China allows foreign-invested enterprises to make equity investments within China from the capital account: liberalization of the domestic M&A market beckons

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Ever since China began opening up to the outside world, the right of foreign-invested enterprises ("**FIEs**") to make equity investments within the People's Republic of China (which for these purposes refers to Mainland China excluding the Hong Kong and Macau Special Administrative Regions and Taiwan (the "**PRC**" or "**China**"), using capital contributions (i.e., registered capital or a capital increase) has been a privilege rather than a right: the unqualified right to re-invest was reserved for certain specific types of FIE, including (i) foreign-invested investment enterprises (also known as foreign-invested holding companies), (ii) foreign-invested venture capital investment enterprises, and (iii) qualified foreign limited partner funds (collectively, "**Investment-type FIEs**"). Establishment of Investment-type FIEs was historically something of an obstacle course, with qualification criteria to meet and minimum capital thresholds, and they were subject to quite heavy regulatory scrutiny at the point of establishment due to sensitivities around domestic reinvestment by FIEs.

Historically, FIEs which were not Investment-type FIEs ("**Non-investment FIE**") were only permitted to make domestic equity investments using retained profits derived from their operations, except for generic FIEs having "investment" included in their business scope, which has been, in practice, almost impossible to include or add into the business scope in recent years due to sensitivities around misuse of reinvestment rights. However, more recently there has been renewed momentum to relax these restrictions.

Starting from July 2019, pilot programs were set up in various free trade zones ("**FTZs**"), whereby Non-investment FIEs established in the FTZs were permitted to make domestic equity investments using funds in their capital accounts.

On 25 October 2019, the State Administration of Foreign Exchange ("**SAFE**") published the *State Administration of Foreign Exchange Circular on Further Promoting Cross-border Trade and Investment Facilitation* ("**Circular**"), which took effect on the same date, marking a further relaxation of China's foreign exchange controls. The Circular provides a number of measures in connection with trade and investment activities, which echo recent attempts by the Chinese government to stabilize foreign trade flows and attract more foreign investment. One of those measures is to allow Non-investment FIEs to use their capital accounts to make equity investments within China. In this note, we will look at the implications of this significant and eagerly-awaited change which effectively opens up the domestic M&A market to all FIEs, as well as the impact that the Circular may have on other aspects of the Chinese foreign exchange control regime.

Equity investments by Non-Investment FIEs using capital funds

Article 2 of the Circular provides that Non-investment FIEs are allowed to engage in equity investments in China using the funds from their capital accounts, subject to the following requirements:

- complying with the current *Special Administrative Measures (Negative List) for Foreign Investment Market Access*; and
- the investment project in China is genuine and complies with applicable laws and regulations.

The first leg of the requirements echoes the provisions in the *Foreign Investment Law* (which takes effect on 1 January 2020) (the "**FIL**"), stating that China shall implement a negative list administrative system for foreign investments (including both direct and indirect investments). An equity investment made by an FIE is clearly a form of indirect foreign investment.

Based on the guidelines published by the SAFE for banks on the same date as the Circular, namely the *Guidelines for Banks when Operating Foreign Exchange Business in Connection with Capital Accounts* ("**Guidelines**"), domestic equity investments include both direct investments by Non-investment FIEs as well as acquisitions of equity interests by Non-investment FIEs.

This liberalisation measure draws on the experience gained from the pilot programs run in the FTZs across China earlier this year. Based on those learnings, when reviewing the genuine nature and compliant status of an investment project, banks are required to focus in particular on the rationality of the investment and the connection between the investee and the investor's business. This means that banks may reject speculative investments and/or those that are completely divorced from the core business of the investing FIE, so it is not a complete free-for-all, and banks, rather than SAFE, will be the future gatekeepers.

Do you have to invest in RMB or foreign currency?

Under Article 2 of the Circular, Non-investment FIEs can choose to make equity investments in either foreign currency or Renminbi ("**RMB**"):

- where a Non-investment FIE makes a capital contribution to the investee in the original foreign currency in which the Non-investment FIE's registered capital is denominated, in order to receive the funds, the investee must register with SAFE to receive domestic re-investment through a commercial bank, and open a specific type of foreign exchange account called a "Capital Fund Account" (资本金账户); and
- where a Non-investment FIE makes a capital contribution to the investee in RMB converted from an original foreign capital contribution to the Non-investment FIE's registered capital, the investee must register to receive domestic re-investment with SAFE through a commercial bank and open a specific type of bank account named a "Capital Account – Converted Foreign Exchange Pending Payment (资本项目-结汇待支付账户)".

The Guidelines provide detailed requirements on the registration information needed for investees receiving domestic re-investment (接收境内再投资基本信息登记). The investee or the seller of the equity transfer needs to provide the following documents to the commercial bank in question:

- investment agreement (e.g. Subscription Agreement or the Transfer of Equity Interests Agreement);
- documents evidencing the relationship between the investee and the investor;
- undertaking letter issued by the Non-investment FIE stating that (i) the investment complies with the Negative List; (ii) the relevant procedures have been carried out in accordance with applicable laws; (iii) the Non-investment FIE assumes the legal consequences of the investment.

The Circular being silent on the point, the Guidelines make it clear that Chinese individuals receiving equity investment from Non-investment FIEs (which can only happen in an equity interest transfer scenario) are not required to open either a "Capital Fund Account" or "Capital Account – Converted Foreign Exchange Pending Payment".

The use of capital remains restricted

Though funds are now allowed to be transferred from a Non-investment FIE to domestic capital companies, the use of such funds is still subject to monitoring by SAFE.

Under the Guidelines, funds placed in the "Capital Account – Converted Foreign Exchange Pending Payment" are not allowed to be used for the following purposes:

- direct or indirect payments for any business beyond the business scope of the company,

or in which investment is prohibited by laws or regulations;
- except where otherwise permitted by law, direct or indirect investment in any securities other than those investment products issued by banks with a principal guarantee;
- making loans to non-affiliated companies, unless permitted under the company's business scope; or
- construction or purchase of real property other than for self-use (this restriction does not apply to real estate companies).

Furthermore, the Guidelines also require banks to conduct a genuineness and compliance reviews for every payment made from the "Capital Account – Converted Foreign Exchange Pending Payment" as mentioned above, and to keep the supporting documents for 5 years. The review approach adopted by the Guidelines is that the bank will go back and review the genuineness and lawfulness of the last payment before proceeding to make the current payment; however, if the last payment previously passed the genuineness and lawfulness review, then the bank is not required to conduct the review. In comparison to the pilot programs in the FTZs earlier this year, this approach demonstrates SAFE is adopting a conservative position on the administration of capital account payments, in contrast to the post-transaction spot check-based approach being implemented for capital account transactions under the pilot program in the Shanghai FTZ.

What does the liberalisation of equity investments within China mean to foreign investors?

First of all, this change makes establishing Investment-type FIEs significantly less attractive, as their ability to re-invest within China was historically one of the key drivers for establishing such vehicles, although wider business scopes and possibly more latitude in terms of the scope of permitted investments as well as the procedural advantages described below may mean they still have a raison d'être. Although Investment-type FIEs still have certain advantages in terms of procedures when making equity investments (for instance, when the Investment-type FIE makes an equity interest using RMB converted from its original foreign capital contribution, the investee is not required to carry out registration and is not required to open the "Capital Account – Converted Foreign Exchange Pending Payment" to receive capital), it is now an open question as to whether these procedural and other advantages by themselves are enough to tip the balance for the foreign investor to choose these vehicles going forwards. Foreign investors worried about the qualifications such as high China asset thresholds, longer set up timelines, and greater scrutiny from the Chinese government during the establishment process can breathe a sigh of relief.

Furthermore, it is now possible for a foreign investor to structurally replicate a Chinese "holding company" entity. With the liberalization of the use of capital funds for investment purposes, a foreign investor can now establish a wholly foreign-owned enterprise to serve as a holding company, which in turn can establish various operational subsidiary entities in China, without having to go through all the hoops traditionally associated with forming such vehicles or having retained profits available for re-investment.

Other notable changes mentioned in the Circular

In addition to relaxing restrictions on equity investments by Non-investment FIEs, the Circular provides 6 additional measures aimed at foreign trade facilitation and 5 additional measures for foreign investment facilitation. We have highlighted the major changes relevant to foreign investors:

Pilot program for facilitating payments made from capital accounts

After the Circular becomes effective, certain eligible enterprises[1] in the pilot areas are

[1] Taking Shenzhen as an example, eligible enterprises are non-financial institution enterprises that have not been found to have been in violation of any foreign exchange regulations in recent years, and if it is in the *Foreign Exchange Receipts and Payments in Goods Trade List* (

exempted from submitting supporting documents for genuineness review for payments made from certain capital accounts (generally including capital contributions, foreign loans and funds raised from overseas listings).

Banks can monitor the payments using prudential supervision. This measure has been adopted in 12 free trade zones and has now been expanded to the 6 newly-established free trade zones in 2019 and the entire municipality of Shanghai[2].

Relaxation of restrictions on deposits made by foreign investors in transactions

Deposits remitted from foreign investors in transactions are now allowed to be used directly for capital contributions, payment of consideration, or can be converted into RMB and used for payment of the consideration of underlying transactions or contractual penalties in China.

Changes to the foreign debt management regime

Borrowers of foreign loans are now allowed to cancel foreign loan registrations with competent banks instead of local branches of SAFE. In addition, the time limits for cancellation for foreign loan registrations have been removed.

Non-financial institution borrowers are now allowed to register foreign loans in an amount equal to up to twice of their net asset value with their respective local branches of the SAFE at any given time, instead of making registration every time a foreign loan is obtained. Borrowers can directly instruct banks on the receipt of drawdown funds and RMB conversion within their registered foreign loan quota.

Conclusion

Overall, the liberalisation of domestic reinvestment by FIEs under the Circular is clearly a welcome and timely development. It can be seen as part of the wider levelling of the playing field with domestic investors that will be encapsulated by the FIL, which essentially means FIEs become subject to the same basic legal regime as their domestic capital counterparts except where the FIL provides otherwise. The timing of the two pieces of legislation, where the Circular takes effect on the same date as the FIL (see our client notes on the FIL here[3]), is obviously not a coincidence, and represents a 'big bang' in terms of harmonization of the domestic capital and FIE regimes, given that the restrictions on reinvestment only applied to FIEs. They should provide a welcome boost to the domestic M&A market for foreign investors, although other factors such as the 25% enterprise income tax rate on a sale of equity by an FIE as compared to the 10% rate on sale of equity in an FIE (i.e. one or more layers above) by an offshore entity may still limit take-up of the opportunity.

The measures set out in the Circular are also consistent with the overall trend of further relaxing foreign exchange controls in China (although this has seen various ups and downs, with the 2016 crackdown on outbound direct investments by Chinese companies being one of the larger 'bumps in the road'). However, the measures include several pilot programs with a limited scope or geographical coverage and the government reserves the right to halt these programs at any time. Foreign exchange control in China is usually driven by short-term government policy and its political agenda.

At this sensitive time, when China is hoping to reach agreement with the United States of America to end the damaging Sino-U.S. trade war, the question is whether these measures have been implemented for political expediency or whether they represent a genuine and permanent determination by the Chinese government to liberalize its foreign exchange regime. The answer to these questions remains to be seen in terms of how these measures will

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[2] The 18 free trade zones are those in Shanghai, Guangdong, Tianjin, Fujian, Liaoning, Zhejiang, Henan, Hubei, Chongqing, Sichuan, Shanxi, Hainan, Shandong, Jiangsu, Guangxi, Hebei, Yunnan and Heilongjiang.

[3] The Foreign Investment Law gets wings: draft implementation regulations released for public consultation ;
The Foreign Investment Law: a new chapter opens for foreign direct investment in China;
China breaks new ground with Foreign Investment Law-related Intellectual Property ("IP") reform.

be implemented in practice, with banks rather than SAFE very much in the front line, the concern being that opaque window guidance from SAFE may be used to regulate bank administration of this area, making it a less transparent and predictable environment for FIEs.

Contacts

Hong Kong

Andrew McGinty
Partner, Hong Kong
andrew.mcginty@hoganlovells.com

Beijing

Michael Zou
Counsel, Beijing
michael.zou@hoganlovells.com

Aldo Boni de Nobili
Senior Associate, Beijing
aldo.bonidenobili@hoganlovells.com

Tony Yang
Junior Associate, Beijing
tony.yang@hoganlovells.com

Shanghai

Jun Wei
Partner, Shanghai
jun.wei@hoganlovells.com

Shantay Cong
Senior Associate, Shanghai
shan.cong@hoganlovells.com

Jia Zhan
Associate, Shanghai
jia.zhan@hoganlovells.com

Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest*
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
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