



New Measures to Control Inflow and Outflow of Forex Funds

The continuous inflow of forex funds into China has become a major concern of the Chinese Government because of the potential impact on the stability of China's economy. In a bid to slow down the inflow of "hot money", the State Administration of Foreign Exchange ("SAFE") has introduced new measures to tighten the administration of forex inflow through both current and capital account items.

New measures on trade account items - foreign debt registration is now required for advance export collection and deferred import payment

The SAFE has issued Huifa [2008] No.29, Huifa [2008] No.30 and Huifa [2008] No.31 ("Circular 29, 30 and 31") published recently (albeit dated back to July 2008) to introduce a new mechanism for tracking the inflow of foreign exchange through trade account items into China. The gist of the new mechanism is as follows:

1. Exporters are required to open a special bank account for the collection of export proceeds in forex. The bank will assess the level of export proceeds that the entity can convert into RMB or transfer out from the special account with reference to the data accessible via the linked system of China e-Port. The maximum amount of export proceeds that an entity can convert into RMB is controlled within its export forex collection quota.
2. Exporters are required to perform foreign debt registration for any advance collection of export proceeds in forex before the actual export of goods. The registration should be done via the SAFE on-line system for trade finance registration within 15 days after conclusion of the export contract or upon actual receipt of payment. Exporters should de-register the record from the on-line system after the actual export of goods.
3. Importers are required to perform similar foreign debt registration for making deferred import payments via the SAFE on-line system. The registration should be made either within 15 days after conclusion of the import contract or within 15 days after the 90th day of the issuance of import declaration form. Importers should de-register the record from the on-line system after remittance of the import payment.

PwC Observation

Chinese entities with import and export business, including production foreign investment enterprises ("FIEs") and Foreign Invested Commercial Enterprises, will be affected by the new policies in the following aspects:

- According to Circular 31, the export forex collection quota for general trade and import processing trade will be limited to the declared value of export as per the export customs declaration forms. In other words, a company, unlike previous practice, will not be able to convert the export proceeds collected in advance into RMB to finance its operation until the actual export has taken place. Companies which rely heavily on cash collection in advance as a kind of trade finance may need to consider other financing arrangements under the new mechanism.
- The trade payables or receivables as registered will not take up the foreign loan quota, i.e., the difference between total investment and registered capital. Nevertheless, it is worth noting that a company that fails to comply with the foreign debt registration and de-registration formalities will be subject to penalty similar to foreign debt non-compliance in accordance with the new Chinese Forex Regulations effective from 1 August 2008. The penalty could be as high as 30% of the export / import payment involved.

New measures on capital account items - Conversion of forex registered capital into RMB is subject to more stringent measures

SAFE has also introduced more stringent measures to administer the conversion of forex paid-up registered capital into RMB with the issuance of Huizongfa [2008] No.142. Highlights of the measures are summarized as follows:

1. Capital verification should be performed on the paid-up capital before its conversion into RMB. The total amount of paid-up capital in forex that can be converted into RMB should not exceed the accumulated paid-up capital which has been verified by a local CPA.
2. Usage of the converted RMB should be within the allowable business scope approved by the relevant Chinese approval authorities. Particularly, the converted RMB cannot be used for property investment (except for the purchase of self-use property) and equity investment unless specifically prescribed in the relevant regulations.
3. FIEs are required to provide detailed documentation to support the application for converting forex of over USD50,000 into RMB.
4. Chinese entities and individuals should now collect forex proceeds from the disposal of equity interest of Chinese entities to foreign investors through a special forex account. SAFE will issue an approval document to endorse the opening of the special forex bank account and collection of the relevant proceeds. Similar to conversion of paid-up capital by FIEs, the Chinese companies and individuals are required to disclose the usage of the converted RMB and provide valid supporting documents such as payment orders.
5. SAFE will strengthen its supervision on the banks' processing of FIEs' applications for converting paid-up capital into RMB and tighten up its on-going inspection on the usage of such converted RMB. Penalty will be levied on FIEs should they be found to have: i) changed the usage of the RMB capital without proper approval; or ii) used the RMB capital for repayment of un-used RMB loans.

PwC Observation

Foreign investors and their FIEs would need to pay attention to the following areas under the new policies of Circular 142:

i) Conversion of paid-up capital

Before Circular 142, conversion of paid-up capital was a relatively straight-forward procedure as long as the amount in question is under USD200,000. The converted RMB can be retained in the RMB basic account of the FIE as working capital. In terms of compliance, what the FIEs need to do is to provide the bank with a breakdown on the usage of the converted paid-up capital in the next conversion application. This new circular has, however, introduced tougher requirements which would have impact on FIEs, namely:

- Given the stringent documentation requirements for conversion of paid-up capital into RMB, the finance personnel should make sure that the valid documents are available to justify the conversion of paid-up capital into RMB for meeting the working capital need of the company and achieving efficient cash-flow management.
- FIEs are required to prepare a payment order to the bank specifying the payees of the converted RMB. According to the standard format of the payment order provided by SAFE, an FIE, together with its legal representative, has to declare that capital verification has been done and the converted RMB will be used within the approved business scope and according to the usage specified. In other words, both the FIE and its legal representative will have to bear the legal responsibility that may arise from changing the usage of the converted RMB without prior approval. Management or the finance personnel in-charge are advised to handle the payment order with due care in view of the potential legal liability.

ii) Equity investment by FIEs

It has been specified in Circular 142 that unless an FIE has the relevant business scope for equity investment activities, it cannot use the paid-up capital for making equity investment or property investment in China unless otherwise specified in the relevant Chinese laws and regulations.

Foreign investors who tend to use FIEs as a holding vehicle for equity investment in China would need to be aware of the following potential impacts as brought about by Circular 142:

▪ Use of FIE for equity investment in restricted industry sector

Due to the current restriction on foreign investment participation in the real estate sector in China, we observed that some foreign investors have contemplated the use of a consulting service FIE to hold domestic real estate companies. Following the implementation of Circular 142, the use of FIE, particularly those with "consulting services" as their approved business scope but without any real business substance, for equity investment in restricted industry sectors may no longer be feasible.

▪ Equity investment activities through equity investment FIEs or private equity ("PE") fund set-up

Recently, Tianjin and Shanghai governments issued their own local regulations to promote the establishment of equity investment entities (either by domestic or foreign investors) and PE fund set-up. Since these special investment vehicles are allowed to engage in equity investment activities as specified in their allowable business scope, presumably they should not be subject to the restriction on the use of paid-up capital in forex for equity investment under Circular 142. On this premise, the establishment of equity investment FIEs or PE fund set-up would provide an alternative investment vehicle next to Chinese Holding Companies and foreign-invested venture capital enterprise to carry out equity investment activities. Meanwhile, the formation of the equity investment FIEs and PE fund set-up is still at a very initial stage, more clarifications from the relevant Chinese authorities on the setting up and operation of the special investment vehicle would be highly necessary.

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