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Influence of New Foreign Exchange Policies on Cross-Border Capital Flow

By David Yu and Bernie Liu

On 5 August 2008, the amended *Regulation on Foreign Exchange Administration* (the "**New Regulation**"), which was promulgated on 1 August 2008 by the State Council of the People's Republic of China (the "**PRC**"), came into effect and became the governing regulation under the PRC laws on foreign exchange. The New Regulation introduces amendments in several aspects in relation to the foreign exchange management on capital account and current account, which is intended to strengthen the supervision on foreign exchange conversion so as to control the increasing pressure on foreign currency reserves, facilitate the increase in demand on overseas direct investment, and create a fair market and new financing venue for both domestic and cross-border players.

Stricter Supervision on FIE's Foreign Exchange Conversion:

The New Regulation strengthens the supervision on the foreign exchange conversion by foreign invested enterprise (**FIE**) into RMB and the use of conversion proceeds, and levels up the administrative penalty materially to an administrative penalty equivalent to the misused conversion proceeds at most if the use of conversion proceeds is beyond the approved usage. The State Administration of Foreign Exchange (the "**SAFE**") further issued the *Circular on Relevant Operational Issues on Registered Capital Conversion Administration of Foreign Invested Enterprise* (the "**Circular 142**") on 29 August 2008, which specifies that (i) the FIE's conversion proceeds shall not be used for equity investment or real estate investment (save for self-use real estate and the FIEs engaging in real estate industry), and (ii) the FIE can convert no more than USD 50,000 for its daily operational expenses.

According to the approval and registration practice for foreign direct investment, the reinvestment by an FIE does not require the approval from the FIE's original approval authority, save for the prohibited and

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restrictive industries for foreign investment. To clarify the approvable usages, it is the first time for the SAFE to clarify that the FIE shall not covert the foreign exchange for purpose of making equity investment in China, including greenfield investment,[1] equity transfer and capital increase. The aforementioned restriction on equity investment under the Circular 142 does not apply to the scenario that the FIEs use RMB capital obtained from resources other than the registered capital conversion to make equity investment, though FIEs in general are unable to generate sufficient cash flow for equity investment through their business operation within short term after its incorporation.

With regard to the conversion quota for daily operational expenses, before the Circular 142, an FIE could convert to the maximum USD 200,000 as daily operational expenses without submitting the supporting transaction documents under the SAFE rules. The Circular 142 reduces the conversion quota for daily operational expenses to from USD200,000 to USD 50,000, which is applied by the foreign exchange banks in practice as a daily quota for conversion without supporting documents. The reduction of daily conversion quota has a clear influence on the companies with equity investment from venture capital investors or private equity investors by means of capital increase, as in case that such company does not have a capital expenditure plan, it will not be able to freely use the subscription price by converting the foreign exchange into RMB in a relatively short term and therefore be subject to the risk of exchange rate in the future.

Facilitating Overseas Direct Investment

In recent years, the PRC companies, including domestic companies and FIEs, became more actively involved in overseas direct investment. However, due to involvement of complicated domestic approval process, it normally takes 2-6 months to obtain the approvals, which has rendered the failure of some transactions. In addition, without foreign exchange income, it is difficult for the PRC companies to lock up the transaction by making deposit payment to the transaction counterpart in a timely manner.

The New Regulation removes the procedure for examining the source of foreign exchange fund, shortening the whole process at most by 20 working days (taking Shanghai as an example), and introducing a new foreign exchange administration mechanism that the PRC companies can at discretion keep their foreign exchange income in their offshore accounts, which avails the lockup of overseas deal and increases the flexibility of the PRC companies in conducting their overseas direct investment.

Creating Fairer Market and New Financing Structure for Domestic Companies

Before the New Regulation, domestic companies in general were not able to obtain foreign debt from, or provide security to, overseas company.

The New Regulation removes the qualifications imposed on domestic companies to provide security to overseas companies and leaves to the SAFE the discretion on whether to approve the provision of security based on the applicant's financial status, although domestic companies can only provide security to overseas companies on behalf of their invested enterprises.

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Further, with the removal of aforementioned qualifications, the New Regulation creates possibility for domestic company to obtain overseas financing, that is, to provide security to overseas companies on behalf of overseas subsidiaries, although such financing mechanism needs to be further adopted in practice by the SAFE and other approval authorities (if applicable).

Conclusion

Generally speaking, the New Regulation poses a positive influence on M&A. Although, in respect of the foreign exchange conversion, the New Regulation limits the daily operational expense quota to USD 50,000 and strengthen the supervision on the use of foreign exchange conversion proceeds, the New Regulation in practice reduces the legal risks involved in the FIEs' daily business operation, facilitates the overseas investment and the provision of security to overseas companies, which avails the capital flow positively.

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1 Greenfield Investment means the investment made by means of incorporating a new company.

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