

China Further Tightens Control of Outbound Direct Investment

CHINA REGULATION WATCH¹

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On August 18, 2017, the National Development and Reform Commission (国家发展和改革委员会) (“NDRC”), Ministry of Commerce (商务部) (“MOFCOM”), the People’s Bank of China (中国人民银行) and Ministry of Foreign Affairs (外交部) jointly published Further Guidelines on the Monitoring and Supervision of Outbound Direct Investment (关于进一步引导和规范境外投资方向的指导意见) (the “ODI Guidelines”). The main purpose of the ODI Guidelines, which are consistent with a series of written and unwritten restrictions on outbound direct investment (“ODI”) implemented over the past 18 months, is to promote ODI in sectors that align with China’s national economic and strategic goals.

1. Previous Rules Regarding ODI

China previously adopted rules that streamlined the approval process for ODI. Pursuant to (i) the Measures for the Management Outbound Investment Regulations (境外投资管理办法), issued by MOFCOM on September 9, 2014, and (ii) the Measures for the Administration of Confirmation and Recordation of Overseas Investment Projects (境外投资项目核准和备案管理办法), issued by NDRC on May 8, 2014, ODI projects are subject to the approval of different authorities depending on (a) the investment amount, and (b) whether the investment is related to “sensitive regions” or “sensitive industries”.² According to the relevant rules, 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 should only need to be registered with the local branch of MOFCOM, and the investors can then work with their relevant People’s Republic of China (“PRC”) bank to convert Renminbi into foreign currency.

A slower economic growth rate, lower Renminbi exchange rate against the U.S. dollar and fewer foreign exchange reserves, however, have caused China to start imposing formal and informal restrictions on ODI since early 2016.

In particular, restrictions in connection with the approval process for converting Renminbi into foreign currency have made completing ODI projects increasingly difficult. In December 2016, a joint press release regarding ODI from NDRC, State Administration of Foreign Exchange (国

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² “Sensitive regions” means war zones or states without diplomatic relations with China, and “sensitive industries” means basic telecommunication operations, cross-border water resource development and exploitation; large scale land development, electric main and power systems, news agencies and media.



家外汇管理局) (“SAFE”) and other governmental agencies indicated that SAFE will view an ODI project negatively, and likely prohibit conversion of Renminbi into foreign currency, if the project involves any of the following elements:³

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

As a result of the formal and informal restrictions, according to a senior officer of the Department of Outward Investment and Economic Cooperation (对外投资和经济合作司) of MOFCOM, from January 2017 to July 2017, China’s aggregate ODI fell to US\$57.2 billion, a decrease of 44.3% compared with the first seven (7) months of 2016.⁴

2. ODI Guidelines Industry Classification

In line with previously adopted written and unwritten rules, the ODI Guidelines classify ODI projects by industry into three categories. The table below describes each such category.

ODI Project Industry	Specifications
Encouraged Industry	<ul style="list-style-type: none"> • Infrastructure projects that facilitate adopting China’s Belt and Road Initiative (一带一路) policy; • Investment projects that facilitate promoting the development of China’s advanced equipment and technologies; • High-tech and innovative research; • Energy and mining exploration; • Agriculture; and • Service industry.
Restricted Industry	<ul style="list-style-type: none"> • Investments in war zones or states without diplomatic relations with China; • Real estate, hotels, cinemas, entertainment and sports clubs; • Equity investment funds without business operations; and • Investments that violate environmental,

³ See press release posted at Xinhuanet.com.

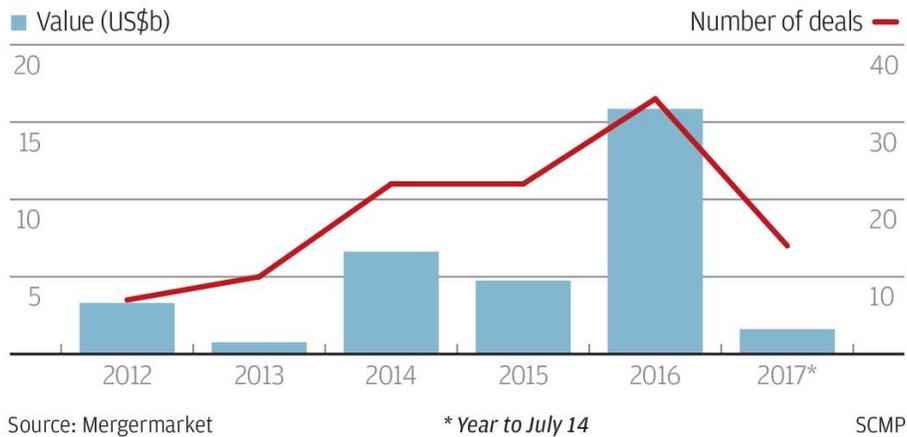
⁴ See MOFCOM Official Website.



ODI Project Industry	Specifications
	energy or safety standards adopted by the areas where the investee is located.
Prohibited Industry	<ul style="list-style-type: none"> • Investments that relate to China’s core military technology or military products; • Investments that relate to China’s techniques or products that are prohibited for exportation; • Gambling and pornography industries; • Investments that violate international treaties that China is a party to; and • Investments that impair China’s national interests or security.

The ODI Guidelines are not really a new regulation, but are more of a confirmation of policies that have already been implemented for some time. For example, investments in real estate, hotels, films, entertainment and athletic clubs have never been openly encouraged by the Chinese government. Since various Chinese government departments publicly announced in December 2016 that “irrational” ODI in real estate, hotels, films, entertainment and athletic clubs is not welcome, China’s aggregate ODI in such industries in 2017 have dropped 82.5% compared to the previous year.⁵

China’s outbound investment in the hotel, property and entertainment sectors



⁵ See Sina.com.



3. ODI Guidelines Management Systems Improvement Requirement

The ODI Guidelines also require the relevant government departments to improve their management systems. There is no clear explanation in the ODI Guidelines, however, as to what specific improvements are required. According to an interview with a senior officer of NDRC, improvement of the management systems includes:⁶

- Due Diligence. The relevant government departments must strengthen the due diligence process in connection with proposed ODI projects. Rigorous due diligence, however, is also not a new hurdle for market participants. Prior to the release of the ODI Guidelines, based on conversations with our contacts at PRC banks in January 2017, PRC banks are required by SAFE to conduct a detailed due diligence process in connection with proposed ODI projects, including (i) confirming the source of Renminbi proceeds to determine whether such 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 determine 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 banks must strictly enforce these due diligence requirements.
- Blacklist. The relevant government departments are also required to establish blacklists to include investors that have violated the relevant ODI rules. An information sharing system among different government departments shall also be developed to supervise proposed ODI projects.
- Future Legislation. NDRC is leading the creation of Outbound Direct Investment Regulations (境外投资条例). This represents the first time that China's government has clarified that there will be formal regulations to monitor and supervise ODI.

⁶ See [NDRC website](#).