

# China Legal Briefing\* 243

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## **1. China's New Foreign Exchange Rules Reignite Overseas Financing and Round-Trip Investment**

On 14 July 2014, the State Administration of Foreign Exchange ("SAFE") of the People's Republic of China ("PRC" or "China") released Circular No. [2014]37 dated 4 July 2014 on *Notice of the State Administration of Foreign Exchange on the Administration of Foreign Exchange Involved in Overseas Investment, Financing and Return on Investment Conducted by Residents in China via Special-Purpose Vehicles* ("Circular 37"), which superseded and repealed Circular No. [2005]75 ("Circular 75") previously issued by SAFE in October 2005.

The release of Circular 37 is viewed by many as a significant development in SAFE's evolving oversight of Chinese residents' overseas and round trip investments as well as SAFE's efforts to support China's "going global" strategy and to further facilitate cross-border capital transactions. Circular 37 re-defines certain key terms used in Circular 75, broadens the financing channel for SPV, expands the registration scope, simplifies certain registration procedures and clarifies relevant penalties, as more specifically described below.

### **1. Redefinition of Certain Key Terms**

#### **Special Purpose Vehicle (SPV)**

Circular 37 re-defines SPV as "the offshore enterprise directly established or indirectly controlled for the purpose of investment or financing by domestic residents (including domestic institutions and domestic resident individuals) with assets or interests in domestic enterprises legally held thereby, or with overseas assets or interests legally held thereby."

Compared with Circular 75, the definition of SPV in Circular 37 has two major differences:

- a) The purpose of an SPV is no longer restricted only to overseas financing (mainly for IPO or debt financing), and it appears that such SPV may also carry out alternative investment activities like cross-border acquisitions; and
- b) A Chinese resident can use overseas assets or interests to set up an SPV.

Unlike Circular 75, which more narrowly defined SPVs to focus on offshore financings for domestically owned assets, Circular 37 expands the scope of SPV to cover both return investments and overseas investments and financings. Whereas Circular 75 was less clear on this issue, Circular 37 seems to provide greater certainty that individuals will be able to set up an SPV for overseas investment and financing purposes, and not only for return investment purposes.

Additionally, under Circular 37, a domestic resident forming an SPV will be entitled to use legally held overseas assets and interests to capitalize such SPV, which also is a new development as compared to what was permitted under Circular 75. On the other hand, such changes to the SPV definition in effect expand the scope of foreign exchange registration, so that domestic residents (whether institution or individual) need to make the corresponding foreign exchange registration for setting up a SPV by utilizing either their onshore or offshore assets or interests, and whether the purpose of the SPV is for overseas investment, financing or return investment.

### **Domestic Residents**

Circular 37 applies to “domestic residents” which expressly includes “domestic institutions” and “domestic resident individuals”. Moreover, “domestic resident individuals” refers to “Chinese citizens holding mainland identity card, military identity documents or identity documents for Chinese armed police force, as well as overseas individuals who do not hold any mainland legal identity document, but have habitual residences within the territory of China for commercial reasons.”

The implementation guideline attached to Circular 37 further notes that an individual holding both PRC and overseas (including Hong Kong, Macau and Taiwan) legal identity documents will be treated as an overseas individual for the purpose of foreign exchange registration.

### **Return (or Round-Trip) Investment**

Circular 37 has revised the definition of “Return (or Round-Trip) Investment” as “the direct investment activities directly or indirectly carried out onshore by domestic residents through SPVs, namely the activities whereby domestic residents establish foreign-invested enterprises or projects onshore by way of new establishment, merger and acquisition, etc., and obtain the ownership, controlling power, operation and management rights and other interests thereof.” This new definition of such investment activities is more broadly worded than the definition in Circular 75, and captures not only offshore financings of existing onshore interests, but also new green-field onshore investments.

## **2. Broadened Financing Channels for SPV**

Pursuant to Circular 37, on the basis that there is a real and reasonable need, domestic enterprises directly or indirectly controlled by Chinese domestic residents could provide loans to the SPV duly registered by such Chinese residents. What’s more, the Chinese residents were also allowed to purchase

foreign currencies and remit them overseas for the purpose of setting up an SPV, sharing buybacks or delisting when there is a real and reasonable need.

Compared with Circular 75, Circular 37 provides for SPVs with two new financing sources—in addition to overseas financing—from which SPVs could receive funds from the domestic side: domestic residents individuals and domestic institutions. To a certain extent, it could also help to improve the financing efficiency of an SPV and further encourage Chinese companies to do overseas financing and investments (e.g. IPOs).

### **3. Expansion of Registration Scope**

Article 9 requires an amended SAFE registration or a deregistration when a domestic resident no longer has interests in a registered SPV (whether due to stock conversion, bankruptcy, dissolution, liquidation, expiry of the operating period, identity change or other reasons), or where a domestic resident is no longer required to apply for the registration of SPVs.

Further, Article 12 provides a domestic resident with the opportunity to supplement the registration if, prior to Circular 37's effective date, such resident made a capital contribution to an SPV with legitimate domestic and overseas assets or interests, but failed to apply for the requisite SAFE registration. The supplemental registration should follow the same procedures and requirements as an initial registration, except that the domestic resident should submit an explanatory statement regarding its prior failure to complete the registration. In such event, SAFE will determine whether to accept a SAFE registration from such domestic resident and whether to impose an administrative punishment.

Finally, Article 6 provides that where a non-listed SPV uses its equity or options to grant equity incentives to the directors, supervisors and senior management personnel of a Mainland enterprise under its direct or indirect control, as well as other employees with employment or labor relations with the said Mainland enterprise, the relevant Mainland resident individual may exercise his/her equity rights after applying to the Foreign Exchange Bureau in charge of the relevant SPV. In this way, the equity incentives can be registered with SAFE and the money needed to exercise the equity right can be remitted outside PRC.

While the new registration procedures in Circular 37 are more streamlined and simplified, it remains to be seen how local SAFE authorities will actually interpret and implement such registration procedures. Based upon the streamlined guidelines, we would expect less substantive review to a varying degree depending on the locality, and we hope that such rules will provide more predictability and certainty regarding the SAFE registration procedures.

#### **4. Adjusted Requirements on SAFE Registration**

First, with respect to the initial registration, the requirement on when to apply to SAFE for registration has been changed. Under Circular 75, the Chinese resident had to apply to SAFE for registration prior to establishing or controlling an overseas SPV. But according to Circular 37, Chinese residents should apply for SAFE registration before they make capital contributions to the SPV.

Second, according to Circular 75, when the SPV carried out overseas financing, the Chinese resident had to apply to SAFE for change registration with respect to adjustments of the SPV's net assets. When there were major changes to the capital of the SPV (such as an increase or decrease of capital, equity transfer or exchange, merger or division, long-term equity or debt investment, external guarantee, etc.), the Chinese resident also had to apply for change registration. But under Circular 37, the change registration is only required: (1) when the basic information of the SPV (including Chinese individual shareholder, name, term of business, etc.) changes or (2) when there is capital increase or decrease, equity transfer or exchange, merger or division, and other relevant important changes made by the Chinese individual. So compared with Circular 75, the scope of change registration in Circular 37 has been narrowed down to changes in the basic information and capital related to the Chinese individual.

Third, Circular 37 further sets out the procedure of how to apply for registration if a Chinese resident failed to complete it before the implementation of Circular 37.

#### **5. Clarified Penalties for Violations**

Compared with Circular 75, Circular 37 makes the penalties for relevant violations more explicit. Any Chinese resident that violates the provisions set forth in Circular 37 and commits other illegal activities against the foreign exchange administration will be punished by SAFE in accordance with specific provisions set out in the *Regulations of the People's Republic of China on Foreign Exchange Administration*.

#### **6. Conclusion**

Circular 37 expands the SAFE registration scope, simplifies registration procedures and provides more flexibility in respect of certain foreign exchange related matters – all of which are intended to facilitate China's "going global" strategy and to promote the development of the China's real economy with both domestic and overseas resources. How it actually will be implemented in practice

is yet to be tested. In this regard, the local bureaux of SAFE throughout China may interpret Circular 37 in different ways, pending further guidance and feedback from SAFE. Nevertheless, despite potential near-term challenges, the adoption of Circular 37 to replace Circular 75 should be welcomed as a positive development in relation to SAFE's evolving oversight of Chinese residents' cross-border investments – whether for overseas or round-trip purposes.

## **2. Shanghai Lowering Standards for Headquarters of Multinational Corporations to Enjoy Preferential Policies**

On 14 July 2014, the Shanghai Municipal Commission of Commerce, the Shanghai Human Resources Bureau, the Exit-Entry Administration Bureau of the Shanghai Public Security Bureau and the Shanghai Entry-Exit Inspection and Quarantine Bureau jointly released the *Supplementary Provisions on Encouraging Multinational Corporations to Establish Regional Headquarters* (Hu Shang Wai Zi [2014] No. 348, the "Supplemental Provisions"), which took immediate effect and will be valid for the upcoming five years.

Similar to the *Provisions of Shanghai Municipality on Encouraging Multinational Corporations to Establish Regional Headquarters* released by People's Government of Shanghai Municipality in 2012 (Hu Fu Fa [2011] No. 98, the "2012 Provisions"), the purpose of the Supplemental Provisions is to attract foreign capital and facilitate foreign investment. Under the Supplemental Provisions, the headquarters institution of a multinational corporation (the "Headquarters Institution"), although failing to meet the standards for being the headquarters of a multinational corporation as specified in the 2012 Provisions, could still enjoy similar preferential policies if meeting the following conditions:

1. the total assets of the multinational corporation shall be no less than USD 200 million, and the multinational corporation has established no less than three foreign-invested enterprises in China, at least one of which is registered in the Shanghai Municipality;
2. the person in charge of the overall regional business of the multinational corporation and the senior management personnel in charge of the corresponding functions must work in the Shanghai Municipality on a permanent basis; and
3. the business premises of the Headquarters Institution cover an area of more than 500m<sup>2</sup>, and more than 50 employees perform the operations and management functions of the headquarters.

The preferential policies mainly focus on simplification of exit-entry and employment/residence permit formalities, as well as more convenience for customs clearance, i.e. Chinese employees of a headquarters institution who need to go abroad for business purposes may, in accordance with the relevant provisions, apply for a passport at the Shanghai Municipality and enjoy the green channel service.

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