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New SAFE Rule Circular 19 Reigniting Round-trip Investment in PRC

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On May 27, 2011, the State Administration of Foreign Exchange of PRC ("SAFE") issued *Operating Instructions on Foreign Exchange Administration for Domestic Residents Engaging in Financing and Round-tripping Investment via Overseas Special Purpose Vehicles* ("Circular 19"), which goes into effect on July 1, 2011.

Circular 19 removes some major obstacles to round-trip investments and has an effect of encouraging offshore investments and reviving round-trip investments. It indicates SAFE's policy shift from restricting to monitoring and regulating offshore equity financing activities. This client alert summarizes the key changes and effects of Circular 19, as well as its implications for investors.

1. REVIVING ROUND-TRIP INVESTMENT

Prior to Circular 19, offshore investments had only two viable approaches to be registered with SAFE: outbound investment for entities, and Circular 75¹ for domestic residents. The former has been primarily used for offshore investments, the approval of which has been difficult to secure. The latter, often referred to as "round-trip investment", applies only to special purpose vehicles as defined in Circular 75 ("SPVs"), which are offshore entities set up by PRC domestic residents with the purpose of acquiring onshore assets or equity in a PRC company through such entity (usually accomplished through an offshore equity financing). Circular 106² was issued in 2007 as guidance for the implementation of Circular 75, which, despite clarifying certain concepts and procedures, tightened the regulatory environment for round-trip investments. Following the issuance of Circular 77³ in 2009, provincial SAFE's stopped registering certain investments which were previously provided for under Circular 106, for instance, conversion of an offshore company set up by a PRC resident that did not fall into Circular 75's definition of SPV (a "non-SPV") into a SPV, and the retroactive registration for an existing but unregistered SPV for the purpose of round-trip investments. As a consequence, it has become increasingly difficult to obtain registration with SAFE.

Failure to obtain a SAFE registration has severe implications for round-trip investors. It substantially increases the risks of failing to comply with the PRC regulatory requirements for PE/VC investments with an offshore structure, and reduced the deal flow for the "red-chip" model IPO at offshore capital markets. Investors were also forced to invent round-trip investment schemes that resemble Circular 75, which can be highly burdensome.

¹ Circular 75, entitled *Relevant Issues Concerning Foreign Exchange Control on Domestic Residents* was issued on October 21, 2005 by SAFE, which requires Chinese residents to register with the local SAFE branch in relation to the establishment of a SPV, its round-trip investment and capital changes.

² Circular 106, entitled *An Operating Procedure for the Circular on Foreign Exchange Issues Related to Equity Finance and Return Investments by Domestic Residents through Offshore Special Purpose Vehicles*, was issued by the General Affairs Department of SAFE on May 31, 2007.

³ Circular 77 was an internal policy of SAFE, which was not publicly released.

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Circular 19 revives round-trip investments by: (i) reopening the door to Circular 75-type registration by overruling Circular 77; (ii) providing detailed guidance on registration not only for SPVs but also for outbound investments and foreign direct investments, and further expands the scope of SAFE monitoring to non-SPVs; and (iii) easing the registration requirements and conditions. As a result, we expect the registration of offshore investments and round-trip investments barred under Circular 77 to become available again.

2. BROADER COVERAGE

Circular 19 not only regulates SPV round-trip investments, but also covers the registration of outbound investments by PRC residents and foreign direct investments into the PRC, regardless of whether a SPV structure is adopted or not. The broader coverage of SAFE registration provides more flexibility in terms of investment schemes, and strengthens SAFE's monitoring capability for offshore investments.

Circular 19 requires registration for three types of investments: (1) SPVs established by domestic individual residents, including their establishment, capital changes, and the acquisition of domestic companies; (2) the establishment of foreign-invested enterprises ("FIEs"), which covers offshore companies' (including both SPVs and non-SPVs) greenfield investments and the acquisition of domestic companies; and (3) outbound investments by domestic entity residents, including their offshore subsidiaries' capital changes and reinvestments.

Under section (2) of Circular 19, non-SPV investments become registrable, nevertheless through a different route. Under section (3) of Circular 19, when a SPV invests into a foreign company, the transaction shall also be registered. As such, Circular 19 extends its jurisdiction to not only the SPV registration but also any reinvestments by the SPV and non-SPV, including their subsidiaries or affiliates.

3. REGISTRATION AVAILABLE FOR NON-SPV INVESTMENTS

After the adoption of Circular 77, the mechanism for converting non-SPVs into SPVs was no longer available. Thus, in effect, it became difficult to secure SAFE registration for a non-SPV investment into the PRC. Under Circular 19, however, non-SPV foreign investors that are directly or indirectly controlled by domestic individuals or entities can also register with SAFE through a new approach; the local SAFE is authorized to register those offshore entities established for a non-round-trip investment purpose as "non-SPV round-trip investment" under the administrative system of SAFE. Contrary to the "register first or game over" rule, SAFE provides registration status review for non-SPVs, which would grandfather certain pre-existing non-SPVs if they satisfy certain conditions such as compliance with foreign exchange control rules.

In general, registration for non-SPVs is less stringent than that of SPVs. For example, local SAFE could authorize their sub-branches to regulate and process non-SPV registrations, while the examining and approval authority for a SPV entity is still restricted to the provincial level SAFE. More importantly, non-SPVs are allowed to conduct round-trip investments prior to the completion of SAFE registration.

4. REMEDIES FOR NON-COMPLIANCE

Circular 106 provided that an unregistered round-trip investment having taken place before March 31, 2006, could register retroactively after paying penalties. However, such retroactive registration was barred after the issuance of Circular 77. Hence, such failure to register with SAFE beforehand constituted a complete bar to a subsequent round-trip investment.

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Circular 19 reinstates retroactive registration and provides a route by which previously non-compliant round-trip investments are brought in line with the law by paying penalties. In contrast with Circular 106, there is no deadline for the retroactive registration of an unregistered round-trip investment. Further, Circular 19 specifies the criteria for calculating penalties: (i) whether actual changes in the capital of the SPV have taken place, (ii) whether false representations and warranties were made by the FIE when applying for a SAFE registration, and (iii) whether the domestic company controlled by the SPV has remitted funds to the SPV in the form of profits, shareholder's loan and proceeds of investment, equity transfer, capital reduction and liquidation.

In early 2011, one of our clients successfully managed to register retroactively after paying penalties in a non-substantial amount to the local SAFE, and we are glad to see that the approach towards such individual case is being extended via the regime of Circular 19 and will become generally applicable. This is very encouraging news for investors who are seeking to rectify their previous investment structure and non-compliance with the SAFE registration.

5. EASIER REGISTRATION

Decentralizing authority

Under Circular 106, the establishment and control of an offshore SPV by domestic entity residents has to be submitted to the central SAFE for review and approval through a local SAFE. Circular 19 authorizes provincial level SAFE to regulate and process all categories of registration provided. Also, as briefly mentioned in item 3, the provincial level SAFE has the authority to further delegate its power to its sub-branches with respect to non-SPV registrations.

We expect that the delegation of power to the local SAFE will facilitate the round-trip investment registration process.

Removing the "operating history" requirement

Prior to Circular 19, the SAFE registration required that the domestic target company in a round-trip investment have a three-year operating history. Additionally, an offshore company conducting a greenfield investment, if controlled by a PRC resident, was required to have a two-year operating history before registration.

For most Chinese companies seeking PE/VC investment, these requirements are hard to fulfill. Circular 19 eliminates such "operating history" requirements, and consequentially eases the implementation of round-trip investments.

Reducing burden of documentation

Moreover, under Circular 19, SAFE no longer requires applicants to provide documents such as business and financing plans, financial statements or audit reports⁴ of the domestic enterprise, which reduces the burden on the applicants.

Specifying time of registration

Finally, Circular 19 specifies the time of SAFE registration for each type of investment. For SPVs controlled by domestic individuals, registration for their offshore financing, offshore reinvestment and remittance of capital proceeds to domestic individuals shall take place within 30 days after such changes occur; and registration for other material changes of SPVs may be done during the "annual-inspection period" of the SPVs' onshore subsidiaries. Regarding outbound investments

⁴ Audit report may be required for retroactive registration for SPVs and FIE registration if such an FIE has not yet participated in the "foreign exchange annual-inspection".

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by domestic entities, the domestic entities shall proceed with the registration within 60 days after the relevant changes of their offshore subsidiaries occur.

Furthermore, Circular 19 confirms that SPVs are not required to register prior to their establishment. However, no substantial changes to the capital or shareholding of such SPVs are permitted until the completion of registration.

6. CONCLUSION

The excessive liquidity, the skyrocketing foreign exchange reserves, and the continuous pressure on domestic inflation have intensified the difficulties of SAFE regulation. Circular 19 indicates a major policy shift by SAFE in its ongoing battle against hot money. Through encouraging offshore investments and round-trip investments, SAFE seeks to create a favorable regulatory environment to curb excessive liquidity. Meanwhile, the comprehensive information on offshore investment collected through the registration process is constructive for future policy-making in response to the offshore fund inflows, and is also beneficial for taxation and commerce administrative purposes.

In short, Circular 19 is a great development for both onshore companies and offshore PE/VC investors, since it encourages offshore investments and revives round-trip investments, regardless of whether the offshore company is a SPV or not. Although MOFCOM and NDRC have not adopted the same or similar action to change its policy and approval procedure for offshore investment and round-trip investment, we believe that Circular 19 is a good starting point, and will facilitate offshore investment and revive round-trip investment.

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