

CHINA MATTERS

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China Re-opens Door to Invest in Offshore Holding Vehicles

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Overview

On November 1, 2005, Circular No. 75 [2005] of the State Administration of Foreign Exchange (SAFE) of the People's Republic of China (PRC) became effective. Circular No. 75 supersedes Circulars No. 11 and 29 [2005], which for the past nine months have made it difficult for a PRC company to restructure its ownership into an offshore holding company (typically in the Cayman Islands or British Virgin Islands) to receive foreign investment.

The offshore holding company structure appeals to foreign investors such as private equity and venture capital funds in part because it provides an easier exit for the investor, either through an initial public offering outside China or through a trade sale to another foreign buyer.

Circulars No. 11 and 29 provided in part that PRC residents may not establish or control a company outside China, nor transfer assets or equity within China in exchange for assets or equity outside China, without obtaining approval from the Ministry of Commerce (MOFCOM) and registering such a transaction with SAFE.

As a result, in the first three quarters of 2005, there was a significant reduction in the number of announced private equity and venture transactions in China as foreign investors and potential portfolio companies grappled with how Circulars No. 11 and 29 would affect their investment strategies.

Circular No. 75 is widely seen as SAFE's attempt to provide a middle-ground in which foreign investors

are afforded a viable means of making investments in China through the use of offshore holding vehicles, while the PRC government, particularly SAFE, is given a way to monitor and regulate such investments.

Highlights of Circular No. 75

- **Registration.** A PRC resident must register an investment with SAFE if the investment involves (1) the establishment or control of a special purpose vehicle (SPV) outside of China; or (2) the injection of PRC assets into a SPV or a financing transaction by a SPV that holds PRC assets.
- **Repatriation.** A PRC resident must repatriate all distributions of income, dividend and profit received from a SPV within 180 days after receipt of such distributions.
- **Major Structure Change.** If a SPV undergoes a major change in its capital structure, including an increase or decrease of capital, transfer or exchange of equity interests, or merger or spin-off, such event must be reported to SAFE within 30 days after occurrence.
- **Retrospective Application.** A PRC resident who established or controlled a SPV prior to the effectiveness of Circular No. 75 must register with SAFE prior to March 31, 2006.

Major Differences between Circular No. 75 and Circulars No. 11 & 29

- **Approval vs. Registration.** One of the main objections against Circulars No. 11 and 29 was that MOFCOM did not approve any application under Circulars No. 11 and 29. This made compliance with the require-

ments of those circulars very difficult since MOFCOM approval was a condition to SAFE registration. Circular No. 75 drops the MOFCOM approval requirement and merely requires registration with SAFE, which is presumably a less demanding process.

• **Definition of Control.** As an indication of SAFE's growing ability to "keep up" with the foreign investors and their professional advisors, Circular No. 75 specifically defines "control" to include alternative investment structures, such as the use of trusts, nominee holders, agents, convertible securities, call options and repurchase options. While it was not entirely clear in Circulars No. 11 and 29 whether such alternatives constituted "control", Circular No. 75 appears to capture such alternative transaction structures.

Uncertainties under Circular No. 75

• **Registration Procedures.** Although Circular No. 75 sets forth the documents that must be submitted for registration purposes, it does not describe the registration process, the procedures involved, the scope of review by SAFE and, perhaps most importantly, the time required for such registration to be completed and the grounds upon which SAFE may reject a registration application.

• **Definition of "PRC Resident."** As in Circulars No. 11 and 29, there is uncertainty under Circular No. 75 as to who is captured under the definition of "PRC resident". One critical question is how much time an individual who does not hold a PRC passport may spend in China before becoming a person who "regularly lives in China", and therefore a PRC resident. The fact that SAFE used "regularly lives in China" rather than a bright-line threshold such as "183 days a year" will likely give rise to uncertainty and subject Circular No. 75 to varying interpretations.

• **Definition of "Control."** Although the term "control" is defined in Circular No. 75, uncertainties remain as to how such a definition will be applied in practice. For example, how is "control" determined when there is more than one PRC resident involved, especially when one PRC resident does not individually control the SPV, but as a group, PRC residents control the SPV?

• **Business Plan.** Circular No. 75 allows the proceeds raised in a financing transaction by the SPV to be repatriated into China but stipulates that the proceeds shall be used in accordance with the "use of proceeds" description in a business plan. The fact that Circular No. 75 did not further elaborate as to "when" the repatriation should occur is likely to cause uncertainty over whether the SPV still has the flexibility to use the proceeds in accordance with commercial and operational needs, or whether it must decide on a use of proceeds early on. There is also uncertainty over whether SAFE will accept a fairly broad "use of proceeds" description in the business plan.

• **Administration by local SAFE offices.** It remains unclear how any difference in interpretation of Circular No. 75 between different local SAFE offices will be reconciled.

Paul Hastings currently represents foreign investors, PRC companies and individuals in various transactions that are affected by Circular No. 75. The above discussion is neither exhaustive nor specific and must not be relied upon as legal advice. For a more detailed discussion, or for a full English translation of Circular No. 75, please contact one of our lawyers listed below.

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