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Newsletter

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Legal Updates

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Legal Updates

1. SAFE Circular 36 Changes Policy for the Settlement of Foreign Exchange Capital, Benefitting Foreign-invested PE Funds and Ordinary Foreign-invested Enterprises (Authors: Yong WANG, Qian LI)

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 areTianjin 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 Area.[1]

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 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

[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.

discretion. Article 1of 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 though 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:

(a) 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;

(b) it shall not, directly or indirectly, use the foregoing capital and funds for investment in securities, unless otherwise prescribed by laws and regulations;

(c) 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

(d) 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:

(a) expenditures within the FIE's business scope;

(b) payment of RMB deposits and transfers to the centralized fund management account;

(c) repayment of RMB loans that have been used up;

(d) foreign exchange purchases and payments or direct repayment of external debts;

(e) foreign exchange purchases and payments or direct external payment of funds to foreign investors due to capital reduction or divestment;

(f) foreign exchange purchases and payments or direct external payment of current account expenditures; and

(g) 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.

(a) 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.

(b) 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 to2008, 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.

2. CBRC Issues Interim Provisions on the Administration of Specialized Subsidiaries of Financial Leasing Companies (Authors: Shu WANG, Jun ZHU)

On July 23, 2014, the China Banking Regulatory Commission (the "**CBRC**") issued the *Interim Provisions on the Administration of the Specialized Subsidiaries of Financial Leasing Companies* (the "**Interim Provisions**").

The Interim Provisions further specifies how financial leasing companies are permitted to establish subsidiaries to conduct financial leasing business in accordance with their business needs, which was first stated in the *Administrative Measures for Financial Leasing Companies* (the "**Administrative Measures**") re-issued in March 2014. Pursuant to the Interim Provisions, financial leasing companies are permitted establish specialized subsidiaries to conduct financial leasing business in specific areas overseas, and in China's free trade zones and bonded zones, and includes the financial leasing of aircraft, vessel and other leasing business areas recognized by the CBRC.

The Interim Provisions removes the prior limitation whereby financial leasing companies were only allowed to establish subsidiaries in the form of project companies. The Interim Provisions will contribute to the further development of specialized financial leasing businesses by financial leasing companies and isolate legal risk in certain business areas. They will also facilitate the development of offshore financial leasing businesses by financial leasing companies through offshore financial leasing platform companies. This article analyzes and discusses the main provisions of the Interim Provisions and its possible influence.

"Specialized Subsidiaries" and how they are Difference from Project Companies in Bonded Areas

The Interim Provisions first introduced the concept of a financial leasing company's "specialized subsidiary." According to Interim Provisions, a "specialized subsidiary" means a specialized leasing subsidiary established overseas and in China's free trade zones and bonded areas by a financial leasing company, in accordance with relevant laws and regulations, for the purposes of conducting financial leasing business in "specific areas."The term "specific areas" means the areas where a financial leasing company has conducted financial leasing business and where it has sound operations. This includes the financial leasing of aircraft, vessels, and others leasing businesses recognized by the CBRC.

Specialized subsidiaries are different from project companies in bonded areas (the "**Project Company in Bonded Areas**"). A Project Company in Bonded Areas is established by a financial leasing company pursuant to the *Notice on Relevant Issues Concerning Financial Leasing Companies' Establishment of Project Companies in Domestic Bonded Areas to Conduct Financial Leasing Business* issued by CBRC in 2010. The differences between a specialized subsidiary established pursuant to the Interim Provisions and a Project Company in Bonded Areas are as

follows:

(1) **Different functions:** A specialized company separates certain mature financial leasing businesses from other lesser mature businesses to leverage the advantages in such mature financial leasing businesses. By contrast, Project Companies in Bonded Areas do not have such a function. Rather, its main function is to isolate relevant project risk for a specific leasing project conducted by the financial leasing company.

(2) **Different standards for establishment:** CBRC approval for the financial leasing company is required for the establishment of each specialized subsidiary. The financial leasing company applicant has to meet relevant conditions, and complete relevant application and business launch formalities. By contract, so long as the financial leasing company obtains the financial leasing business qualification for a Project Company in Bonded Areas from the CBRC, it can then establish a Project Company in Bonded Areas in the same way as it would when establishing a normal company for a relevant lease project (the Project Company in Bonded Areas is required to correspond to a specific lease project).

(3) **Different organizational attributes:** the specialized subsidiaries shall obtain financial license and thus are financial institutions; however Project Companies in Bonded Areas are ordinary enterprises.

Domestic Specialized Subsidiaries and Offshore Specialized Subsidiaries

In addition to permitting financial leasing companies to establish domestic specialized subsidiaries in China's free trade zones and bonded areas, the Interim Provisions expressly permit financial leasing companies to establish specialized subsidiaries overseas.

Prior to the introduction of the Interim Provisions, relevant regulations did not expressly permit financial leasing companies to directly establish subsidiaries overseas. As a result, there were some legal obstacles financial leasing companies faced when establishing project companies or business platform companies overseas. Namely, financial leasing companies had to act as a lessor through project companies or platforms controlled by affiliates overseas, thereby complicating the transaction structures and creating uncertainty.

Following the introduction of the Interim Provisions, financial leasing companies can directly establish platform companies for their offshore leasing businesses overseas (in traditional jurisdictions such as Ireland),provided that the establishment of such companies is approved by the CBRC. Financial leasing companies would then conduct the relevant offshore financial leasing businesses through the newly established project companies. This reform will enable financial leasing companies to further define the equity relationships of their offshore lease projects, simplify transaction structures for relevant lease projects, and facilitate the lease and financing support financial leasing companies provide to their platform companies or project companies overseas.

Requirements for Financial Leasing Companies when Applying to Establish a Specialized Subsidiary

Per the Interim Provisions, the requirements to establish a domestic specialized subsidiary are different than the requirements to establish an offshore specialized subsidiary. In general, the requirements to establish an offshore specialized subsidiary are more favorable to the financial leasing company than the requirements to establish a domestic specialized subsidiary. A summary of the requirements is below:

Domestic Specialized Subsidiary	Offshore Specialized Subsidiary
(1) Good corporate governance structure, sound and effective risk management system and internal control system; (2) Good consolidated management ability; (3) Meets various regulatory requirements as set forth in the Administrative Measures; (4) The balance of equity investments shall not exceed 50% of net assets (for consolidated financial statements); (5) Has certain advantages with respect to business stock, talent reserve, etc.; has abundant experience with respect to professional management and the conduct of business by project companies, and is able to effectively support a specialized subsidiary to conduct financial leasing business in specific areas; (6) The investment is made with self-owned capital, and no investment is made with entrusted capital, debt financing, or other nonself-owned capital; (7) Complies with laws and regulations, was not involved in any high-profile case, and has not materially violated laws and regulations in the past two years; and (8) Satisfies other prudent conditions as stipulated by the CBRC.	(1) Demonstrated need to expand business; need a clear overseas expansion strategy; (2) Has internal management and risk management ability that are suitable for overseas business expansion; (3) Has a dedicated and talented team that is suitable for the overseas business environment; (4) Operations are in good condition, and the applicant has been profitable for the past two consecutive fiscal years; and (5) Complies with applicable laws and regulations of relevant countries or regions.

Requirements for Specialized Subsidiaries once they are Established

(1) Domestic specialized subsidiaries

Once it is established, a domestic specialized subsidiary established by a financial leasing company shall meet the following requirements:

(a) The name of a specialized subsidiary shall reflect the name of the financial leasing company parent; the specific area in which it carries out financial leasing business shall be specified.

(b) Minimum registered capital requirement of RMB 50 million or the equivalent in a freely convertible currency.

(c) The financial leasing company parent shall hold 100% of its equity.

(d) Has qualified directors, senior executives, and employees that are familiar with the financial leasing business (directors and senior executives shall be subject to a qualification review system).

(e) Articles of association comply with the PRC Company Law and the CBRC's rules; it has sponsors that comply with the relevant requirements; it has sound corporate governance, internal controls, and risk management systems, as well as an information management system that is suitable for its business operations.

(f) Has a place of business, security measures, and other facilities that are suitable for its business operations; and

(g) Satisfies other prudent conditions as stipulated by the CBRC.

Notably, the Interim Provisions permits a financial leasing company to attract other investors when establishing domestic specialized subsidiaries. These investors shall satisfy the conditions required under the Administrative Measures relating to sponsors of a financial leasing company. The sponsors shall also demonstrate the ability to enhance the business expansion ability and risk management level of the domestic specialized subsidiary in the relevant financial leasing areas. The ability for a financial leasing company to attract other investors when establishing a domestic specialized subsidiary may enrich its capital structure in specific areas.

(2) Offshore specialized subsidiaries

Although there are various requirements for domestic specialized subsidiaries once they are formed, there are no specific requirements for offshore specialized subsidiaries in the Interim Provisions in this respect. The Interim Provisions only require financial leasing companies to obtain the CBRC's approval prior to initiating the formation of an offshore specialized subsidiary in accordance with the laws and regulations of the jurisdiction where such offshore specialized subsidiary is intended to be registered. Within fifteen (15) days of the incorporation of the offshore specialized subsidiary, the financial leasing company is required to submit a report to

the CBRC. The directors and senior executives of the offshore specialized subsidiary also have to be approved in advance by the CBRC.

Operating Rules of Specialized Subsidiaries

According to the Interim Provisions, specialized subsidiaries established by financial leasing companies shall comply with the following operating rules:

(1) The financial leasing company may, in accordance with its business scope, authorize the business scope of its specialized subsidiary in accordance with the principle of prudent operations (excluding inter-bank borrowing and fixed-income securities investment businesses), and report it to the CBRC for filing.

(2) When a specialized subsidiary establishes a project company overseas to conduct financial leasing business, it shall comply with relevant reporting obligation provisions for financial leasing companies in the Notice on Relevant Issues Concerning Financial Leasing Companies' Establishment of Project Companies in Domestic Bonded Areas to Conduct Financial Leasing Business issued by the CBRC in 2010.

(3) The specialized subsidiary shall, after it issued bonds overseas or after its offshore project company begins to conduct financial leasing business, report, on a quarterly basis, to the bank regulatory bureau in its jurisdiction, and the bank regulatory bureau in the place where the financial leasing company is located.

(4) The specific requirements and procedures for various types of business and associated transactions conducted by specialized subsidiaries shall be governed by the associated relevant provisions that are applicable to the business conducted by financial leasing companies.

(5) The specialized subsidiary shall establish a sound corporate governance structure, and scientifically segregate its departments and their duties.

(6) In principle, people in charge of a specialized subsidiary shall be senior executives of the financial leasing company.

Supervision of Specialized Subsidiaries by the CBRC

The CBRC has the following supervisory authority over specialized subsidiaries:

(1) Implement consolidated supervision of the specialized subsidiary; to permit the CBRC to implement consolidated supervision, financial leasing companies shall uniformly implement the relevant regulatory requirements imposed by the CBRC.

(2) The ratio of net capital and risk-weighted assets of a domestic specialized subsidiary shall not be lower than the minimum regulatory requirements imposed by the CBRC.

(3) The domestic specialized subsidiary shall submit its financial statements and other statements

required by the CBRC to the bank regulatory bureau in its locality.

(4) The specialized subsidiary shall, by reference to applicable CBRC rules, establish a capital management system, asset quality classification system, reserve system, and internal auditing system.

(5) If any significant matter occurs relating to an offshore specialized subsidiary, the financial leasing company parent shall report such matter to the CBRC within fifteen (15) working days.

(6) The financial leasing company shall submit special reports containing relevant information about its specialized subsidiaries, on a quarterly basis, to the CBRC.

Important Announcement

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