



Promoting Facilitation of Cross-border Investment and Financing (I): Opening Channels for Foreign-exchange Capital Equity Investment by FIEs

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Evolution of policy on FIE foreign exchange capital in equity investment

The State Administration of Foreign Exchange (“SAFE”) promulgated on October 25, 2019 the *Circular on Further Promoting Cross-border Trade and Investment Facilitation* (Hui Fa [2019] No. 28) (“Circular 28”), to further promote the reform of “Powers, Regulation and Services”, to improve the financial capabilities and standards of foreign exchange administration and services entities, and to facilitate cross-border trade and investment. One of the most notable policies in Circular 28 is the elimination of restrictions on non-investment foreign-invested enterprises (“FIEs”) from making domestic equity investments with foreign-exchange capital.

Over more than a decade since the promulgation of Circular 142 in 2008, the administration of foreign exchange capital has steadily shifted along with China’s international balance of payments and economic situation from “strict control” to a step-by-step “orderly opening”, approaching the goal of realizing capital account convertibility. In this article, we attempt to organize for your reference the complex foreign exchange regulations involving restrictions on the use of foreign exchange capital in equity investment in China.

Date	Rules and Regulations	Main Contents
2008/08/29	Circular of the General Affairs Department of the State Administration of Foreign Exchange on Relevant Business Operations Issues Concerning Improving Administration for the Payment and Settlement of the Foreign Exchange Capital of Foreign-invested Enterprises (Hui Fa [2008] No. 142) (“Circular 142”)	Provided a negative list for the use of foreign exchange capital, and clearly prohibited the settlement of foreign exchange capital for use in domestic equity investments.

Date	Rules and Regulations	Main Contents
2011/07/18	Supplementary Circular of the General Affairs Department of the State Administration of Foreign Exchange on Relevant Business Operations Issues Concerning Improving Administration for the Payment and Settlement of the Foreign Exchange Capital of Foreign-invested Enterprises (Hui Fa [2011] No. 88)	Supplemented the materials required for FIE settlement of foreign exchange capital under Circular 142, strengthened the authenticity reviews of the use of foreign exchange capital settlement funds, and strengthened the control of foreign exchange capital by lowering the quota for foreign exchange capital payment and settlement from RMB 200,000 to RMB 50,000.
2011/11/09	Circular of the State Administration of Foreign Exchange on Issues Concerning Further Clarifying and Regulating Foreign Exchange Administration under Some Capital Accounts (Hui Fa [2011] No. 45)	Reiterated that foreign exchange capital cannot be settled for use in domestic equity investment, except in the case of equity investment-type FIEs.
2013/05/11	Circular of the State Administration of Foreign Exchange on Printing and Distributing the Provisions on Foreign Exchange Administration of Domestic Direct Investments by Foreign Investors and the Supporting Documents (Hui Fa [2013] No. 21)	Reiterated the restrictions under Circular 142 and further provided that, unless otherwise stipulated, when a foreign-invested enterprise with "investment" as its principal business makes a domestic equity investment (including FIEs, venture capital FIEs, and foreign-invested equity-invested enterprises), the investment must be made by transfer of foreign capital currency, and investment with foreign exchange capital settlement funds is prohibited.
2014/07/04	Circular of the State Administration of Foreign Exchange on Relevant Issues Concerning Pilot Reform in Some Regions of the Administrative Approaches to Settlement of Foreign Exchange Capital of Foreign-invested Enterprises (Hui Fa [2014] No. 36) (" Circular 36 ")	Permits FIEs in the pilot areas to exercise discretionary foreign exchange capital settlement; begins to loosen the restriction of prohibiting the use of foreign exchange capital in equity investment. In addition to investments in foreign currency, when an FIE with "investment" as its principal business intends to invest in a domestic enterprise, it may do so by directly transferring foreign exchange capital to the account of the investee enterprise according to the actual investment scale, provided that the FIE ensures the authenticity and compliance of the domestic investment project. However, this policy is unclear.
2015/03/30	Circular of the State Administration of Foreign Exchange Concerning Reform of the Administrative Approaches to Settlement of Foreign Exchange Capital of Foreign-invested Enterprises (Hui Fa [2015] Circular 19)	Circular 19 essentially reiterates the contents of Circular 36, except that the applicable scope of the provisions of Circular 36 are extended nationally from pilot areas.
2016/06/09	Circular of the State Administration of Foreign Exchange on the Policies for Reforming and Standardizing Management of Foreign Exchange Settlement under the Capital Account (Hui Fa [2016] No. 16)	Unifies the capital account supervision policy, and reiterates provisions under Circular 36 and Circular 19 that govern the use of foreign exchange capital in equity investment.
2019/07	Various free trade zones have successively promulgated implementing rules for the pilot reform of foreign exchange capital administration, including China (Shanghai) Pilot Free Trade Zone, China (Tianjin) Pilot Free	The pilot zones have successively introduced detailed rules with respect to the use of foreign exchange capital in FIE equity investment. These rules have allowed non-investment FIEs to invest in domestic equities with foreign exchange receipts

Date	Rules and Regulations	Main Contents
	Trade Zone, China (Guangdong) Pilot Free Trade Zone, Guangzhou Nansha New District, Zhuhai Hengqin New District, China (Fujian) Pilot Free Trade Zone, China (Hubei) Pilot Free Trade Zone, and China (Chongqing) Pilot Free Trade Zone	under the capital account or RMB funds from foreign exchange settlement based on the actual investment scale in accordance with law, provided the FIEs ensure the authenticity and compliance of the projects.
2019/10/23	State Council executive meeting	The meeting passed 12 measures to promote cross-border trade and investment facilitation, mainly including: allowing non-investment FIEs to undertake domestic equity investment with foreign exchange capital.
2019/10/25	Circular of the State Administration of Foreign Exchange on Circular on Further Promoting Cross-border Trade and Investment Facilitation (Hui Fa [2019] No. 28)	Cancellation of restrictions on non-investment FIEs investing in domestic equities with foreign exchange capital.

Major contents of Circular 28

I. Allows non-investment FIEs to make domestic equity investments with foreign exchange capital

The above policy history clearly indicates that the Chinese government adopts a cautious attitude toward the use of foreign exchange capital in domestic equity investment by non-investment FIEs—there has been only limited loosening of the policy following prohibition under Circular 142. Besides a few exceptions following adoption of the “discretionary settlement system”, the use of foreign exchange capital in domestic equity investment has generally been limited to FIEs (including investment FIEs, venture capital investment FIEs, and equity investment FIEs) and FIEs with words such as “investment” in their business scopes. In practice, the threshold is high for establishing an investment FIE. Currently, among 370,000 FIEs registered in China, only 3,000 or fewer are investment FIEs, accounting for less than 1% of this figure. This picture has made it difficult for reinvestment with foreign capital in domestic equities.

The opening process was gradual. Beginning in July 2019, each of the pilot free trade zones relaxed non-investment FIE settlement of foreign exchange capital for use in equity investment. Then, Circular 28 expanded this reform policy nationally. Circular 28 has laid a new foundation for enterprises in their investment planning and has brought a landmark change to capital markets.

According to Circular 28, non-investment FIEs only need to meet the following two substantive requirements to invest in domestic equities with foreign exchange capital:

1. Do not violate the effective Special Administrative Measures (Negative List) for the Access of Foreign Investment

Under Circular 28, the lifting of restrictions on equity investment does not mean the waiver of the

foreign investment access negative list¹. Instead, FIEs will still need to meet the basic requirements under the foreign investment negative list when investing in equities with foreign exchange capital. Thus, such investments must not involve industries prohibited to foreign investment.

2. Domestic projects to meet the “authenticity and compliance” requirements

“Authenticity” is a core principle that the Chinese government has consistently upheld in the regulation of foreign exchange capital. The pilot trade zones trialed the “**authenticity and compliance**” requirement with respect to the foreign exchange capital regulation. For example, in the Shanghai Pilot Free Trade Zone, “non-investment FIEs may invest in domestic equities with foreign exchange receipts under the capital account or RMB funds from foreign exchange settlement based on actual investment scale in accordance with law, provided they ensure the authenticity and compliance of the projects”, according to the Rules for the Implementation of Further Promotion of the Foreign Exchange Pilot Reform Program in the China (Shanghai) Pilot Free Trade Zone (Version 4.0). Circular 28 reiterates these requirements and emphasizes the authenticity and compliance of “projects”.

Based on previous enforcement of the rules in pilot areas, “project authenticity and compliance” is an important item to be verified when banks review foreign exchange capital equity investments. Generally, banks require enterprises to prove the investment projects are commercially reasonable, and may even require an investment FIE to prove that an investment project has a definite connection to its current business operations—banks may directly reject equity investment transactions that are purely speculative in nature.

II. Clarifies the process of equity investment with foreign exchange capital in original currency and settlement funds

On the basis of opening foreign exchange capital equity investment, Circular 28 further specifies the particular methods for FIEs to invest in equities with foreign exchange capital, which include “transfer of foreign exchange capital in original currency” and “settlement of foreign exchange capital for equity investment”.

1. Transfer of foreign exchange capital in original currency

Circular No. 28, for the first time, officially permits non-investment FIEs to invest in equities through “transfers in original currency.” Specifically, the investee enterprise will make a record-filing for receipt of the domestic reinvestment and open a foreign exchange capital account with a bank in its place of registration. Circular [2015] No. 13 adjusted the capital contribution confirmation registration to contribution currency receipt registration for foreign investor’s domestic investment. Circular No. 28 further simplifies the procedure by cancelling the contribution currency receipt registration and provides for the transfer in original currency method.

¹ According to Article 3 of the Interim Provisions on Domestic Investment by Foreign-Invested Enterprises, FIEs may not invest in industries prohibited to foreign investment.

2. Settlement of foreign exchange capital for equity investment

Settlement of foreign exchange capital for equity investment is a method basically the same as those previously implemented in pilot areas. Specifically, an investee enterprise will go to a bank in its place of registration to make a record-filing for domestic reinvestment, and open a “capital account – account for foreign exchange settlement and pending payment” to receive the corresponding funds (RMB funds or RMB funds from foreign exchange settlement in the investee enterprise’s account for foreign exchange settlement and pending payment). “Account for foreign exchange settlement and pending payment” is a special RMB account created in connection with discretionary foreign exchange settlement under Circular [2014] No. 36. The account is used to deposit RMB funds converted from discretionary foreign exchange settlement to make various payments. Thus, in principle, the accounts are governed by the administrative rules applicable to foreign exchange capital. The above operating procedures are reiterated in Operating Guidelines for Banks Providing relevant Foreign Exchange Business under the Capital Account (“**Guidelines**”), attached as Annex 2 to the Circular of the State Administration of Foreign Exchange on Streamlining of Foreign Exchange Accounts (Hui Fa [2019] No. 29), which further provides that those procedures should also be followed if investee enterprises subsequently make domestic equity investments.

It is worth noting that the “equity investment form” referenced in Circular 28 is not limited to direct investment in investee enterprises, but also includes investment made through “equity transfers”, which are further clarified in the Guidelines.

III. Use of funds remains limited to designated purposes and is subject to ex-post review for each transaction

It should be noted that under Circular 28, although non-investment FIEs are allowed to make equity investments with foreign exchange capital, restrictions remain on the use of foreign exchange capital. The restrictions stipulated under Circular [2016] No. 16 are reiterated in the Guidelines, including a prohibition on the direct or indirect use of foreign exchange capital for the following purposes: expenditures outside the scope of business, purchase of non-guaranteed wealth management, extending loans to non-affiliates, and investments in real estate not for self-use, etc. These restrictions will remain as a “red line” for the use of foreign exchange capital going forward.

In addition, the Guidelines also require banks to verify the authenticity and compliance of transactions occurring in accounts for foreign exchange settlement and pending payment. Specifically, banks will verify the authenticity and compliance of supporting materials of previous transactions when they receive payment instructions with respect to these accounts (previous transactions that have been verified will not be re-verified). Banks will retain relevant supporting materials related to foreign exchange receipts of domestic institutions under the capital account and use the supporting materials for five years for future reference.

The above-mentioned supervision mode for funds in accounts for settlement and pending payment basically follows the supervision of “foreign exchange capital account payment and settlement”—that is, the bank verifies the authenticity and compliance of the first transaction at the time of the second transaction. Under this supervision mode, enterprises actually have less freedom than under the

“selective reviews” adopted this year in the pilot free trade zones. “Selective review” means that, taking the Shanghai Pilot Free Trade Zone as an example, qualifying enterprises within the zones can freely make payments with foreign exchange receipts under the capital account without submitting supporting materials at the time of each transaction; instead, the bank will later make selective reviews of the transactions.

Major influence of Circular 28

Looking ahead, the reform, which has lifted restrictions on FIE domestic investment with foreign exchange capital, will bring significant changes to corporate investment transaction structures and cash flows, and will create a more favorable market environment for investors:

I. Reduce advantages of investment FIEs

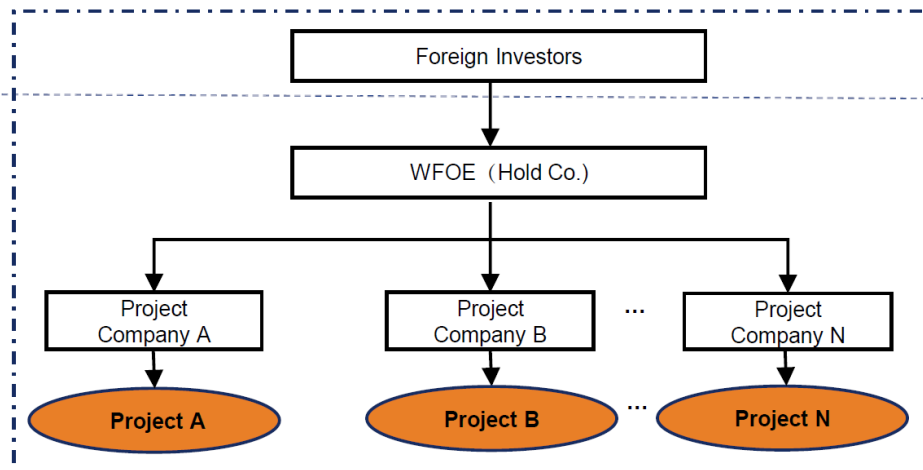
As mentioned above, the number of registered investment FIEs in China is quite limited due to high establishment thresholds. Although under the discretionary settlement system, non-investment FIEs with business scopes containing words such as “investment” had been permitted to settle foreign exchange capital for use in domestic equity investments, it is unfortunate that in practice few investors can successfully establish non-investment FIEs which include “investment” in their business scopes. In some areas, although the policies are relatively flexible and permit the application for establishment of general equity investment FIEs, in practice, local governments still examine applications according to specific conditions. Therefore, prior to the introduction of Circular 28, non-investment FIEs still faced considerable restrictions on their domestic equity investment with foreign exchange capital settlement funds.

To some extent, Circular 28 may weaken the popularity or even doom the existence of investment FIEs because it permits non-investment FIEs to directly make foreign exchange capital investments, which is more convenient and efficient. Prior to the introduction of Circular 28, in some places, local governments have already reduced the entry thresholds for investment FIEs. For example, the Shanghai municipal government promulgated Several Opinions on Promoting Development of Regional Headquarters of Multinational Corporations in the Municipality in August 2019, to lower the conditions for foreign investors to establish investment companies. Specifically, the Opinions lower the prior-year asset requirement for applicants from USD 400 million to USD 200 million, and cancel the requirements for domestic paid-in registered capital and the applicant’s number of invested enterprises. Despite these favorable conditions, it is still hard to say whether the investment FIE can hold its place after the introduction of Circular 28.

II. Domestic holding companies

Taking the real estate industry as an example. Before the introduction of Circular 28, FIE foreign exchange capital settlement funds could not be considered as investment funds for domestic enterprises. Thus, most foreign investors could only set up a holding company offshore and set up domestic wholly foreign-owned enterprises (“WFOEs”) as real-estate project companies. Under Circular 28, WFOEs may directly act as holding platform companies. Specifically, a foreign investor may choose to establish a WFOE as a holding/platform company within China based upon tax policy

preferences and other factors. The WFOE then will own real estate project companies through M&A or capital increases, thereby achieving the purpose of concentrating real estate project resources within the domestic holding company.



Looking forward

I. Where is QFLP going?

In addition to direct investment in domestic enterprises, foreign investors mainly participate in domestic equity investment in pilot areas through Qualified Foreign Limited Partners (“QFLPs”). The main advantage of QFLP is that foreign currency may be converted into RMB at the QFLP level in one installment, and then the converted RMB funds may be invested into multiple domestic projects, thereby avoiding the inconvenience of making foreign exchange settlements for each transaction. Although QFLP access thresholds have been lowered in various places, many foreign investors still feel hesitant because they need to obtain pre-approval from local financial services bureaus to establish QFLPs on a case-by-case basis, there are relatively high requirements for offshore investors, and the time required for the application process is unpredictable. Circular 28 opens channels for direct domestic equity investment, but the transactions are subject to bank review on a case-by-case basis. Therefore, it remains to be observed in practice whether QFLP can remain popular with foreign investors.

II. Authenticity and compliance

Under Circular 28, subject to the principle of “authenticity and compliance”, foreign investors will still face difficulty in establishing shell special purpose vehicles and in their investments in other investment platforms. Therefore, it needs further observation whether the FIEs can construct multi-tier, complex ownership structures as easily as domestic-funded enterprises, and whether FIEs can make subsequent equity investments through other investment platforms.

III. Foreign capital look-through reviews

Following Circular 28, it is worth noting how the competent authorities will examine tiered investment structures in industries with foreign investments restrictions (such as medicine, education, value-added telecommunications, etc.). Before the introduction of Circular 28, competent industry authorities were not overly sensitive to the background of foreign capital during the equity investment review process due to the restrictions on foreign exchange capital in restricted industries. In some cases, the authorities may have identified an investment as domestic merely upon examining the first tier of an investment structure. However, Circular 28 makes it easier to circumvent foreign investment supervision through “reinvestment”, so we cannot not exclude that in the future industry regulators will strengthen the look-through review of shareholders’ foreign investment backgrounds.

Conclusion

“Ten years it takes to grind a sword, its frosty edge has yet to be tested”, more than a decade has passed since promulgation of Circular 142 which prohibited FIEs from settling foreign exchange capital to make equity investments. Circular 28 removes this prohibition and opens the doors for non-investment FIEs to make equity investments with foreign exchange capital. However, since some provisions of Circular 28 are relatively vague, certain issues still need to be further explained at the policy level with respect to the extent of autonomy banks are given in practice. We expect that forthcoming detailed rules and supporting provisions will extend more support for investors.

Important Announcement

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