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China's SAFE Further Streamlines Forex Procedures for Foreign Direct Investment

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On May 11, 2013, the State Administration of Foreign Exchange ("SAFE") issued the *Provisions for Administration of Foreign Exchange Relating to Inbound Direct Investment by Foreign Investors* (外国投资者境内直接投资外汇管理规定) ("Circular 21"), effective May 13, 2013. Circular 21 represents a further step by SAFE to simplify and unify the relevant foreign exchange registration procedures following issuance of the *Circular on Further Improvement and Amendment of Foreign Exchange Control Policies on Direct Investment* (国家外汇管理局关于进一步改进和调整直接投资外汇管理政策的通知) ("Circular 59") (effective in December 2012).

As discussed in a [prior Morrison & Foerster alert](#), Circular 59 covers foreign exchange filings relating to both foreign direct investment into China ("FDI") and Chinese outbound investment. Circular 21 was issued to further clarify Circular 59 with regard to FDI, and supplements Circular 59 by confirming additional types of foreign exchange registrations.¹

SAFE's foreign exchange control regime prior to Circular 59 required SAFE approvals for a wide range of foreign exchange transactions regarded as "capital account" transactions undertaken in relation to FDI. Circular 59 and Circular 21 effectively rescind this approval requirement—going forward, a registration with SAFE suffices.

However, neither Circular defines "registration" or otherwise makes clear whether "registration" is a mere formality or involves the kind of substantive review process undertaken by SAFE and its relevant branches in the past. In addition, in connection with a registration process, Chinese governmental authorities typically do retain significant discretion on whether to accept registration applications, which begs the question of whether a registration process would be materially less burdensome than an approval process.

Notwithstanding these questions, we note that Circular 21 contains 23 registration forms providing a full set of consolidated registration forms in relation to FDI, and has abolished and replaced 24 existing foreign exchange regulations. Each of the forms provides detailed instructions and specific registration application documents for each specific FDI transaction, making the registration procedures relatively transparent, precise and easy to follow, potentially leaving less room for governmental authorities to make arbitrary decisions to deny registrations. In addition, SAFE has further delegated specific supervisory power to banks.

¹ According to Circular 21, to the extent that there is any discrepancy between Circular 21 and any previously-issued and current effective SAFE regulations, including Circular 59, Circular 21 prevails.

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In relation to this newly-issued Circular 21, we particularly note the following:

1. Definition of Inbound Direct Investment

SAFE introduces relatively new terminology under Circular 21—“*外国投资者境内直接投资*” or “foreign investors’ inbound direct investments” in English. Circular 21 defines “foreign investors’ inbound direct investments” as an act of a foreign institutional or individual investor to establish, by way of new formation or a merger and acquisition transaction, a foreign invested enterprise (“**FIE**”) within the territory of China,² in which such investor obtains ownership, control and/or operating and management right.³ Notably, Circular 21 also applies such term to foreign investors’ investments in domestic financial institutions.⁴ Previous differential SAFE treatments for different types of FDI have been conceptually consolidated under this newly created terminology “foreign investors’ inbound direct investments”.

2. Key Features of SAFE Registration Requirements

Similar to Circular 59, Circular 21 explicitly states that foreign exchange matters in connection with foreign investors’ inbound direct investments are subject only to foreign exchange registrations.⁵ Under Circular 21, a foreign investor or an FIE is required to complete a registration with SAFE in advance for each of the following FDI matters (except for the establishment of an FIE, in which case the registration may be carried out after its establishment):

- receiving funds onshore from overseas to pay for start-up costs;
- establishment of an FIE;
- capital contributions to an FIE using cash, in kind, equity interests or intangibles;
- payment of consideration for acquiring equity interests in a domestic company from a Chinese party;
- capital increase, reduction, equity transfer or any other changes to the registered capital with respect to an FIE;
- receiving proceeds onshore for any equity transfer and M&A transactions involving a domestic company;
- cancellation of an FIE or converting an FIE into a domestic company;
- onshore reinvestment of an FIE.

² Under China’s foreign investment regulatory regime, the reference to the “territory of China” usually refers to Mainland China only without including the Hong Kong Special Administrative Region, the Macau Special Administrative Region or Taiwan.

³ Please refer to Article 2 of Circular 21. It is interesting to note that Circular 21 also refers to “control” and “operating and management rights” in addition to “ownership” (which usually refers only to an equity interest). It may provide a ground for SAFE to extend its authority to those contractual arrangements that enable a foreign party to have control or operation and management rights over an FIE or a domestic company.

⁴ Please refer to Article 17 of Circular 21. Foreign investment into the financial sector in China is generally under the supervision of the People’s Bank of China and not under the general FIE regulatory system regulated by the Ministry of Commerce (“**MOFCOM**”). It seems that SAFE intends to consolidate the foreign exchange registration requirements for foreign investments in China’s financial institutions into the general FIE foreign exchange control system under this Circular 21.

⁵ Please refer to Article 3 of Circular 21.

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As mentioned above, neither Circular 59 nor Circular 21 defines “registration,” leaving open to some extent the question of whether a registration process would be materially less burdensome than an approval process.

In fact, Circular 21 contemplates a review and examination process associated with the various foreign exchange registrations, and such process could potentially be extensive under certain circumstances.⁶ We nonetheless believe that, by enacting Circular 21, SAFE seeks to simplify and streamline the foreign exchange registration regime. Our observations in this regard are:

- Circular 21 contains a specific template registration form for each of 23 categories of transactions with detailed accompanying instructions, evidencing a clear intention to clarify documentation and other registration requirements, making it easier for both the registration applicants and SAFE offices to follow.⁷
- Circular 21 specifies that SAFE’s processing time for a registration application is 5 business days, which may be extended to 20 business days in special circumstances. This timeframe is shorter than under prior rules,⁸ providing further evidence of SAFE’s intention to make foreign exchange registration under Circular 21 more of a formality than subject to a substantive review process.

3. Banking Matters

Consistent with Circular 59, Circular 21 allows the relevant party who has properly completed the requisite SAFE registrations to deal with banks directly for handling the following banking matters:

- opening foreign exchange start-up costs accounts, foreign exchange capital accounts, assets realization accounts (资产变现账户), and onshore reinvestment special accounts;
- purchasing foreign exchange for payment purposes;
- transferring funds.

The complicated SAFE approvals previously required for account openings and use of funds for ordinary course of business are no longer required under Circular 59 and Circular 21. However, it is noted that conversion of foreign exchange into RMB for investment purposes is still subject to certain SAFE regulatory control.

4. Onshore Reinvestment

Consistent with Circular 59, Circular 21 requires only registration with SAFE in connection with (a) a foreign investor’s contribution to the increase in registered capital of an FIE, regardless of whether such contribution is made with the foreign investor’s capital funds or through capitalization of surplus reserve funds, undistributed

⁶ For example, Article 6 of the *Operating Guidelines and Specifications on Matters Relating to the Inbound Direct Investment Business* (境内直接投资业务操作指引说明)(the “**Guidelines**”) states that SAFE is entitled to request an applicant to provide proof of the reasonableness of the transaction consideration under certain special circumstances relating to foreign exchange incomes and expenses.

⁷ 49 out of 52 pages of Circular 21 are template registration forms appended with detailed instructions for application documents, reviewing and examine principles, time limitation for handling, and power for SAFE agencies at different levels. Most importantly, Circular 21 also lists all of the applicable laws and regulations as references for SAFE offices, which presumably could narrow the discretionary room to arbitrarily deny a registration application.

⁸ In the previous regulatory regime, it would require 20 business days to have an application processed for any SAFE approval or registration purposes.

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profits and registered foreign debts or (b) reinvestment in an FIE of funds (including RMB) lawfully obtained onshore, such as profits and proceeds from equity transfer or a liquidation. This change involves elimination of the requirement to obtain SAFE approval for reinvestment of onshore generated RMB income. Circular 21 also contemplates that a bank can directly open a reinvestment special account, without SAFE's involvement.

Further, the *Reply on Issues Concerning the Foreign Exchange Administration of Foreign Reinvestment in RMB* (关于外商以人民币再投资外汇管理有关问题的复函) (Circular 2000 No. 129) effective as of May 10, 2000 ("Circular 129") was abolished by Circular 21. Circular 129 was very unpopular in private equity and venture capital circles, because it restricted the conversion of foreign exchange into RMB for reinvestment purposes. As such, abolition of Circular 129 should be welcomed by PE and VC investors.

However, we note that certain other circulars relating to the usage of capital funds still remain effective⁹ and, therefore, certain restrictions on the RMB settlement of foreign exchange capital funds and use of such settled RMB funds still remain unchanged under Circular 59 and Circular 21. Article 9 of Circular 21 states that the RMB settlement of foreign exchange capital funds of an FIE and use of such settled RMB funds shall comply with the relevant foreign exchange control regulations, and the foreign exchange capital funds and the RMB funds settled therefrom must be used in the ordinary course of operations of such FIE with authentic self-use purposes, which essentially means that these funds can only be used for business operations of FIEs approved by MOFCOM and may not be used for any onshore reinvestment, such as equity and securities investments, unless an FIE is a foreign-invested venture investment enterprise approved by MOFCOM.

5. Implications for PE Investors

Circular 21 abolished the *Reply to Questions Relating to Onshore Equity Investment with Foreign Exchange Capital Funds of Foreign Invested Venture Capital Enterprises* (关于外商投资创业资本金结汇进行境内股权投资有关问题的批复) (Circular 2008 No. 125) ("Circular 125") and the *Notice on Issues concerning the Foreign Exchange Administration of Foreign Invested Partnership Enterprises* (国家外汇管理局关于外商投资合伙企业外汇管理有关问题的通知) (Circular 2012 No. 58) ("Circular 58"). With Circular 125 abolished, capital flows involving capital contributions and returns on investments between a foreign invested venture capital enterprise ("FIVCE") and its portfolio companies no longer require SAFE approval. With Circular 58 abolished, a foreign invested partnership ("FIP") is treated no differently from other FIEs with respect to their respective foreign exchange matters. With respect to an FIVCE or an FIP, a relatively simple advance registration with SAFE will suffice for it to process any necessary bank remittances and other procedures in connection with its operations. This change should ease regulatory and administrative burdens associated with FIVCEs and FIPs and make them more attractive as investment vehicles for foreign private equity investors.

⁹ For example, the Notice on the Relevant Operating Issues concerning the Improvement of the Administration of Payment and Settlement of Foreign Currency Capital of Foreign Invested Enterprises (关于完善外商投资企业外汇资本金支付结汇管理有关业务操作问题的通知) (Circular 2011 No. 45) effective as of August 29, 2008 and the Supplementary Notice on the Relevant Operating Issues concerning the Improvement of the Administration of Payment and Settlement of Foreign Currency Capital of Foreign Invested Enterprises (关于完善外商投资企业外汇资本金支付结汇管理有关业务操作问题的补充通知) (Circular 2012 No. 59) effective as of August 1, 2011.

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6. Round Trip Investment

Circular 21 explicitly abolished the famous Circular 19¹⁰ in relation to round-trip investments. However, Circular 45¹¹ still remains effective. If an inbound direct investment is a round-trip investment, current foreign exchange registration requirements are still applicable and the parties to any such transaction need to be aware of and carefully address these SAFE registration requirements. However, of particular interest, under Circular 21, we note that a round-trip investment made by Chinese residents through overseas special purpose vehicles no longer requires a separate SAFE registration, but is now subject to the same SAFE registration as applied to other inbound direct investments.

7. Conclusion

By systematically simplifying and integrating foreign exchange administrative procedures in connection with FDI, Circular 21 represents a welcome (if possibly modest) step towards free conversion of foreign exchange for capital account transactions, and continues the shift away from the approval-oriented foreign exchange control regime to a new registration-based foreign exchange administration regime. In addition, SAFE has further delegated specific supervisory power to banks and continued its move away from its role as a hands-on regulator. However, it remains to be seen whether FDI investors will find the relevant procedures, be they an approval or a registration, materially less burdensome.

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¹⁰ Circular 21 abolished the Operating Procedures concerning the Foreign Exchange Administration of Company Financings and Round-Trip Investments by PRC Residents through Overseas Special Purpose Vehicles (境内居民通过境外特殊目的公司融资及返程投资外汇管理操作规程) (Circular 2011 No. 19) effective as of July 1, 2011. Please refer to our previous client alert on Circular 2011: New SAFE Rule Circular 19 Reigniting Round-trip Investment in PRC (<http://www.mofo.com/files/Uploads/Images/110614-New-SAFE-Rule-Circular-19.pdf>).

¹¹ Circular 45 refers to the Notice of Further Clarification and Compliance of Issues concerning Foreign Exchange Supervision over Capital Accounts (关于进一步明确和规范部分资本项目外汇业务管理有关问题的通知) effective as of November 9, 2011.

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