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Client Alert Commentary

Latham & Watkins Mergers & Acquisitions Practice

August 30, 2017 | Number 2204

China Issues Formal Guidance for Outbound Direct Investments

Key Points:

- The guidelines classify outbound investment into three groups: encouraged, restricted, and prohibited transactions.
- China will promote outbound direct investments transactions that are strategically important to China's growth and development.
- China will discourage or prohibit outbound direct investments that run counter to the PRC's national interests or are prone to "irrational" risk-taking.

Since November 2016, the People's Republic of China (PRC) has been increasing its scrutiny of outbound direct investments (ODI) made by PRC companies. Consistent with that trend, the PRC formalized the regulatory pathway for ODI transaction approval on August 18, 2017, by issuing the Opinions on Further Guiding and Regulating Outbound Investment (关于进一步引导和规范境外投资方向的指导意见) (the Guiding Opinions). The Guiding Opinions were jointly issued by the PRC's National Development and Reform Commission (NDRC), the Ministry of Commerce (MOFCOM), the People's Bank of China, and the Ministry of Foreign Affairs.

The Guiding Opinions promote outbound investments that align with the PRC's "One Belt, One Road" policy, endorse investments in certain strategically important areas, and discourage or prohibit those ODI transactions that the PRC believes are against its national interests or prone to irrational risk-taking. The formalization of these ODI policies help clarify the regulatory framework for potential Chinese buyers and ODI sellers.

Background

From 2014 to November 2016, the Chinese government gradually liberalized regulation of ODI transactions by streamlining the procedures and increasing the transparency of the ODI approval process. However, in November 2016, the PRC began tightening its controls on ODI transactions by investigating the commercial purpose of ODI transactions and implementing stricter controls over offshore remittances of funds. The Chinese government also began restricting ODI transactions using a common financing structure whereby foreign currency loans made outside of China are secured by onshore PRC assets and RMB funds. The tighter controls prolonged the process for obtaining PRC regulatory approvals and resulted in the termination of some previously announced deals. The first half of 2017 saw a sharp decline in ODI transaction volumes, with China’s outbound direct investments in the non-financial sector falling 46%, according to MOFCOM.

The November 2016 ODI controls were implemented through informal guidance and discussions with government officials, often occurring during the submission of an ODI approval request to the PRC government agencies (window guidance). The unofficial and ad hoc nature of the ODI control implementation made it difficult for ODI practitioners to predict the timing and results for the ODI approval process. This led to increased regulatory risk for ODI transactions, in particular for targets outside of China’s “One Belt, One Road” program and for Chinese buyers that had to rely on significant onshore financing. The Guiding Opinions mark the first formal articulation of the ODI regulatory process since November 2016.

The Guiding Opinions

The Guiding Opinions classify outbound investment into three groups: encouraged, restricted, and prohibited transactions. This classification scheme borrows from a familiar structure used to regulate inbound foreign direct investment into the PRC since the 1990s.

Encouraged Transactions

The following ODI targets and industries are encouraged in the Guiding Opinions:

- Infrastructure projects that are conducive to the construction of the “One Belt, One Road” initiative and interconnecting surrounding infrastructure
- Investments that facilitate the deployment of China’s industrial capacity and export of China’s high quality equipment and technology standards
- High-tech businesses, advanced manufacturing enterprises, and overseas research and development (R&D) centers
- Oil, gas, and mineral and energy resource projects which are based on a careful assessment of economic benefits and national interests
- Industries such as agriculture, forestry, animal husbandry, side-line production, and fishery
- Investments in service sectors such as commerce, culture, and logistics, as well as investments which help qualified Chinese financial institutions to establish offshore branches and service networks

The Guiding Opinions indicate that PRC government will facilitate encouraged transactions through preferential taxation, foreign exchange, insurance, customs, and information sharing. However, they do not provide any details on how these preferences might work.

Restricted Transactions

ODI investments which conflict with PRC foreign policies are restricted by the Guiding Opinions, including the following:

- Investments in countries and regions that have no diplomatic relations with China, are currently at war or in chaos, or are restricted by Chinese treaties

- Real estate, hotels, cinemas, the entertainment sector, and sports clubs
- Equity investment funds or investment platforms which do not have underlying operating business
- Outdated or obsolete manufacturing equipment or technologies
- Investments which fail to meet environmental, energy efficiency, or safety standards in the target's jurisdiction

The Guiding Opinions require the ODI transactions in first three restricted categories above to be "approved" by PRC regulators, which involves a higher level of scrutiny and a longer review process than transactions that only require "registration" with PRC regulators. The Guiding Opinions advise PRC investors to exercise caution before participating in a restricted ODI transaction and indicate that specific guidance and warnings will be provided based on the facts and circumstances of each case.

Prohibited Transactions

The Guiding Opinions prohibit ODI transactions that may endanger the national interests or security of China, including transactions relating to the following:

- Export of core military technologies and products without PRC approval
- Technologies, techniques, or products that are banned for export from China
- Gambling or sex industries
- Investments that are prohibited by Chinese treaties

The Guiding Opinions indicate that these transactions will be subject to strict management and control.

Practical Implementation

We expect that the Guiding Opinions will be implemented and administered by the NDRC, MOFCOM, and the State Administration of Foreign Exchange (SAFE). These three regulatory agencies have been the main regulators for ODI investments. The NDRC and MOFCOM (and their respective local and provincial agencies) are responsible for determining whether or not to approve, or accept a registration for, a proposed ODI transaction, as well as the timing of these processes. SAFE and the Chinese banks supervised by SAFE control whether a Chinese buyer can convert *renminbi* into foreign currency and whether those foreign currencies can be remitted outside of China to fund an ODI transaction.

The Guiding Opinions reaffirm a policy that has been in place since late 2016 to scrutinize ODI transactions to determine if they have legitimate investment and business purposes or if they are instead being undertaken to evade foreign capital controls. The Guiding Opinions also require the relevant regulators to establish an inter-agency, ODI "blacklist" to track and punish investors that violate the PRC regulations.

Prior Guidance

Media reports of policies made by the PRC government from November 2016 identified several types of ODI transactions that were subject to enhanced scrutiny. These ODI transactions include:

- Investments of US$10 billion or more

- Investments of US$1 billion or more that are unrelated to the PRC investors' primary business
- Real estate investments of US$1 billion or more made by Chinese state-owned enterprises
- Investments made by partnerships
- Minority Investments of less than 10% of the equity of a publicly listed company
- Investments in an overseas target that is substantially larger than the PRC investor
- Investments by newly established PRC investors
- Transactions that involve the delisting and take-private of any overseas-listed and PRC-based company

The Guiding Opinions do not address or clarify whether these categories remain under scrutiny. However, the general approach in the Guiding Opinions remains consistent with the reported November 2016 policies, which indicates that the transactions listed above may continue to be subject to enhanced scrutiny.

Conclusion

The Guiding Opinions come at a time of increasing regulatory scrutiny over ODI transactions in the PRC. The Guiding Opinions formalize recent restrictions on ODI transactions that the PRC believes are counter to its national security and macroeconomic stability. The new rules above provide a level of increased clarity for deal makers contemplating ODI transactions, which will hopefully spur additional growth in these investments.

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