

# New Developments for Foreign Special Purpose Companies and Round-Trip Investment

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The State Administration of Foreign Exchange of the People's Republic of China ("SAFE") is the principal gatekeeper for incoming and outgoing investment made in foreign currency. SAFE wields tremendous influence over capital inflows and outflows and, as such, the rules it promulgates can significantly affect inbound investments. Recently, SAFE issued Circular 19, the 'Operating Rules for the Administration of Foreign Exchange in Financing and Round-trip Investment by Residents in China via Special-Purpose Companies', an important addition to an existing body of rules and regulations of special importance to foreign investors.

In 2005, SAFE issued the groundbreaking SAFE Circular 75 ("Circular 75"), which allowed domestic residents and foreigners resident in China to, for the first time, establish offshore special purpose companies as a way of accessing international capital markets. Circular 75 was the key legal document in enabling private companies to access the 'red chip' offshore listings, and was also the first rule to specifically require that the domestic resident owners of onshore companies seeking investment via special purpose companies register with SAFE.

Over time, SAFE has clarified and altered certain requirements first established by Circular 75, including in SAFE Circular 106 ("Circular 106"), issued in 2007. Circular 106 set forth in greater detail the requirements for domestic companies

seeking foreign investment, including its application not only to Chinese residents, but to any habitual resident in the PRC, including foreigners.

Circular 19 is largely a clarification and refinement of the abovementioned rules. Taken together with the previous Circulars, Circular 19 focuses on issues related to the requirements and approval process for the use of Special Purpose Companies by resident natural persons, to which it makes some adjustments and updates. Of special note in this Circular are the following points:

#### Expanded Choice in Registration Forum:

According to Circular 19, resident natural persons in China must register at the local SAFE branch where the assets or equity of those persons' domestic enterprise are located; if the assets or equity of the domestic enterprise are present in separate locations, they shall register at the SAFE branch where the main company is located. This clarified Circular 75's requirement of registration at the "Local SAFE Bureau" by defining the locality for registration.

#### Pre-Establishment of Offshore Companies:

Before resident natural persons register with SAFE, they may pre-establish offshore special purpose companies; however, prior to completing registration with SAFE, the special purpose company may not conduct foreign investment, alterations to stock equity, round-trip investment activities or any other substantial capital or equity alterations. This is a significant improvement on a practical level, which will benefit the process with improved efficiency.

#### No Required Operating Period for Domestic Enterprises:

Circular 106 stipulated that resident natural persons registering domestic companies with SAFE provide the company's financial records of the previous three years. This essentially required that

companies seeking foreign investment be legally established for at least three years. Circular 19, however, contains no such requirement or reiteration of the need to submit three years of financial records, seemingly doing away with such requirement. Still, note that Circular 19 does not officially replace Circular 106; therefore, in practice, confirmation with relevant government departments must be sought to confirm whether this requirement would still apply.

#### Dealing with Penalties Before Retroactive Registration:

Unlike the prior rules, Circular 19 specifically stipulates that domestic residents must, *before* registering a directly or indirectly controlled special purpose company with SAFE, deal with any administrative penalties accumulated as a result of: (1) a substantial alteration in the capital or equity of the company; (2) any false promises made by the company; or (3) any profits or other payments remitted abroad between November 1st, 2005 and the date of application by a domestic company directly or indirectly controlled by the special purpose company. After penalties have been dealt with, residents should register the company retroactively with SAFE.

#### Equal Treatment for Foreign Citizens:

Compared to Circular 106, Circular 19 focuses on eliminating the use of foreign citizenship as a way of circumventing SAFE registration. Circular 19 emphasizes that regardless of whether or not a resident natural person holds PRC citizenship, Circular 19 applies to all individuals who are habitual residents of the PRC. This makes all resident natural persons essentially equal in a legal sense, continuing a previous trend of eliminating attempts to avoid registration through foreign citizenship. This emphasizes once more the necessity of registering with SAFE.

Conclusion:

- While the Circular clarified procedures in regard to where domestic companies should register and when offshore special purpose companies may be established, questions remain as to the three-year reporting requirement for domestic companies seeking foreign investment. Because Circular 19 cannot be assumed to have repealed or superseded previous SAFE Circulars, foreign investors and domestic companies seeking foreign capital should pay special attention to further developments in actual practice.
- The recognition of retroactive registration raises the possibility that in an existing round-trip structure, the PRC shareholder of an offshore company will need to deal with administrative penalties before retroactively registering with SAFE. However, such recognition needs to be tested in practice.
- Venture capital investors should remember that although they may establish special purpose companies prior to them being funded, investors cannot actually fund Chinese domestic operating companies without an effective SAFE registration. In general, SAFE registration is still a critical step in foreign investment in China.

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