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## CHINA PRACTICE UPDATE

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### *New SAFE “Round Trip Investment” Circular Lightens the Regulatory Burden on Venture Capital Investments in China*

The State Administration of Foreign Exchange (SAFE), China’s foreign exchange regulatory authority, recently clarified the PRC’s overall attitude with respect to offshore VC investments by setting out clearer registration procedures and expressly permitting VC transactions involving offshore SPV structures, subject to compliance with foreign exchange registration requirements. This clarification was set forth in the Circular on Issues Relating to Financing through Offshore Special Purpose Vehicles by Domestic Residents and Round Trip Investment (Circular No. 75), promulgated on October 21, 2005, with effect from November 1, 2005. Circular No. 75 supersedes two SAFE circulars promulgated earlier this year, Circular No. 11 (January 24, 2005) and Circular No. 29 (April 8, 2005), which were widely regarded as a major roadblock to most VC transactions involving PRC domestic assets and residents. Circular No. 75 retains the core element of the two earlier circulars, i.e., SAFE’s authority to review the establishment or acquisition of offshore entities by PRC domestic residents or entities for the purpose of foreign exchange control and indirectly to prevent tax evasion and for other purposes. It nevertheless clarifies some key vague or ambiguous provisions and alleviates concerns aroused by the earlier circulars.

### Summary of Earlier Circulars

Circular No. 11 and Circular No. 29 significantly complicated offshore private equity and venture capital transactions by (i) subjecting equity investments by domestic residents, in principle even including cashless transactions, to approval by, not merely registration with, the foreign exchange authorities and the Ministry of Commerce; and (ii) limiting the opportunity for Chinese companies to move their assets offshore where they may be more attractive to private equity or venture capital investors. In particular, these circulars severely affected the key exit options of an offshore listing by an offshore holding company and offshore sale.

### Key Elements of Circular No. 75

Circular No. 75 enhances the VC investment climate by defining key terms and simplifying procedures. It defines “Special Purpose Vehicle” (SPV) as an offshore entity directly established or indirectly controlled by PRC residents (including legal persons, i.e., entities with independent legal capacity, and individuals) for the purpose of conducting offshore equity financing (including convertible debt financing) by use of their domestic enterprise assets or interests. “Round

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*Compared to the earlier circulars, Circular No. 75 makes several improvements.*

Trip Investment” is defined as direct investment activities made in China by residents through offshore SPVs including the purchase and swap of assets held by Chinese parties in domestic enterprises, establishment of foreign-invested enterprises (FIEs) in China, controlling domestic assets through contract, or purchasing domestic assets and using such assets to establish FIEs or increase the registered capital of domestic enterprises. Circular No. 75 further defines “control” as the obtaining by PRC residents of operating rights, rights to receive profits and decision-making rights through trusts, nominee arrangements, voting rights, repurchases, convertible debt or similar methods. This definition is much broader and more comprehensive than the definition in the earlier circulars, covering almost all offshore SPV structures typically used by VCs and private equity investors, but does not refer to the 10% actual “control” threshold in SAFE’s interpretation of earlier circulars. There thus is no indication as of yet that non-controlling interests of less than 10% will be exempt from the requirements of Circular No. 75.

Circular No. 75 requires a resident (including legal persons and individuals) to register offshore investments with the local foreign exchange authority prior to the establishment or acquisition of control of an offshore SPV. Among other application documents, a resident is required to submit a business plan detailing the offshore financing arrangements. Legal persons are required to submit additional documentation with respect to the source of their funds and the approval of relevant government authorities for offshore investment. After the foreign exchange authority completes a positive review of the registration documents, it will issue a Foreign Exchange Registration Certificate for Offshore Investment to domestic legal persons or a Foreign Exchange Registration Certificate for Offshore Investment by Domestic Individual Resident to domestic

individuals. When a resident contributes assets or an equity interest that it holds in a domestic enterprise to an offshore SPV or uses such offshore SPV (after the contribution of domestic assets or equity interest) for offshore equity financing, such resident must amend its foreign exchange registration and detail the history of changes in equity interest and equity structure of the domestic enterprise and offshore SPV as well as the method for pricing the equity financing. After the offshore SPV completes an offshore financing, domestic residents are required to repatriate funds that are required to be used in China back to China in accordance with fund use arrangements set out in their business plan or prospectus.

Other key requirements under Circular No. 75 include: repatriation of profits, dividends and any foreign exchange revenue received by PRC residents from the offshore SPV back to China within 180 days; reporting to the local foreign exchange authority within 30 days after the occurrence of a material event to the offshore SPV, such as increases or decreases of total investments, transfers or exchanges of shares, mergers or divisions, long-term equity or debt investments, or external guarantees; confirmation documents by the state-owned assets administration department of the value of the assets or equity required if state-owned assets are involved; a grace period for retroactive registration by March 31, 2006, of offshore SPV structures established before the promulgation of Circular No. 75; the delegation of power to one or two representative residents to handle forex registration matters if an offshore SPV involves multiple domestic residents; and permission for domestic residents to pay dividends, profits, liquidation proceeds and funds received from a reduction of registered capital to the offshore SPV after completion of foreign exchange registration procedures and any subsequent amendments that may be required.

## Major Improvements

Circular No. 75's improvements include:

### ***1. Removal of MOFCOM Approval Requirement for Individuals***

One major improvement is elimination of the requirement for individuals to obtain prior approval from the Ministry of Commerce (MOFCOM) or its local counterpart for the offshore investment as a precondition to SAFE registration. The earlier circulars subjected individuals to the same approval standards for offshore investment as those applicable to legal persons, which upset the VC and private equity community because it jeopardized the opportunity for individuals to liquify their interests through an offshore listing or sale. Removal of MOFCOM approval as a precondition for SAFE registration significantly reduces the burden on individuals in this regard and enables them to establish, gain control of and invest in an SPV for purposes of overseas listings and other transactions through a relatively simple registration process.

### ***2. Elimination of Documentation Requirement With Respect to Funding Sources for Individuals***

Another improvement is elimination of the requirement for individuals to submit documentation certifying the legitimate source of their funds for offshore investments. The removal of this requirement (to which legal persons remain subject) eliminates regulatory scrutiny of personal funds, which is particularly critical if an outside investor advances the funds to a Chinese individual to invest in the offshore SPV or if the funds have a questionable provenance.

### ***3. Express Permission for VC Transactions through Offshore SPV Structures***

Unlike the earlier circulars, Circular No. 75 expressly permits VCs to conduct

transactions through offshore SPV structures. This clarifies the legality of offshore VC structures under Chinese law.

### ***4. No Requirement for Offshore SPVs to Repatriate Funds Received From Overseas Financing to China***

Under Circular No. 75, domestic residents are only required to repatriate funds received from an overseas financing back to China as required in their offshore financing business plan or prospectus. This allows offshore SPVs to retain funds overseas for future M&A and capital activities, which enhances their cash flow and capability to conduct business.

### ***5. Clarification of Application Procedures and Required Documents***

Compared to the earlier circulars, Circular No. 75 sets out in greater detail application procedures and required documentation. However, SAFE's standards for review of applications remain unclear. Moreover, Circular No. 75 does not specify a waiting period during which SAFE must complete its review. As such, execution risk remains for VC and private equity transactions involving domestic assets and residents.

### ***6. Acknowledgment of "Foreign Investment" Status for Investments under a "Round Trip Investment" Structure***

Circular No. 75 requires domestic residents to handle relevant registrations with respect to investments made under a "Round Trip Investment" structure in accordance with foreign investment and foreign debt rules and regulations. Such provision implies that investments made under a "Round Trip Investment" structure will no longer be treated as crypto-foreign investments and will instead be eligible for foreign investment status and any investment and tax preferences associated therewith.

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## 7. Registration Authority

Foreign exchange registrations in connection with “Round Trip Investments” by offshore SPVs may be conducted at the local foreign exchange authority, rather than central SAFE in Beijing as required under the earlier circulars, which will shorten the application process.

## Conclusion

Although Circular No. 75 substantially improves upon the earlier SAFE circulars,

which severely constrained the prospects for VC and private equity deals involving offshore SPVs, it preserves the core content of the earlier circulars, i.e., forex registration prior to offshore investment. Moreover, some issues continue to be vague or ambiguous. For example, the failure to specify SAFE’s registration standards or the length of the review period makes it difficult to judge how Circular No. 75 is likely to be implemented and how VC and private equity transactions will be affected in practice.

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