Acquiring Private Businesses in China under New Foreign Exchange Controls

Seven months since the release of the foreign exchange circular requiring domestic Chinese residents to register investments overseas with the State Administration of Foreign Exchange, it is clear that despite further regulatory developments restrictions on such investments are here to stay. How will offshore investments be structured under the new framework and can the fallout for private equity transactions and overseas listings be avoided?

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In recent years, the preferred structure for foreign financial investors to acquire private enterprises in China, and for Chinese entrepreneurs to list shares of their companies, has been through special purpose vehicles (SPVs) in offshore jurisdictions. In such instances, both the foreign and Chinese investors acquire shares in an SPV. It then acquires equity interests in a Chinese target company founded by the Chinese shareholders of the SPV ('target company'), and converts the target company into a foreign-invested enterprise (FIE). Alternatively, the SPV can establish a new FIE to acquire the assets of the target company.

This structure has many advantages. The shareholders of an SPV can structure their shareholding more freely than under Chinese law, thanks to the more liberal legal environment in offshore jurisdictions. Also, shares in an SPV can be sold to new investors or listed on international stock exchanges without triggering approval requirements from Chinese government authorities.

Two circulars issued by China's State Administration of Foreign Exchange (SAFE), the first on January 24, 2005 – *Circular on Issues Relevant to Improving the Foreign Exchange Administration for Mergers and Acquisitions with Foreign Investment* (January Circular) – and the second on April 8, 2005 – *Circular on Issues Relevant to Registration Regarding Offshore Investments of Individual Domestic Residents* (April Circular) - have created major regulatory obstacles to this structure. SAFE now requires all residents of mainland China (whether or not they are of Chinese nationality) to obtain SAFE approval for their investments in an SPV or other foreign company ('residents' overseas investment').

Any change to the shareholding structure of such foreign company, or equity investment by such foreign company, must also be registered with SAFE. In addition, any FIE established through purchasing, or for the purpose of purchasing, equity or assets of a target company must disclose to SAFE that the Chinese residents who have an indirect ownership interest in the FIE also have an interest in the target company of such an acquisition (a 'relevant acquisition' - see Box 'The January and April Circulars – What do they require?').

In reality, however, SAFE does not accept the above disclosures. If an FIE applies for foreign exchange registration with SAFE now – i.e. after January 25 2005 - its application will be refused unless the FIE represents to SAFE that there are no Chinese residents who would indirectly hold shares in the FIE through a residents' overseas investment.

In the half year that has passed since the issue of the January Circular, overseas listings of offshore companies with Chinese assets and private equity investments in China have suffered from SAFE's refusal to accept prevailing investment practices. They have also suffered from SAFE's lack of clarity about its intentions in promulgating the January Circular. In this environment, investors are seeking answers on two key points: How will the crisis resulting from SAFE's new requirements be resolved? And how can investments be structured under the new framework?

CAN THE SAFE CONUNDRUM BE RESOLVED?

SAFE has given signals to investors and their advisers that it is not in principle opposed to relevant acquisitions. However, SAFE wants to ensure that Chinese residents duly repatriate their foreign exchange income, do not sell Chinese assets under value, and do not avoid foreign exchange controls on capital transactions.

To achieve these aims, SAFE had solicited the Ministry of Commerce (MOFCOM), which regulates overseas investments by Chinese companies and foreign direct investment into China, to create an approval regime that also covers residents' overseas investments. As MOFCOM did not respond to this request, SAFE issued the January Circular and adopted its current radical attitude, partly to prod MOFCOM to act. SAFE also made it known – as reflected in the January Circular – that relevant acquisitions should be conducted as share swaps. SAFE prefers share swaps on the basis that, if shares in a target company are exchanged against shares in a substantial overseas company, it will be easier to verify that both companies have been fairly valued.

MOFCOM is now preparing regulations on cross-border share-swaps. Two drafts have thus far been circulated for comment, and there is hope that such regulations will be adopted by the end of 2005. After the regulations come into effect, SAFE will begin

The January and April Circulars – What do they Require?

According to the *Circular on Issues Relevant to Improving the Foreign Exchange Administration for Mergers and Acquisitions with Foreign Investment* (January Circular) issued by the State Administration of Foreign Exchange (SAFE) on January 24, 2005, the direct or indirect establishment or control of an overseas company by PRC residents ('residents' overseas investment') must be approved by, and registered with SAFE ('overseas investment registration').

After SAFE has approved and registered a resident's overseas investment, any transfer of shares in such an overseas company, increase or reduction of its share capital, merger or split of its the overseas company, or equity investment by such overseas company (an 'overseas company investment') must be reported to SAFE by the PRC resident who is the largest shareholder in the overseas company. Upon such request, the overseas investment registration will be amended by SAFE. This requirement is set forth in the *Circular on Issues Relevant to Registration Regarding Offshore Investments of Individual Domestic Residents* (April Circular) issued by SAFE on April 8, 2005. Currently, SAFE accepts such registrations only with respect to equity investments made prior to January 24, 2005 (the date on which the January Circular was issued). It is not accepting registrations with respect to any new proposed overseas company investment.

After an overseas company has established a foreign invested enterprise (FIE) in the PRC, the FIE's foreign exchange registration with the local SAFE bureau is subject to new requirements stipulated in the January and April Circulars. Some of these requirements relate to instances where the establishment of an FIE is part of an 'acquisition by foreign capital'. The April Circular defines such an acquisition broadly: it includes not only the acquisition of equity interests in, or assets of, PRC companies, but also the 'operation' of assets of a PRC enterprise, control over profits generated by such assets, or exclusive rights to exploit such assets.
Under the January Circular, an FIE established for the purposes of an acquisition by foreign capital must make the following statement when applying for foreign exchange registration:

"Between the new foreign shareholders and the original Chinese shareholders of this company who sell equity (or assets) there is no direct or indirect relationship through equity and assets and there is no other internal transaction in violation of foreign exchange administrative regulations. The relevant payment and settlement arrangement of this transaction complies with the provisions of the Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors. In case of any false representations, this company is willing to bear the corresponding legal responsibilities."

In addition, under the April Circular, when applying for foreign exchange registration, an FIE (whether or not its establishment involves an acquisition by foreign capital) must state in detail who ultimately controls it and what the controlling shareholder's operating history is. If this information is unclear, the FIE must make the following statement:

"If this company obtains its foreign exchange registration through false or misleading representations regarding the direct or indirect shareholding of domestic residents or entities in the foreign investor of this company, the company and its legal representative are willing to bear the legal consequences resulting therefrom."

Alternatively, the FIE may disclose the residents' overseas investment. In fact, however, SAFE does not currently grant foreign exchange registration to any foreign-invested enterprise in which PRC residents indirectly own shares through a residents' overseas investment.

Without foreign exchange registration, an FIE is unable to open foreign exchange bank accounts and will be severely hampered in its operations in China. In particular, it will not be able to receive any foreign exchange funds (including capital contributions) or make any foreign currency payments (including dividends).

accepting residents' registrations for overseas investments and grant foreign exchange registrations to FIE's involved in relevant acquisitions, so long as such acquisitions are in compliance with the share-swap regulations.

While this is good news, the draft share-swap regulations do contain some unwelcome restrictions. Shares in target companies, for instance, may only be exchanged against listed shares of overseas companies. Share-swaps against SPV shares, furthermore, are only permitted if the SPV is beneficially controlled by the target company's shareholders. The SPV must also be listed on an overseas market within six months of the share-swap. These restrictions mean that an early-stage investment cannot be conducted through an SPV in which Chinese residents are shareholders.

In this context, the January and April Circulars, as well as the anticipated share-swap regulations, force investors to reexamine existing deal structures and identify new structures.

HOW TO MANAGE THE NEW LEGAL FRAMEWORK

Report Earlier Investments to SAFE

Despite its generally negative attitude, SAFE accepts overseas investment registrations if an FIE created through a relevant acquisition obtained its foreign exchange registration before January 24, 2005. Indeed, SAFE expects Chinese residents who participated in the relevant acquisition to apply for overseas investment registration. In some cases, high-ranking SAFE officials have personally instructed Chinese entrepreneurs who hold shares in well-known overseas-listed companies to comply with the January Circular. As SAFE has left no doubt about its willingness to enforce the approval requirement for relevant acquisitions made before January 24, 2005, all Chinese entrepreneurs concerned by this requirement should make the necessary filing promptly.

Consider Onshore Structures and Future Conversion

Until the legal framework is clarified, or becomes more favourable, at least some transactions with private entrepreneurs will have to be structured as onshore acquisitions. Under this structure, either a foreign investor acquires an equity interest in a target company or the target company and the foreign investor jointly establish a new FIE which then acquires assets from the target company.

In this scenario, the Chinese shareholders of the target company would likely not obtain shares in an entity that can easily achieve an overseas listing. Usually this would prove unattractive to them, because the prospect of an initial public offering (IPO) in Hong Kong or on NASDAQ remains one of the main motivations for Chinese entrepreneurs selling their shares to private equity investors. However, the acquisition documents could provide for a later 'roll-up' when the law permits. In such a roll-up, the Chinese shareholders exchange their equity interest in the target company against shares in an offshore company that then acquires the target company through a share-swap or other transaction.

Exit through an Overseas Listing

Provisions on SPVs in the draft share-swap regulations are specifically designed to allow equity interests in, and assets of, a target company to be moved offshore prior to an IPO on an international stock exchange. The SPV must be controlled by the same Chinese individuals and enterprises that were shareholders of the target company before the share-swap. Existing foreign investors in the target company may only be minority shareholders in the SPV. The draft share-swap regulations do not contemplate the creation of SPVs for overseas IPOs of foreign-controlled target companies. Indeed, the foreign shareholders would have to transfer control to the Chinese shareholders to be able to benefit from the share-swap regulations.

The draft share-swap regulations reflect SAFE's aim to control the valuation at which Chinese shareholders obtain shares in an SPV. When a target company applies to MOFCOM for approval of a share-swap, a valuation report on the equity interests or assets of the target company must be submitted. In addition, the target company's financial adviser must issue an opinion on the fairness and reasonableness of the share-swap.

Shares in an SPV offered in an ensuing IPO must be issued at a price at least equal to the value at which shares in the target company were converted into shares of the SPV prior to the IPO. This double constraint – fair valuation of the SPV at the time of the share-swap and no decrease of the SPV's valuation between the time of the share-swap and the IPO – is problematic. Unless the value of the SPV's shares at the time of the share-swap is discounted to reflect their lack of liquidity, an adverse change in market conditions could prevent an IPO going ahead at the minimum offer price required by the draft share-swap regulations. There is hope that the final version of the share-swap regulations will provide more flexibility on this valuation issue.

CONCLUSION

In the seven months that have passed since the promulgation of the January Circular, it has become clear that regulatory restrictions on residents' overseas investments are here to stay. The investment community should continue to state its case to SAFE and MOFCOM and raise its concerns on the draft share-swap regulations. Indeed, the community should push for an investor-friendly regulatory framework that allows access to international capital markets for Chinese entrepreneurs. In the meantime, all parties to previous relevant acquisitions need to make sure that Chinese residents involved in these deals apply for overseas investment registration and reconsider their exit strategies in light of the new legal framework.