



JONES DAY
COMMENTARY

CHINA'S NEW FOREIGN EXCHANGE CONTROL RULES OFFER IMPROVED REGULATORY TRANSPARENCY FOR EQUITY FINANCING DEALS

SAFE-CIRCULAR 75

The State Administration of Foreign Exchange of China ("SAFE") has issued new rules, effective as of November 1, 2005, on foreign exchange registration concerning equity financing transactions through offshore "special purpose companies" ("SPCs") and their onshore investment in China. This new set of rules (commonly referred to as "Circular 75") is significant in that the SAFE regulators have willingly considered the relevant comments from the foreign venture capital and private equity investors as well as domestic emerging companies that seek foreign funding to finance their onshore operations. Such comments were voiced in reaction to the two sets of rules the SAFE issued earlier this year.

In January and April 2005, the SAFE issued Circulars 11 and 29, respectively, seeking to tightly control the cross-border flow of capital and assets through

financing arrangements between Chinese entrepreneurs and foreign investors. Under these two earlier Circulars, Chinese residents who wished to establish or hold (directly or indirectly) shares in an offshore company by contributing domestic assets or equity interests to the offshore company were required to obtain prior approval by the relevant authorities and register with the SAFE. However, due to the lack of corresponding rules by other relevant government authorities, the absence of detailed SAFE registration procedures, and the lack of clear guidance from the SAFE, it was difficult for Chinese entrepreneurs to follow these two Circulars when engaging in foreign equity financing deals. Although the SAFE's earlier intent was to establish a system to track the cross-border flow of assets and capital for foreign exchange control purposes, Circulars 11 and 29 in fact adversely affected many venture capital investments through such offshore-onshore arrangements, discouraging foreign investors and Chinese entrepreneurs alike.

In light of the serious concerns raised earlier by the foreign and domestic parties, SAFE officials made efforts to address such concerns by soliciting comments on the drafts of Circular 75. Compared to Circulars 11 and 29, which are no longer being enforced, Circular 75 is a positive development because it reasonably balances regulatory control and investment needs. Many are pleased that Chinese regulators were attentive to the negative impact caused by Circulars 11 and 29; as a result, foreign equity investors who are seriously pursuing deals in China have generally welcomed Circular 75.

PARTIES AFFECTED BY CIRCULAR 75

Circular 75 applies to “domestic resident legal persons” and “domestic resident natural persons.” It defines “domestic resident legal person” as any enterprise legal person, institutional legal person, or other economic organization duly established in China. This generally includes corporate entities organized under the laws of China. Further, Circular 75 defines “domestic resident natural person” as any natural person who holds a Chinese resident card, passport, or other lawful identification, or any natural person who does not have Chinese resident status but habitually resides in China due to reasons of economic interest. These domestic resident legal persons and natural persons, who are collectively referred to also as “domestic residents” throughout Circular 75, must comply with Circular 75 if they engage in transactions that fall within the scope of these new rules. Although the definition of “domestic resident legal person” is relatively clear, the definition of “domestic resident natural person” could cause difficulties in both implementation and compliance. Based on this relatively broad definition, “domestic resident natural persons” could include (i) Chinese passport holders who are also permanent residents of another country, and (ii) foreigners who work or do business in China on a regular basis. Therefore, it is advisable for those who are concerned to seek further clarification from the SAFE if they intend to engage in the type of offshore-onshore transactions as defined in Circular 75.

TRANSACTIONS AFFECTED BY CIRCULAR 75

Circular 75 primarily targets transactions where Chinese domestic residents directly set up or indirectly control offshore SPCs for the purpose of raising offshore equity financing (including convertible debt financing) with domestic assets or legal interests. In recent years, this type of offshore-onshore arrangement, whereby the offshore SPCs raise foreign capital to fund early-stage onshore operations, has been the popular structure among foreign venture capital investors and Chinese domestic entrepreneurs who plan to have initial public offerings outside China (mostly in Hong Kong and the U.S.). Similar structures were also used in the recent NASDAQ IPOs involving operating assets inside China that were owned or controlled by such offshore SPCs.

The SAFE's primary goal in issuing Circular 75 is to regulate “return investment” from the offshore SPCs into China. As defined in Circular 75, “return investment” refers to the direct investment inside China made by domestic residents through their offshore SPCs, and it includes but is not limited to (i) acquiring or swapping the shares of Chinese shareholders in domestic enterprises, (ii) acquiring domestic assets and using such assets to invest in new foreign-invested enterprises in China, and (iii) increasing the registered capital of existing domestic enterprises. Such return investments are covered by the interim rules on foreign-invested mergers and acquisitions issued in 2003 by the predecessor ministry of the Ministry of Commerce (“2003 M&A Rules”). Therefore, parties involved in such offshore-onshore deals should comply with both Circular 75 and the 2003 M&A Rules, which require following a series of procedures and formalities before the closing and effectiveness of such transactions under the Chinese law.

Another key element in determining whether Circular 75 applies to a particular transaction is the term “control.” Circular 75 defines “control” as the “right to operate, receive benefits from or make decisions for the SPC or its domestic enterprise,” as such right may be acquired by the domestic

residents through share purchase, a trust, nominal shareholding, voting power, a buyback scheme, a convertible bond, or other similar means. This definition of “control” appears to be much broader than the term “control” as it is commonly defined in international M&A deals; therefore, it could subject more domestic residents to the reach of Circular 75 than is necessary. It remains to be seen how SAFE officials, when implementing Circular 75, will exercise their discretion to determine whether “control” exists on a case-by-case basis.

MANDATORY REGISTRATION

Circular 75 focuses on the registration procedures and documentation formalities required of domestic residents involved in the offshore-onshore transactions described above, *i.e.*, the “offshore investment foreign exchange registration.” It requires new filings with the SAFE prior to forming or gaining control by the domestic residents of the offshore SPC and, in addition, requires filings for change (i) upon contribution of domestic assets and equity interests to the offshore SPC, and (ii) upon major change in the capital structure of the offshore SPC resulting from equity financing. Even if any change in the capital structure of the offshore SPC does not involve any return investment, the domestic residents in question must file with the SAFE for such change within 30 days of the change. For those deals completed before November 1, 2005 that fall within the scope of Circular 75, the domestic residents in such deals must complete their registration with the SAFE no later than March 31, 2006.

The required filings will be evidenced in the two registration forms applicable to domestic resident legal persons and domestic resident natural persons, respectively. It is important to complete such filings in a timely manner because failure or delay in obtaining such registration on the part of the domestic residents could affect the foreign exchange registration required of the relevant domestic entity involved in the same deal. In addition, after completion of the required registrations, the domestic residents may then make payments to the offshore SPC for the purposes of profit and dividend distribution, liquidation, share transfer, or decrease in capital.

REMITTANCE OF PROFIT BACK TO CHINA IS REQUIRED

Circular 75 permits, but does not require, the domestic residents to transfer the funds raised offshore for use inside China, based on the plan for use of proceeds set forth in the business plan or investment documents. However, profits, dividends, and foreign exchange income resulting from capital change that a domestic resident may receive from an SPC must be remitted back into China within 180 days. Further, the remitted profits or dividends may be deposited into a foreign exchange currency account or settled in the Chinese currency. Also, foreign exchange income resulting from capital change in the offshore SPC may, upon verification and approval by the SAFE, be either reserved in a special capital account or settled in the Chinese currency upon verification and approval by the SAFE. It is worth pointing out that the requirement for the return remittance of such offshore income will apply to the domestic residents but not foreign investors who are not otherwise deemed “domestic residents.”

A MAJOR STEP FORWARD

The issuance of Circular 75 was a major step forward by the SAFE in providing regulatory guidance to venture capital, private equity, and capital market deals involving Chinese entrepreneurs and their operating assets in China. Therefore, one hopes that implementation of Circular 75 will be more transparent, and the relevant Chinese domestic residents should fully comply with Circular 75. While it is expected that SAFE officials will come up with specific implementing procedures at least internally in order to process registration applications, structures and closing schedules in current and future deals involving Chinese domestic residents should be adjusted in accordance with the procedures and formalities set forth in Circular 75. Further, all offshore-onshore deals to which Circular 75 applies will also have to comply with all other relevant Chinese laws, regulations, and rules governing foreign investment transactions.

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