



Private Equity Law

SAFE Circular 36 Changes Policy for the Settlement of Foreign Exchange Capital, Benefitting Foreign-invested PE Funds and Ordinary Foreign-invested Enterprises

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On July 15, 2014, China's State Administration of Foreign Exchange ("SAFE") issued the *Circular of the State Administration of Foreign Exchange on Issues Concerning the Pilot Reform of the Administrative Approach to the Settlement of Foreign Exchange Capital of Foreign-invested Enterprises in Certain Areas* (Hui Fa [2014] No. 36) ("**Circular 36**"). Circular 36 promotes discretionary settlement of foreign exchange capital in 16 pilot areas. They are Tianjin Binhai New Area, Economy Group of Shenyang, Suzhou Industrial Park, Donghu National Independent Innovation Demonstration Zone, Guangzhou Nansha New Area, Hengqin New Area, Chengdu High-tech Industrial Development Zone, Zhongguancun Science Park [in Beijing], Chongqing Liangjiang New Area, the border development and opened regions in Heilongjiang Province where pilot foreign exchange administrative reform is implemented, Wenzhou Comprehensive Financial Reform Pilot Area, Pingtan Comprehensive Experimental Area, China-Malaysia Qinzhou Industrial Park, Guiyang Comprehensive Bonded Zone, Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone and Qingdao Comprehensive Wealth Management and Financial Reform Pilot Area¹.

Circular 36 became effective on August 4, 2014 and supersede prior provisions in the event there is a conflict between *Circular 36* and those provisions. *The release of Circular 36 means that for the time being, the Circular of the General Affairs Department of the State Administration of Foreign Exchange on Issues Concerning the Improvement of Business Operations with Respect to the*

¹ It is worth noting that Shanghai is not included in Circular 36's pilot areas. In accordance with the *Circular of the State Administration of Foreign Exchange's Shanghai Branch on Issuing Implementing Rules for Foreign Exchange Control to Support the Construction of the China (Shanghai) Pilot Free Trade Zone* issued on February 28, 2014, FIEs in the China (Shanghai) Pilot Free Trade Zone have begun to settle foreign exchange capital at their discretion earlier this year. Here, a FIE opens, with the bank where its capital account is located, a corresponding RMB deposit account, which is then used to deposit RMB funds obtained from the discretionary settlement of foreign exchange and also used to process various payment procedures.

Administration of Payment and Settlement of the Foreign Exchange Capital of Foreign-invested Enterprises (Hui Zong Fa [2008] No.142) and other relevant regulations do not apply to the settlement of foreign exchange capital of foreign-invested enterprises (“**FIEs**”) within the aforementioned pilot areas.

Highlights of Circular 36

1. Discretionary settlement in Circular 36 v. payment-based settlement in Circular 142

Circular 36 allows FIEs within the covered pilot areas to settle foreign exchange capital at their discretion. Article 1 of Circular 36 provides that “discretionary settlement” means a situation where a FIE may, according to its actual business needs, settle with a bank, the portion of foreign exchange capital in its capital account confirmed by the local foreign exchange bureau as having capital contribution rights and interests. In other words, as long as FIEs confirm and register their capital contribution rights and interests, they can apply with banks to settle their foreign exchange at their discretion. Moreover, in these circumstances, FIEs can settle all of their foreign exchange capital on a discretionary basis. According to Article 4 of Circular 36, FIEs whose main business involves investment (“**Investment FIEs**”) are allowed to directly settle their foreign exchange capital and use the capital obtained from such foreign exchange settlement to make domestic equity reinvestment, including purchasing and establishing domestic enterprises. That is, for Investment FIEs, discretionary settlement applies to equity investment in domestic enterprises, while payment-based settlement applies for other types of settlement of foreign exchange capital.

By contrast, FIEs outside the pilot areas covered by Circular 36, where Circular 142 still applies, are required to submit certificates prior to foreign exchange conversion to RMB demonstrating the purposes for which RMB funds are to be used, including commercial contracts or payment advances issued by payees. If the total accumulated enterprise capital settlement and payment into the same foreign exchange capital account reaches 95% of accumulated credit, the bank has to verify the authenticity of the invoice and other required relevant proofs before handling the remaining procedures for settlement or payment of the capital. Most importantly, RMB funds derived from capital settlement cannot be used for any domestic equity investment.

2. Discretionary settlement - Flow of funds and eligibility

According to Circular 36, a FIE in a piloted area who obtains RMB from settlement cannot use such funds for direct domestic equity investment. Rather, FIEs shall open, with the bank of where its capital account is held, a corresponding capital account (the “**Account Pending Foreign Exchange Settlement Payment**”). The Account Pending Foreign Exchange Settlement Payment is used to deposit RMB funds obtained from discretionary settlement of foreign exchange, and the bank will supervise such funds through this special account.

Though discretionary settlement of foreign exchange is intended to facilitate the settlement of foreign exchange capital, RMB funds obtained from such settlement still has to be used truthfully for the FIE's own operational purposes within its scope of business.

According to Circular 36, a FIE shall NOT use its capital and RMB funds obtained through discretionary foreign exchange settlement for any of the following purposes:

- (1) it shall not, directly or indirectly, use the foregoing capital and funds for expenditures beyond its business scope or for expenditures prohibited by the laws and regulations of the State;
- (2) it shall not, directly or indirectly, use the foregoing capital and funds for investment in securities, unless otherwise prescribed by laws and regulations;
- (3) it shall not, directly or indirectly, use the foregoing capital and funds to disburse RMB entrusted loans (unless it is within its business scope), repay inter-company loans(including third-party advances) or repay RMB bank loans that have been sub-lent to third parties; or
- (4) it shall not use the foregoing capital and funds to pay expenses relating to the purchase of real estate that is not for self-use, unless it is a foreign-invested real estate enterprise.

Expenditures by the FIE of funds in an Account Pending Foreign Exchange Settlement Payment shall merely include:

- (1) expenditures within the FIE's business scope;
- (2) payment of RMB deposits and transfers to the centralized fund management account;
- (3) repayment of RMB loans that have been used up;
- (4) foreign exchange purchases and payments or direct repayment of external debts;
- (5) foreign exchange purchases and payments or direct external payment of funds to foreign investors due to capital reduction or divestment;
- (6) foreign exchange purchases and payments or direct external payment of current account expenditures; and
- (7) other capital account expenditures registered or approved by the relevant foreign exchange bureau.

3. Channels for a FIE's domestic equity investment

RMB funds deposited in the Account Pending Foreign Exchange Settlement Payment are not allowed to be directly paid to the investee company and shall, instead, be transferred into the investee company's Account Pending Foreign Exchange Settlement Payment. Furthermore, keep in mind that the enterprise being invested is also required to use the RMB it receives

truthfully for its own operational purposes. Nevertheless, Circular 36 still provides ordinary FIEs in pilot areas with two channels for domestic equity reinvestment.

- (1) Where an ordinary FIE makes a domestic equity investment using the amount obtained from foreign exchange settlement, Circular 36 provides that the enterprise receiving the investment shall first conduct a domestic reinvestment registration and open a corresponding Account Pending Foreign Exchange Settlement Payment with the local foreign exchange bureau, after which the FIE transfers the RMB funds obtained from foreign exchange settlement, consisting of the actual amount of its investment, to the Account Pending Foreign Exchange Settlement Payment opened by the enterprise being invested.
- (2) Where an ordinary FIE makes a domestic equity investment involving equity investment payments, the transaction is governed by current regulations on domestic equity reinvestments. Namely, the enterprise being invested shall first conduct domestic reinvestment registration at the local foreign exchange bureau, and then open the corresponding special domestic reinvestment account.

4. Facilitating foreign-invested PE investment

Circular 36 specifically regulates Investment FIEs. Investment FIEs include foreign-invested investment companies, foreign-invested venture capital enterprises, and foreign-invested equity investment enterprises. While Investment FIEs are not subject to the requirements in Circular 142, Circular 36 removes administrative burdens on Investment FIEs with respect to their investment in domestic enterprises.

Under Circular 36, Investment FIEs are allowed to directly settle their foreign exchange capital and transfer that amount into the account of an enterprise being invested, provided that the relevant domestic investment project is real and compliant. The settlement of foreign exchange capital by Investment FIEs for purposes other than for equity investment in domestic enterprises is still governed by payment-based settlement. Circular 36 makes investment in domestic enterprises by Investment FIEs easier in two respects. First, the standard for Investment FIEs with respect to investment in domestic enterprises has changed from one that required the investment to be made for “its own operational purposes” to merely one that requires the investment to be “real and compliant.” Second, Investment FIEs are entitled to directly settle their foreign exchange capital and transfer that amount directly to the enterprise being invested (i.e. it is not required to open an Account Pending Foreign Exchange Settlement Payment).

Significance and influence of Circular 36

1. Controlling foreign exchange risk

Prior to Circular 36, FIEs could only settle foreign exchange capital when they had an actual business need. In the absence of one, such capital could only be deposited in the capital account in a foreign currency. Therefore, if the RMB increases appreciated against the currency in the capital account, FIEs had to bear currency exchange losses. However, under Circular 36, FIEs are entitled to settle foreign exchange capital at its discretion and deposit the RMB obtained from the settlement in the Account Pending Foreign Exchange Settlement Payment. In addition, FIEs are and permitted to fund the enterprise being invested according to the actual business needs of that enterprise. Therefore, discretionary settlement of foreign exchange capital provided in Circular 36 could assist FIEs in effectively avoiding foreign exchange losses.

2. Removing obstacles for overseas listings and reorganizations of red-chip enterprises

In a typical overseas listing and reorganization of red-chip Chinese enterprises, the overseas listing vehicle usually acquires domestic enterprises by establishing a wholly foreign-owned enterprise (“WFOE”). However, according to Circular 142, the WFOE’s foreign exchange capital could not be settled and used to purchase the equities of these domestic enterprises. As the WFOE is a newly established enterprise, it would ordinarily not have enough profits and funds to acquire other enterprises without relying on a settlement of foreign exchange capital, which significantly restricted the timeliness and convenience of the acquisition and reorganization. By permitting discretionary settlement of foreign exchange capital, Circular 36 removes these obstacles for red-chips who establish a WFOE in a pilot area.

3. New method for overseas funds entering China

With respect to foreign-invested PE and VC enterprises, the issuance of Circular 36 is welcome news because it means they can more easily make equity investments in China again after a 6 year absence. Prior to 2008, foreign-invested PE and VC enterprises invested in China normally by establishing a WFOE and using the RMB funds obtained from settling the WFOE’s registered capital to purchase the equity in domestic target(s). However, starting in 2004, there appeared to be a bubble in China’s real estate and equity markets, a shot money accelerated into China. In response, SAFE issued a series of regulations to strengthen its supervision and control of the settlement of foreign exchange. In August 2008, SAFE published Circular 142, which aimed to build a sound supervisory system for the settlement of foreign exchange. However, Circular 142’s rule that “unless otherwise provided, RMB funds derived from capital settlement shall not be used for any domestic equity investment” created a barrier for foreign-invested PE enterprises entering China, since their investments could not be made in RMB.

FIEs in pilot areas are now allowed to make domestic equity investments, which will help the pilot areas improve their ability to attract FIEs. According to the current foreign exchange framework, if foreign capital is invested in projects encouraged or permitted by the Chinese government,

such investment can be made after the settlement of foreign exchange capital without the need to obtain approval from the Ministry of Commerce. It is understood that the new government is streamlining administration and delegating power to the lower levels of government. In this context, Circular 36 provides a new method for overseas capital to enter China.

Important Announcement

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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