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ASPATORE
Foreign Investments in China: Basics and New Developments

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Introduction

There is an ancient Chinese saying that describes someone with no knowledge of the environment and no experience with swimming but trying to cross a river: “Crossing the river by holding onto the pebbles at the bottom.” You may stumble because the water is rapid and the pebbles are unstable, but hopefully you will learn from your own mistakes and eventually make it to the other side. This is a relevant way to describe the learning process experienced by the Chinese legislators, as they establish a body of law to regulate a large and growing market economy driven in part by significant amounts of foreign investment.

China runs an independent and distinct legal system, which varies significantly from either the common law or traditional continental/civil law. Though there is no case law in China, almost every governmental agent and quasi-governmental organization issues regulations, rules, and/or measures that apply within its own scope of authority, and follows its own established precedents and procedures. So apart from laws promulgated by the central legislative branch, there is a considerable amount of nuanced legislative practice, some of which are not even publicly available. For foreign investment, since the gate of China was opened to foreign investors a little over thirty years ago as part of the country’s economic reform, the relevant rules were formulated from scratch, and the policies and statutes are subject to continuous change as the government alters its course from time to time to advance its reformation agenda. Therefore, it is critically important for a potential foreign investor to keep abreast of any change to the Chinese foreign investment laws.

In this chapter, we will introduce the basic rules on foreign investments in China with a focus on capital controls and industrial restrictions, and analyze certain new trends in structuring deals in connection with recent changes. The discussion in this chapter will set forth several key issues for you to consider before you decide to make investments in China.
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**Issue One: Registered Capital and Total Investment**

The first things to consider before entering into China include: (i) how much money is to be invested, (ii) whether such money will be contributed in the form of equity or debt, and (iii) when such contribution will be made. A company in China is required to have a minimum amount of registered capital that the investors commit to contribute to fund its initial operations. In other words, it is an amount that the investor must invest in China, which can be used on capital expenditures as well as working capital, including the costs of hiring employees, conducting marketing campaigns, purchasing raw materials, etc. With respect to foreign invested businesses, the investors must also propose an amount of total investment—an amount that is commensurate with the nature and the scale of the intended new business. Both the registered capital and the total investment should match the feasibility study report submitted by the foreign investor for government approval.

Until recently, it was necessary for a foreign invested business to have a minimum amount of registered capital approved before its shareholders could remit a corresponding amount of foreign currency into China and convert it into RMB, the legal currency of China. In the past, companies established by foreign investors were required to apply for a set amount of registered capital and contribute at least 15 percent of such amount within ninety days and the remainder within two years. However, following the amendment to Chinese company law effective on March 1, 2014, the Ministry of Commerce (MOFCOM, the main government authority regulating foreign investments) issued a circular in June 2014 that waived the requirement on the minimum amount and contribution schedule of registered capital for a foreign invested business, and permitted foreign investors and their Chinese partners to agree on matters regarding registered capital under the business’s charter documents and joint venture contracts. These new changes effectively loosened the control on registered capital and provided more flexibility to potential investors in determining capital structure. This also reduced the entry barrier for many small businesses that
would otherwise find it difficult to commit the prohibitively large amounts of money to initially fund a company in China. However, since registered capital is still subject to approval, MOFCOM may still maintain specific requirements on minimum amount or contribution schedule in certain cities or industries. It is advisable for a foreign investor to inquire with the local government authority before formally submitting an application to establish its Chinese subsidiary.

Unlike registered capital, total investment is not a committed amount of fund. The difference is vitally important. Many misconstrue registered capital as equivalent to the total investment that can be invested into their Chinese company. Total investment is the sum of: (A) registered capital and (B) the amount of indebtedness that can be incurred by the Chinese company in the form of foreign currency shareholder loans. Utilizing a shareholder loan has a few advantages compared to capitalizing the Chinese subsidiary with 100 percent equity (i.e., the registered capital). Due to foreign exchange controls in China, putting some money in as a shareholder loan is beneficial because it is much easier to repay a shareholder loan and remit funds outside China. In comparison, once fund is contributed as registered capital, it is extremely difficult to convert it back into foreign currency and remit that to the foreign investor, because capital reduction, liquidation, and even dividend payments are all subject to a rigorous approval process. In addition, compared to receipt of dividends or profits from a Chinese company, debt repayment does not require the Chinese company to have retained earnings for distribution to its shareholders or make withholding payment of Chinese enterprise income tax payable by its shareholders, offering both financial flexibility and tax savings. While companies may only pay dividends once or twice each year from registered capital due to the requirement of audited financial statements before dividends can be declared, a shareholder loan can be repaid at any time and without any audit. Bearing these key differences in mind, a foreigner should take full advantage of this difference between total investment and registered capital, also known as the “debt to equity ratio,” subject to the maximum leverage ratio described below.
MOFCOM prescribes the maximum debt to equity ratio—i.e., for a certain amount of registered capital, the corresponding amount of total investment cannot exceed a legally determined multiple. For example, if the registered capital is between US$2.1 million and US$5 million, the maximum debt to equity ratio is 1:1—i.e., the total investment can be no more than twice of the amount of the registered capital. As the registered capital increases, the debt to equity ratio also increases, capping off at the highest debt to equity ratio of 2:1 where the registered capital is US$10 million or above. This means for a registered capital of US$10 million, the total investment can be US$30 million and the investor can leverage up to US$20 million of foreign exchange loan.

This requirement is intended to prevent hot money from abusing the debt to equity ratio, while allowing strategic investors to maintain a certain level of flexibility in structuring their investments in China. Although the minimum registered capital requirements have been cancelled, these restrictions on debt to equity ratio are still effective. It is important for a potential foreign investor to be aware of these limits and nuances in structuring its fund flow into and outside of China.

**Issue Two: Foreign Exchange Controls and Fund Flow**

After the amount of total investment and registered capital has been decided, the next key issue to consider would be foreign exchange controls. For the unknowing, this usually becomes a significant bottleneck. It is not possible to use any foreign currency, such as USD or Euro, to settle any accounts in China, and a foreign investor cannot wire foreign exchange into China without a foreign exchange registration with the State Administration of Foreign Exchange (SAFE, the government authority in charge of foreign exchange control). Below are the different steps needed to get your funds flowing in your Chinese company:

- Step 1: After your Chinese company is established, you must apply to SAFE for a foreign exchange registration certificate. This
certificate allows you to open a foreign exchange account at one of China’s designated foreign exchange banks.

- Step 2: Open your foreign exchange account with one of these designated foreign exchange banks.
- Step 3: Now you can remit the foreign currency equivalent of your Chinese company’s registered capital into your established foreign exchange account according to the approved contribution schedule.
- Step 4: The registered capital stays in the foreign exchange account in the form of foreign currency until your Chinese company submits contracts and invoices to the designated foreign exchange bank to prove proper usage of funds in China and to convert the foreign currency into RMB. Only after the amounts are converted into RMB, are you then able to make your payments (capital expenditures, working capital, etc.).

Though currency settlement and payment through the designated banks by submitting contracts and invoices is not as onerous as the SAFE approval process that used to be in place, foreign invested companies still complain that such process imposes unnecessary burdens on use of funds that already sit in their bank accounts.

Instead of investing directly into a Chinese company, foreign investors routinely choose to bring their Chinese partners to a tax haven such as the Cayman Islands or the British Virgin Islands to set up a holding company there. The holding company will, often through offshore intermediary companies, acquire or establish a wholly owned Chinese company. Such a structure allows the foreign parties to provide capital to the business based in China and participate in distributions at the offshore level, while still enjoying the legal protection of the common law system and the contractual rights afforded to investors, which are not always recognized under Chinese companies law. Any future financings, sales or public offerings of securities would be conducted offshore as well, eliminating the need to obtain Chinese government approvals for such changes in a company’s capital structure. Furthermore, Chinese individuals find this is often the best approach to attract offshore financing and complete an IPO on a non-
China stock exchange, while effectively avoiding many of the restrictions placed on foreign exchange and protected industries. These offshore structures have been given the title the “red-chip structure.”

Chinese regulators quickly realized that the red-chip structure had successfully avoided the regulations in place at that time. In response, SAFE issued a regulation in 2005 (known as Circular 75), imposing a registration requirement on all “round-trip” acquisitions of domestic assets by Chinese citizens who use an offshore special purpose vehicle to conduct such acquisitions. Failure to make or update such registration may cause disapproval of round-trip acquisitions and jeopardize the IPO of the Chinese business so acquired. Furthermore, in 2006, MOFCOM and certain other authorities issued the Provisions on Mergers and Acquisitions by Foreign Investors (known as Circular 10), reinforcing the rules under Circular 75 by requiring all acquisitions between onshore and offshore affiliated parties to go through central MOFCOM approval. In practice, since the issuance of Circular 10, MOFCOM has not accepted any such application for any affiliated acquisitions except for transactions among listed companies or state-owned enterprises. In the post-Circular 75 and Circular 10 era, a foreign investor using red-chip structure should be aware of the foreign exchange requirements imposed on the Chinese founders of the business, and ensure that they complete all registrations and amendments with respect to any capital structure change of the offshore holding company.

Recently SAFE issued a new regulation, Circular 37,1 to replace Circular 75, effective as of July 4, 2014. Circular 37 makes no fundamental change to the registration mechanism under Circular 75. While Circular 37 provides more detailed procedures, the scope of registration has been extended from “round-trip” acquisitions to include all outbound investments conducted by Chinese residents—

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i.e., “one-way” outbound acquisitions. Furthermore, Chinese parties must register the contribution of both domestic and overseas assets to any offshore special purpose vehicle. Though the public still awaits SAFE to clarify certain implementing rules of Circular 37, it is fair to say that the registration requirements under Circular 37 are actually more extensive than those under Circular 75. Despite initial media reports suggesting the foreign exchange controls set forth under Circular 75 having been abolished, interested parties have quickly come to realize that Circular 37 not only reinforced the controls under Circular 75 but also extended such controls—thus requiring each party considering red-chip structures to be even more careful about the foreign exchange controls that might be applicable to their businesses.

Issue Three: Investing in Protected Industries, the Use of Variable Interest Entities

The Catalogue for the Industrial Guidance of Foreign Investments (the Catalogue, last amended in 2011), issued by MOFCOM divides all industries into four categories: encouraged, permitted, restricted, and prohibited. China encourages foreign investment if it provides the country with new inventions in technology, and rewards encouraged businesses with certain government subsidies, tax incentives, and waivers. Few businesses fall under the “encouraged” category. The second category is “permitted,” and includes anything not named in the Catalogue. In other words, if the business is not specifically restricted, prohibited or encouraged, then it is permitted. Approximately 90 percent of businesses fall into the permitted category. The “restricted” category does exactly what it says—it allows foreign investment into certain industries, but with restrictions on the percentage of foreign ownership. The “restricted” label carries different meanings for different industries. Usually, a restricted business cannot be wholly foreign owned and must be structured as a Sino-foreign joint venture with a Chinese shareholder owning a specified minimum percentage. Finally, “prohibited” industries simply are not open to foreign investment. These may be obvious, such as industries relating to national defense, but some prohibited businesses
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are unique to China. For example, most Internet and media businesses are prohibited from foreign investment. It is not possible for a foreign investor to have a direct investment in a Chinese e-commerce company such as Alibaba or JD.com, as they fall under the prohibited industries. A foreign investor should always find its proposed business in the Catalogue first and see which category it falls under, then make an informed decision on the business structure.

Many of the restricted or prohibited businesses are attractive to foreign investors given their historical potential for high growth. In the past two decades, foreign investors have found ways to continue to invest in these “restricted” or “prohibited” industries by using a variable interest entity structure (a VIE Structure). Although foreign investors cannot directly invest into the business engaged in the prohibited industry, they can set up a Chinese foreign invested company in an encouraged or permitted category, and then have two Chinese passport holders act as nominee shareholders to establish a real e-commerce company holding the licenses and permits required to conduct such business in China. The domestic company (engaged in the prohibited industry), also known as the variable interest entity (the VIE), and the Chinese foreign invested company can then enter into various control contracts, pursuant to which all of the profits of the VIE go to the Chinese foreign invested company in the form of management or consulting fees, and the foreign invested subsidiary controls the VIE through voting proxy, equity pledge, and various other arrangements with the nominee shareholders. To the extent the VIE is deemed to be controlled by the offshore holding company through its Chinese foreign invested company, it is then possible to consolidate the financial statements of the VIE into the offshore group and list the foreign holding company on an international stock exchange. Almost all of the famous Chinese listed companies in the Internet business use the VIE Structure—to name a few, Sina, Tencent, Baidu, Weibo, and JD.com. The industries include, but are not limited to, prohibited industries such as the Internet, telecommunications, media, and domestic education.
The VIE Structure obviously has inherent risks, the most notable of which include lack of effective control over nominee shareholders of the VIE and dubious enforceability of the control contracts under the VIE Structure. Alibaba, the largest player in the Chinese e-commerce market, which is expected to list on the NYSE in September 2014, provides a very visible example of the risk associated with these control contracts. Yahoo!, Soft Bank, and various foreign investors are all shareholders of Alibaba, making it necessary for Alibaba to use the VIE Structure to hold its China businesses and assets, with Chinese founders, including Jack Ma, acting as the nominee shareholders of the Alibaba VIEs. One of Alibaba’s most profitable branches was its third-party payment platform, Alipay, the Chinese equivalent of PayPal. In 2010, Jack Ma, the main founder of the Alibaba empire, transferred all the equity interests of Alipay to himself and other co-founders, claiming that the central bank of China would not issue a license for online payment services if Alipay continued to operate under the VIE Structure. Alibaba did not seek to enforce the control contracts under the VIE Structure against Jack Ma and his co-founders, and Yahoo! eventually reached a settlement with Alibaba for the loss of the Alipay business. This demonstrates how much the VIE Structure depends upon the good faith of the nominee shareholders. If and when the nominee shareholders decide not to honor their obligations under the control contracts, the whole VIE Structure would collapse because there is limited to no recourse available to enforce these control contracts.

A more recent attack on the VIE Structure came from a staff report generated by the US-China Economic and Security Review Commission in June 2014. After examining the VIE Structure of Chinese Internet companies listed on the US stock exchanges, the analyst concluded that the VIE Structure does not appear to be a sustainable model if major Chinese companies, such as Alibaba, continue to list on US stock exchanges, and the scenario could be akin to the Chinese reverse-merger debacle that cost US investors billions of dollars in losses. After the issuance of this report, many private equity and venture capital funds focusing on the China market received inquiries from their limited partners, such as US pension funds and social welfare funds, checking on whether the money has
been invested into any Chinese company with a VIE Structure. As the concern was raised by an official report, the paranoia is unlikely to dissipate soon. However, the VIE Structure remains as the only viable and tested alternative for foreign investors to invest into certain protected industries in China. It is unlikely any alternative will be used in the foreseeable future.

Conclusion

Although trying to understand Chinese foreign investment laws is not quite the blind man in the dark room looking for the black cat that is not there, it is nevertheless a challenge for even the most experienced businessmen and legal practitioners. Savvy international investors often find themselves in the dark due to lack of local knowledge, and seasoned Chinese entrepreneurs often come up a little short on international practices. This chapter is not a DIY kit for foreign investment in China. The author only wishes to shed some light on the most common issues for those who are considering or already taking their first steps to making investments into China. Rather than holding onto loose pebbles, foreign investors and Chinese entrepreneurs should use experienced advisors (both financial and legal) to act as a bridge to cross their own rivers into China.

Key Takeaways

- Since it is not possible to use US dollars to settle an account in China, and a business cannot wire the money to China without a foreign exchange registration, your clients should consider establishing a subsidiary in China to obtain approval for a foreign exchange quota.
- If your client wants to invest in a lucrative prohibited industry, educate the client about the benefits and risks of setting up a foreign-invested consulting company and having two Chinese passport holders act as nominees to set up a real company. This allows the US company to obtain a Chinese government license for the prohibited business.
• Encourage your client to leverage some of the registered capital equity as a shareholder loan, as it makes it easier to repatriate part of the client’s investment.

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