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CHINA UPDATE

September/October 2014

New Foreign Exchange Regulations for Registered Capital for Foreign Invested Enterprise

Key Points

- Legislation removes a number of rules previously introduced under Circular 142.
- Most important are the changes to rules on conversion and use of foreign currency registered capital of FIEs.
- Circular 36 adopts a concept of "conversion at will".
- Equity investment by converted registered capital is no longer prohibited.
- Regulation provides separate rules applicable for general type of FIE and FIE whose principal activities are investment.

Background

On July 15, 2014, the State Administration of Foreign Exchange ("SAFE") issued *Notice on Issues Relating to Pilot Scheme of Reform of Administration of Foreign Currency Capital Settlement by Foreign Investment Enterprises in Certain Regions* ("Circular 36"), which came into effect on August 4, 2014. The importance of Circular 36 is that it changes the rule on conversion and use of foreign currency registered capital of foreign invested enterprise ("FIE"), which were established under Huizongfa [2008] No. 142 ("Circular 142").

Regulation Background

Under Circular 142, the Renminbi funds of an FIE created by converting registered capital shall be used within the scope of business approved by the respective authorities, and shall not be used for domestic equity investments. The conversion of registered capital shall be based on review of the usage of the fund, and conversion is only allowed based on actual payment basis. The company must submit documentary evidence for the purpose of the Renminbi funds for approval of the conversion.

Except for certain specified purpose (e.g. petty cash or salaries), the converted RMB funds should be paid to the approved recipient within a prescribed time.

Highlights of Circular 36

With the issuance of Circular 36, many rules under Circular 142 have been removed.

1. Conversion at will of foreign currency registered capital

Circular 36 adopts a concept of "conversion at will" (also known as "discretion conversion" or "voluntary conversion"), as opposed to conversion on payment basis.

- Conversion on payment basis is the principle set out in the old Circular 142, where conversion of foreign currency registered capital in a FIE's capital funds account should be processed based on each single demand of Renminbi payment.
- "Conversion at will" is roughly defined in Circular 36 as conversion of an FIE's foreign currency registered capital in accordance with the enterprise's actual business needs. No review of the purpose of the funds is required when doing the conversion.

Currently, the percentage of the registered capital that a FIE registered within the pilot scheme region (see the list of regions in Appendix) can be converted is 100%, according to Circular 36. SAFE may adjust such percentage where appropriate considering the national balance of international payments.

The Conversion at will scheme is not a mandatory measure to be implemented by FIE. FIE can choose whether to convert all or only part of the registered capital, where FIE may have more flexibility. However, once the registered capital has been converted into Renminbi, it is not allowed to convert it back to foreign currency into the capital account. Therefore, the timing and amount of the conversion should be well planned by FIE, considering the fluctuation of foreign exchange market.

2. Administration of converted payment account

The FIE shall open a corresponding "Converted Currency Payment Account" to deposit the Renminbi converted from the registered capital under the conversion at will pilot program. Use of such Renminbi funds from registered capital by FIE shall be based on true transaction, and only for the purpose of its own capital demands. According to Circular 36, the following usages are strictly prohibited by SAFE:

1. Renminbi funds shall not be used for expenditure outside the enterprise's scope of business or expenditure prohibited by State laws and regulations;
2. unless otherwise stipulated by laws and regulations, Renminbi funds shall not be used for securities investments;
3. Renminbi funds shall not be used for Renminbi-denominated entrusted loans (except where permitted by the scope of business), repayment of loans between enterprises (including third party advances), and repayment of bank loans re-loaned to a third party;
4. except for foreign-funded real estate enterprises, Renminbi funds shall not be used for payment of expenses relating to purchase of real estate not for its own use.

According to Circular 36, the usage of Renminbi funds in the Converted Currency Payment Account is still subject to scrutiny. In this regards, it is believed that there is no fundamental change regarding the administration of the usage of registered capital, i.e., payment of the Renminbi funds converted from registered capital should still be based on real transaction. Thus it is more accurate to define the pilot scheme as "conversion at will", rather than "use at will".

3. Equity Investment by converting registered capital

Though there is no fundamental change to the administration principle over the registered capital, there is indeed one noticeable change to the Circular 36. Equity investment by converted registered capital is no longer prohibited. Circular 36 provides separate rules applicable for general types of FIE and FIEs whose principal activities relate to investments.

a) General Type of FIE

For equity investment made by the general type of FIE, the invested enterprise shall complete registration formalities for reinvestment in China with the foreign exchange bureau locally and open a Converted Currency Payment Account of its own. The investor will transfer the Renminbi converted in accordance with the actual investment scale to the Converted Currency Payment Account opened by the invested company. Use of the funds by the invested company in the Converted Currency Payment Account should still be subject to the same administrations by SAFE.

b) Foreign Invested VC/PE Funds

According to the langue in the Circular 36, FIEs whose principal activity is investment can convert the registered capital in accordance with the actual investment scale. Those FIEs, as clearly listed by Circular 36, include: foreign invested holding companies ("CHC"), foreign invested venture capital enterprises ("FIVICE"), and foreign invested equity investment enterprises. The converted Renminbi of those FIEs can be transferred to the bank account of the invested company, as long as the investment is real and complies with the law.

Before the promulgation of Circular 36, the conversion of the registered capital could be subject to more restrictions and limits, especially for foreign invested VC/PE funds. As a nationwide policy, it was only feasible for foreign invested VC funds to invest into start-up new, high-technology companies with their converted registered capital. Conversion of registered capital to make equity investments in Renminbi by other foreign invested equity investment enterprises are only allowed and permitted in a local level under pilot programs and with several restrictions (known as local QFLP policies granted on a case by case basis), those restrictions may include strict qualification review of the foreign fund manager; the size the of the fund; a quota imposed on the registered capital that can be converted; the industries and sectors to be invested.

Under Circular 36, such restrictions seem to be removed from SAFE's side. Procedurally, such change may help to facilitate a more efficient investment by foreign invested VC/PE funds.

Appendix: List of the Pilot Regions

- Tianjin Binhai New District
- Shenyang Economic Zone
- Suzhou Industrial Park
- Donghu National Innovation Demonstration Zone
- Guangzhou Nansha New District and Hengqing New District
- Chengdu Hi-tech Industrial Development Zone
- Zhongguancun National Innovation Demonstration Zone
- Chongqing Liangjiang New District
- Heilongjiang Border Development and Open Foreign Exchange Administration Reform Pilot Scheme Area
- Wenzhou Comprehensive Financial Reform Experimental Zone
- Pingtan Comprehensive Experimental Zone
- China-Malaysia Qinzhou Industrial Park
- Guiyang Comprehensive Bonded Zone
- Shenzhen Qianhai Shengang Modern Services Industry Cooperation Zone
- Qingdao Wealth Management Comprehensive Financial Reform Experimental Zone

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Brief of New SAFE Circular 37

Key Points

- Circular 37 replaces nearly ten-year old Circular 75
- Definition of "Special Purpose Companies" amended
- Definition of "Round-Trip Investment" amended
- New Registration for Employee Option Shares of Unlisted Companies
- Circular 37 allows two ways to make the contribution to the SPV

The State Administration of Foreign Exchange ("SAFE") has further adjusted and streamlined its foreign exchange control on capital account by issuing the Notice of State Administration of Foreign Exchange on Further Improving and Adjusting Foreign Exchange Control Policies for Capital Account (the "Notice") on January 10, 2014, which took effect on February 10, 2014.

Background

On July 4, 2014, the SAFE stipulated a Notice on the Administration of Foreign Exchange Involved in overseas Investment, Financing and Round-Trip Investment Conducted by Domestic Residents Through Special Purpose Companies ("Circular 37"). The Notice of the SAFE on the Administration of Foreign Exchange Involved in overseas Investment, Financing and Round-Trip Investment Conducted by Domestic Residents Through Special Purpose Companies issued by the SAFE on October 21, 2005 ("Circular 75") was simultaneously terminated.

Highlights of the Legislation

1. Definition of "Special Purpose Companies"

The term "Special Purpose Companies" ("SPV") in Circular 37 refers to overseas enterprises directly established or indirectly controlled by domestic residents (including domestic institutions and domestic individual residents) for the purpose of investment and financing by utilizing the domestic or overseas assets or equity they legally hold. Compared with the definition used in the Circular 75, the new definition has two material changes: in Circular 75, an SPV is set up only for the purpose of financing, while in Circular 37 an SPV is also allowed to invest. The other difference is that, in Circular 75, domestic residents can establish an SPV by its domestic assets only, while Circular 37 also allows overseas assets legally held by such residents.

2. Definition of "Round-Trip Investment"

Round-Trip Investment under Circular 75 was largely a description of the typical VIE structure. In Circular 37, such definition was changed to a very general description of direct domestic investment activities conducted by domestic residents directly or indirectly through special-purpose companies, which not only refers to establishment of the wholly foreign owned enterprise, but also covers M&A transactions.

3. New Registration for Employee Option Shares of Unlisted Companies

In 2012, SAFE issued Circular 7, pursuant to which, the stock option issued to a Chinese employee by a foreign company shall be subject to the registration with the SAFE before being exercised. However, that circular only stipulates the registration for a listed company, and SAFE does not accept any application for the stock options issued by a private company. Circular 37 has a clear requirement that the employee option shares issued by a unlisted SPV shall also be subject to the registration with SAFE. Pursuant to the Circular 37, before exercising the options granted by a SPV, the Chinese option holder shall file the registration with SAFE by submitting the requested documents, including the registration certificate of the SPV, the evidence of the employment relationship between the SPV and the option holder, and the evidence of the authenticity of the equity incentive plan.

4. Contribution to SPV

Other than the set-up of the SPV by the overseas assets legally held by domestic residents, Circular 37 also allows the following two methods to make the contribution to the SPV:

i) Domestic companies held or owned by domestic residents have the right to provide capital support to the SPV duly registered with the SAFE, based on real and reasonable needs and according to current regulations.

ii) Domestic residents may purchase foreign exchange and remit such foreign exchange to overseas countries for the establishment, equity repurchases or de-listing of the SPV, based on real and reasonable needs.

However, Circular 37 does not specify the procedure or requirement for such financial support to the SPV.

Conclusion

Circular 37 introduces interesting developments for the regulations and supervision of the establishment and operation of the SPV, and clarifies the requirements for certain grey areas. However, as many changes are new and fundamental, the local departments of the SAFE are still in the process of draft the implementation rules for the Circular 37. It is still hard to say when the Circular 37 can be fully applied.

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SAFE Issues New Provisions to Ease Cross-Border Guarantees

Key Points

- Three Guarantee Types Under New Provisions
- Registration Instead of Approval for Execution and Performance
- Fewer Restrictions on Quota Limits and Qualification Requirements for Guarantors
- Restrictions on the Use Purpose of the Money Obtained from Outbound Guarantees

Background

On May 12, 2014, the State Administration of Foreign Exchange ("SAFE") issued the Provisions on Foreign Exchange Control for Cross-border Guarantees and its implemented guidelines, the Operational Guidelines for the Administration of Cross-border Foreign Exchange Guarantee (collectively, the "New Provisions"), which came into effect on June 1, 2014. The New Provisions have superseded a series of regulations previously issued by SAFE and made significant changes to ease the requirements for cross-border guarantees.

Highlights of Cross-Border Guarantees Provisions

The New Provisions provide three kinds of cross-border guarantees:

1. *Nei Bao Wai Dai*, which refers to the guarantee provided by an onshore guarantor (including banks, non-bank entities and PRC individual) for a debt owing by an offshore debtor to an offshore creditor (the "Outbound Guarantee"). The New Provisions allow multiple guarantors under an Outbound Guarantee.
2. *Wai Bao Nei Dai*, which refers to the guarantee provided by an offshore guarantor for a debt (excluding entrustment loans) owing by an onshore debtor to an onshore creditor (the "Inbound Guarantee"), under which the onshore debtor must be a non-financial institution and the onshore creditor must be a financial institution.
3. Other types of cross-border guarantees other than above (the "Other Guarantees").

Registration Instead of Approval for Execution and Performance

Under the previous cross-border guarantee regime, a PRC entity was unable to grant any guarantee for an offshore loan without pre-approval issued by SAFE. Based on the New Provisions, the execution and performance of the guarantee agreement will not be subject to SAFE's approval. Currently, failure to register with SAFE will not invalidate the guarantee as a pre-condition.

Specifically, for the Outbound Guarantee, the execution of a guarantee agreement (and any subsequent change to its major terms as well as its termination) shall be registered with SAFE. In the case that the guarantee provider is a bank, the bank shall register the guarantee through an online platform with SAFE, while a non-bank guarantee provider shall register with local SAFE within 15 working days after the date of such agreement. Where the debtor fails to repay the loan, the domestic guarantor may perform the guarantee on its own (if the guarantor as a bank) or directly with the bank (if the guarantor as non-bank organization).

For the Inbound Guarantees, the domestic creditor shall register the guarantee through an online platform with SAFE. In the case that the debtor fails to repay the loan, the onshore creditor may collect the guarantees directly with the offshore guarantor, and the onshore debtor shall register the debt as a short term foreign debt with local SAFE within 15 working days after the guarantee performance.

For Other Guarantees, there is no registration requirement unless otherwise stipulated for execution or performance of such guarantees.

Fewer Restrictions on Quota Limits and Qualification Requirements for Guarantors

Under the previous cross-border guarantee regime, the total outstanding amount of the foreign guarantee, domestic foreign exchange guarantee and foreign debts of a financial institution incorporated in China shall not exceed 20 times the amount of its foreign exchange funds. As to a non-financial institution, the foreign guarantee balance shall not exceed 50% of its net assets, nor its foreign exchange revenue in the preceding year. Such requirements have been abolished in the New Provisions.

The New Provisions do not require the ratio of the net assets to overall assets of a guarantor as stipulated before, and the domestic guarantors are now allowed to provide guarantees for non-affiliated enterprises under Outbound Guarantees. The domestic guarantor, however, shall hold the debtor's shares of capital for Outbound Guarantees if the guarantees are the repayment obligations for the overseas loans issued by the debtor. Under Inbound Guarantees, the onshore debtor shall ensure that the total outstanding principal amount of all its liabilities from the performance of the guarantee will not exceed its audited net assets in its audit report of the previous year.

Restrictions on the Use Purpose of the Money Obtained from Outbound Guarantees

Offshore debtors under the Outbound Guarantees can only use the gained money for normal operation and are forbidden from any speculative transactions. Without approval from SAFE, the offshore debtor is not allowed to remit any money supported by the Outbound Guarantee back into China, including i) any direct or indirect equity investment in or intercompany loan to a Chinese entity; ii) acquisition of any offshore entity which has more than 50% assets located in China; iii) repayment of any debts which were originally financed for equity investment in or intercompany loan to a Chinese entity; and iv) pre-payment under a trade transaction of goods or services to a China entity, which is made more than one year ahead of the provision of the goods or services and the amount of which is more than US$1 million and 30% of the total contract price.

Conclusion

The New Provisions aim to relax control over cross-border guarantee to ensure it is more flexible and convenient, making significant efforts to be in line with the policy of liberalizing Rinminbi, and helping enterprises to cost-effectively use funds from onshore or offshore guarantees. The New Provisions and its intended results are likely to be welcomed by the market.

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New SAFE Provisions on Centralized Management of Foreign Exchange Funds

Key Points

- Concept of "domestic master account for foreign exchange funds" and "international master account for foreign exchange funds" explained
- Foreign exchange funds in domestic master account and international master account can flow freely within quota amount
- Centralized Receipts and Payments of Foreign Exchange allows a multinational company to control foreign exchange risks at the headquarters level and reduce its financial burden

Background to the Development of Centralized Operation and Management of Foreign Exchange Funds by Multinational Companies

On 28 February 2014, SAFE Shanghai Bureau issued the *Implementation Rules on Foreign Exchange Control to Support the Development of China (Shanghai) Pilot Free Trade Zone* ("FTZ Rules"), with its appendix I focusing on centralized operation and management of foreign exchange funds in the China (Shanghai) Pilot Free Trade Zone ("Shanghai FTZ"). On 16 May 2014, the Shanghai FTZ pilot program was officially launched, with the first batch of bank-enterprise cooperation agreements on centralized operations and management of foreign exchange funds for headquarters of multinational companies in Shanghai FTZ being signed. A total of 21 enterprises signed cooperation agreements with 13 banks, marking the beginning of implementation of this important foreign exchange measure in the Zone.

On 1 June 2014, *Provisions on the Centralized Operation and Management of Foreign Exchange Funds by Multinational Companies* ("SAFE Provisions") issued by SAFE took effect, so that such foreign exchange reform has been extended to a national level. In terms of the applicability of SAFE provision and FTZ Rules, the SAFE provision shall apply nationwide except for in the Shanghai FTZ area, whereas the FTZ Rules shall govern the centralized management of foreign exchange funds for multinational companies if their headquarters or financial companies in charge are located in the Zone.

Introduction to Several Key Aspects of SAFE Provisions

Domestic Master Account for Foreign Exchange Funds and International Master Account for Foreign Exchange Funds

The first aspect is the concept of "domestic master account for foreign exchange funds" and "international master account for foreign exchange funds". Domestic master account allows a multinational company to collect the foreign exchange funds of its domestic member enterprises and put them under centralized operation and management by its headquarter or financial company in China. International master account allows a multinational company to collect the foreign exchange funds of overseas member enterprises and put them under centralized operation and management. In the past, the international master account of a multinational company used to be opened in areas such as Hong Kong, but can now be opened in domestic China.

Centralized management of account can allow the multinational company to establish their so-called internal bank, so as to have better control over its financial risk and have more efficient and effective internal financial management.

The multinational companies must meet the following requirements in order to be qualified to open the two accounts:

1. They should have authentic business needs;
2. They should have the sound management structure and internal control system for foreign exchange funds;
3. They have established the corresponding electronic system for internal management;
4. The scale of foreign exchange receipts and payments in the previous year shall exceed US$100 million (calculated on a consolidated basis of all domestic member enterprises); and
5. They must not have committed any grave violations of laws or regulations on foreign exchange in the last three years.

The qualified multinational companies shall make a filing with their local tax bureaus. The local tax bureaus shall complete the filing-record procedure within 20 working days and issue a filing notice. The multinational companies may then apply for the opening of domestic mater account and international master account with qualified banks.

Connection of the Domestic Master Account and the Overseas Master Account

The second key aspect is the connection of the domestic master account and the overseas master account. The foreign exchange funds in domestic master account and international master account can flow freely within quota amount. However, the multinational company may need to report the fund flow between the domestic master account and international master account on a monthly basis.

The quota amount for net inflow of foreign exchange funds from international master account to the domestic master account shall not exceed the combined foreign debt quota of domestic member enterprises. The combination of foreign debt quota, instead of spreading the foreign debt quota among domestic member

enterprises, allows multinational company to allocate the foreign debt more flexibly and effectively, and can reduce its financial cost.

The quota amount for net outflow of foreign exchange funds (or overseas lending) from domestic master account to international master account should, in general, not exceed 50% of the combined owners' equity of its domestic member enterprises. According to the previous SAFE regulations, the previous overseas lending quota is 30% of the owners' equity. Such an increase is particularly relevant for Chinese outbound investment, as a Chinese headquarter may lend more money to finance their overseas subsidiaries, which may face difficulties in obtaining bank loans from overseas banks. On the other hand, the loosening of overseas lending can also be used as a means to properly use some of China's large amount of foreign reserve, according to a SAFE official.

The connection of the domestic master account and overseas master account can, in general, allow international companies to allocate their internal capital more freely and reduce their costs.

Centralized Receipts and Payments of Foreign Exchange

The third key aspect is Centralized Receipts and Payments of Foreign Exchange as well as Netting Settlement of Foreign Exchange under Current Accounts. The mechanism of Centralized Receipts and Payments of Foreign Exchange allows the PRC headquarters or financial company to handle payment and receipt of foreign exchange funds under current account on behalf of its domestic member enterprises via its domestic master account. This mechanism allows the multinational company to control the foreign exchange risks at headquarter level and reduce its financial burden.

The Netting Settlement mechanism allows the multinational company to consolidate foreign exchange receipts and payments under current account in a certain period as a single foreign exchange transaction. In principle, the netting settlement shall be made at least once a month. Previously, each time a company receives or pays foreign exchange, it has to run through the settlement procedure. The Netting Settlement mechanism can reduce the pressure on the financial staff of the multinational company, and reduce its finance cost accordingly. According to a financial manager of Sony, Sony Shanghai can reduce finance cost up to several hundred thousand US dollars thanks to the Netting Settlement mechanism. The Netting Settlement mechanism is, of course, most conducive to the multinational companies engaging in a great deal of trading business.

The Negative List

The fourth key aspect is the negative list for settlement of foreign exchange by capital fund and foreign debt. The foreign exchange by capital fund and foreign debt in the domestic master account may be settled on a discretionary basis. The RMB funds obtained from exchange settlement shall be transferred into a special RMB deposit account, and may be directly paid after examining and verifying the authenticity within the business scope of all its member enterprises.

The settlement of foreign exchange funds shall comply with the current regulations on foreign exchange control, and may not be used:

1. Directly or indirectly for the payments beyond the business scope of enterprises or the scope of usages designated for foreign debt funds or payments prohibited by the laws and regulations of the State;
2. Directly or indirectly for investment in securities and derivatives, unless otherwise stipulated by laws or regulations;
3. For disbursing RMB entrusted loans (unless permitted under its business scope), repaying inter-corporate borrowings (including third-party advances) and repaying RMB bank loans that have been sub-lent to third parties; or
4. To pay for the expenses related to the purchase of real estate not for self-use, unless it is a foreign-invested real estate enterprise.

Comparison of SAFE Provisions and FTZ Rules

In general, the SAFE provisions and FTZ Rules have similar provisions. However, there are differences between the two including i) different qualification requirement, ii) different validity period for filing, and iii) different requirements on banks.

First, the requirements in SAFE provisions and FTZ Rules on the trial qualification for multinational companies are different:

According to the SAFE provisions, multinational companies must satisfy the following requirements:

1. Have authentic business needs;
2. Have the sound management structure and internal control system for foreign exchange funds;
3. Have established the corresponding electronic system for internal management;
4. The scale of foreign exchange receipts and payments in the previous year shall exceed US$100 million (calculated on a consolidated basis of all domestic member enterprises);
5. Have committed no grave violations of laws or regulations on foreign exchange in the latest three years.

However, the FTZ Rules does not have the US$100 million threshold as a requirement. Instead, the FTZ Rules requires that the multinational company shall have the certificate issued by the FTZ management committee confirming that it is qualified for the trial program, which leaves the FTZ management committee certain discretionary power.

Second, pursuant to FTZ Rules, the filing with Shanghai SAFE bureau is valid only for two years and may be extended accordingly. However, the SAFE Provisions does not provide for the validity period of filing.

Third, pursuant to FTZ Rules, the bank may review relevant documentations related with Centralized Receipts and Payments and Netting Settlement of Foreign Exchange under Current Accounts within 30 days after receipts or payments take place. However, the SAFE rule does not have similar requirements, meaning that under SAFE provision, the bank needs to review the documentation before the transactions take place.

Conclusion

With the implementation of SAFE Provisions and FTZ Rules, multinational companies in China can now benefit from the flexibility in allocating their foreign exchange funds, manage the foreign exchange funds at the headquarter level and reduce financial risks, and, most importantly, reduce their overall financial costs. However, to qualify for the trial programs, the multinational companies must, among others, have proper electronic system for internal management and a sound management structure and internal control system for foreign exchange funds. Therefore, multinational companies may need to overhaul the financial management system of their domestic member enterprises, often with the guidance from the cooperating banks, which could be burdensome and costly.

In addition, the implementation of SAFE Provisions and FTZ Rules reflect China's aim to gradually reduce its foreign exchange restrictions. The trial programs might encourage multinational companies to establish their regional or global headquarters in China. Furthermore, the trial programs might be an important milestone for the internationalization of Renminbi.

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Shanghai PFTZ Developments in the First Half of Year 2014

Key Points

- Amendments made to overseas investments rules
- Chinese companies and FIEs are now allowed to borrow RMB from overseas
- Free Trade Account is a critical step in the financial reform of the zone
- Several changes introduced to the Negative List

Highlights Of The Developments

1. Overseas Investment – Five Days from Signing to Closing[1]

No NDRC/MOFCOM Approval Required
When the China (Shanghai) Pilot Free Trade Zone ("Shanghai FTZ") claimed that the NDRC and MOFCOM approvals for overseas investment by Chinese companies were no longer required in the Zone, there was doubt about whether it could actually be implemented. Now, experience shows that indeed, no overseas investment approval (neither NDRC nor MOFCOM as required elsewhere in China) is needed for overseas investment under US$30 million by companies formed in the Zone. Instead, an investor only needs to go through a registration process with the Administration Committee of the Shanghai FTZ, which takes less than five days. The successful experience indicates that an overseas investment can be closed in five days from a regulatory perspective, as compared with a three to six month period outside of the Zone, which may even be rejected.

No SAFE Approval
Once the registration of overseas investment is completed, the investor may directly deal with its bank to convert and send the investment amount. Outside the Zone, additional SAFE approval is required to realize the payment.

No Project or Target Needed
Outside the Shanghai FTZ, a Chinese company, in order to form an overseas company, must demonstrate that the company is formed for a specific project which will then be reviewed and approved by NDRC and MOFCOM. In the Shanghai FTZ, no reason has to be given; a company may freely form a foreign shell company in advance and wait for the right opportunity. However, when a real deal emerges, the project needs to be registered with the Zone in order to make the payment.

[1] Administrative Measures on Record Filing of Incorporation of Companies with Outbound Investment by Enterprises in China (Shanghai) Pilot Free Trade Zone

2. Expansion of Use of RMB – Consider Borrowing RMB from Overseas[2]

Low Finance Cost
Chinese companies are suffering from the tightened liquidity and the finance cost in China for medium and small size companies is as high as 10% or more. Chinese companies borrowing foreign currency are subject to strict quota limitation and approval. In PFTZ, both Chinese companies and FIEs may now borrow RMB from overseas, the cost of which is only 3-4%.

Chinese Company – No Approval Required; Equal to Registered Capital In the Zone, a Chinese company may borrow overseas RMB without approval, but is limited to an amount equal to its paid-in registered capital x n (which is published by Central Bank from time to time, presently n = 1). An FIE may choose to be subject to the difference between registered capital and total investment, or the same quota as that for a Chinese company.

Use of the Borrowed RMB
Use of the borrowed RMB is more flexible, in principle, and can be used by the borrower for any purpose other than financial investment or lending, such as any contract payment to outside of Shanghai FTZ. Although it is unclear whether a borrower may use the RMB for direct investment (share acquisition) in a Chinese company outside of the Zone, practice shows that it is not impossible.

RMB Cash Pool
For multinational companies that have extensive business dealing with China (receipt and payment from and to China), setting up a RMB cash pool might be an option to facilitate cash flow in China and avoid the complicated China foreign exchange restrictions. Companies may consolidate all RMB cash in one account and distribute among affiliates as needed. A few multinational companies, such as Roche, have set up a RMB cash pool

3. Free Trade Account – A Critical Step of Financial Reform of Shanghai FTZ[3]

Official Launch
In our previous China Updates, we discussed the financial reforms contemplated in Shanghai FTZ and, among other things, how the Free Trade Account ("FTA") attracts the most interest. At that time, however, the FTA had not been realized due to the lack of implementing rules and banks' installation of necessary system. On May 21, 2014, the People's Bank of China (the "Central Bank") officially launched FTA in the Zone.

What is FTA?
FTA is a bank account for both RMB and foreign currency. It has all the features of an offshore account (i.e., free flow of cash to any offshore account) and may freely connect with other accounts in China on certain conditions.

Who Can Open FTA?
An FTA account is available to (i) any foreign entity, (ii) any entity formed in the Shanghai FTZ, (iii) any foreign individual that has worked in the Zone for more than a year, and (iv) any Chinese individual that has worked in and paid personal taxes in the Zone for more than a year.

Where to Open FTA?
Initially, five banks' branches in the Shanghai FTZ have passed the test and been certified by the Central Bank to operate FTA business, including Bank of China, China Construction Bank, the Shanghai Pudong Development Bank, Bank of Shanghai and the Industrial and Commercial Bank of China. Further banks, including various foreign banks, are proactively applying for the FTA business.

Permitted Use of FTA
At initial stage, only RMB can be traded in an FTA, which will be expanded to foreign currencies in the near future. Funds in an FTA can be used for all kinds of current accounts and direct investment purpose.

4. 2014 Negative List[4]

Shortened List
The Negative List (list of restrictions on foreign investment) is supposed to be revised from time to time. There are 33 restrictions on foreign investment under the 2013 Negative List that have either been removed or relaxed in the 2014 Negative List, e.g., qualification requirement of foreign investors to certification organization, the share percentage restrictions on various logistics business.

Transparency
Compared with to the 2013 Negative List, the 2014 Negative List is a lot clearer in terms of the detailed conditions and restrictions for each item. The 2013 Negative List was issued in a rush and was, as a result, less comprehensive and organized. The 2014 Negative List is one more step towards a mature negative list that can be adopted throughout China.

No Substantive Freedom
Having said the foregoing, the 2014 Negative List does not substantively decrease the number of restrictions on foreign investment. The purpose of the list is to make those restrictions more transparency.

Conclusion

It is worthwhile monitoring the developments in the Shanghai FTZ for the foreseeable future, particularly in relation to (i) expanding the application of certain trial rules to elsewhere of China, such as overseas investment approvals, and (ii) the use of FTA and further freedom of foreign currency flow.

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[2] Notice of Shanghai Head Office of People's Bank of China on Efforts to Promote Cross-border Use of RMB in China (Shanghai) Pilot Free Trade Zone

[3] Opinions of the People's Bank of China on Providing Financial Support for the Development of China (Shanghai) Pilot Free Trade Zone

Notice of the Shanghai Head Office of the People's Bank of China on Releasing the Rules for Implementation of Split Accounting Businesses in China (Shanghai) Free Trade Pilot Zone (For Trial Implementation) and the Rules for Prudential Management of Risks Relating to Split Accounting Businesses in China (Shanghai) Free Trade Pilot Zone (For Trial Implementation)

[4] Announcement of the Shanghai Municipal People's Government on Promulgating the Special Administrative Measures for Access of Foreign Investment to China (Shanghai) Pilot Free Trade Zone (Negative List) (2014 Revision)

What's New in the New Anti-Monopoly Filing Guidelines?

Key Points

- New Filing Guidelines amend version promulgated on January 5, 2009
- Guidelines define control to mean 'the right to control or exert a decisive influence on an undertaking', with multiple factors to be considered in the determination of control
- Guidelines clarify the rules of calculation of turnover
- Contractual arrangement with regard to designation of notifying party will not be recognized as a valid defense in the case of failure to notify

Background to the Guidelines

The Anti-Monopoly Bureau of the Ministry of Commerce ("MOFCOM") of the People's Republic of China ("PRC") released a new version of the Guiding Opinions on the Notification of Concentration of Undertakings ("New Filing Guidelines") on June 6, 2014, which amended the previous version promulgated on January 5, 2009. Whereas certain existing rules set forth in the previous version of such guiding opinions or other regulations related to the notification of concentration of undertaking are incorporated, the New Filing Guidelines present certain new rules adding clarity to the requirements of MOFCOM with regard to the notification of concentration of undertakings. The following new rules deserve attention.

Highlights of the Guidelines

Determination of Control

Under PRC law, a transaction is subject to the notification of concentration of undertakings with MOFCOM only if the participating undertakings reach the statutory thresholds with regard to their turnover in the last fiscal year, and one or more undertakings acquire control over another through such transaction. Previously, there was no guidance on the determination of such control until the issuance of the New Filing Guidelines.

The New Filing Guidelines define control to mean 'the right to control or exert a decisive influence on an undertaking.' According to the Guidelines, in order to determine the existence of such control, one would need to consider multiple legal and factual factors, including without limitation:

i. the purposes of the transaction and future development plan

ii. the shareholding structure and the change resulting from the transaction

iii. the matters subject to voting by shareholders, including historical meeting attendance and voting mechanism

iv. the composition of board of directors or supervisors and voting mechanism

v. the appointment of senior officers

vi. the relationship among shareholders and among directors, e.g. voting trust, person acting in concert, etc.

vii. whether there is any material commercial arrangement among participating undertakings

Such factors, though being considered by the MOFCOM in the determination of control as a matter of practice, are specified in a regulation for the very first time. Nonetheless, it remains unclear how each of these factors function in the determination of control – for example, whether an investor's acquisition of 30% of equity interest of a target company with the right to appoint two out of the five directors constitutes control over the target.

It is noteworthy that a draft version of the Guiding Opinions on the Notification of Concentration of Undertakings for public comments in early 2009 used to provide that the acquisition of (i) more than 50% voting shares or assets of an undertaking, or (ii) the right to decide on the appointment of one or more directors and senior officers, budget, operations and sales, pricing, material investment, or other material management and operational matters of such undertaking through the acquisition of shares or assets or contractual arrangements constitutes acquiring control over such undertaking provided, however, that the veto rights to the amendment of articles of association, increase or decrease of capital, and liquidation that are granted to protect the interests of minority shareholders should not be considered as control. Such specific guidance was removed from the official guiding opinions issued in 2009 and was not included in the New Filing Guidelines either. However, from a practical point of view, MOFCOM may have been following such guidance, especially with regard to the acquisition of more than 50% voting shares and the right to appoint one or more directors and senior officers. Given the absence of any specific guidance under the New Filing Guidelines, such practice may likely continue.

In relation to the determination of control, the New Filing Guidelines recognize the concept of joint control. In particular, the establishment of a joint venture is subject to the notification of concentration of undertakings with the MOFCOM only where such joint venture is jointly controlled by multiple parties. The concept of joint control, however, has existed as a matter of practice for a number of years. As a joint venture partner typically acquires the right to appoint at least one director or senior management, it would be considered as having control, jointly with other shareholders, over the joint venture based on the specific guidance noted above.

Calculation of Turnover

Under the anti-monopoly regulations in the PRC, the turnover of an undertaking in a given transaction generally includes not only the turnover of the undertaking itself but the turnover of its affiliates with which there is control relationship in the last fiscal year. In this regard, the New Filing Guidelines clarify that the turnover generated by any affiliate which was sold or with which the control relationship was terminated in or before the last fiscal year should be excluded.

According to the existing rules, where a transaction involves only a portion of an undertaking, the turnover of the seller in this transaction should be limited to the turnover of such relevant portion provided that the seller, after the transaction, no longer has any control over such relevant portion. The New Filing Guidelines specify that such provision is mainly applicable to the following two scenarios:

(i) in the case of asset sales, only the turnover generated by the assets to be sold will be considered in the determination of the seller's turnover as long as the seller no longer has any control over such assets after completion of the asset sales, and

(ii) in the case of sales of all or portion of equity interest of a target company, only the turnover of such target company will be considered in the determination of the seller's turnover as long as the seller no longer has any control over the target company after the completion of the transaction.

Whereas the New Filing Guidelines clarify that the turnover of a participating undertaking jointly controlled by multiple parties must include the turnover of all such controlling parties, no clarity is offered for the calculation of the turnover of a participating undertaking's affiliates that are jointly controlled by the participating undertaking and other parties.

According to the existing rules, the turnover of such affiliates jointly controlled by the participating undertaking and others should be calculated "only once". However, it is unclear whether such calculation should be interpreted as split equally among the controlling parties, allocation in accordance with the shareholding percentages of the controlling parties, or otherwise. Though an undertaking usually includes the turnover of the affiliates under its control only where the financial statements of such affiliates are consolidated into those of the participating undertaking, it remains to be clarified whether such practice complies with the requirement of calculation "only once".

Liabilities of Failure to File

With respect to the participating undertakings with the statutory obligation to notify MOFCOM of the concentration of undertakings, the existing rules provide that all parties to a merger have the obligation of notification whereas the party or parties acquiring control in other types of concentration of undertakings have such obligation. According to the New Filing Guidelines, the undertakings may enter into a contractual arrangement whereby one party is designated to make the notification on behalf of all the parties with the obligation of notification; however, such contractual arrangement will not be recognized as a valid defense of other parties if the designated party fails to notify.

Timing of Filing

According to the New Filing Guidelines, the notification needs to be made after the execution of a transaction agreement and before the implementation of the transaction. Nonetheless, where the sales of equity interest of a China-based company are at issue, it remains unclear whether the implementation of the transaction means the approval of the equity transfer by the competent commerce authority, the issuance of a new business license of the target company reflecting such equity transfer, or otherwise.

It is also noteworthy that, according to the standard notification form developed by MOFCOM, they may accept a framework agreement, a memorandum of understanding or similar, as opposed to a definitive transaction agreement, for the commencement of its review in certain special circumstances, e.g., for the purposes of complying with mandatory requirements under other PRC laws or policies or regulations of other jurisdictions. It would be reasonable to expect that such practice may likely continue to be allowed.

Conclusion

The New Filing Guidelines add clarity to the requirements of MOFCOM with regard to the notification of concentration of undertakings, especially those related to the determination of control and calculation of turnover, though certain rules that might cause uncertainty in their implementation remain to be further clarified.

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Reform of Foreign Exchange Control in Foreign Direct Investments[5]

Key Points

- SAFE's reform to liberate foreign exchange control
- Registration system adopted to replace approval system in foreign exchange sector
- Voluntary settlement of capital account piloted in special areas
- Optimistic expectation of further relaxation of foreign exchange control in future

Background

In China, direct investments mainly refer to foreign direct investments ("FDIs") and outbound direct investments ("ODIs"). The State Administration of Foreign Exchange ("SAFE") (or its local branches) is the competent authority in charge of regulatory control of foreign exchange in direct investment sector.

Over the years, SAFE had always adopted strict regulatory controls of foreign exchange and complicated approval formalities in direct investment sector. Until July 2009, SAFE carried out significant reform and liberated the control of foreign exchange in ODIs. However, the same reform did not happen in FDIs at that time.

It might seem overdue, but such reform in FDIs became inevitable along with changes of China's cross-border balance of payment. In late 2012, SAFE released a rule initially liberating foreign exchange controls in FDIs. In May 2013, SAFE enacted a special rule which explicitly liberates such controls.

The regulatory control of foreign exchange in FDIs has been changed from approval regime to registration regime which is the most significant reform in history in FDIs. Obviously, SAFE has made up its mind to achieve an objective of streamlining administration and instituting decentralization in the supervision on FDIs.

Core-Rules

Foreign investors making investments in China and legal practitioners practicing in FDI sectors may have an impression: there were a large number of complicated and miscellaneous rules and regulations in respect of foreign exchange controls.

Fortunately, SAFE had updated and grouped together such rules and regulations simultaneously when carrying out the reform of foreign exchange controls in FDIs. Such action is reflected in the revocation of a number of old regulations and the promulgation of the following rules:

- *Circular of the State Administration of Foreign Exchange on Further Improving and Adjusting the Direct Investment Foreign Exchange Administration Policies (promulgated on 19th November 2012 and taking effect on 17th December 2012); and*
- *Circular of the State Administration of Foreign Exchange on Printing and Distributing the Administrative Provisions on Foreign Exchange in Domestic Direct Investment by Foreign Investors and Relevant Supporting Documents (promulgated on 11th May 2013 and taking effect on 13th May 2013).*

The main body of the above rules provides for principles of the reform of foreign exchange controls. Their annexes detail how to register with SAFE and operate foreign exchange affairs with banks.

Liberation

Along with implementation of the above rules, SAFE no longer requires an approval of foreign exchange affairs. Parties involved in FDIs only need to register the relevant information and changes on FDIs with SAFE. After registration with SAFE, the parties may open foreign exchange accounts with banks and handle foreign exchange affairs in line with the registered information.

- Start-up funds registration

  SAFE has revoked approvals of account opening and settlement as well as domestic transfer respecting foreign exchange of start-up expenses and other funds ("start-up funds") relating to the establishment of foreign invested enterprises ("FIEs").

  SAFE only requires foreign investors to register with it general information on the start-up funds. In general, the start-up funds for each project in which foreign investors contribute should not exceed US$300,000; the relevant foreign exchange account should expire and be closed after six months (exceptions apply). The registered start-up funds can be deemed as share capitals that foreign investors contribute for the follow-up establishment of FIEs.

  After registration with SAFE, foreign investors may directly open account with bank as well as remit, settle and transfer the start-up funds via such account. Foreign investors can only open a start-up funds account with a bank at the place where FIEs are to be domiciled.

- Establishment registration

  FIEs are required to register with SAFE their general formation information after establishment, especially including shareholders and share capitals.

  SAFE has revoked approvals of account opening and settlement as well as domestic transfer respecting foreign exchange of FIEs' share capitals. SAFE has also revoked restrictions on account opening location and limits to the -number of share capital accounts as well as quota of funds transferred to each share capital account. FIEs may open share capital accounts in places other than where domiciled, and may open more than one account.

  After registration with SAFE, FIEs may directly open an account with the bank as well as remit, settle and transfer their share capitals via such account.

[5] We only refer to foreign direct investments in ordinary industries in the Article and those in special industries, e.g., equity investment and venture capital investment, are excluded hereunder.

- Registration for acquisition of domestic companies by foreign investors

  Besides directly and newly setting up FIEs, foreign investors may acquire shares in domestic companies to set up them. As required, FIEs must register with SAFE their conversion from domestic companies after share acquisition by their foreign investors, and include general conversion information, shareholders and share capitals.

  For domestic sellers, SAFE has also revoked approvals of account opening as well as remittance and domestic transfer of sales price. In addition, SAFE has also revoked its restriction on account opening for sales price in places other than where domestic sellers are domiciled.

  After the registration with SAFE, domestic sellers may open an asset realization account with bank as well as remit, settle and transfer share sales price that foreign investors pay via such account.

- Security funds

  SAFE has revoked approval of account opening and funds transfer respecting foreign exchange for security of cross-border transactions and biddings.

  However, the general information of concerned parties and securities shall be registered with SAFE. The foreign exchange funds for the purpose of security cannot be settled.

- Change registration

  FIEs are required to register with SAFE the following changes in connection with their original registered information:

  - general corporation information including, without limitation, company name, business scope, legal representative, and registered address;
  - investment information including, without limitation, registered capital, total investment amount, forms of investment, registered currency, investors, and subscripted share capital; and
  - merger, split-up, removal.

  In case of an advance capital recovery proposed by foreign investors, such recovery shall be registered with SAFE. The accumulated recovery funds which have been paid and remitted out of China shall not exceed the amount that foreign investors invested initially.

  A de-registration of foreign exchange is required, if FIEs:

  - are to be closed due to bankruptcy, dissolution, expiration of duration of operation, merger or split-up;
  - have been converted to a domestic company due to foreign investors' capital withdrawal via capital decrease, share transfer and advance capital recovery, etc.

  FIEs may directly purchase from banks and remit out the foreign exchange funds arising out of capital decrease, liquidation, advance capital recovery and distribution of profits after the relevant registration with SAFE.

- Reinvestments registration

  SAFE has revoked approval of reinvestment by foreign investors by way of:

  - increase of capital being sourced from capital reserves, surplus reserves and undivided profits and registered foreign loans;
  - domestic legitimate incomes arising out of domestic profits, share transfer, capital decrease, liquidation, advance capital recovery;

  However, the invested enterprises need to register with SAFE for such reinvestment by foreign investors. After registration, the foreign exchange for reinvestment may be transferred to the invested enterprises without SAFE approval.

- Contribution confirmation

  FIEs are required to register with SAFE for their foreign investors' paid-up capital contribution including cash and in-kind payment.

  In the event of share acquisition of domestic companies by foreign investors, such registration for paid-up share sales price is also required.

  After the capital contribution registration, foreign investors may purchase from banks and remit out foreign exchange funds arising out of FIEs' capital decrease, liquidation, share transfer, distribution of profits and advance capital recovery, or reinvest in China by using the aforementioned funds.

Control

SAFE has largely liberated its control of foreign exchange in FDIs. However, this does not mean that SAFE already lets matters drift towards supervision on foreign exchange. Actually, SAFE still achieves its supervision through certain special measures.

- Control of foreign exchange accounts

  SAFE requires that the concerned parties involved in FDIs open foreign exchange accounts with banks and that all foreign exchange funds be handled through such accounts.

- Control of exchange settlement and conversion

  The concerned parties involved in FDIs cannot settle and convert foreign exchange at their wills. They can only settle and convert foreign exchange funds for purpose of self-use with a real use purpose.

- Banks' obligations of review and registration

  Banks shall make sure that the concerned parties involved in FDIs have registered with SAFE for their foreign exchange affairs before opening accounts, depositing, settling and transferring foreign exchange funds for the concerned parties. In the meantime, banks also need to check and review the relevant documents that the concerned parties submit to make sure that all documents are authentic and consistent.

  In addition, banks are under obligation to upload and register timely all information in respect of the handled foreign exchange affairs in SAFE's data system.

- SAFE's investigation and sanction

  SAFE carries out statistics and monitors cross-border balance of payment, settlement and sale of foreign exchange as well as changes of foreign investors' rights and interests through FIEs' registration, data information uploaded by banks, annual review of FIEs and random check of foreign exchange related affairs.

  In case banks or FIEs violate its rules, SAFE will conduct investigations and impose sanctions on the violators. For banks, SAFE may revoke its delegation and require a pre-approval before banks handle foreign exchange affairs for their clients.

  In addition to the above, SAFE has a special authority to adjust control policies on foreign exchange in accordance with its statistics and monitor status.

Pilot

On 1 October 2013, China (Shanghai) Pilot Free Trade Zone ("PFTZ") was officially opened up. There are special policies and new rules adopted in the Free Zone, among others, the *Opinions of the People's Bank of China on Providing Financial Support for the Development of China (Shanghai) Pilot Free Trade Zone* promulgated and effective on 2 December 2013. Banks were delegated to process the registration and change for foreign exchange under direct investment in the PFTZ. On the premise of ensuring the authenticity of transactions and the complete collection of data, the foreign exchange funds under direct investment in the PFTZ may be settled at will.

To speed up the reform of foreign exchange under direct investment, SAFE released a *Notice of the State Administration of Foreign Exchange on Issues Relating to Pilot Scheme of Reform of Administration of Foreign Currency Capital Settlement by Foreign Investment Enterprises in Certain Localities* on 4 July 2014, which expanded the voluntary exchange settlement to additional 16 special pilot areas, namely Tianjin Binhai New District, Shenyang Economic Zone, Suzhou Industrial Park, Donghu National Innovation Demonstration Zone, Guangzhou Nansha New District and Hengqing New District, Chengdu Hi-tech Industrial Development Zone, Zhongguancun National Innovation Demonstration Zone, Chongqing Liangjiang New District, Heilongjiang Border Development and Open Foreign Exchange Administration Reform Pilot Scheme Area, Wenzhou Comprehensive Financial Reform Experimental Zone, Pingtan Comprehensive Experimental Zone, China-Malaysia Qinzhou Industrial Park, Guiyang Comprehensive Bonded Zone, Shenzhen Qianhai Shengang Modern Services Industry Cooperation Zone, and Qingdao Wealth Management Comprehensive Financial Reform Experimental Zone. The FIEs in the aforesaid pilot areas may settle their foreign exchange funds under capital accounts at will.

Conclusion

Apparently, the new regime of foreign exchange control already enhances foreign exchange liquidity as well as facilitates and speeds up foreign direct investment progress.

We expect that SAFE would liberate further its control on settlement and conversion of foreign exchange and that in future FIEs might be allowed to settle and convert foreign exchange funds at their wills throughout the country, on which we will keep a close eye.

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