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Legal Updates

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1. Promoting Facilitation of Cross-border Investment and Financing (I): Opening Channels for Foreign-exchange Capital Equity Investment by FIEs

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Evolution of policy on FIE foreign exchange capital in equity investment

The State Administration of Foreign Exchange ("**SAFE**") promulgated on October 25, 2019 the *Circular on Further Promoting Cross-border Trade and Investment Facilitation* (Hui Fa [2019] No. 28) ("**Circular 28**"), to further promote the reform of "Powers, Regulation and Services", to improve the financial capabilities and standards of foreign exchange administration and services entities, and to facilitate cross-border trade and investment. One of the most notable policies in Circular 28 is the elimination of restrictions on non-investment foreign-invested enterprises ("**FIEs**") from making domestic equity investments with foreign-exchange capital.

Over more than a decade since the promulgation of Circular 142 in 2008, the administration of foreign exchange capital has steadily shifted along with China's international balance of payments and economic situation from "strict control" to a step-by-step "orderly opening", approaching the goal of realizing capital account convertibility. In this article, we attempt to organize for your reference the complex foreign exchange regulations involving restrictions on the use of foreign exchange capital in equity investment in China.

Date	Rules and Regulations	Main Contents
2008/08/29	Circular of the General Affairs Department of the State Administration of Foreign Exchange on Relevant Business Operations Issues Concerning Improving Administration for the Payment and Settlement of the Foreign Exchange Capital of Foreign-invested Enterprises (Hui Fa [2008] No. 142) ("**Circular 142**")	Provided a negative list for the use of foreign exchange capital, and clearly prohibited the settlement of foreign exchange capital for use in domestic equity investments.
2011/07/18	Supplementary Circular of the General Affairs Department of the State Administration of Foreign Exchange on Relevant Business Operations Issues Concerning Improving Administration for the Payment and Settlement of the Foreign Exchange Capital of Foreign-invested Enterprises (Hui Fa [2011] No. 88)	Supplemented the materials required for FIE settlement of foreign exchange capital under Circular 142, strengthened the authenticity reviews of the use of foreign exchange capital settlement funds, and strengthened the control of foreign exchange capital by lowering the quota for foreign exchange capital payment and settlement from RMB 200,000 to RMB 50,000.
2011/11/09	Circular of the State Administration of Foreign Exchange on Issues Concerning Further Clarifying and Regulating Foreign Exchange Administration under Some Capital Accounts (Hui Fa [2011] No. 45)	Reiterated that foreign exchange capital cannot be settled for use in domestic equity investment, except in the case of equity investment-type FIEs.

Date	Rules and Regulations	Main Contents
2013/05/11	Circular of the State Administration of Foreign Exchange on Printing and Distributing the Provisions on Foreign Exchange Administration of Domestic Direct Investments by Foreign Investors and the Supporting Documents (Hui Fa [2013] No. 21)	Reiterated the restrictions under Circular 142 and further provided that, unless otherwise stipulated, when a foreign-invested enterprise with "investment" as its principal business makes a domestic equity investment (including FIEs, venture capital FIEs, and foreign-invested equity-invested enterprises), the investment must be made by transfer of foreign capital currency, and investment with foreign exchange capital settlement funds is prohibited.
2014/07/04	Circular of the State Administration of Foreign Exchange on Relevant Issues Concerning Pilot Reform in Some Regions of the Administrative Approaches to Settlement of Foreign Exchange Capital of Foreign-invested Enterprises (Hui Fa [2014] No. 36) (**"Circular 36"**)	Permits FIEs in the pilot areas to exercise discretionary foreign exchange capital settlement; begins to loosen the restriction of prohibiting the use of foreign exchange capital in equity investment. In addition to investments in foreign currency, when an FIE with "investment" as its principal business intends to invest in a domestic enterprise, it may do so by directly transferring foreign exchange capital to the account of the investee enterprise according to the actual investment scale, provided that the FIE ensures the authenticity and compliance of the domestic investment project. However, this policy is unclear.
2015/03/30	Circular of the State Administration of Foreign Exchange Concerning Reform of the Administrative Approaches to Settlement of Foreign Exchange Capital of Foreign-invested Enterprises (Hui Fa [2015] Circular 19)	Circular 19 essentially reiterates the contents of Circular 36, except that the applicable scope of the provisions of Circular 36 are extended nationally from pilot areas.
2016/06/09	Circular of the State Administration of Foreign Exchange on the Policies for Reforming and Standardizing Management of Foreign Exchange Settlement under the Capital Account (Hui Fa [2016] No. 16)	Unifies the capital account supervision policy, and reiterates provisions under Circular 36 and Circular 19 that govern the use of foreign exchange capital in equity investment.
2019/07	Various free trade zones have successively promulgated implementing rules for the pilot reform of foreign exchange capital administration, including China (Shanghai) Pilot Free Trade Zone, China (Tianjin) Pilot Free Trade Zone, China (Guangdong) Pilot Free Trade Zone, Guangzhou Nansha New District, Zhuhai Hengqin New District, China (Fujian) Pilot Free Trade Zone, China (Hubei) Pilot Free Trade Zone, and China (Chongqing) Pilot Free Trade Zone	The pilot zones have successively introduced detailed rules with respect to the use of foreign exchange capital in FIE equity investment. These rules have allowed non-investment FIEs to invest in domestic equities with foreign exchange receipts under the capital account or RMB funds from foreign exchange settlement based on the actual investment scale in accordance with law, provided the FIEs ensure the authenticity and compliance of the projects.
2019/10/23	State Council executive meeting	The meeting passed 12 measures to promote cross-border trade and investment facilitation, mainly including: allowing non-investment FIEs to undertake domestic equity investment with foreign exchange capital.

2019/10/25	Circular of the State Administration of Foreign Exchange on Circular on Further Promoting Cross-border Trade and Investment Facilitation (Hui Fa [2019] No. 28)	Cancellation of restrictions on non-investment FIEs investing in domestic equities with foreign exchange capital.

Major contents of Circular 28

I. Allows non-investment FIEs to make domestic equity investments with foreign exchange capital

The above policy history clearly indicates that the Chinese government adopts a cautious attitude toward the use of foreign exchange capital in domestic equity investment by non-investment FIEs—there has been only limited loosening of the policy following prohibition under Circular 142. Besides a few exceptions following adoption of the "discretionary settlement system", the use of foreign exchange capital in domestic equity investment has generally been limited to FIEs (including investment FIEs, venture capital investment FIEs, and equity investment FIEs) and FIEs with words such as "investment" in their business scopes. In practice, the threshold is high for establishing an investment FIE. Currently, among 370,000 FIEs registered in China, only 3,000 or fewer are investment FIEs, accounting for less than 1% of this figure. This picture has made it difficult for reinvestment with foreign capital in domestic equities.

The opening process was gradual. Beginning in July 2019, each of the pilot free trade zones relaxed non-investment FIE settlement of foreign exchange capital for use in equity investment. Then, Circular 28 expanded this reform policy nationally. Circular 28 has laid a new foundation for enterprises in their investment planning and has brought a landmark change to capital markets.

According to Circular 28, non-investment FIEs only need to meet the following two substantive requirements to invest in domestic equities with foreign exchange capital:

1. Do not violate the effective Special Administrative Measures (Negative List) for the Access of Foreign Investment

Under Circular 28, the lifting of restrictions on equity investment does not mean the waiver of the foreign investment access negative list[1]. Instead, FIEs will still need to meet the basic requirements under the foreign investment negative list when investing in equities with foreign exchange capital. Thus, such investments must not involve industries prohibited to foreign investment.

2. Domestic projects to meet the "authenticity and compliance" requirements

"Authenticity" is a core principle that the Chinese government has consistently upheld in the regulation of foreign exchange capital. The pilot trade zones trialed the "**authenticity and compliance**" requirement with respect to the foreign exchange capital regulation. For example, in the Shanghai Pilot Free Trade Zone, "non-investment FIEs may invest in domestic equities with foreign exchange receipts under the capital account or RMB funds from foreign exchange settlement based on actual

[1] According to Article 3 of the Interim Provisions on Domestic Investment by Foreign-Invested Enterprises, FIEs may not invest in industries prohibited to foreign investment.

investment scale in accordance with law, provided they ensure the authenticity and compliance of the projects", according to the Rules for the Implementation of Further Promotion of the Foreign Exchange Pilot Reform Program in the China (Shanghai) Pilot Free Trade Zone (Version 4.0). Circular 28 reiterates these requirements and emphasizes the authenticity and compliance of "projects".

Based on previous enforcement of the rules in pilot areas, "project authenticity and compliance" is an important item to be verified when banks review foreign exchange capital equity investments. Generally, banks require enterprises to prove the investment projects are commercially reasonable, and may even require an investment FIE to prove that an investment project has a definite connection to its current business operations—banks may directly reject equity investment transactions that are purely speculative in nature.

II. Clarifies the process of equity investment with foreign exchange capital in original currency and settlement funds

On the basis of opening foreign exchange capital equity investment, Circular 28 further specifies the particular methods for FIEs to invest in equities with foreign exchange capital, which include "transfer of foreign exchange capital in original currency" and "settlement of foreign exchange capital for equity investment".

1. Transfer of foreign exchange capital in original currency

Circular No. 28, for the first time, officially permits non-investment FIEs to invest in equities through "transfers in original currency." Specifically, the investee enterprise will make a record-filing for receipt of the domestic reinvestment and open a foreign exchange capital account with a bank in its place of registration. Circular [2015] No. 13 adjusted the capital contribution confirmation registration to contribution currency receipt registration for foreign investor's domestic investment. Circular No. 28 further simplifies the procedure by cancelling the contribution currency receipt registration and provides for the transfer in original currency method.

2. Settlement of foreign exchange capital for equity investment

Settlement of foreign exchange capital for equity investment is a method basically the same as those previously implemented in pilot areas. Specifically, an investee enterprise will go to a bank in its place of registration to make a record-filing for domestic reinvestment, and open a "capital account – account for foreign exchange settlement and pending payment" to receive the corresponding funds (RMB funds or RMB funds from foreign exchange settlement in the investee enterprise's account for foreign exchange settlement and pending payment). "Account for foreign exchange settlement and pending payment" is a special RMB account created in connection with discretionary foreign exchange settlement under Circular [2014] No. 36. The account is used to deposit RMB funds converted from discretionary foreign exchange settlement to make various payments. Thus, in principle, the accounts are governed by the administrative rules applicable to foreign exchange capital. The above operating procedures are reiterated in Operating Guidelines for Banks Providing relevant Foreign Exchange Business under the Capital Account ("**Guidelines**"), attached as Annex 2 to the Circular of the State Administration of Foreign Exchange on Streamlining of Foreign Exchange Accounts (Hui Fa

[2019] No. 29), which further provides that those procedures should also be followed if investee enterprises subsequently make domestic equity investments.

It is worth noting that the "equity investment form" referenced in Circular 28 is not limited to direct investment in investee enterprises, but also includes investment made through "equity transfers", which are further clarified in the Guidelines.

III. Use of funds remains limited to designated purposes and is subject to ex-post review for each transaction

It should be noted that under Circular 28, although non-investment FIEs are allowed to make equity investments with foreign exchange capital, restrictions remain on the use of foreign exchange capital. The restrictions stipulated under Circular [2016] No. 16 are reiterated in the Guidelines, including a prohibition on the direct or indirect use of foreign exchange capital for the following purposes: expenditures outside the scope of business, purchase of non-guaranteed wealth management, extending loans to non-affiliates, and investments in real estate not for self-use, etc. These restrictions will remain as a "red line" for the use of foreign exchange capital going forward.

In addition, the Guidelines also require banks to verify the authenticity and compliance of transactions occurring in accounts for foreign exchange settlement and pending payment. Specifically, banks will verify the authenticity and compliance of supporting materials of previous transactions when they receive payment instructions with respect to these accounts (previous transactions that have been verified will not be re-verified). Banks will retain relevant supporting materials related to foreign exchange receipts of domestic institutions under the capital account and use the supporting materials for five years for future reference.

The above-mentioned supervision mode for funds in accounts for settlement and pending payment basically follows the supervision of "foreign exchange capital account payment and settlement"—that is, the bank verifies the authenticity and compliance of the first transaction at the time of the second transaction. Under this supervision mode, enterprises actually have less freedom than under the "selective reviews" adopted this year in the pilot free trade zones. "Selective review" means that, taking the Shanghai Pilot Free Trade Zone as an example, qualifying enterprises within the zones can freely make payments with foreign exchange receipts under the capital account without submitting supporting materials at the time of each transaction; instead, the bank will later make selective reviews of the transactions.

Major influence of Circular 28

Looking ahead, the reform, which has lifted restrictions on FIE domestic investment with foreign exchange capital, will bring significant changes to corporate investment transaction structures and cash flows, and will create a more favorable market environment for investors:

I. Reduce advantages of investment FIEs

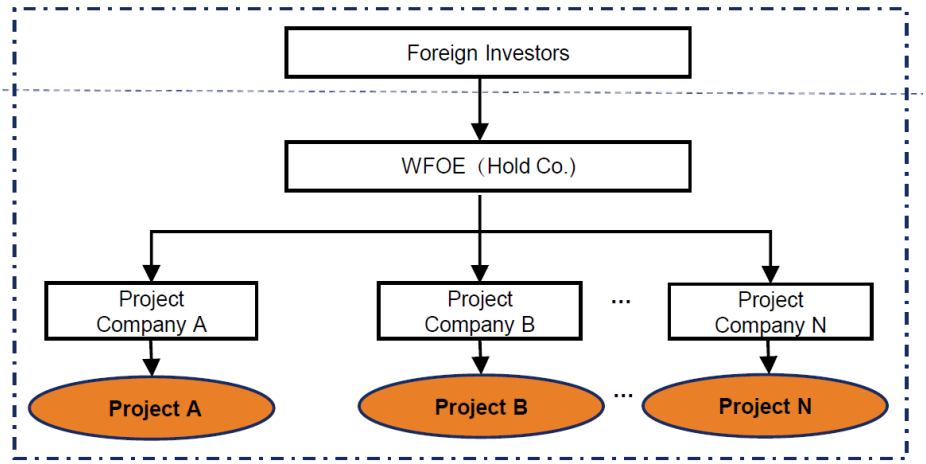
As mentioned above, the number of registered investment FIEs in China is quite limited due to high establishment thresholds. Although under the discretionary settlement system, non-investment FIEs

with business scopes containing words such as "investment" had been permitted to settle foreign exchange capital for use in domestic equity investments, it is unfortunate that in practice few investors can successfully establish non-investment FIEs which include "investment" in their business scopes. In some areas, although the policies are relatively flexible and permit the application for establishment of general equity investment FIEs, in practice, local governments still examine applications according to specific conditions. Therefore, prior to the introduction of Circular 28, non-investment FIEs still faced considerable restrictions on their domestic equity investment with foreign exchange capital settlement funds.

To some extent, Circular 28 may weaken the popularity or even doom the existence of investment FIEs because it permits non-investment FIEs to directly make foreign exchange capital investments, which is more convenient and efficient. Prior to the introduction of Circular 28, in some places, local governments have already reduced the entry thresholds for investment FIEs. For example, the Shanghai municipal government promulgated Several Opinions on Promoting Development of Regional Headquarters of Multinational Corporations in the Municipality in August 2019, to lower the conditions for foreign investors to establish investment companies. Specifically, the Opinions lower the prior-year asset requirement for applicants from USD 400 million to USD 200 million, and cancel the requirements for domestic paid-in registered capital and the applicant's number of invested enterprises. Despite these favorable conditions, it is still hard to say whether the investment FIE can hold its place after the introduction of Circular 28.

II. Domestic holding companies

Taking the real estate industry as an example. Before the introduction of Circular 28, FIE foreign exchange capital settlement funds could not be considered as investment funds for domestic enterprises. Thus, most foreign investors could only set up a holding company offshore and set up domestic wholly foreign-owned enterprises ("**WFOEs**") as real-estate project companies. Under Circular 28, WFOEs may directly act as holding platform companies. Specifically, a foreign investor may choose to establish a WFOE as a holding/platform company within China based upon tax policy preferences and other factors. The WFOE then will own real estate project companies through M&A or capital increases, thereby achieving the purpose of concentrating real estate project resources within the domestic holding company.



Looking forward

I. Where is QFLP going?

In addition to direct investment in domestic enterprises, foreign investors mainly participate in domestic equity investment in pilot areas through Qualified Foreign Limited Partners ("**QFLPs**"). The main advantage of QFLP is that foreign currency may be converted into RMB at the QFLP level in one installment, and then the converted RMB funds may be invested into multiple domestic projects, thereby avoiding the inconvenience of making foreign exchange settlements for each transaction. Although QFLP access thresholds have been lowered in various places, many foreign investors still feel hesitant because they need to obtain pre-approval from local financial services bureaus to establish QFLPs on a case-by-case basis, there are relatively high requirements for offshore investors, and the time required for the application process is unpredictable. Circular 28 opens channels for direct domestic equity investment, but the transactions are subject to bank review on a case-by-case basis. Therefore, it remains to be observed in practice whether QFLP can remain popular with foreign investors.

II. Authenticity and compliance

Under Circular 28, subject to the principle of "authenticity and compliance", foreign investors will still face difficulty in establishing shell special purpose vehicles and in their investments in other investment platforms. Therefore, it needs further observation whether the FIEs can construct multi-tier, complex ownership structures as easily as domestic-funded enterprises, and whether FIEs can make subsequent equity investments through other investment platforms.

III. Foreign capital look-through reviews

Following Circular 28, it is worth noting how the competent authorities will examine tiered investment structures in industries with foreign investments restrictions (such as medicine, education, value-added telecommunications, etc.). Before the introduction of Circular 28, competent industry authorities were not overly sensitive to the background of foreign capital during the equity investment review process due to the restrictions on foreign exchange capital in restricted industries. In some cases, the authorities may have identified an investment as domestic merely upon examining the first tier of an investment structure. However, Circular 28 makes it easier to circumvent foreign investment supervision through "reinvestment", so we cannot not exclude that in the future industry regulators will strengthen the look-through review of shareholders' foreign investment backgrounds.

Conclusion

"Ten years it takes to grind a sword, its frosty edge has yet to be tested", more than a decade has passed since promulgation of Circular 142 which prohibited FIEs from settling foreign exchange capital to make equity investments. Circular 28 removes this prohibition and opens the doors for non-investment FIEs to make equity investments with foreign exchange capital. However, since some provisions of Circular 28 are relatively vague, certain issues still need to be further explained at the policy level with respect to the extent of autonomy banks are given in practice. We expect that forthcoming detailed rules and supporting provisions will extend more support for investors.

2. Comments on the Regulations for the Implementation of the Foreign Investment Law (Draft for Comment)

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Evolution of policy on FIE foreign exchange capital in equity investment

On November 1, 2019, the Ministry of Justice issued for public comment the *Regulations for the Implementation of the Foreign Investment Law of the People's Republic of China (Draft for Comment)* (the "**Draft Regulations**"), jointly drafted by the Ministry of Justice, the Ministry of Commerce, and the National Development and Reform Commission. The Draft Regulations, which will serve as the implementing regulations for the *Foreign Investment Law of the People's Republic of China* (the "**Foreign Investment Law**"), aim to further clarify the principled provisions and requirements of the Foreign Investment Law and to facilitate its implementation.

Main contents

I. Promote and protect investment

The Draft Regulations reiterate the principle of promoting and protecting foreign investment, and further detail the relevant provisions of the Foreign Investment Law. The main contents of the Draft Regulations include:

1. Broadening the forms and types of foreign investment in China by specifying that foreign investors may co-invest with Chinese natural persons and that foreign investment includes non-equity investment (Articles 3 and 4);

2. Requiring the government to hear and consider opinions from foreign parties (including foreign chambers of commerce) in the process of formulating relevant laws on foreign investment, and specifying the methods for foreign-invested enterprises ("**FIEs**") to participate in standards setting work (Articles 10 and 15);

3. Requiring governments at all levels to publish relevant policies and guidelines for foreign investment and to adopt a unified and transparent foreign investment management system (Articles 10, 11 and 21);

4. Establishing a foreign investment positive list and continuing to implement preferential policies; clarifying that governments must not arbitrarily breach their commitments made in accordance with the law (Articles 13, 28, and 29);

5. Specifying at the administrative regulation level that foreign investors may receive preferential treatment when they make reinvestments with profits obtained through domestic investment (Article 14);

6. Further clarifying issues of concern for foreign investors, including (1) detailing circumstances of foreign exchange control violations (Article 23); (2) clearly requiring establishment a punitive

compensation system and an expedited collaborative protection mechanism for intellectual property infringement (Article 14); (3) detailing circumstances of illegal forced technology transfers (Article 25); and (4) strengthening government protection of enterprise trade secrets (Article 26).

II. Equal treatment of domestic and foreign investment

The Draft Regulations further detail requirements for governments at all levels and emphasize that domestic and foreign investment are equals in the process of policy formulation and implementation by:

1. Specifying that governments must not discriminate against foreign investment and should fairly handle foreign investment applications when formulating and implementing policies and regulations in connection with capital arrangements, land supply, tax and fee exemptions, licenses and permits, project declarations, job title evaluations, and human resources (Article 9);

2. Prohibiting the government from requiring FIEs to be subject to technical requirements that are higher than mandatory standards, and further specifying that FIEs must not be compelled to use voluntary standards or group standards (Article 16);

3. Specifying that the government shall undertake legitimate inspections and fair competition reviews when formulating regulatory documents on foreign investment (Article 27);

4. Clarifying that conditions and procedures be consistent for domestic and foreign investment in respect of market entry administrative licenses, additional requirements will not be imposed on FIEs such as additional examination criteria, procedures and documents (Article 37).

III. Clarify transition arrangements for unifying the three FIE laws

The Draft Regulations clarify certain arrangements for the transition to the Foreign Investment Law from the currently effective “three foreign investment laws” by:

1. Stipulating a six-month legal change period in addition to the five-year transition period of the Foreign Investment Law, extending the enterprise change period and specify the legal consequences of failing to handle changes within the prescribed period (Article 42);

2. Specifying that the existing profit distribution arrangements of equity or contractual joint ventures will not be affected by organizational structure adjustments, and guaranteeing the existing interests of all investors (Article 43).

Observations

Despite these highlights, many provisions in the Draft Regulations still await further clarification and adjustment, including:

I. Ambiguity in the definition and supervision of non-equity investment

As mentioned above, Article 4 of the Draft Regulations specifies that foreign investment includes non-equity investments (i.e. new project investments in China, which refer to investments by foreign

investors in specific projects in China without establishing an FIE or acquiring shares, equities, asset interests, or other similar interests in domestic enterprises), which broadens the forms and types of foreign investment in China. However, the current provisions of Article 4 are too general for uniform supervision. In this regard, we recommend that the Draft Regulations refer to the description of foreign investment activities stated in the January 2015 public comment draft of the Foreign Investment Law[2] to clarify whether certain circumstances constitute "foreign investment":

1. Financing provided for one year or more to projects in China;
2. Obtaining concessions for the exploration and development of natural resources, or concessions for the construction and operation of infrastructure in areas under Chinese jurisdiction; and
3. Obtaining real estate rights in China such as land use rights and housing ownership rights.

From another perspective, the Draft Regulations lack relevant provisions on access management and in-process and ex-post supervision with regard to the above-mentioned forms of investment, which could cause these forms of investment to become impractical due to a lack of systems and rules.

II. Limited exemption of foreign investment restrictions for round-trip investments

According to Article 35 of the Draft Regulations, round-trip investments can be exempted from negative list market access restrictions. However, this exemption is not conducive to attracting foreign investment because it only applies to round-trip investments of overseas enterprises established and fully owned by Chinese investors, and emphasizes 100% Chinese capital, which excludes a large number of other overseas enterprises that are established for offshore financing purposes by Chinese investors. In addition, Article 35 also provides that only upon State Council approval are round-trip investments not subject to access restrictions. This level of examination and approval is set too high and could result in being unable to obtain approvals in practice.

III. Ambiguity in the supervision of FIE domestic reinvestment

In current regulatory practice, it is unclear whether a domestic enterprise invested in by an FIE (excluding the three types of foreign-invested investment enterprises) is a "foreign-invested enterprise" or a "domestic / domestic-invested enterprise". According to Article 2 of the Foreign Investment Law, foreign investment includes "direct or indirect" investment activities of foreign investors, so foreign investment should also include domestic reinvestments by foreign investors through domestic enterprises under their control. On the other hand, domestic reinvestments by a domestic enterprise should not be considered foreign investment where a foreign investor merely owns shares in the enterprise but has no control. However, the Draft Regulations do not define and distinguish among FIE reinvestment activities. This lack of higher-level regulatory guidance will make it difficult to unify regulatory policies among the various departments and commissions in respect of FIE reinvestment and will result in inconsistencies in practice.

IV. Market regulation department review may result in a new barrier to foreign investment access

[2] In Chinese,《中华人民共和国外国投资法（草案征求意见稿）》.

According to Article 38 of the Draft Regulations, if a foreign investor applies to establish an FIE in an industry listed in the market access negative list, the market regulation department will examine whether the FIE meets the shareholding ratio and senior management requirements when handling the FIE's registration. Although the Draft Regulations also stipulate that the market regulation department need not repeat the review if the relevant competent authorities have already reviewed the application, in general, the relationship between market access approval and registration review remains ambiguous. According to the currently valid pre-examination and approval catalogue for industry and commerce registration, competent authority approval is a pre-requisite for registration of FIEs in negative-listed industries and foreign investors are required to hold an approval certificate when registering with the market regulation department. If the market regulation department still examines whether the requirements are met at the time of registration, it may result in a second substantive review and constitute an additional barrier to entry.

V. The meaning of "overseas Chinese" needs further clarification

According to Article 44 of the Draft Regulations, "investments made by overseas Chinese within the territory of China shall be governed in reference to the Foreign Investment Law and these [Draft Regulations]". "Overseas Chinese" refer to Chinese citizens who permanently reside abroad, including those (1) who have obtained long-term or permanent residency in their country of residence and have been residing in the country for two consecutive years, and the cumulative time of residence in the country is no less than 18 months within two years; or (2) who, although not having obtained long-term or permanent residency in their country of residence, have obtained a legal residence permit in the country for five consecutive years or more and have resided in their country of residence for cumulatively no less than 30 months within five years, while Chinese citizens who study or take business trips abroad are not considered overseas Chinese.[3] For purposes of implementing the regulations, there is a need to clarify the meaning of overseas Chinese in connection with foreign investment at the administrative regulation level under the principle of "priority based on permanent residence and center of economic interest".

The Foreign Investment Law will come into effect in fewer than two months. We expect the regulators to adjust and improve the Draft Regulations after reviewing opinions and suggestions from various circles to lay a solid foundation for the upcoming Foreign Investment Law.

[3] Provisions of the Office of Overseas Chinese Affairs of the State Council on Defining the Identities of Overseas Chinese, Chinese Foreign Nationals, Returned Overseas Chinese and Their Family Members.

3. Unveiling of the H-share "Full Circulation" Reform

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The China Securities Regulatory Commission ("**CSRC**") has recently unveiled the H-share "full circulation" reform with the promulgation of the *Guidelines on Applying for "Full Circulation" of Unlisted Domestic Shares of H-share Listed Companies* (CSRC Circular [2019] No. 22, issued on November 14, 2019, the "**Guidelines**") and publication on the CSRC website of official answers to questions related to the reform, the *CSRC Spokesperson's Press Conference Q&A Regarding the Comprehensive Launch of the "Full Circulation" Reform* for *H-share Listed Companies* (the "**CSRC Q&A**").

H-share "full circulation" – a Primer

The "full circulation" of H-share listed companies has been a long-discussed topic. Prior to the pilot implementation of the reform, domestic companies listed on the H-share market could not publicly trade their domestic unlisted shares on the Hong Kong Stock Exchange, thereby restricting the overall liquidity of the companies' shares and also, to a certain extent, causing the Hong Kong Stock Exchange to become less attractive as an IPO location for domestic companies.

Previously, during the "full circulation" pilot reform in 2017, several documents were promulgated with respect to the pilot implementation of the reform, beginning with CSRC issuing opinions on the H-share "full circulation" pilot reform, followed by China Securities Depository and Clearing Corporation Limited ("**CSDC**") and the Shenzhen Stock Exchange promulgating the *Implementing Rules for the Pilot Reform of "Full Circulation" of Shares of H-share Listed Companies (for Trial Implementation)* and the *Guidelines for Handling Business under the Pilot Reform of "Full Circulation" of Shares of H-share Listed Companies (for Trial Implementation)*. During the pilot period, three companies were approved for "full circulation" of their shares on the H-share market, including Legend Holdings (03396.HK), China Aerospace Science and Industry Corporation (02357.HK), and Weigao Group (01066.HK).

This time, CSRC has promulgated the Guidelines to specify rules for H-share "full circulation", marking the formal launch of the "full circulation" reform[4].

Key points of H-share "full circulation"

I. Shares eligible to apply for "full circulation"

According to the Guidelines, the following types of shares of H-share listed companies or companies applying for IPO on the H-share market are eligible to apply for H-share "full circulation": unlisted domestic shares held by domestic shareholders before an overseas public offering; unlisted domestic shares issued after an overseas public offering; unlisted shares held by foreign shareholders.

It is worth noting that after an H-share listed enterprise is approved for "full circulation", additional

[4] The reform involves H-share companies that are solely listed on the Hong Kong Stock Exchange. Unlisted domestic shares of H-share companies after being converted into H-shares can be listed and traded on the Hong Kong Stock Exchange. The "full circulation" program does not apply to A+H-share listed companies.

shares that it issues to domestic shareholders are still regarded as domestic shares, and it is thus necessary again to apply for "full circulation" for those shares to be traded on the H-share market.

II. Application conditions and requirements

According to the Guidelines, domestic shareholders of H-share listed companies may decide on the number and proportion of shares to apply for "full circulation" and entrust the enterprise to submit a "full circulation" application, provided that doing so complies with relevant laws, regulations, and state-owned asset management, foreign investment, industry supervision, and other policy requirements.

According to the CSRC Q&A, CSRC will actively and orderly advance "full circulation" reform work in accordance with laws and regulations based upon the principle of "one mature, one put forward". Compared with the previous CSRC requirements which consisted of four basic conditions for pilot enterprises, the Guidelines greatly reduce the thresholds for applicant enterprises by no longer placing conditions on the applicant's industry and scale, or setting enterprise approval quotas and completion deadlines. (For the trial period requirements, please refer to CSRC Spokesman Chang Depeng's Answer to Reporter's Questions on Issues Related to the Pilot Implementation of "Full Circulation" Reform for H-share Listed Companies; of these basic conditions, two restricted pilot enterprises as follows: the enterprise applicant must be in an industry that upholds the development concepts of innovation, coordination, green, openness, and sharing, is in line with the direction of national industrial policy development, is suitable for the national strategy of serving the real economy and supporting construction of the "Belt and Road", must represent an excellent enterprise, the equity structure of the enterprise's shares is relatively simple, and the market value of its existing shares is not less than HKD 1 billion).

According to the Guidelines, the H-share "full circulation" must still abide by existing restrictions on foreign investment. That is, an enterprise may apply but must comply with foreign investment ratio restrictions when determining the number and proportion of shares to apply for "full circulation" if the enterprise is in an industry subject to special administrative measures for foreign investment (negative list) in which foreign investment is restricted but not prohibited. The specific implementation of these restrictions remains to be observed.

III. Application timing and decision-making, examination, and approval procedures

In terms of application timing, according to the Guidelines, an unlisted enterprise that applies for an IPO on the H-share market may submit an application for "full circulation" together with its IPO application. This means that it is possible for an H-share listed enterprise have restrictions removed on overall liquidity of its shares at the IPO through administrative approval procedures. Enterprises that have been listed on the H-share market may separately submit an application for "full circulation" to CSRC at any time, or they may choose to submit an application together with an application for overseas refinancing based on their own circumstances.

The relevant decision-making, examination, and approval procedures for the "full circulation" program mainly include the enterprise's internal decision-making, approval by the competent authority (if applicable), and examination and approval by CSRC:

1. **Internal enterprise decision-making:** H-share listed enterprises or enterprises applying for an IPO on the H-share market should undertake necessary internal decision-making procedures to fully protect shareholders' right to know and right of participation. During the pilot period, three pilot enterprises clearly specified in their articles of association the relevant procedures for "full circulation" matters, and specified that they are not subject to voting procedures for shareholders' meetings, class meetings, and other matters.

2. **Competent authority approval:** The H-share "full circulation" program must be carried out "in compliance with relevant laws, regulations, and state-owned asset management, foreign investment, industry supervision, and other policy requirements." In the CSRC Q&A, the spokesperson also emphasized the procedures for obtaining advance approval from the competent authorities: financial, quasi-financial, and other companies which have requirements for the admission of shareholders should obtain the approval of the competent supervisory authorities in advance; "full circulation" applications for state-controlled enterprises and state-held shares are required to comply with the relevant regulations on supervision and management of state-owned equity.

   Relevant enterprises applying for "full circulation" should, based on actual circumstances, submit supervisory opinions issued by the competent supervisory department (if applicable), and the government approval to the state-owned equity conditions and the conversion of state-owned shares into overseas listed shares (if applicable), according to the administrative licensing guidelines published on the official CSRC website for the *"Examination and Approval of Overseas Public Offerings and Listings of Limited Companies (Including Additional Issuances)"* (the latest version was published in July 2019).

3. **CSRC examination and approval:** Applications for "full circulation" will be handled through CSRC administrative licensing procedures for "*Examination and Approval of Overseas Public Offerings and Listings of Limited Companies (Including Additional Issuances)"*.

IV. Procedures for registering "full circulation" shares

Subject to the needs of cross-border securities market supervision, "full circulation" shares will be registered through special cross-border share conversion registration and share registration procedures:

1. **Cross-border share conversion registration:** After CSRC approval, CSDC will undertake the relevant procedures to convert the fully circulated shares from unlisted domestic shares to shares eligible to be listed and traded on the Hong Kong Stock Exchange.

   It is worth noting that H-share "full circulation" applications for domestic unlisted shares are irreversible. This means "full circulation" shares which have undergone cross-border share conversion registration procedures to register as overseas-listed shares cannot be converted back into unlisted domestic shares. This issue requires the special attention of H-share listed companies and their shareholders who also plan to apply for IPOs on the A-share market.

2. **Share registration:** Shares which have completed cross-border share conversion registration will

be deposited with CSDC Hong Kong Co., Ltd. ("**CSDC Hong Kong**"), which will serve as the nominee holder. The shares will then be deposited in the name of CSDC Hong Kong with Hong Kong Securities Clearing Enterprise Limited, and Hong Kong Securities Clearing Company Nominees Limited will be registered as the ultimate nominee holder of the shares in the register of shareholders of the H-share listed enterprise.

V. Procedures for trading shares after "full circulation"

According to the Guidelines, domestic shareholders of an H-share listed enterprise will be able to sell the "full circulation" shares of the enterprise and purchase the Hong Kong-listed shares of the enterprise (the purchase function has not been enabled for technical reasons and will be fixed after the completion of technical system and other conditions).

Domestic shareholders of an H-share listed enterprise must authorize the enterprise to choose a domestic securities company to participate in the trading of "full circulation" shares. Specifically, the domestic shareholders will entrust a domestic securities company to submit a transaction instruction through Shenzhen Securities Communications Co., Ltd. to a Hong Kong securities company designated by the domestic securities company. The Hong Kong securities company will then trade the shares on the Hong Kong Stock Exchange in accordance with the exchange's rules.

In addition, according to the CSRC Q&A, domestic shareholders are allowed to participate in H-share "full circulation" services through existing RMB ordinary share accounts (i.e. A-share securities accounts) without having to open new securities accounts, which differs from the pilot period where shareholders of pilot enterprises were required to open special "full circulation" accounts with CSDC for share trading.

Looking forward

The unveiling of the H-share "full circulation" reform provides flexibility for improving the liquidity of company shares, and may also attract more domestic companies to consider conducting IPOs on the Hong Kong Stock Exchange without establishing an overseas structure, especially those enterprises that are unsuitable for setting up overseas structures and have difficulty in completing public offerings on the A+H share markets, and will help domestic enterprises to make better use of both domestic and overseas markets and resources for development. It remains to be observed whether offshore structure-based IPOs, a prevailing IPO model for PRC enterprises to list on the Hong Kong exchange, will be affected after the "full circulation" reform. In the future, CSDC will join with the Shenzhen Stock Exchange to formulate implementing rules related to the "full circulation" program to stipulate the specific business mechanisms and arrangements of the reform. We will also continue watching the progress, effects, and issues regarding the "full circulation" reform.

Important Announcement

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