China implements new foreign exchange rules in the Free Trade Zones

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Background

The State Administration of Foreign Exchange ("**SAFE**"), China's foreign exchange regulator, announced on several occasions this year – which marks the 40th anniversary of SAFE's establishment – its commitment to optimize China's foreign exchange rules to keep up with China's efforts in liberalizing its economy. These reforms are about to come to life, although on a limited basis: from July to August 2019, 11 provincial branches of SAFE and Shenzhen SAFE issued their respective pilot rules concerning a series of new foreign exchange measures applicable in all of China's current 11 provincial Free Trade Zones as well as the Shenzhen Shekou Free Trade Area (together, "**FTZs**"), either in the form of *Notice of Launching Foreign Exchange Innovation Business* ("**Notices**"), *Implementing Rules for Foreign Exchange Management Pilot Reform* ("**Implementing Rules**"), or a combination of the two (together, "**FTZ Pilot Rules**").

The FTZ Pilot Rules supplement and modify the foreign exchange practices and manuals applicable in the FTZs. In particular, the Notices provide updated guidelines, while the Implementing Rules provide updated guidelines and certain additional detailed rules. The FTZ Pilot Rules have been published according to instructions issued by SAFE centrally and are viewed as one step forward towards China's comprehensive foreign exchange reform.

Main reforms introduced by the FTZ Pilot Rules

The FTZ Pilot Rules introduce the following substantial changes to the existing foreign exchange regime, examined in the following paragraphs of this client alert: (1) opportunity to opt into the New Regime (as defined below), (2) freedom to use capital account funds to carry out equity investment in China, (3) freedom to choose the currency to be used to disburse and repay cross-border loans, and (4) simplified foreign exchange procedures with respect to certain types of transactions.

1. Opportunity to opt into the New Regime

The *Circular on Matters Concerning the Macro-prudential Management of Overall Cross-border Financing (Yin Fa [2017] No.9)* issued by the People's Bank of China on January 11, 2017 ("**Circular 9**") fundamentally changed the rules governing the ability of Chinese enterprises (excluding governmental financing platforms and real estate enterprises) to incur cross-border debt (namely offshore loans in foreign currency or RMB). Prior to Circular 9, the maximum amount of cross-border borrowing ("**Maximum Foreign Debt**") of a non-financial foreign-invested enterprise ("**FIE**") was equal solely to its "*foreign debt borrowing gap*", which means the difference between the "*total investment amount*" and the "*registered capital*" of the FIE ("**Old Regime**"). Circular 9 introduced a new formula to determine the Maximum Foreign Debt ("**New Regime**"), under which the Maximum Foreign Debt is calculated based on the net asset value and outstanding foreign borrowings, in each case on a risk-weighted basis. Please refer to our client alert "*New PBOC Circular potentially raises the overseas borrowing ceiling for borrowers in China: but is it a game changer?*" for a more detailed analysis of the New Regime.

Circular 9 requires FIEs (excluding governmental financing platforms and real estate enterprises) to choose either the Old Regime or the New Regime during a one year transitional period, with respect to existing FIEs, or upon establishment, with respect to newly established FIEs. No further change is allowed once this choice has been made. Under the FTZ Pilot Rules, enterprises incorporated in the FTZs are given another opportunity to switch to the New Regime, if they previously opted for the Old Regime.

2. Use of funds under the capital account[1]

Traditionally, only FIEs that include "*investment*" in their business scope are allowed to use the funds under their capital account to make onshore equity investments. This type of business scope is typically only given to FIEs established in the form of "*foreign-invested investment company*" ("**Investment FIE**"), which requires meeting certain onerous thresholds that do not apply to "*plain vanilla*" FIEs[2]. On July 4, 2014, SAFE issued the *Circular on Issues concerning the Pilot Reform of the Administrative Approach in relation to the Conversion of the Foreign Exchange Capital of Foreign-Invested Enterprises in Certain Regions (Hui Fa [2014] No. 36)* ("**Circular 36**"), which for the first time expressly allowed a non-Investment FIE established in any of the 16 pilot areas specified in Circular 36 to use the funds under its capital account to make an onshore equity investment, subject to the prior registration of the target of such investment with the competent SAFE[3].

The FTZ Pilot Rules have improved the regime in force under Circular 36 in two ways: (1) they have expanded significantly the territorial scope of Circular 36, allowing non-Investment FIEs incorporated in the 12 FTZs – a much larger area compared to the 16 pilot areas under Circular 36 – to use their funds under the capital account to make onshore equity investments, subject to the authenticity and legality of the transaction, and (2) they have removed the above mentioned requirement of prior registration with SAFE.

Foreign companies can take advantage of the FTZ Pilot Rules in managing their group financial resources more efficiently to expand their presence in China. For instance, a Chinese subsidiary established in an FTZ could use the funds provided by its parent company through a capital increase to make equity investments in other entities in China. This possibility unlocks new structuring options for foreign investments in China.

However, it is worthwhile noting that there is no mention in the FTZ Pilot Rules of whether non-Investment FIEs that do not include "*investment*" in the business scope are entitled to make onshore equity investments. In the absence of further clarifications in this regard, there may be inconsistencies in the way this regime is implemented by the local branches of SAFE. Therefore, the implementation of this rule under the FTZ Pilot Rules remains to be further tested in practice.

3. Currency used to disburse and repay cross-border loans

The FTZ Pilot Rules offer the freedom to choose the currency to be used to disburse and repay cross-border loans granted to FIEs established in the FTZs. In particular, the FTZ Pilot Rules allow the funds borrowed under a cross-border loan to be disbursed in a foreign currency different from the foreign currency denominated in the loan agreement, provided that any funds disbursed using a given currency must be repaid with the same currency. Compare this with Circular 9, which imposes the use of a single currency, as denominated in

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1 In the context of the foreign exchange rules, foreign exchange funds are divided into "*current account*" and "*capital account*". The current account records the trade in goods and services, while the capital account records the movement of capital (both equity capital and debt).

2 The requirements to establish an Investment FIE include, among others: (1) either (a) the value of the foreign investor's total assets is at least USD400 million in the year prior to the application, and the foreign investor has already established an FIE in China with a registered capital exceeding USD10 million fully paid-up, or (b) the foreign investor has already established at least 10 FIEs in China with their combined registered capital exceeding USD30 million fully paid-up; and (2) the registered capital of the Investment FIE is at least USD30 million.

3 Circular 36 was later replaced by the *Circular on Reforming the Administrative Approach in relation to the Conversion of Foreign Exchange Capital of Foreign-Invested Enterprises (Hui Fa [2015] No. 19)* issued by SAFE on March 30, 2015 ("**Circular 19**"), which provides that onshore equity investments made by non-Investment FIEs are subject to certain additional rules. Please refer to our client alert "*China liberalises settlement of foreign exchange capital through SAFE Circular 19: a game-changer for the foreign investment fund industry?*" for a more detailed analysis of Circular 19.

the loan agreement, for purposes of disbursing and repaying the cross-border loan.

4. Simplified foreign exchange procedures

The FTZ Pilot Rules simplify a number of procedures applicable to certain types of foreign exchange transactions. The most notable innovations are examined below.

- **Inward remittance under capital account**

  Under the rules in force before the FTZ Pilot Rules, Chinese enterprises are only entitled to receive capital account funds from overseas subject to submitting a set of application documents for review and approval by the bank where their capital account has been set up. This procedure normally takes several hours to complete.

  The FTZ Pilot Rules eliminate the above mentioned pre-approval procedure, replacing it with a post-remittance review to be carried out by the capital account bank on a spot basis on its clients from time to time. As no prior approval is sought from the bank, the timing required to transfer capital account funds into an FIE from overseas is greatly reduced, being essentially equal to the time routinely required to process any cross-border bank transfer.

- **Cancellation of foreign debt registration**

  The FTZ Pilot Rules make it easier to obtain the cancellation of the registration of foreign debt incurred by FIEs established in the FTZs, upon its full discharge. They allow the cancellation to be obtained simply through an application filed with the account bank in the FTZ, instead of the more onerous requirement of a filing with the local SAFE which would otherwise apply.

- **Special rules issued by certain FTZs**

  In addition, certain FTZs have issued special rules that further liberalize the foreign exchange regime applicable in their territories with respect to certain specific types of transactions. For example:

  - **Financial leasing**

    Financial leasing companies in the Guangdong FTZ, Shanghai FTZ and Tianjin FTZ are allowed to collect rental payments in foreign currencies from clients in these FTZs if more than 50% of the funds such leasing companies used to purchase the leased assets derived from onshore or offshore foreign currency loans.

  - **Financial currency derivative products**

    Qualified banks in the Guangdong FTZ, Hainan FTZ, Shaanxi FTZ, Fujian FTZ, Shanghai FTZ and Tianjin FTZ are entitled to provide RMB and foreign currency derivative products to their clients to be used in connection with their business.

  - **Trade financing**

    The trade financing proceeds provided by banks in the Hubei FTZ, Sichuan FTZ and Shanghai FTZ to offshore entities can be deposited in the non-resident accounts ("**NRAs**") opened by the offshore entities with such banks. In addition, the funds in the NRAs can be pledged as security for foreign currency loans provided by banks in these FTZs to the offshore entities, provided that the proceeds of such loans can only be used within China.

Conclusion

The FTZ Pilot Rules have to some extent materialized SAFE's commitment to push forward the liberalization of China's foreign exchange regime and to simplify the administration of the capital account. These reforms only apply to the FTZs at the moment, and the degree and effects of their implementation remain to be observed. It is unclear if and when these reforms will be expanded to the whole of China, although it is expected that this will happen at some point, given the FTZ's nature of testing ground for future nationwide reforms.

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