SAFE RELAXES RULES ON EQUITY INVESTMENT BY FIEs

To improve the business environment in China and further open the economy, the State Administration of Foreign Exchange ("**SAFE**") announced new measures to facilitate cross-border trade and investment and streamline administrative procedures. The *Circular on Further Promotions to Facilitate Cross-border Trade and Investment* (Huifa [2019] No. 28, "**Circular 28**") went into effect on 25 October 2019.

In the circular, SAFE introduces 12 broad reform measures, the most noteworthy of which is the cancellation of restrictions on equity investments made by foreign-invested enterprises ("**FIEs**") in China.

BACKGROUND

Before Circular 28, only FIEs that had a registered business scope containing "investment" were permitted to use their registered capital to make equity investments in China. Such FIEs were generally limited to holding companies, venture capital and equity investment firms. Ordinary FIEs whose permitted scope of business did not include "investment" were not allowed to make equity investments in China using their registered capital (in foreign currency or converted RMB). For these FIEs:

- Obtaining regulatory consent to include "investment" in their business scope was practically difficult, if not impossible;
- The limited means available to engage in investment business (i.e. setting up a foreign-invested holding company, venture capital or equity investment firm) were all subject to stringent capital requirements and restrictions; and
- The only way to make an equity investment in China was to use their own available operating cash and/or local RMB financing. Foreign loans were not allowed for equity investments.

According to data published by SAFE, there are more than 370,000 registered FIEs in China, among which less than 3,000—less than 1%—are investment FIEs. Indeed, the strict equity investment requirements presented serious obstacles to a large amount of foreign investment.

CHANGES AND IMPROVEMENTS BROUGHT BY CIRCULAR 28

Cancellation of restrictions on equity investment by FIEs in China

Under Circular 28, any FIE, regardless of whether it has "investment" in its business scope, can make equity investments in China using foreign currency in the registered capital account or RMB converted from the initial foreign investment made in foreign currency, as long as:

- Such investment is in line with the market access requirements of the Negative List[1]; and
- The equity investment project is authentic and compliant.

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[1] The Special Administrative Measures for Foreign Investment Access ("**Negative List**"), promulgated on 30 June 2019 and became effective on 30 July 2019.

Banks may require an FIE to prove that a specific investment is commercially reasonable and review whether the target has any commercial relationship with the business currently operated by the FIE.

Clarification of administrative procedures for domestic equity investment

As mentioned above, to make an equity investment in a Chinese domestic company, non-investment FIEs may use their registered capital in foreign currency or converted RMB. If they use foreign currency, the target entity must (a) register its receipt of the domestic reinvestment; and (b) open a capital account to receive the funds. Registration of the currency contribution with SAFE is no longer required.

If a non-investment FIE uses converted RMB funds from their initial capital injection for the domestic equity investment, the target entity must (a) register its receipt of the domestic reinvestment; and (b) open a "pending RMB conversion account" to receive the reinvestment[2].

COMMENTS

In recent years, SAFE has been gradually relaxing restrictions on FIEs' use of their registered capital funds and foreign debt accounts. The release of Circular 28 further loosens China's strict foreign exchange measures in favour of promoting trade and investment. It now has explicitly eliminated the hurdle for non-investment FIEs to make equity investments in China using their registered capital.

For foreign investors, such reform is very welcome as it indicates that investment FIEs are no longer the only options for making equity investments in China. They now have more flexibility in planning their business and investments. However, Circular 28 also stresses the authenticity and compliance review requirement for foreign exchange administration. It remains to be seen how the requirements for domestic equity investments will be implemented in practice.

Gide will continue to monitor the SAFE reforms. Please feel free to contact us should you have any questions.

[2] This account is a special RMB account introduced in 2014 reforms initiated by SAFE. It is an RMB account subject to regulatory supervision as a foreign exchange capital account.

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