



SAFE's New Circular 37 Enhances and Facilitates Round-Trip Investment Registration in PRC

On July 14, 2014, China's State Administration of Foreign Exchange ("SAFE") issued the *Notice on Relevant Issues concerning Foreign Exchange Administration for Domestic Residents Engaging in Overseas Financing and Investing through Round-Trip Investment via Special Purpose Companies* ("Circular 37"), together with its two appendices—the *Operational Guidance for Relevant Practice for Round-Trip Investment* ("Guidance") and the *Application Form for Foreign Exchange Practice for Capital Direct Investment* ("Application Form," collective, the "New Rule"), which became effective on the same date. The New Rule supersedes the previous *Notice on Relevant Issues concerning Foreign Exchange Administration for Domestic Residents Engaging in Overseas Financing through Round-Trip Investment via Special Purpose Companies* promulgated by SAFE on November 1, 2005, commonly known as the "Circular 75," which had been the main regulation governing foreign exchange administration of a Chinese investor's "round-trip" investment (further defined below).

The New Rule is intended to simplify and facilitate cross-border transactions conducted by domestic residents and to better serve the development of the Chinese economy in order to enhance the convertibility of capital in cross-border transactions.

This *Commentary* summarizes the key changes made under the New Rule and also compares these changes to Circular 75. We also analyze the possible impact on Chinese investors, which are the intended targets of this new rule, after the publication of Circular 37.

Major Changes

Definition of "Special Purpose Company." The first notable difference between Circular 37 and Circular 75 is the change of the definition of "Special Purpose Company" ("SPC"). According to Circular 75, an SPC is any overseas entity directly established or indirectly controlled by a domestic resident (either a business entity or a natural person) for the purposes of overseas equity financing using any domestic enterprise's assets or equity interests held by the resident. Circular 37 defined "SPC" as a foreign enterprise directly established by or indirectly controlled by a domestic resident, including a domestic entity and a domestic individual (collectively, "Domestic Resident") through any domestic enterprise's assets, rights or interests, or through any overseas assets, rights or interests legally held by such domestic resident for the purpose of investing or financing.

Compared to the definition under Circular 75, the definition of “SPC” under Circular 37 expands the purposes of establishment of such SPC to include “investment” in addition to “financing.” Previously, Circular 75, together with the *Notice on Further Improving and Adjusting Foreign Exchange Administration Policies for Direct Investment* (“Circular 59”) issued on November 21, 2012, set up the legal regime that domestic individuals who make direct investments in China via overseas entities did not fall into the definition of “SPC” under Circular 75 and therefore were not subject to SAFE SPC registration. This created a confusion as to whether such overseas investment via an SPC is permitted under Circular 75. From SAFE’s perspective, such investment activities were considered “Chinese Individual’s non-SPC Round-Trip Investment” in terms of SAFE’s statistics system. Now, under Circular 37, it becomes feasible for a Domestic Resident to set up an overseas entity for investment purposes and use this overseas entity as the shareholder of a new Chinese company. This means that an SPC may now be accepted by SAFE for registration for the broader “investment” purposes even without any future plan to make further overseas investment, be listed in an overseas stock exchange, or be used as the vehicle for any other financing plan.

Furthermore, overseas enterprises set up by using “overseas assets, rights, or interests,” as opposed to “domestic enterprise’s assets, rights, or interests,” legally held by Domestic Residents will also be regarded as SPCs and will be subject to the regulation of Circular 37. Such expansion of definition means that many overseas enterprises, which in the past may not have been considered as SPCs, will now be covered under the regulation of the current Circular 37.

Definition of “Round-Trip Investment.” Circular 37 defines “round-trip investment” as “direct domestic investment activities conducted by Domestic Resident directly or indirectly through a SPC, i.e., through setting up foreign invested enterprise or project (“FIE”) through greenfield investment or merger and acquisition to obtain relevant ownership, right of control or right of management or administration, etc.” In comparison to Circular 75, Circular 37 recognizes that establishment of a FIE through greenfield investment will also fall within the scope of the round-trip investment. Being able to register with SAFE for such structure means more clarity for

Chinese founders when they put together a structure involving a “round-trip investment” and having a structure approved for foreign private equity investors to invest in the SPC that controls the Chinese asset/investment via a FIE.

Scope of “Individual Domestic Resident.” The Guidance of Circular 37 further clarifies the definition of “individual Domestic Resident” and provides that individuals who legally hold both Chinese and foreign identity documents will be considered as foreign individuals, and thus are not subject to registration obligation under Circular 37 when investing in SPCs with overseas capital or interests. Therefore, it has removed the registration obligation of some domestic individuals who have foreign passports.

First-Level-Only Registration. Previously, Circular 75 required registration for each level of overseas entities established by the Domestic Resident. Under the Guidance of Circular 37, only the top-level SPC that is directly established by the Domestic Resident needs to be registered. In other words, a Domestic Resident no longer needs to disclose to SAFE the other levels of overseas entities set up underneath the umbrella of the top-level entity. This simplifies the registration process and removes certain registration burden from Domestic Residents, which will result in time and cost saving for the Domestic Resident in making such investments.

Change of Registration Timing. According to Article 3 of Circular 37, a Domestic Resident must complete registration for overseas investment before making contributions to the overseas SPCs. This is different from Circular 75, which requires registration before the establishment of the SPC. In other words, Circular 37 permits the establishment of the SPC before registration with foreign exchange authorities. However, before a Domestic Resident may contribute any money into such SPC, application for registration needs to be filed with SAFE. This is a more practical approach since, unlike company incorporation in China, the overseas SPCs can be established without any capital injection (or with a minimum capital such as US\$1.00).

Scope and Time Limit for Change of Registration and Remitting Profits Onshore. Article 5 of Circular 37 sets forth the requirement of change of registration when the Domestic

Resident increases or decreases its capital, transfers its shares, merges, divides, makes long-term equity or debt investments, or provides external guarantees, which differs from the relevant provisions under Circular 75. Under Circular 75, the registration obligation was triggered by any changes associated with the SPCs.

For the purpose of providing simplicity and convenience for Domestic Residents making cross-border capital transactions relating to investment or financing activities via SPCs, Circular 37 removes the reporting and filing requirement for matters that do not involve changes of Domestic Residents or cross-border movement of capital. For example, no change of registration is required when an overseas third party injects investment into the SPC.

Additionally, Circular 37 eliminates the requirement under Circular 75 that the change of registration must be made “within 30 days” of occurrence of the change and replaces it with “timely,” which may give the Domestic Resident more time for registration. Circular 37 also eliminates the requirement under Circular 75 that profits or dividends from the SPCs must be transferred back in China within 180 days as long as it complies with the relevant foreign exchange requirements, for example, to be used in overseas investment.

Employee Stock Option Plans. Circular 37 for the first time allows employee stock option plan (“ESOP”) registration for directors, supervisors, managers, and employees working in domestic enterprises directly or indirectly controlled by non-listed overseas companies.

Before the promulgation of Circular 37, domestic employees could register ESOPs only if such stock option was issued by an overseas listed SPC. Domestic employees who had employee stock options in a nonlisted foreign company were unable to properly realize such rights and remit money relating to such option to overseas company, nor could they legally exchange their income from selling the stock option into RMB. The New Rule allowing employee stock options issued by nonlisted companies will solve many existing registration problems and will facilitate ESOPs to be more popular in nonlisted foreign companies with Chinese employees.

Financing from Domestic Residents to SPCs. Article 10 and Article 11 of Circular 37 permit Domestic Residents to provide financing to SPCs with domestic or overseas capital or interests lawfully held by them. Article 10 specifies that financing by Domestic Residents can be made by domestic enterprises directly or indirectly controlled by the Domestic Residents, and Article 11 further specifies that such financing can be made for the purpose of establishment, buyback, or delisting of the SPCs.

Prior to the promulgation of Circular 37, the SPCs could not obtain financing from Chinese domestic entities or individuals. Circular 37 is a significant breakthrough that resolves to a great extent the need for financing of overseas SPCs and substantially simplifies the procedure for Domestic Residents investing abroad.

Allowance for Remedial Registration. Article 12 of Circular 37 clarifies the procedure for remedial registration, providing that Domestic Residents that failed to initially register with SAFE for their round-trip investment at the time of the investment can make a remedial registration so as to legalize those round-trip investments under the New Rule. Having said this, the New Rule also lists relevant applicable penalties that will be imposed by SAFE when such remedial registration applications are made.

Conclusion

Compared to Circular 75, Circular 37 embraces many of the gray areas that Circular 75 failed to address. Meanwhile, Circular 37 loosens the government’s control over Domestic Residents, especially individuals, in making foreign investments. There are still gray areas yet to be clarified by Circular 37, however, which the Chinese government may address in future notices and regulations. For now, Circular 37 will give Chinese investors more flexibility in making foreign investments.

Lawyer Contacts

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

H. John Kao

Beijing

+86.10.5866.1111

hjkao@jonesday.com

Jessie Chenghui Tang

Beijing

+86.10.5866.1183

jtang@jonesday.com

Patrick H. Hu

Shanghai

+86.21.2201.8006

phu@jonesday.com

Ian M. Liao

Shanghai/Beijing

+86.21.2201.8049/+86.10.5866.1219

iliao@jonesday.com

Liming Yuan

Shanghai

+86.21.2201.8000

lyuan@jonesday.com

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