traditionally exercised a high level of discretion in interpreting and enforcing its regulations, and that the practice of SAFE's branches may vary from place to place, it remains to be seen how the provisions of Circular 37 will be interpreted and implemented in practice.

Furthermore, even though Circular 37 relaxes the foreign exchange registration procedures for roundtrip investments, other hurdles remain in terms of structuring roundtrip investments, including the limitations on roundtrip investments under the M&A Rules.

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