



JONES DAY
COMMENTARY

IMPACT OF RECENT RESTRICTIONS ON FOREIGN INVESTORS IN THE CHINESE REAL ESTATE MARKET

China is experiencing rapid development, and the real estate and construction industries are playing a vital role. Recently, the Vice Minister of the Ministry of Construction (“MOC”), Qi Ji, indicated that these two industries constitute more than 10 percent of the national economy.

The Chinese currency has also continued to appreciate sharply since 2006, and as a result, more and more foreign investors wish to invest in China’s real estate market to benefit from capital and currency appreciation.

Accordingly, over the past year the Chinese central government has issued numerous laws, policies, and administrative regulations in an attempt to cool down the real estate market. The most recent measures, which will also affect local developers, include the enforcement of the land appreciation tax and penalties for hoarding land. This *Commentary* will provide a summary of the regulations issued over the past

year that directly affect foreign investors in China’s real estate market.

SUMMARY OF THE RESTRICTIONS

Circular 171. On July 11, 2007, MOC, the Ministry of Commerce (“MOFCOM”), the National Development and Reform Commission, the People’s Bank of China, the State Administration of Foreign Exchange (“SAFE”), and the State Administration for Industry and Commerce (“SAIC”) jointly issued *Opinions Governing the Market Access and Administration of Foreign Investment in Chinese Real Estate Market* (“Circular 171”).

Circular 171 requires a foreign investor intending to purchase Chinese real estate to do so through an entity established in China. Further, where a foreign investor purchases a domestic real estate company through equity transfer or by other means, it must pay the transfer fees in a lump sum using its own capital.

As to the registered capital requirement, Circular 171 requires a foreign-invested real estate enterprise (“FIRE”) with an investment amount of no less than RMB 10 million to have registered capital of no less than 50 percent of its total investment amount. Where the total investment is less than RMB 10 million, current regulations remain unchanged.

Circular 171 prescribes specific establishment procedures for FIREs. For example, FIREs cannot obtain the formal Foreign-Invested Approval Certificate and Business License before they obtain the State-Owned Land Use Certificate.

In the event that the FIRE is in the form of a Sino-foreign joint venture (“SFJV”), the parties to the SFJV must not guarantee direct or indirect “fixed revenues” to any party in their joint-venture contract or any other investment documents. Where a FIRE fails to pay the registered capital fully, fails to obtain the State-Owned Land Use Certificate, or fails to make the project development capital reach 35 percent of the total project investment, it cannot obtain domestic or overseas loans, and the foreign exchange administrative department will not approve the settlement of its foreign exchange loans.

Circular 25. On March 6, 2007, MOFCOM issued its *Guidance Opinion on 2007 Foreign Investment Affairs* (“Circular 25”). In Circular 25, MOFCOM expressly stated that the Chinese government will strictly restrict foreign investment in China’s real estate market.

Circular 50. On May 23, 2007, MOFCOM and SAFE jointly issued the *Notices Governing Further Strengthening and Regulating Approvals and Supervision of Direct Foreign Investment in Real Estate Sector* (“Circular 50”).

Circular 50 reiterates many of the principles under Circular 171, in particular that in order for foreign investors (either companies or individuals) to invest in Chinese real estate development or operation, they must establish foreign-invested enterprises. If such enterprises intend to expand their business into real estate development or operation, they are required to obtain approvals from the relevant approval authorities, *i.e.*, MOFCOM or its local branches.

Under Circular 50, foreign investors are required to purchase the land-use rights before they apply to set up a FIRE development company in China. Circular 50 confirms the require-

ment under Circular 171 that the guarantee of direct or indirect “fixed revenues” is forbidden.

Round-trip investment is also restricted. “Round-trip investment” refers to investment from offshore special purpose vehicles invested in or controlled by Chinese enterprises or individuals. Circular 50 restricts local developers from disguising themselves as foreign enterprises by setting up offshore parent companies and thus reinforces the government’s control over mergers and acquisitions or investment in domestic real estate enterprises by way of round-trip investment. Further, SAFE and its local branches may impose sanctions on any disguised establishment of FIRE companies and their outward foreign currency payment as well as any profits from such disguised investment in the Chinese real estate market.

Circular 50 requires that any approvals from local approval authorities for setting up FIREs must be immediately filed with MOFCOM. Without filing with MOFCOM, the FIREs cannot deal with the foreign exchange settlement for capital account items.

Circular 130. On July 10, 2007, SAFE issued an internal document entitled *Circular of the General Affairs Department of SAFE on the Distribution of the List of the First Group of Foreign Invested Real Estate Projects which has Filed with the Ministry of Commerce* (“Circular 130”).

According to Circular 130, SAFE will not register any foreign debt of a FIRE if the FIRE obtained approval from the local Bureau of Commerce (“COFCOM”) and filed with MOFCOM after June 1, 2007. This also applies to FIREs that are established and approved before June 1, 2007, where such FIREs wish to increase their registered capital after June 1, 2007. Accordingly, after June 1, 2007, shareholders in FIREs may invest only by way of equity, and registration of foreign debt (including third-party loans and shareholder loans) will not be allowed. The date that a FIRE is deemed to have obtained its approval certificate is the date stated on the approval certificate.

Further, SAFE will not process any foreign exchange registration (or amendment of registration) of foreign exchange settlement for capital account items (*i.e.*, any increase or decrease in registered capital or payment or repayment of foreign debt, including third-party loans and shareholder loans) for a

FIRE that has been approved by the relevant COFCOM after June 1, 2007, but has not been filed with MOFCOM.

Circular 130 requires SAFE to regularly publish and maintain an online database of FIREs that have been filed with MOFCOM, for reference by the branches of SAFE as well as banks that are designated to handle foreign exchange matters. From December 17, 2007, to January 11, 2008, MOFCOM published eight name lists including 182 FIREs that have been filed with MOFCOM.

The practical result of Circular 130 is that the only avenue open to foreign institutional buyers is to inject registered equity capital into a new project entity. Debt financing in China is now significantly restricted.

2007 Catalogue. The State Council revised the *Catalogue of Guidelines for Foreign Investment* (“2007 Catalogue”) in October 2007.

Low-cost residential developments have been removed from the Encouraged Catalogue. The development of high-end hotels, office buildings, and convention centers has always been in the Restricted Catalogue, so there is no change to their status. The development of high-end residential buildings is neither encouraged nor restricted, so it is therefore permitted (again, no change from the previous regulations). Trade in the secondary real estate market, as well as real estate agency or brokering, is now restricted, and this might have an impact on foreign investors.

The removal of low-cost residential developments from the Encouraged Catalogue will probably not have a significant impact on foreign investors, as this is not an area on which they have typically focused. However, the inclusion of the secondary real estate market in the Restricted Catalogue will likely cause considerable difficulties for foreign investors looking to acquire or sell real estate developments in China because of the uncertainty about the nature and definition of the secondary market, which will necessitate further clarification.

SAIC Investigations. In December 2007, SAIC issued an internal notice on its web site requiring its local branches to investigate the status of foreign investment in the Chinese real estate market. We anticipate that the investigation results may provide the foundations for further regulations and policies.

IMPACT

Overall. When read together, these circulars and policies show the commitment of the Chinese government to restrict and supervise foreign investment in China’s booming real estate market, especially high-end real estate development.

As with many industries in China, the real estate market is susceptible to government intervention, and the recent frequent policy changes have exacerbated the situation. The revised 2007 Catalogue further demonstrates the determination of the Chinese government to take restrictive measures toward real estate development in China for the longer term. It seems that government intervention will continue.

Market Entrance. Our experience currently is that the regulatory authorities are slow in approving foreign investments in real estate, particularly where the investment is in the form of a wholly foreign-owned enterprise, where approvals appear to have stopped.

The likely effect of Circular 130, even when read with Circulars 50 and 171, is that foreign investors will encounter more difficulties in acquiring Chinese real estate. The 2007 Catalogue will also cause considerable difficulties for foreign investors seeking to enter the Chinese secondary real estate market. Although the definition and inclusion of the secondary real estate market in the Restricted Catalogue are uncertain, it is likely that transactions in the market will be subject to more scrutiny from the authorities. One impact might be to encourage foreign investors to look at mergers with Chinese developers as an entry method.

Financing. It is clear that Circular 130 is already severely restricting the cash flow of foreign developers of projects in China. Foreign investors may lose the ability to invest in new projects or make claims ahead of other creditors of the onshore company to the extent that loans must now be injected as equity. Investors may also lose an important means for remittance of funds offshore in ways other than as dividends out of earnings and surplus, since any reductions in registered capital now require the consent of MOFCOM.

It is also likely that Chinese developers will face funding restrictions, as bank debt is tightly restricted. This will also lead to more cooperation with foreign developers and funders.

CONCLUSION

These are clearly uncertain times for foreign investors in Chinese real estate, yet many foreign investors believe that the underlying value in the market is too great to ignore. Thus, notwithstanding the series of cooling measures adopted by the Chinese central government, it is unlikely that foreign investment in Chinese real estate will slow dramatically any time soon.

According to updated figures from the National Bureau of Statistics of China, from January to November 2007, the national total investment in real estate was RMB 3,204.3 billion, in which foreign investment was RMB 53.9 billion. The percentage of foreign investment in relation to the total investment is therefore relatively small, and certainly not large enough to justify the measures that have been enacted and targeted at foreign investors.

LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Ashley M. Howlett

86.10.5866.1113

ahowlett@jonesday.com

This *Commentary* was prepared with the assistance of Tracy He, a legal assistant in Jones Day's Beijing Office.

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our web site at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the author and do not necessarily reflect those of the Firm.