

SAFE Circular 19 Provides New Operating Instructions on Foreign Exchange Administration for Round-Trip Investment in China

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On May 20, China's State Administration of Foreign Exchange (SAFE) issued the "Operating Instructions on Foreign Exchange Administration for Domestic Residents Engaging in Financing and Round-tripping Investment via Overseas Special Purpose Vehicles" (Circular 19), which came into effect on July 1. As an implementing guidance to further clarify Circular 75,¹ Circular 19 consists of three major sections detailing registration procedures and requirements in relation to (i) the establishment of special purpose vehicle (SPV) and other offshore entities by domestic resident individuals and round-trip investment by such SPVs and offshore entities, (ii) foreign-invested enterprises, and (iii) outbound investment by domestic entities. In this LawFlash, we will focus on the major changes to the registration procedures, requirements, and policies concerning round-trip investment.

According to Circular 75, domestic resident individuals have to register with SAFE before they set up offshore entities with the purpose of acquiring onshore assets or equity in a company established under the Chinese laws through such offshore entities. In 2007, SAFE issued Circular 106² as an implementing guidance of Circular 75, tightening the regulatory environment for round-trip investments. Following the release of Circular 77³ in 2009, SAFE stopped registering certain investments; for instance, conversion into an SPV of an offshore company set up by domestic residents that did not fall into Circular 75's definition of an SPV (and so would be considered a Non-SPV, which is generally a company that has substantial operations), as well as the retroactive registration for an existing but unregistered SPV for the purpose of round-trip investment. Circular 19 overrides Circular 77 to the extent of any inconsistency, and provides more transparent and practical guidance for foreign exchange registration. Below are the major points.

1. Circular 75 is the "Relevant Issues Concerning Foreign Exchange Control on Domestic Residents" issued by SAFE in October 2005.

2. Circular 106 is the "Operating Procedure for the Circular on Foreign Exchange Issues Related to Equity Finance and Return Investment by Domestic Residents through Offshore Special Purpose Vehicles" issued by SAFE in May 2007.

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

New Concept of “Non-SPV Round-Trip Investment”

After the adoption of Circular 77, conversion of a Non-SPV into an SPV was no longer possible; therefore, it was difficult to secure SAFE registration for the round-trip investment by a Non-SPV. Circular 19 explicitly puts forward the concept of “Non-SPV round-trip investment,” where a domestic resident individual conducts direct investment in China through a Non-SPV. Such an individual is not required to go through the registration process for an SPV before such Non-SPV invests in an onshore entity, but such onshore entity should be annotated as “Non-SPV round-trip investment” in SAFE’s administrative system. Moreover, Circular 19 allows a Non-SPV to convert into an SPV, overruling Circular 77.

Retroactive Registration for an Unregistered SPV

Circular 106 provided that domestic resident individuals that concluded a round-trip investment before completing registration with SAFE could register retroactively after paying certain penalties, but such remedies for noncompliance were barred after the adoption of Circular 77. As a result, failure to register with SAFE before an investment constituted an obstacle to a subsequent round-trip investment. Circular 19 reinstates retroactive registration and specifies the following 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 onshore entity when applying for the SAFE registration; and (iii) whether the domestic company controlled by the SPV has remitted funds to the SPV in the form of profits, principal and interests of shareholders’ loans, investment proceeds, equity transfer, capital reduction, or liquidation.

Registration Requirements for Newly Established Businesses

As required in previous regulations, when a domestic resident individual plans to conduct a round-trip investment, a three-year operating history is required for the domestic target company. However, under Circular 19, if the domestic target company has not been established, the applicant may instead provide a written statement with the consent of all domestic equity owners regarding overseas financing, which implies that the operating history requirement has been eliminated. In addition, Circular 19 requires that domestic resident individuals provide evidence that the equity or assets they obtained abroad and plan to invest in the offshore entity are in full compliance with Chinese laws and regulations in relation to foreign exchange administration. It is not yet clear what particular documents SAFE will require. In practice, SAFE may ask the applicant to provide documents such as an (overseas) employment contract, payroll, tax receipt, or tax return.

Establishment of SPV and SAFE Deregistration

Circular 19 confirms that domestic resident individuals can set up SPVs before they register with SAFE, but no substantial changes to the capital or shareholding of such SPVs are permitted until the completion of SAFE registration. If an SPV is liquidated or transferred and domestic resident individuals no longer own or control the SPV, domestic resident individuals should deregister such SPV after they transfer the liquidation or transfer proceeds back into China.

Implications

Circular 19 expressly states that it will supersede Circular 77 to the extent of any existing inconsistency between the two, but it does not specify the exact relationship between Circular 19 and Circular 106. It is therefore unclear how SAFE will interpret Circular 19 in practice. There are many uncertainties, but we expect things to become more definitive in the future.

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

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