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China Law & Policy (August 2019)—Holding Companies, SPVs, and Collateral Interests, Oh My!—Shanghai Pilot Reforms Signal New Opportunities for Foreign Investors in China

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Foreign investors could enjoy a dramatic improvement in structuring options for their China investments thanks to recently adopted pilot reforms by the Shanghai Branch of the State Administration of Foreign Exchange (SAFE). The rules purportedly allow foreign investors to set up a new Chinese company and invest in other companies from its registered capital, among other welcome changes. This would be another significant milestone in China's recent reforms to overhaul it's FDI regime, which have included eliminating the Sino-foreign joint venture laws in favor of bringing foreign investment under the protections of China's Company Law, reducing the number of approvals for foreign investment into China, and reducing the number of industries closed to foreign investment.

Background

For almost 30 years, foreign investors have been forced to structure their investments in China under an increasingly outdated legal regime. The original paradigm underlying these rules contemplated an isolated and insular Chinese economy, where foreign investors were allowed only limited avenues for participation, with the goal of Chinese policymakers being to update China's manufacturing infrastructure while largely keeping foreign investors at arm's length. Under this paradigm, it was contemplated that foreign investment would take the form of one-off, special purpose companies, all of which were initially required to take the form of joint ventures. With a few cautious exceptions, foreign companies were not allowed to set up special purpose vehicles (SPVs) to help bring order to investments, and it was cumbersome to set up corporate groups within China. Over time, this has resulted in a proliferation of enterprises that are just "one step" over the border. The archetypal case is the multinational with five 100% subsidiaries in China, all held by Hong Kong SPVs.

New Rules

SAFE promulgated the Rules to Facilitate Pilot Reforms of Foreign Exchange Administration in Shanghai Free Trade Zone (Version 4.0)《进一步推进中国(上海)自由贸易试验区外汇管理改革试点实施细则(4.0 版)》(the "Pilot Rules") on July 10, 2019. The Pilot Rules ostensibly apply only to companies registered within the Shanghai Free Trade Zone (Shanghai FTZ). However, to the extent that companies in the Shanghai FTZ are allowed to operate outside of the free trade zone, the impact of the Pilot Rules are potentially more far-reaching. Among other reforms adopted by the Pilot Rules:

- **FIE Equity Investment Reform**: Foreign invested enterprises (FIEs) registered within the Shanghai FTZ can make equity investments within the PRC even if "investment" is not a part of their business scope;
- **Foreign Debt Reform**: Companies registered within Shanghai FTZ that were previously subject to statutory leverage ratios on foreign borrowing (e.g., total investment minus registered capital) may choose to change to a net asset test (two times total net assets) to calculate their cap on foreign borrowings;
- **Cross-Border Cash Pool Reform**: To establish a cross-border cash pool, multinational companies within the Shanghai FTZ only need to show international income and payments of US$50,000,000 in the preceding year (the national threshold is US$100,000,000).

The first reform is potentially a big deal. Shanghai SAFE's recognition that an FIE need not have "investment company" in its business scope in order to make equity investments in China upends a SAFE rule of more than ten years that barred most FIEs from such investments. (Prior to that rule, there were other limits on the ability of FIEs to make equity investments.) Moreover, according to window inquiries, Shanghai SAFE understands this change to mean that any FIE registered in the Shanghai FTZ is now free to use its registered capital and foreign borrowings to make other investments in the PRC, although banks will still be responsible for reviewing whether a transaction is bona fide and in compliance with relevant regulations.

There are some caveats. Any company invested by an FIE under the Pilot Rules will be subject to the same foreign investment industry restrictions as an FIE[1]. More importantly, despite promising window guidance from

Shanghai SAFE, the Pilot Rules are new. There have been past situations where the promise of reforms fizzled out as bureaucratic interpretation proved more conservative over time. Based on discussions with Shanghai banks, they have not received instructions from SAFE concerning this application of the Pilot Rules.

Shanghai SAFE does not seem to view the Pilot Rules' provision on investment by FIEs as new and apparently thinks of the policy as a restatement of the Circular on Reforming and Regulating Policies on the Control over Foreign Exchange Settlement of Capital Accounts (《国家外汇管理局关于改革和规范资本项目结汇管理政策的通知》, "Circular 2016"), which was promulgated by the State Administration of Foreign Exchange in June 2016. Shanghai SAFE's view is that Circular 2016 already made it clear that FIEs may use registered capital to invest in the PRC. However, in practice, despite Circular 2016, FIEs have not been permitted to invest registered capital in the PRC if their business scope did not include "investment." Possibly indicating that the Pilot Rules may reflect a broader trend, the local administration of foreign exchange for Fujian Special Economic Region and Zhongguancun Innovation Demonstration District (Beijing) have also promulgated policies to permit FIEs to make equity investments, although these policies are limited to Taiwanese investors or investments made using debt capital.

Opportunities for Foreign Investment

Assuming due implementation of the Pilot Rules, several important structuring opportunities would become available for foreign investors into China. Among others:

- For new investors into China that need to establish multiple subsidiaries from the outset, it would be possible to set up a domestic holding company to house headquarters operations and to bring order to PRC investments without having to go through the outdated holding company rules first adopted in 2003. This would allow foreign businesses to streamline set-up in China and adopt an efficient corporate structure from day one.
- It would be possible to set up SPVs in the Shanghai FTZ. This would have a range of benefits, from facilitating venture style investments in Chinese domestic companies to insulating liability.
- It would be possible for foreign investors to enjoy the same ability as domestic investors to get a valid collateral interest. It has historically been difficult for foreign investors to take a collateral interest because foreign exchange rules blocked cross-border collateral arrangements. To the extent that an investor can establish an SPV in China, any collateral interest taken by the SPV would be treated as a domestic collateral interest rather than a cross-border transaction.

These are only a few of the possibilities. The Pilot Rules potentially offer a substantial reform that would finally provide foreign investors many of the same tools that are already enjoyed by Chinese investors. To the extent that the Pilot Rules live up to their promise, they will reflect an important step in China's continued effort to overhaul and rationalize the foreign investment regime.

O'Melveny recognizes legal consultant Tiffany Liu for her valuable contribution in researching and drafting this article.

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[1] Separately, there is some ambiguity whether the subsidiary of an FIE set up in the FTZ should be treated as an FIE or a domestic company. For at least the last 19 years, the settled position of MOFCOM and the State Administration of Industry of Commerce was that (except in a few narrow cases), the subsidiary of an FIE should be treated as a domestic company. By contrast, SAFE seems to take the view that such a subsidiary should be treated as an FIE. That said, it is not clear that the SAFE view has any substantive impact, as it appears SAFE does not intend to impose any of the substantive foreign exchange obligations on such a subsidiary that would otherwise apply to a typical FIE.
