

Title: More on Forex Aspects of a Changing Investment and M & A Climate

Published By: China Law & Practice

Date: April 2003, Volume 17, No. 3

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The new *Acquisition of Domestic Enterprises by Foreign Investors Tentative Provisions* (effective April 12 2003, see page 27 for a full translation) constitutes one of the most important developments in foreign direct investment law since the last revisions of the *Sino-foreign Equity joint Venture Law*, the *Sino-foreign Cooperative Joint Venture Law* and the *Wholly Foreign-owned Enterprises Law*. The March 3 2003 *Issues Relevant to Improving Foreign Exchange Control on Foreign Direct Investment Circular* (the Circular, effective on April 1 2003) looks to support the developments in foreign direct investment law and clarify some issues in this area.

The Circular is a comprehensive regulation covering numerous aspects of foreign exchange control in foreign direct investment, and contains some new points, which way facilitate further foreign direct investment.

Merger and Acquisitions

In respect of the purchase consideration paid by foreign investors to acquire a PRC company, the Circular makes it clear that SAFE will only allow remittance of dividends and other returns realized from the target company in proportion to the paid-in purchase consideration. For example, if a foreign investor pays 50% of purchase consideration, the foreign investor can only have 50% of the dividends declared and distributed to it remitted out of the PRC. The foreign investors need to make a registration with SAFE after payment of the purchase consideration to procure a registration certificate, which according to the Circular is the legal evidence proving the payment of purchase consideration. SAFE will request the presentation of such registration certificate when the foreign investors remit the dividends. This requirement gives teeth to the "how much you can get depends on how much you have paid" rule established by MOFTEC in the merger and acquisition regulations; MOFTEC intends to make foreign investors pay their purchase consideration promptly.

Contribution to Registered Capital

In addition to cash, equipment and intangibles already covered in existing laws, the Circular gives the following as acceptable forms for contributing to registered capital in a foreign-invested enterprise (FIE): (i) conversion of retained earnings or undistributed profits into registered capital; (ii) conversion of foreign investors'

credits to FIEs into registered capital; and (iii) reinvestment of benefits realized from other FIEs. Among these, conversion of foreign investors' credits into equity is a noteworthy point that creates more room for FIEs to plan their corporate financing. For example, a convertible shareholder's loan under the Circular is a possible option for investors.

Pre-incorporation Onshore Accounts

Because of the PRC's rigid foreign exchange controls, many foreign investors find it very cumbersome to deal with foreign exchange matters at the pre-incorporation and promotion phases in setting up FIEs. A foreign investor must remit each expenditure into the PRC. Establishment of an FIE may involve numerous remittances if such a foreign investor has no established subsidiaries in the PRC; even if there is an existing subsidiary, accounting and tax problems for the subsidiary can crop up if those expenditures for establishment of a new FIE are made in lieu of subsidiaries.

Under the Circular, foreign investors are allowed to open a special account in their own names for the purpose of their direct investment activities in the PRC. Such special purpose accounts are classified into four categories: (1) *investment account*; a foreign investor can open such an account to run its businesses without an FIE subsidiary (such businesses are limited to construction contracting, oil drilling, mineral exploitation, venture capital investment and other sectors); (2) *acquisition account*; a foreign investor can use money in such an account to buy real estate, equipment and other assets for establishment of an FIE; (3) *expenditure accounts*; the proceeds in such account can be used to pay costs and expenses in connection with preparatory works for incorporation, such as market investigation and planning; and (4) *surety accounts*; the foreign investor can use proceeds in this account to provide surety if a surety is requested by certain parties. The balance of proceeds in acquisition accounts, expenditure accounts and surety accounts can be converted into contributions to registered capital if FIEs are established, or can be remitted if no FIE is established.

Foreign investors are also allowed to use proceeds in onshore personal non-residence accounts or accounts opened in offshore branches of foreign exchange designated banks (banks authorized by SAFE to deal with foreign exchange related businesses) to make capital contributions to FIEs.

Several charts are attached to the main text of Circular, in which SAFE lists the relevant regulations, application documents, review criteria, competent authorities and other matters in respect of the procedures and formalities set forth in the main text. Foreign investors should refer to such charts to find out more technical details.