SPEEDREAD

On August 18, 2017, the State Council of China issued a notice forwarding the Guiding Opinions on Further Guiding and Regulating the Direction of Outbound Investments (the Guiding Opinions) as jointly drafted by the National Development and Reform Commission (NDRC), Ministry of Commerce (MOFCOM), People’s Bank of China (PBOC) and Ministry of Foreign Affairs. The Guiding Opinions are the first official rules adopted after China increased its control over capital outflows in late 2016.

In 2016, the value of the RMB depreciated over 6% against the US dollar and China’s foreign exchange reserves dropped sharply. Among different types of capital outflows, China’s outbound direct investment (ODI) continued to surge, with a 53.7% increase on a year-on-year basis in 2016. Such depreciation in the value of the RMB and the continuous and extraordinary levels of capital outflows have been cause for concern in the Chinese government, and since late 2016, there has been widespread media coverage of China’s restrictions on outbound investments by Chinese companies. For instance, the State-owned Assets Supervision and Administration Commission, in line with such regulatory trends, promulgated new rules tightening outbound investments by central state-owned enterprises. While some other measures reported by the media have not been adopted in official rules, both public statements made by Chinese government officials and our experience in various transactions both suggest that such new measures have in practice been implemented.

The Guiding Opinions were issued against the backdrop of a substantial reduction in Chinese ODI. ODI out of China dropped to USD48.19 billion in the first half of 2017 (a 45.8% decrease on a year-on-year basis). Although the exact impact of the Guiding Opinions remains to be seen, they provide market players with official guidance on the chances for a given outbound transaction to gain approval from Chinese authorities.
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Framework of the Guiding Opinions

The Guiding Opinions set out lists of encouraged, restricted and prohibited outbound investment activities in guiding and regulating the direction of ODI, as described below.

(a) Encouraged outbound investments:

- **Infrastructure**: outbound infrastructure investments that facilitate the “belt & road” construction and the interconnectivity of peripheral infrastructure.
- **Capacity and equipment**: outbound investments that promote the export of advantaged capacity, high-quality equipment and technical standards.
- **High-tech and advanced manufacturing**: outbound investments that strengthen cooperation with foreign high-tech and advanced manufacturing enterprises (such as establishing research & development centers abroad).
- **Energy and resources**: participation in the exploration and development of outbound oil and gas, minerals and other energy and resources.
- **Agriculture**: cooperation in the agriculture industry with other countries and investment cooperation in farming, forestry, livestock and finishing industries.
- **Services**: outbound investments in business and trade, culture, logistics and other areas of services, and establishment by qualified financial institutions of branches and service networks abroad.

(b) Restricted outbound investments:

- **Sensitive countries and regions**: outbound investments in sensitive countries and regions which have not established diplomatic ties with China, are in war, or are restricted by bilateral or multilateral treaties or agreements with China.
- **Specific sectors**: real estate, hotels, film studios, entertainment, sports clubs, etc.
- **Investment platform**: establishment of overseas equity investment funds or investment platforms without actual, specific industrial projects.
- **Environmental protection, energy consumption and safety standards**: outbound investments that do not meet the environmental protection, energy consumption and safety standards of the host country.
- **Technical standards**: outbound investments using outdated production equipment that does not meet the technical requirements of the host country.

The Guiding Opinions expressly require the first three types of restricted outbound investments listed above to be subject to the approval by the relevant authorities (as opposed to a filing requirement), which will require preparation and submission of substantial application materials and prolonged review time, while the fourth and fifth types listed above are not expressly subject to approval.

(c) Prohibited outbound investments:

- Investments involving core military technology and products.
- Investments involving export-prohibited technology, process/techniques or products.
- Investments in gambling and sex industries.
- Investments prohibited by international treaties entered into by China.
— Investments that endanger or may endanger national interests and national safety.

Following the release of the Guiding Opinions, NDRC has been actively advancing the legislative process in relation to outbound investment approval and filing rules to reflect the Guiding Opinions. On November 3, 2017, NDRC published draft regulations entitled “Measures for Administration of Enterprises Overseas Investments”, which are open for public comment until December 3, 2017. Other government authorities are also expected to update their policies. The adoption of these implementing measures will likely provide more transparency and guidance to the execution of outbound investment transactions. We will continue to provide updates on the development of this legislative process.

Tightening control over remittance

Since late 2016, apart from tightening supervision on outbound investments, it has been reported that measures have been taken to control outbound payments. Set forth below are some examples of such “policy measures”, which may change from time to time:

(a) Banks are required to report any overseas transfers of US$5 million or more under any capital account item (covering both foreign currency and RMB funds) per transaction to the State Administration of Foreign Exchange (SAFE). Such overseas transfers can only be made after the local foreign exchange authorities have re-examined the underlying transaction in respect of which the transfer has been requested to verify its authenticity and compliance with relevant regulations.

(b) SAFE has also tightened controls over ODI with a capital outflow of US$50m or more. Such fund transfers will only be made after re-examination of the authenticity and compliance with relevant regulations of the underlying transactions by the central SAFE.

(c) The rules for cross-border RMB lending by Chinese companies (which used to be more relaxed than the regime for cross-border lending in foreign currency) have also been modified by PBOC. The cross-border lending limit (ie below 30% of the lender’s total equity) and shareholding requirement (ie that the lender and the borrower must have a shareholding relationship), which previously applied only to foreign currency lending, has now been applied to cross-border RMB lending. In addition, the rules expressly provide that such cross-border RMB lending by Chinese companies should be registered with SAFE.

Practical pointers and outlook

People generally hold the view that the restrictions, imposed due to the pressure of capital outflows and RMB depreciation, are not an attempt to stop the “Going Out Policy” that the Chinese government has been promoting in recent years, but to improve the quality of such transactions. In other words, the objective of the various restrictions is to inject some discipline into overseas investments and to prevent flight of so-called
“hot money”. Of particular concern were attempts by Chinese companies to acquire targets in industries where they had no underlying competence, and transactions motivated by a desire to purchase trophy assets or for reasons of moving funds offshore. Noting this, caution should be paid when engaging in cross-border transactions in China or with Chinese investors. The following is a list of our observations and practical guidance in light of the new restrictions.

- Outbound investments in the encouraged category (such as infrastructure relating to the “belt & road” initiative, energy and resources and agriculture) are expected to be assessed with more lenience.

- As the inherent regulatory risk in outbound transactions has increased significantly, it is important to apply a mechanism that can fairly allocate such risks. For example, foreign vendors may consider negotiating break fees and deposits or making appropriate adjustments in the valuation to account for additional closing risk, noting that some of these mechanisms may not be so easy for Chinese investors to accept. Transactional documents must be carefully negotiated to allocate regulatory risks properly.

- In an auction setting, a foreign vendor should firstly be careful in assessing and selecting Chinese buyers. Chinese buyers in the form of limited partnerships, with limited assets, or those established recently, will carry greater regulatory risk than others, as they are more heavily scrutinized by Chinese regulators (even in the Guiding Opinions era). It is advisable to choose buyers that have substantive operations and that hold a considerable scale of assets. Proper due diligence should be conducted on the buyer about whether the payment can be transferred out of China as well as the time and plan for such transfer.

- Parties should be cautious when engaging in outbound investments in sectors which fall under the restricted sectors, such as real estate, hotels, film studios, entertainment and sports clubs. It will likely be difficult to obtain the outbound investment approvals in these sectors due to the stricter level of scrutiny imposed.

- The relevant measures possibly will increase the difficulty of outbound fund remittance. A Chinese buyer may consider alternative plans such as using offshore funding to avoid the need to make payment from China to overseas, noting, however, that the feasibility of this option will depend on the Chinese buyer’s overseas financing capability. For outbound investment deals that are able to complete filings with NDRC and MOFCOM, parties will need to budget additional time for deal closing as fund transfers may take much longer to be approved under the newly-imposed controls.

- Timely communication with Chinese regulators is important given the current regulatory situation. Chinese buyers are encouraged to apply for approval or filing as early as possible and to actively communicate with Chinese regulators and banks. Foreign invested enterprises in China with a dividend distribution plan involving large sums should consult the relevant banks and local SAFE early on to understand the current best practice for overseas repatriations.

According to the Guiding Opinions, further implementing measures are expected to be issued in the future. We will continue to closely monitor developments and provide updates in due course.
Key contacts

If you require advice on any of the matters raised in this document, please call any of our partners or your usual contact at Allen & Overy.

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