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New Rules Regarding Domestic Equity Investments by Foreign-Invested Enterprises Incorporated In China

1. History review

Pursuant to the “*Notice of the General Affairs Department of the State Administration of Foreign Exchange (the “SAFE”) on the Relevant Operating Issues concerning the Improvement of the Administration of Payment and Settlement of Foreign Currency Capital of Foreign Funded Enterprises*” issued on August 29th, 2008 (the “**Notice 142**”), the foreign-invested enterprises (“**FIEs**”) were for a long time prohibited from using the foreign currencies contributed to their registered capital (or RMB resulting from the conversion of the registered capital in foreign currencies) to make equity investment in China, if their business scope did not refer to equity investments.

On March 30th, 2015, SAFE promulgated the “*Circular of the State Administration of Foreign Exchange on Reforming the Administration of Foreign Exchange Settlement of Capital of Foreign-invested Enterprises*” (“**Circular 19**”), which seems opening the door to the FIEs to use its registered capital in domestic equity investment.

In fact, according to its Article IV, the FIEs, with or without “investment” in their business scope, are authorized to make equity investment in China by using the RMB obtained from settlement of their registered capital in authentic projects which are complying with relevant laws and regulations.

However, concurrently, Circular 19 reinstates in its Article III the principle of using the registered capital within the business scope of an FIE:

“The registered capital of a foreign-invested enterprise and the RMB funds obtained from the exchange settlement thereof shall not be used for the following purposes:

- *For expenditures, directly or indirectly, beyond the enterprise's business scope or those prohibited by the laws and regulations of the State...”*

SAFE has not published any circular to explain or settle such contradiction.

In practice, most of local SAFEs and banks held the opinion that an FIE without “investment” in its business scope was still prohibited from using its registered capital to make domestic equity investments.

To be able to make equity investment in China, these FIEs could only use the profits generated by their activities in China instead of their registered capital.

Under such constraints, some foreign investors were not able to use their existing subsidiaries as platform for further equity investment in China. They were obliged to make the equity investment directly from abroad with the following disadvantages:

- Obligation to incorporate new FIEs while the formalities for the incorporation of an FIE and for any subsequent modification are relatively more complicated than those for a domestic company (the subsidiary of an existing FIE).
- Complicated organizational chart in China without the possibility of optimization.
- Until December 31st, 2019, the FIEs incorporated under the form of sino-foreign joint-venture are obliged to be governed by the PRC Joint Venture Law which gives the veto right to a minority shareholder for strategic decisions such as AOA amendment, termination or dissolution of the company, capital increase or decrease, merger or spin off of the company.

2. Restrictions lifted on domestic equity investments

On October 25th, 2019, the SAFE promulgated the *“Circular of the State Administration of Foreign Exchange on Further Promoting the Ease of Cross-Border Trade and Investment”* (**“Circular 28”**).

In this Circular 28, FIEs are allowed to lawfully make domestic equity investments by using their capital under the premise of no violation of the prevailing special administrative measures for access of foreign investments (negative list) and authenticity and compliance with regulation of domestic investment projects, even if they do not have “investment” in their business scope.

In case the domestic equity investment is made by transferring the original currency of the registered capital of an FIE, the investee shall conduct registration of domestic reinvestment as per provisions and open a capital account to receive the capital.

In case the domestic equity investment is made in RMB, the investee shall conduct the registration of receiving domestic reinvestment as per provisions and open a “capital account - account pending for foreign exchange settlement payment” to receive corresponding capital.

3. A new financing option

Circular 28 breaks through the obstacles under which FIEs could not smoothly carry out domestic equity investment in the past years by offering more flexibility for their investment structuring in China. Thanks to this new financing option offered to a non-investment FIE, the latter is authorized to make a domestic equity investment either by transferring the original currency of its registered capital or by capital settlement.

However, we anticipate that non-investment FIEs may face some practical difficulties during the first few months after the effectiveness date of Circular 28 as the local SAFEs and banks usually need some time to make the necessary modifications to their systems and internal working rules for the implementation of a new SAFE rule.

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