

# Asia Alert

## China's New Foreign Exchange Rule Expands Scope and Streamlines Registration Process

By Steven Xiang, Anthony Wang and Yi Chen

*A frequently asked due diligence question for private equity or strategic investors in a China transaction is whether the Chinese shareholders of the target company have properly complied with applicable foreign exchange control regulations in connection with the target's offshore corporate structure. Chinese foreign exchange authorities recently released a new rule which provides more specifics in respect of the required registration for Chinese residents or individuals to establish offshore holding companies.*

On July 14, 2014, the State Administration of Foreign Exchange ("**SAFE**") of the People's Republic of China ("**PRC**" or "**China**") released *Circular No.[2014]37 dated July 4, 2014 on Issues Relating to the Administration of Foreign Exchange in Respect of Offshore Investments, Financings and Return Investments by Domestic Residents through Special Purpose Vehicles* ("**Circular 37**"), which superseded and repealed *Circular No.[2005]75 on Issues Relating to the Administration of Foreign Exchange in Respect of Financings and Return Investments by Domestic Residents through Offshore Special Purpose Vehicles* ("**Circular 75**") which was previously issued by SAFE in October 2005.

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

### Certain Key Changes and Expansion of Registration Scope

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

Circular 37 redefines 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.*" 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

**Asia Alert** is published by the Asia offices of Weil, Gotshal & Manges LLP, one of the preeminent global law firms with approximately 1,200 lawyers in 20 offices located in the US, Europe and Asia including Beijing, Hong Kong and Shanghai.

### Recent Asia Transactions and Recognitions

- Weil is nominated for M&A Team of the Year and Private Equity Team of the Year 2014 by *China Law & Practice*
- Weil earned a “Stand Out” ranking in the *Financial Times Innovative Asia Pacific Legal Award 2014* for its work on the GE/XD transaction
- Weil advised Baring Private Equity Asia and other members of a consortium in their approximately \$3 billion take-private acquisition of Giant Interactive Group Inc., one of the largest take-private transactions by a US-listed Chinese company in the recent years
- Weil advised J.P. Morgan, Deutsche Bank and Goldman Sachs on the financing of Hony Capital’s £900 million (\$1.54 billion) acquisition of Pizza Express from the Gondola group
- Weil advised to Lenovo Group, a China-based publicly traded personal computer maker (the world’s largest) and worldwide provider of IT products and services, in its approximately \$2.9 billion acquisition of the Motorola Mobility smartphone business from Google
- Weil advised Suez Environnement, who, with its joint venture partner, is selling their indirect 42% stake in the Companhia de Electricidade de Macau – CEM, S.A., Macau’s power provider, for \$612 million to Nam Kwong Development, a China state-owned enterprise
- Weil advised the investors consortium, which included HOPU Fund and Bank of China, in the \$2.5 billion investment in Singapore’s Global Logistic Properties
- Weil was awarded Asia M&A Team of the Year by *IFLR* in 2013

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 due to economic interests.*” 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.*” Such 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 onshore green-field investments.

While Circular 37 omits the express reference to contractual control, it still describes control in a very broad manner. As such, the broad definition should capture contractual control arrangements (as commonly seen in VIE investment structures

used for certain restricted industries). However, Article 4 of Circular 37 expressly notes that “*the registration of an overseas SPV is not indicative of the compliance of its investment and financing activities with the requirements of competent industry departments.*”

### **A More Streamlined and Simplified Registration System**

In addition to the changes to defined terms, Circular 37 (and its implementing guidelines) clarifies and simplifies certain of the SAFE registration requirements – focusing primarily on the foreign exchange related issues which are more administrative in nature.

**Initial Registration.** Pursuant to Article 3 and the accompanying procedural guidelines, initial SAFE registration by the domestic resident will be required prior to the making of any capital contributions into the SPV. We note that that the implementation guideline has removed the prohibition on any offshore financing, equity change and return investment prior to the completion of SAFE registration. Rather, the domestic residents cannot make capital contribution to the SPV prior to completing SAFE registration. Additionally, Circular 37 only requires SAFE registration in respect of the top-level SPV established or controlled by the domestic resident, as opposed to any of the intermediate or subsidiary SPVs that may fall below such top-level SPV.

**Registration Amendment.** Pursuant to Article 5, amendments to the initial SAFE registration shall be promptly made when the registered SPV experiences significant changes, including in respect of its domestic resident individual shareholder, its name, operating period or other basic information, or increase or reduction of contribution by the domestic resident individual, the transfer or replacement of equity, or merger or division. While there is no set deadline in respect of such registration amendment, the domestic resident may only engage in subsequent cross-border business activities (e.g., repatriation of profit and bonuses) in respect of such SPV following completion of the amendment filing.

### **Registration Amendment and Deregistration.**

Article 9 requires amended SAFE registration or 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.

**Supplemental Registration.** Finally, Article 12 provides a domestic resident with the opportunity to make up 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 in completing the registration. In such event, SAFE will determine whether to accept a SAFE registration from such domestic resident and whether to assess any administrative punishment.

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 that could vary from locality to locality, and we hope that such rules will provide more predictability and certainty regarding the SAFE registration procedures.

### **Other Key Developments of Circular 37**

#### **Registration by Domestic Employees in Respect of Equity Incentive Awards of Non-listed SPVs**

Prior to Circular 37, foreign exchange registration with SAFE has only been available in respect of equity incentive awards that have been issued by a publicly-listed company to domestic resident employees. In this regard, the exercise by domestic employees of equity incentive awards issued by non-listed overseas companies had not been subject to any SAFE rules or regulations – leaving

Chinese employees unable to properly exercise such equity incentive awards due to foreign exchange restrictions. Following the issuance of Circular 37, a domestic resident individual who is a director, supervisor, senior management personnel or other employee of a domestic enterprise that is under control of a non-listed SPV may now apply for registration with the SAFE prior to exercising his/her equity incentive awards granted by the non-listed SPV. As a result, while existing SAFE rules continue to govern the exercise of awards in overseas publicly-listed companies, Circular 37 provides a path for Chinese employees to also exercise equity incentive awards of a non-listed SPV.

#### ***Offshore Profits No Longer Required to be Repatriated within 180 Days***

Whereas Circular 75 previously required profits, dividends or other proceeds obtained from disposal of SPV interests to be repatriated onshore within 180 days of receipt, Circular 37 has removed such 180-day repatriation requirement. Rather, Circular 37 simply notes that any repatriation of such profits, dividends or other proceeds shall comply with SAFE provisions on current accounts or capital accounts, as applicable.

#### ***Allowing Cross-Border Capital Support to SPV***

Circular 37 further liberalizes cross-border foreign currency flow in relation to the SPV. Specifically, when there are real and reasonable needs, a domestic enterprise that is directly or indirectly controlled by a domestic resident may extend loans to the registered SPV. Additionally, a domestic resident is permitted to purchase and remit foreign exchanges overseas, on the basis of real and

reasonable needs of an SPV (including to fund its establishment costs, a share repurchase, delisting, etc.)

#### ***Specific Penalties for Violations of Circular 37***

Unlike Circular 75, which had more general statements in respect of the consequences for violations thereof, Circular 37 articulates specific penalties for violation of its provisions. Specifically, depending on the type of violations of Circular 37, domestic residents shall be subject to the relevant administrative or criminal (as the case maybe) penalties pursuant to Article 39, 41 and 48, respectively, of the PRC Foreign Exchange Administration Regulations.

#### **Final Observations**

While 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 promote the development of the China' real economy with both domestic and overseas resources – how it actually will be implemented in practice is yet to be widely tested. In this regard, the local bureaus 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. 

**Asia Alert** is published by the Asia offices of Weil, Gotshal & Manges LLP, a global law firm with 20 offices located in the US, Europe and Asia.

Weil's Asia practice advises Asian and international corporate and private equity clients on a wide range of cross-border transactions throughout Asia-Pacific. Our lawyers in the region advise on mergers and acquisitions, divestitures, joint ventures and strategic alliances, minority investments, restructurings, fund formation, international security offerings and other capital markets transactions, as well as general corporate matters.

**For more information, please contact the following attorneys:**

Steven Xiang	<a href="#">Bio Page</a>	<a href="mailto:steven.xiang@weil.com">steven.xiang@weil.com</a>	+86 21 6016 6301
Anthony Wang	<a href="#">Bio Page</a>	<a href="mailto:anthony.wang@weil.com">anthony.wang@weil.com</a>	+86 21 6016 6315
Yi Chen	<a href="#">Bio Page</a>	<a href="mailto:yi.chen@weil.com">yi.chen@weil.com</a>	+86 21 6016 6323

©2014. All rights reserved. Quotation with attribution is permitted. This publication provides general information and should not be used or taken as legal advice for specific situations that depend on the evaluation of precise factual circumstances. The views expressed in these articles reflect those of the authors and not necessarily the views of Weil, Gotshal & Manges LLP. If you would like to add a colleague to our mailing list or if you need to change or remove your name from our mailing list, please log on to <http://www.weil.com/weil/subscribe.html> or e-mail [subscriptions@weil.com](mailto:subscriptions@weil.com).