

CHINA ALERT

SAFE CIRCULAR NO. 142: NEW MEASURES TO RESTRICT SETTLEMENT OF FOREIGN EXCHANGE TO RENMINBI

By September 30, 2008, China boasted the highest foreign exchange reserves in the world (more than 1.9 trillion dollars),¹ and the exchange rate between the renminbi (RMB) and the U.S. dollar (USD) rose from 8.27:1 on July 21, 2005, to around 6.836:1 on October 27, 2008. To address the concern that billions in “hot money” might have flown into China under the guise of “foreign direct investment” intending to take advantage of the RMB’s appreciation, the State Administration of Foreign Exchange (SAFE) issued a new circular (Circular 142) on August 29, 2008,² which aims to further restrict the settlement of foreign exchange to RMB.

1. **NEW RESTRICTIONS: NO SETTLEMENT OF FIE’S REGISTERED CAPITAL FOR ACTIVITIES BEYOND BUSINESS SCOPE, FOR EQUITY INVESTMENT, FOR INVESTMENT IN NON-SELF-USE REAL ESTATE PROPERTIES OR FOR INVESTMENT IN SECURITIES**

Before Circular 142 was promulgated, the Chinese government had abolished the requirement that settlement of registered capital of foreign-invested enterprises (FIEs) from foreign exchange to RMB was subject to approval by SAFE or its local counterpart.³ For instance, before Circular 142 was promulgated, if an FIE wanted to make an equity investment, it would be allowed to convert its registered capital from foreign exchange to RMB and then make the investment in China with this RMB. This is no longer feasible post-Circular 142.

Circular 142 explicitly restricts FIEs from converting their registered capital from foreign exchange to RMB for activities beyond their business scope, for equity investments in China, for the purchase of non-self-use real estate properties or for investment in securities (unless they otherwise comply with the relevant law).⁴

In particular, Circular 142 limits the sources of funding that an FIE may utilize for equity investment in China. Nevertheless, Circular 142 does not prohibit an FIE from making

¹ See the statistics posted at SAFE’s official Web site:
http://www.safe.gov.cn/model_safe/tjsi/tjsj_detail.jsp?ID=11040000000000000000.19&id=5.

² The *Circular of Operation Issues Related to the Perfection of Administration of Payment-Related Settlement of FIEs’ Registered Capital from Foreign Exchange to RMB*.

³ See, e.g., the *Circular of SAFE to Tentatively Reform the Administration Method of Settlement of Registered Capital of FIEs*, promulgated by SAFE on August 8, 2001, and the *Circular of SAFE to Reform the Administration Method of Settlement of Registered Capital of FIEs*, promulgated by SAFE on June 17, 2002.

⁴ Article 3 of Circular 142.

equity investments. Therefore, Circular 142 should not be read as a measure to deter equity investment by FIEs, and an FIE that has generated sufficient RMB income may still invest using its RMB funds. Circular 142 merely reflects the Chinese government's policy of controlling the foreign exchange that flows into China in the name of foreign direct investment, in order to ensure that it is utilized for the specific business activities written into the relevant FIE's business scope, but not in other business activities.

2. CAPITAL VERIFICATION REQUIRED BEFORE SETTLEMENT

Before settlement, Circular 142 explicitly requires that an FIE must have its registered capital contribution verified by an accounting firm.⁵ Furthermore, the capital verification and settlement of registered capital should be handled through a computerized system controlled by SAFE.⁶

Apparently, with these measures, the Chinese government will possess more accurate firsthand knowledge about the actual amount injected into China and converted into RMB in the name of foreign direct investment. This information will also presumably help the government obtain authentic and reliable statistical data regarding foreign investments.

3. REQUIRED DOCUMENTS

Before Circular 142, an FIE could settle its registered capital when it had actual needs. Specifically, for settlement of more than USD200,000, if the FIE could present supporting documents (such as a payment request or invoice), the bank would convert the FIE's registered capital from foreign exchange to RMB and directly remit the money to the party that the FIE intended to pay. For settlement of no more than USD200,000 or for the purpose of the FIE's payment of salaries, etc., the bank would also convert the money and reserve it in the FIE's bank account, on condition that the FIE should present to the bank a breakdown of usage of the exchanged amount when the FIE requests its next exchange.⁷

Circular 142 further restricts that, for purpose of the settlement, an FIE shall provide the following documents to its bank—

1. its IC Card of Foreign Exchange Registration⁸
2. an order issued by the FIE to its bank to settle the FIE's registered capital in RMB and to remit such RMB
3. documents evidencing the use of the settled RMB, such as a contract or payment order
4. the FIE's latest Contribution Verification Report issued by an accounting firm
5. documents evidencing that payment of the FIE's RMB, previously settled from its registered capital, is made in accordance with relevant payment orders, and breakdown and tax receipts of such payments
6. other documents deemed necessary by the bank.⁹
(For settlement of no more than USD50,000, the FIE does not need to submit documents (3) and (5) listed above.)

After the settlement, if the FIE's foreign exchange registered capital account and RMB account are opened with the same bank, the settled RMB must be actually remitted to the recipient on the same day of settlement; if with different

⁵ Article 1 of Circular 142.

⁶ Article 2 of Circular 142.

⁷ *The Circular of SAFE to Improve the Administration of Review of Settlement of FIEs' Registered Capital and Registration of Foreign Debt*, promulgated by SAFE on May 17, 2004.

⁸ From May 1, 2008, through July 31, 2008, the paper Foreign Exchange Registration Certificates were replaced with IC Cards. This was done to facilitate the government's data collection, inspection and adoption of precautionary measures.

⁹ Article 5 of Circular 142.

banks, the bank with which the RMB account is opened shall remit the RMB to the recipient within two working days.

4. RESTRICTIONS ON THE SETTLEMENT OF ACQUISITION PAYMENT

In addition to restrictions regarding settlement of FIE's registered capital, Circular 142 sets forth similar restrictions on the settlement of foreign exchange payments made by foreign investors to Chinese companies or individuals for equity acquisitions from a Chinese seller. These require the Chinese seller to settle the acquisition payment in RMB by presenting the order of payment, documents evidencing usage of the settled RMB and documents evidencing that payment of RMB previously settled is being made in accordance with relevant payment orders.¹⁰

This is a huge change. Before Circular 142, Chinese sellers could settle the acquisition payment without restrictions, but, from now on, they will be able to settle the payment only when they have actual needs. However, an issue related to the implementation of this requirement of Circular 142 is: what constitutes a Chinese seller's actual needs? For example, are investments in the stock market and real estate properties justifiable needs?

As acquisition payment is not foreign investment but a Chinese seller's earnings from selling its enterprises, it makes business sense to allow the Chinese seller the freedom to spend the money when it wants. If so, however, the restrictions in Circular 142 on settlement of acquisition payment will be easily circumvented as long as the Chinese seller is able to find some projects on which to spend money. Whether the Chinese government will strictly restrict settlement of acquisition payment will be subject to further clarification by the government.

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In early October, SAFE posted a piece of news on its Web site, stating that, on the one hand, SAFE will strictly administer the settlement of FIEs' registered capital and short-term foreign debts, and, on the other, SAFE will simplify its administrative approval processes. Furthermore, SAFE will try to issue new policies and take new measures in around six months' time to simplify these administrative approval requirements, as well as facilitate money flow in international trade. We hope the new measures, if implemented, will not further restrict FIEs' freedom in the settlement of their registered capital.

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¹⁰ Article 6 of Circular 142.