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October 13, 2014

China's New Foreign Exchange Control Rule on Outbound and Round-Trip Investment

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Replacing Circular 75, Circular 37 simplifies the SAFE registration process for Chinese residents seeking offshore investments and financings, and it liberalizes cross-border capital outflow by Chinese residents. In addition, Circular 37 also permits registration of equity incentive plans of non-listed Special Purpose Vehicles.

In July 2014, the State Administration of Foreign Exchange (SAFE) of the People's Republic of China released the *Notice of the State Administration of Foreign Exchange on Administration of Foreign Exchange Involved in Offshore Investment, Financing and Round-Trip Investment Conducted by Domestic Residents Through Special Purpose Vehicles* (SPVs) (Circular Hui Fa [2014] No. 37) (Circular 37). Circular 37 superseded Circular 75 (Circular Hui Fa [2005] No. 75), which regulated the same subject matter and was issued by SAFE almost ten years ago.

Circular 37 is intended to simplify and facilitate cross-border capital transactions in order to support China's "going-out" policy. It expands the definitions of certain key terms used in Circular 75, simplifies the registration procedures, and expands the registration scope. It also permits non-listed SPVs to register their equity incentive plans with SAFE.

We summarize below the key points of Circular 37.

Expanded Definition of Key Terms

- **Special Purpose Vehicles.** Circular 37 defines SPVs as offshore enterprises directly established or indirectly controlled by domestic residents (including individual residents) for the purpose of investment and financing by utilizing the domestic or offshore assets or interests they legally hold.

  Circular 75 defined SPVs as only those set up for offshore financing purpose. Circular 37 expands the purposes of establishment of SPVs to include both offshore financing as well as offshore investment. While under Circular 75, domestic residents could only establish SPVs using their domestic assets or interests, Circular 37 allows domestic residents to use legally held offshore assets or interests to capitalize the SPVs.

- **Round-Trip Investment.** Under Circular 37, "round-trip investment" refers to direct domestic investment activities conducted by domestic residents directly or indirectly through SPVs, by virtue of setting up new foreign-invested enterprises or projects in China, mergers and acquisitions, and obtaining ownership, controlling rights or management rights in the enterprises or projects.

  The more broadly worded new definition in Circular 37 covers round-trip green-field investment and M&A and other means of obtaining ownership or control over PRC assets by domestic residents, in addition to offshore financing of the existing onshore interests (which was the only round-trip investment contemplated under Circular 75).

Financing SPVs by Domestic Residents

Circular 37 further liberalizes cross-border funds transfer in relation to the SPVs. Where there are real and reasonable needs, any domestic enterprise directly or indirectly controlled by domestic residents may grant loans to registered SPVs. Also, based on real and reasonable needs, domestic residents may purchase and remit foreign exchange overseas, for the establishment, share repurchase or de-listing of the SPVs.

Simplified Registration Process

Circular 37 clarifies and simplifies SAFE registration procedures for SPVs.

- **Initial Registration.** Domestic residents must complete initial registration before making contributions to the SPV. This is different from Circular 75, which requires registration before establishment of the SPVs. In addition, Under Circular 37, SAFE registration is required only for the top-level SPVs established or controlled by the domestic residents.

- **Amendment and De-registration.** In case of any significant changes, such as changes in the domestic resident individual shareholders, the name and term of operating of a registered SPV, or any other major events such as capital increase, reduction, share transfer or replacement, consolidation or division, the domestic resident must amend the registration with SAFE "in a timely manner" (versus "within 30 days" under the previous regime). The domestic resident may engage in subsequent cross-border business activities only after amending the registration.

  When a domestic resident no longer holds any interests in the registered SPV due to share transfer, bankruptcy, dissolution, liquidation, expiry of the operation period, identity change or any other reasons, or when a domestic resident is no longer required to conduct SAFE registration for SPV, the domestic resident should amend the SAFE registration or de-register.

- **Remedial Registration.** If, prior to implementation of Circular 37, a domestic resident has made capital contribution to a SPV with his or her legitimate domestic or offshore assets or interests but did not go through SAFE registration process, such domestic resident should provide SAFE with an explanation for the prior failure to register and make remedial registration. SAFE will determine whether to accept the registration retrospectively and whether to impose administrative penalties upon any act in violation of regulations on foreign exchange.

Repatriation of Offshore Profits

Circular 37 eliminates the requirement under Circular 75 that profits or dividends from SPVs must be transferred back to China within 180 days. Instead, Circular 37 simply notes that any repatriation of such profits, dividends or other proceeds must comply with SAFE regulations on current accounts or capital accounts.

Equity Incentive Plans through Non-Listed SPVs

Circular 37 for the first time allows (but the Circular does not require) registration of equity incentive plans for directors, supervisors, senior management and employees working in domestic enterprises directly or indirectly controlled by non-listed SPVs.

Prior to the promulgation of Circular 37, SAFE registration could only be made for equity incentive plans of foreign listed companies in accordance with *Circular of the SAFE on Issues concerning the Administration of Foreign Exchange Used for Domestic Individuals' Participation in Equity Incentive Plans of Companies Listed Overseas* (Circular Hui Fa [2012] No. 7). Circular 37, allowing registration for equity incentive plans of non-listed companies, will solve many existing registration problems and will provide a path for Chinese employees to exercise equity incentive awards of non-listed SPVs.

Some Observations

The adoption of Circular 37 to replace Circular 75 is a positive development on foreign exchange control of Chinese residents' cross-border investment, but how it will be implemented in practice is yet to be tested. For example, it would be helpful for non-listed companies that don't fall within the definition of SPVs if the implementing rules would extend the possibility of registration of equity incentive plans to all non-listed companies. We will monitor the actual interpretation and enforcement of the above changes by SAFE and keep our clients advised.

If you have any questions about the content of this advisory, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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