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Reported Foreign Exchange Restrictions in China Affect Outward Remittances

In late November and early December 2016, Chinese and international media reported on enhanced enforcement of outbound investment and foreign exchange controls by Chinese authorities in an attempt to check the volume of overseas acquisitions and halt the slide of the exchange rate of the Renminbi against the U.S. dollar. These actions reportedly target outbound direct investment ("ODI") transactions (including offshore investments through overseas subsidiaries) and cross-border loans to affiliates by Chinese corporations as well as payment of dividends by Chinese companies to foreign shareholders. Various business sources have confirmed that, at least in some cases, payments and transactions have been negatively affected.

There is little reliable information about the substantive and procedural content of the new restrictions. No regulation or notice has been published by government authorities, nor have government officials publicly confirmed the existence of any of the reported documents and actions. PRC media have posted purported extracts from official documents, but these extracts have been taken down from the Internet, presumably upon government request.

ODI

Regulatory Framework

The principal Chinese regulators for ODI are the Ministry of Commerce ("MOFCOM") and the National Development and Reform Commission ("NDRC") and their respective local counterparts. If an applicant or a target is in a specialized industrial sector (e.g. insurance), an ODI transaction may be subject to approvals of the regulators in charge of such industrial sector, in lieu of MOFCOM. As a general rule, Chinese investors are required to file an ODI transaction with MOFCOM and NDRC in advance. Transactions above certain threshold amounts or in a sensitive country or industry require approval instead of filing. MOFCOM and NDRC could apply the reported stricter scrutiny requirement in their review of filings and applications for approval. It appears that the two regulators have in some cases taken steps in this direction by requesting that additional documents and materials be submitted, demanding interviews with applicants and sometimes delaying the acceptance of the application.

In addition, as a capital account transaction, conversion of Renminbi into foreign currency and overseas remittance for payment for an ODI transaction requires approval from the State Administration of Foreign Exchange ("SAFE") or its local counterpart, unless an applicant has been granted an ODI quota by SAFE in advance as a "Qualified Domestic Institutional Investor." The Chinese investor may apply for SAFE approval after completing the required MOFCOM and NDRC procedures.

Reported Regulatory Action

Bank officials and business executives have indicated that Chinese banks have rejected or slowed down processing of requests for conversion and overseas remittance of funds for ODI transactions in an amount of US$5 million or more. According to some reports, banks must submit these requests for clearance to four agencies (NDRC, MOFCOM, SAFE and the People's Bank of China ("PBOC"), China's central bank) and banks are not allowed to process overseas remittance of funds before the ODI transaction is approved by the relevant authorities, including MOFCOM and NDRC. Even transactions that have already gone through ODI approval processes, but for which payment has not yet been made, would have to be reviewed again.

It appears that the Chinese government is implementing temporary measures to restrict or prohibit certain types of ODI projects. According to some reports, these measures are scheduled to remain in place through September 2017. The relevant approval authorities are being required to implement "stricter control" of the following types of ODI transactions:

i. acquisition or development of real property projects by State-owned enterprises involving an investment of more than US$1 billion;

ii. ODI outside the core business of the Chinese investor and involving an investment of more than US$1 billion;

iii. ODI involving an investment of more than US$10 billion;

iv. ODI by partnerships;

v. ODI in an overseas listed company where the acquired interest represents less than 10% of the share capital of the listed company;

vi. ODI projects where the capital of the Chinese parent investor is smaller than that of its overseas subsidiary or where the Chinese parent investor was established less than a year ago;

vii. ODI for the purpose of taking overseas listed Chinese companies private; and

viii. ODI by a Chinese investor that has a high debt to asset ratio or low rate of return on equity.

It is not clear whether "stricter control" means that these investments will be subject to stricter scrutiny in existing approval procedures or additional approval procedures. In addition, criteria for approval under this "stricter control" have not been articulated and it is not clear what the likelihood of approval might be.

Outbound Loans by PRC Corporations

SAFE regulations enable Chinese corporations to lend to their overseas affiliates within a quota determined by SAFE on a case-by-case basis. In late November 2016, the PBOC reportedly issued an unpublished notice to strengthen the scrutiny of such loans. Based on available information, the notice does not make the existing regime more restrictive, but merely restates the main conditions to be verified before the loan amount can be remitted overseas: the lender must have registered with SAFE and obtained a quota and must have an equity ownership relationship with the overseas borrower. The loan amount must be within the available balance of the quota granted by SAFE and, together with all other cross-border loans extended by the same corporation, must not exceed 30% of the lender's shareholders' equity.

Cross-Border Security by PRC Corporations

In 2014, SAFE liberalized the regime applicable to PRC entities and individuals giving security for obligations by a foreign debtor to a foreign creditor (known as *neibao waidai*). Most importantly, the security grant is no longer subject to prior SAFE approval; only a subsequent registration of the grant with SAFE is required.

SAFE is now interpreting the requirements for use of funds under this regime more broadly. Under the 2014 regulations on cross-border security grants, a debtor may not remit funds secured by a PRC guarantor under a *neibao waidai* arrangement directly or indirectly into China through loans, equity investments or securities investments. Recently, however, SAFE has refused to register guarantees by PRC Guarantors where the proceeds of the underlying loans were to be used to acquire assets that are primarily in China, even though the proceeds would be entirely paid to foreign sellers in an offshore acquisition. As a cross-border guarantee is not enforceable without SAFE registration, obtaining acquisition financing from Chinese entities for target companies with significant underlying PRC assets has become more difficult.

Overseas Dividend Remittance

Media reports as well as statements by representatives of foreign chambers of commerce in China allege that payment of dividends by PRC companies to foreign shareholders have been delayed in recent weeks. It appears that banks are reviewing the legally required supporting documents for such payments more strictly than before and in some cases are submitting these documents to SAFE for review, thus extending the processing time required to complete payment instructions. As with ODI related payments, both SAFE and the banks seem to be targeting dividend payments in an amount of US$5 million or more.

There is no basis in PRC law for this enhanced scrutiny. Under Chinese foreign exchange regulations, overseas payment of dividends is a current account transaction that does not require regulatory approval or review. Banks are only required to review the authenticity of the supporting documents. For a payment above US$50,000, board resolutions approving the declaration and payment of dividends and evidence of the withholding of corporate income tax must be submitted to the bank. Regulations do not require a substantive review or SAFE approval of the payment. However, it appears that closer scrutiny of supporting documents by the banks is being used to frustrate or delay large dividend payments.

Business Impact

The above summary shows that PRC regulators have various tools available to slow down remittances. Reports indicate that PRC banks have been instructed to apply the intended higher level of scrutiny and that payments have started to be negatively affected by it. With respect to corporate loans and dividend payments, it is not clear whether existing regulatory processes will change or whether any new substantive criteria will be applied. The immediate consequence is likely delay in payments that are otherwise permitted under law.

In addition to delays, there may be a more structural effect on ODI, as the PRC government shows its concern over the quality of outbound investments and the degree of risk incurred by Chinese corporations in various industries. Both Chinese and foreign parties to an ODI transaction should carefully review financing structures and anticipate a longer period to closing due to inquiries and requests for supplementary documents from Chinese authorities. Given the greater uncertainty, deal protection terms such as deposits, termination events and reverse break-up fees will become even more important in negotiating ODI deals, although these protection terms may be difficult to implement, then no funds can be remitted overseas.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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