PILLAR LEGAL

China Restricts Offshore Investments by Domestic Companies

CHINA REGULATION WATCH[1]
January 13, 2017

By: Greg Pilarowski | Jack Chen

During much of 2016, China's State Administration of Foreign Exchange (国家外汇管理局) ("SAFE"), the ministerial level agency tasked with regulating foreign exchange matters, has informally changed its policies to restrict the ability of companies based in the People's Republic of China (the "PRC" or "China") to convert Renminbi into foreign currency for the purpose of making offshore direct investments ("ODI"). These policy changes have taken place as China's economic growth rates decline and China experiences a weakening of its currency and a decline in its foreign exchange reserves. This regulation watch provides background on China's foreign exchange controls, an overview of China's written rules for ODI, and our "best guess" at SAFE's recent policy changes relating to ODI procedures based upon our contacts with various market participants.

1. Background.

The Renminbi, China's currency, which is also known as the yuan, is fully convertible under the current account, which means that companies based in China may convert Renminbi into U.S. Dollars or other foreign currencies to pay for things like services provided by an offshore company or imported manufacturing component parts. The Renminbi is not fully convertible, however, under the capital account. As a result, converting Renminbi into U.S. Dollars or other foreign currency for purposes of making offshore direct investments or ODI is subject to certain PRC government restrictions.

During the past several years, under the policy roughly translated as the "Going Global Strategy" (走出去战略), the PRC government has encouraged PRC companies to make foreign investments in order to obtain offshore resources, such as advanced technologies or important raw materials. To implement this strategy, the PRC government issued various regulations which simplified the approval process for ODI.

Starting in early 2016, however, SAFE began to adjust its policies to impose restrictions on ODI. These restrictive measures generally involve detailed scrutiny of proposed ODI projects by banks and SAFE, as well as the exercise of SAFE's discretionary power to reject any ODI project.

---

[1] This China Regulation Watch is provided by Pillar Legal, P.C. (the "Firm") as a service to clients and other readers. The information contained in this publication should not be construed as legal advice, and use of this memorandum does not create an attorney - client relationship between the reader and the Firm. In addition, the information has not been updated since the date first set forth above and may be required to be updated or customized for particular facts and circumstances. This China Regulation Watch may be considered "Attorney Advertising" under applicable law. Questions regarding the matters discussed in this publication may be directed to the Firm at the following contact details: +1-925-474-3258 (San Francisco Bay Area office), +86-21-5876-0206 (Shanghai office), email: greg@pillarlegalpc.com. Firm website: www.pillarlegalpc.com.

Unfortunately, SAFE did not change its policies through an official public rule, but rather on an informal basis. As a result, information on many of these policy changes is generally only available through informal contacts with market participants.

There have, however, been several formal rule changes that reflect the general policy shift toward greater restrictions on ODI, including the following:

- $10,000 Bank Wire Reporting Rule. On December 28, 2016, the People's Bank of China (中国人民银行), which is the central bank of China, issued the Administrative Measures regarding Reporting Large or Suspicious Transaction by Financial Institutions (金融机构大额交易和可疑交易报告管理办法), which will become effective as of July 1, 2017 (the "Bank of China Large Transaction Measures"). Pursuant to the Bank of China Large Transaction Measures, financial institutions must report to the Anti-Money Laundering Monitoring and Analysis Center of China (中国反洗钱监测分析中心) any bank wires initiated on behalf of an individual in the amount of US$10,000 or more to a bank outside of China.[2]

- Application Letters for Individuals. Starting from January 1, 2017, SAFE requires PRC banks to adopt a new system for converting Renminbi into foreign currencies. Under the new system, PRC individuals are required to file a detailed application letter to the bank, which must disclosure matters such as how and when they will use the foreign currency.[3]

Some proposed changes have been reported in the press but have not yet been released as actual rules or requirements. For example, Nanyang Sin-Chew Lianhe Zaobao (联合早报), a prestigious Chinese language news agency based in Singapore, reported that the PRC government is considering requiring state-own companies to sell a certain percentage of their foreign currency to the central bank in exchange for Renminbi.[4]

Other changes are unverified, however, but may very well also be correct. We understand, for example, that the staff of certain PRC banks have been instructed to not share articles on their WeChat groups that relate to Renminbi depreciation.

These formal and informal restrictions on foreign exchange come at a time when China's economic growth rate is slowing, and China is experiencing a weakening of its currency and a decline in its foreign exchange reserves. China's annual economic growth for 2015 was 6.9%, while the annual economic growth rates for 2007 and 2010 were 14.2% and 10.6% respectively[5].

---

[2] See Article 5(4) of Administrative Measures regarding Reporting Large or Suspicious Transaction by Financial Institutions (金融机构大额交易和可疑交易报告管理办法).

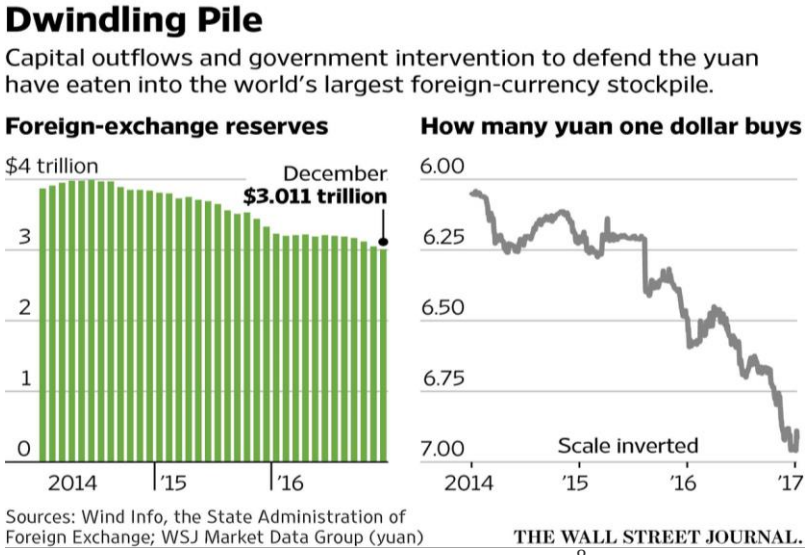
[3] See "Journalist Experience Foreign Exchange Purchase Application Letter: More Detailed Options and More Complicated Process (记者体验新版购汇申请书：选项更详尽 流程更复杂)" (Chinese) posted at ifeng.com.

[4] See "China May Require State-Own Companies to Sell Foreign Currency in Order to Deal with RMB Depreciating and Dropping of Foreign Exchange Reserve (应对更严峻人民币贬值和资本外流 中国或要国企强制结汇)" (Chinese) posted at Zaobao.com.

[5] See data on Nation Bureau of Statistics of China website.

Source: based on data on Nation Bureau of Statistics of China website[6]

In addition, the Renminbi's exchange rate against the U.S. dollar has fallen from its strongest position of RMB 6.093 to US$1.00 on January 14, 2014, to RMB 6.937 to US$1.00 on December 30, 2016. China's foreign exchange reserves have also fallen from an all-time high of US$3.993 trillion on June 30, 2014, to US$3.011 trillion on December 30, 2016.[7]



Source: Wall Street Journal[8]

2. Written Rules for Offshore Direct Investment.

In connection with China's "Going Global Strategy", as noted above, China adopted rules that streamlined the approval process for offshore direct investment, or ODI. Pursuant to Article 8 of the Measures for the Administration of Confirmation and Recordation of Overseas Investment

[6] See data on Nation Bureau of Statistics of China website.
[7] See foreign exchange data posted at SAFE website.
[8] See "China Foreign-Exchange Reserves Keep Dropping" posted at WSJ.com.

Projects (境外投资项目核准和备案管理办法), which was issued in May 2014 by the National Development and Reform Commission (国家发展和改革委员会) ("NDRC"), ODI projects are subject to different approval authorities depending on (i) the investment amount and (ii) whether the investment is considered "sensitive":

- NDRC Approval. If an ODI project involves investments in "sensitive regions" (such as a war zone) or "sensitive industries" (such as basic infrastructure or news media) (each such project, a "Sensitive Investment"), or the investment amount is more than US$1 billion, then such investment must be approved by NDRC before it can be completed;

- NDRC and State Council Approval. If an ODI project is a Sensitive Investment, and the investment amount is more than US$2 billion, then such investment must be approved by NDRC and the State Council (国务院) before it can be completed;

- NDRC Registration. If the investment amount of an ODI project is more than US$300 million but less than US$1 billion, and such investment is not a Sensitive Investment, then such investment must be registered with NDRC before it can be completed;

- Local MOFCOM Registration. If the investment amount of an ODI project is less than US$300 million and such investment is not a Sensitive Investment, then such investment must be registered with the local branch of the Ministry of Commerce (商务部) ("MOFCOM") before it can be completed.

In addition, according to Article 1 of the Notice of the State Administration of Foreign Exchange on Further Simplifying and Improving Policies for the Foreign Exchange Administration of Direct Investment (国家外汇管理局关于进一步简化和改进直接投资外汇管理政策的通知) issued by SAFE in June 2015 (the "SAFE Simplification Notice"), SAFE has authorized PRC banks to review and process ODI foreign currency exchange matters, and SAFE will only indirectly oversee the process rather than being directly involved.

Since most ODIs are not Sensitive Investments and are less than US$300 million, under the existing ODI regulating system, the governmental approval process is not that complicated. The investing party generally need only (i) complete the registration process with the local branch of MOFCOM, and (ii) work with their PRC bank to convert Renminbi into foreign currency.

3. Unwritten Rules for Offshore Direct Investment.

In the later portions of 2016, ODI projects became increasingly difficult to complete due to challenges in converting Renminbi into foreign currency. According to our contacts in various PRC banks and other market participants, although the local branches of MOFCOM are still granting registration certificates for ODI projects within their scope of authority, PRC banks have greatly reduced the conversion of Renminbi into foreign currency for ODI projects. We understand that SAFE, which was supposed to only indirectly oversee foreign currency exchange matters according to the SAFE Simplification Notice, is now directly and actively involved with foreign currency exchange matters and is using this means to restrict ODI projects.

Based on conversations with our contacts at PRC banks and other market participants, as well as various domestic news sources, below is a summary of our "best guess" at recent ODI approval practices.

i. Due Diligence. PRC banks are required by SAFE to conduct a detailed due diligence process regarding proposed ODI projects, with such process including (i) confirming the source of Renminbi proceeds to see whether the proceeds are from legitimate activities, (ii) reviewing the investment documents, (iii) confirming whether the ODI project has a legitimate purpose, and (iv) reviewing the financial statements of the PRC company to see if it has a reasonable debt to asset ratio. In addition, SAFE has informally instructed PRC banks that ODI projects are now generally discouraged, and thus the banks must strictly enforce these due diligence requirements.

ii. US$5 Million Threshold. If the investment amount for the proposed ODI project exceeds US$5 million, it will be much more difficult to convert Renminbi into foreign currency to complete the transaction. For these transactions, local SAFE officials may require the management team of the applicant company to visit the SAFE offices for in-person interviews. Some PRC banks have indicated that if the investment amount exceeds US$5 million, they simply cannot convert the Renminbi to foreign currency and thus the transaction cannot be completed. In addition, SAFE now requires a single bank to be responsible for all currency conversions for an ODI project, making it difficult to split a large transaction (which exceeds US$ 5 million) into multiple smaller transactions to ask several banks to provide the foreign currency.

iii. Prohibited Elements. According to a December 2016 joint press release regarding ODI from NDRC, SAFE and other governmental agencies,[9] SAFE will have a negative view toward an ODI project if the project involves any of the following elements:

- Investments into real estate, hotels, films, entertainment and athletic clubs;
- The ODI project is not related to the applicant company's core business;
- An applicant company that is a limited partnership;
- A newly established applicant company with less than one (1) year of operating history; or
- Investment amounts that are large when compared to the scale of the applicant company's own business operations.

In addition to the above informal policies, SAFE is now a defacto decision maker for ODI projects and appears to be exercising this approval authority on a case-by-case basis.

In the current macroeconomic environment, it does not appear as though the ODI approval process will become easier in the near term. In addition, if China's currency continues to weaken and its foreign exchange reserves continue to fall, additional restrictions on ODI projects are likely to be adopted. Due to the now cumbersome approval process and the significant chance of

[9] See press release posted at Xinhuanet.com.

failing to obtain the required approval, many PRC banks are advising their clients to avoid pursuing ODI projects in the near term.