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Examples of Transactions under the FTZ Cross-border Investment System

By Leo Wang and Monica Gao

In the *General Plan for the China (Shanghai) Pilot Free Trade Zone*, it is expressly proposed that liberalization of the investment sector be broadened to support the carrying out various forms of offshore investment by various types of investment entities in the Zone. Additionally, the recordal system (without approval) should be mainly used to administrate the establishment of enterprises for offshore investment purposes. The establishment of offshore equity investment companies in the Zone is encouraged, and qualified investors are supported in establishing offshore private equity Fund of Funds. The Shanghai government has also issued certain complementary regulations on offshore investments by enterprises established in the Zone. However, there has been a dearth of actual transactions under the new system.

In February 2014, Hony Capital invested RMB186 million (US$30 million) abroad, through the Zone cross-border investment platform, to acquire PPTV in conjunction with Suning Appliance. This was the first example of an investment abroad by a private equity fund in the Zone.

Offshore investments by enterprises located outside of the Zone require the approval of the National Development and Reform Commission (NDRC) and the approval of the commerce authorities for establishing an enterprise to investment abroad. These investments are also subject to the oversight of the People's Bank of China and the State Administration of Foreign Exchange (SAFE) in respect of the transfer of funds from the enterprise's account and offshore financing in Renminbi and foreign currencies respectively. Regardless, all of the above mentioned systems have experienced breakthroughs in the Zone.

1) **Offshore investment projects primarily subject to recordal:** the *Administrative Measures of the Zone for the Recordal of Offshore Investment Projects* specify that the Zone management committee (the "Committee") any general offshore investment projects of local enterprises registered in the Zone, which alsofall within the purview of the Shanghai government, are subject to

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administration by the recordal system. Projects above the limit remain subject to the approval of the NDRC. Except for the recordal system, regulations are retained for the special project approval, information reporting system, and the local system for the registration of material offshore investment projects.

2) **Investment in and establishment of enterprises abroad, primarily subject to recordal:** the *Administrative Measures of the Zone for the Recordal of the Investment in and Establishment of Enterprises Abroad* specify that the offshore investments of enterprises, registered in the Zone that fall within the purview of the Committee, are subject to administration by the recordal system. Offshore investment includes the establishment of non-financial enterprises abroad by new establishment, merger, acquisition, etc. as well as the securing of ownership, control, right to operate and manage or other such rights and interests of or in existing non-financial enterprises. Offshore investments involving countries (regions) with which China does not have diplomatic relations, offshore investments in certain countries (regions), offshore investments involving the interests of multiple countries (regions), the establishment of offshore special purpose vehicles, energy and mining type offshore investments, offshore investments that require the solicitation of investors in China, etc. all require the approval of the appropriate commerce authority.

3) **Simplification of foreign exchange conversion procedure:** in December 2013, the People's Bank of China issued the *Opinions on Financially Supporting the Establishment of the China (Shanghai) Pilot Free Trade Zone* which specify that cross-border direct investment from the Zone may, in accordance with relevant regulations of Shanghai, be exempt from advance approval. Such cross-border receipts, payments, and currency exchanges involved can be carried out directly with banks.

At the end of February 2014, the SAFE Shanghai branch issued the *Rules for Exchange Control Support for the Establishment of the Zone*, and in the attached "Rules of the Zone for Foreign Exchange Registration in Connection with Direct Investment", it is specified that banks can carry out offshore investment registration for capital contributions made in cash. The scope of registration is the amount of the registered capital specified in the offshore investment approval or recordal document issued, although in special circumstances and for special purpose vehicles the same must be carried out with the SAFE office.

Investment Examples

Hony Capital designed a recordal and foreign exchange conversion operational route for the cross-border investment in the PPTV project. In addition to basing it on the features of a private equity investment fund, Hony Capital established two entities in the Zone, a fund management company and a fund company (as the investment entity for cross-border investment from the Zone) and the remaining operations were primarily securing the relevant recordal for the cross-border investment project and applying to the SAFE office for foreign exchange conversion. According to the description given by Hony Capital, the recordal authority mainly concerned itself with technical issues, e.g. completeness of the recordal documentation, compliance of the framework for foreign exchange conversion and the investment thereof offshore, oversight in the course of and after the fact, etc., and did not pay particular attention to the internal transaction structure and relevant terms of the PPTV project investment.

Examples of Transactions under the FTZ Cross-border Investment System

Hony Capital's successful investment in PPTV indicates that the competent authorities of the Zone have, in respect of the cross-border investment transactions of enterprises, entered the actual operational stage. With emphasis of their reviews as concentrated on technical aspects, cross-border investment transactions of enterprises required for time administrative approval has been greatly reduced and transaction efficiency greatly enhanced. Furthermore, the structure of controlling a domestic company through a VIE is of positive reference value in respect of the competent authorities' stance toward similar acquisition transactions in future.

However, the number of actual cases available for reference at the moment remains limited, with certain details still awaiting clarification. One example shows the detailed operational rules for supporting cross-border financing for offshore investments from the Zone proposed in the PBOC 30 Article Opinions, the domestic and foreign tax burdens that may be involved in the transactions, etc. Accordingly, while keeping an eye on transaction efficiency, parties to a transaction need to prudently conduct their own fact finding on other factors that could have an impact on their plan.

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