Corporate Alert: Proposed Foreign Investment Law Would Bring Profound Changes to Foreign Investment Regime in China

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On January 19, 2015, China's Ministry of Commerce ("*MOFCOM*") released a draft Foreign Investment Law (the "*Draft Foreign Investment Law*") for public comments, together with MOFCOM's explanatory notes (the "*Explanatory Notes*"). If promulgated, the Draft Foreign Investment Law would supersede three important and long-existing PRC laws on foreign investment, namely the Sino-foreign Equity Joint Venture Law, the Wholly Foreign-owned Enterprises Law and the Sino-foreign Cooperative Joint Venture Law. In its current form, the Draft Foreign Investment Law would bring revolutionary changes to the legal and regulatory regime for foreign investment in China, as it would reduce government control over foreign investment admission, focus on substance rather than form of investment, clarify the legal status of VIE structures, and provide greater commercial flexibility for foreign investment transactions.

Relaxing Foreign Investment Control

The Draft Foreign Investment Law would eliminate the requirement of MOFCOM prior approval for foreign investments in a vast majority of Chinese businesses. The Chinese government has adopted a Foreign Investment Industrial Guidance Catalogue (the "*Catalogue*") which classifies foreign investments in particular industries as "encouraged", "permitted", "restricted" or "prohibited". Currently, prior approval from MOFCOM (or its local counterparts) is required for any foreign direct investment in China, regardless of under which category it falls. According to the Draft Foreign Investment Law, the State Council is expected to issue a "restricted catalogue" and a "prohibited catalogue". MOFCOM approval would only be required for foreign investments in the industries listed on the "restricted catalogue", and the industries listed on the "prohibited catalogue" will remain closed to foreign investment. Foreign investments in any other industry or sector will no longer be subject to MOFCOM approval.[1]

While the Draft Foreign Investment Law lifts the MOFCOM approval requirement for foreign investments in non-restricted businesses, it expands MOFCOM's approval authority to reach certain offshore transactions – that is, any transaction outside of China that results in the *de facto* control of a Chinese entity being passed to a foreign investor is deemed as a foreign investment in China, so if the business of such Chinese entity falls within the "restricted catalogue", the transaction will require foreign investment approval.[2] This is a significant change from the current position where only onshore foreign investments are subject to MOFCOM approval. The rationale behind the change seems quite clear and fair – if foreign investment in a particular sector is restricted, it does not matter whether it is a direct onshore investment or an indirect offshore transaction, especially if *de facto* control is passed to foreign investors.

Focusing on "*de facto* Control"

Under the Draft Foreign Investment Law, who has "control" is the key to determine whether an investor or an investment is Chinese or foreign. In the event of a proposed investment by an offshore investor in a "restricted" business, if the offshore investor can provide satisfactory evidence to MOFCOM showing that it is ultimately controlled by Chinese investors, MOFCOM will treat such investment as domestic. On the contrary, a Chinese entity controlled by foreign

1 Although the Draft Foreign Investment Law does not make a reference to the Catalogue, it is probable that the new "restricted" and "prohibited" catalogues to be adopted by the State Council will replace the Catalogue. It remains to be seen to what extent the new catalogues will differ from the "restricted" and "prohibited" categories in the Catalogue.

2 Offshore structures involving Chinese businesses engaged in "prohibited" activities currently are only possible through the use of VIE structures, but such structures will be challenged and likely disallowed once the Draft Foreign Investment Law comes into effect (assuming substantially in its current form).

investors will be deemed as a foreign investor, and the definition of "foreign investment" will expressly include foreign control of a Chinese business by means other than equity ownership, such as through contract or trust arrangements. In essence, MOFCOM will look at the investor with ultimate control rather than the type of entity used for the investment in determining whether an investment is foreign or domestic.

The Draft Foreign Investment Law defines "control" in respect of a company as (a) directly or indirectly holding 50% or more of the stock, equity, property interests, voting rights or other similar rights or interests in the company; (b) possessing the right or ability to (i) directly or indirectly appoint 50% or more of board members, (ii) ensure that its nominees will obtain 50% or more of board seats, or (iii) exert significant influence over decisions of the board or shareholders meeting; or (c) being able to exert decisive influence over operational, financial, human resources or technical matters of the company through contract, trust or other means.

However, the above definition raises some questions and calls for further clarifications. For example, what if Chinese and foreign investors both satisfy one or more prongs of the "control" definition? Would the single largest shareholder of a public company (e.g., the Chinese founders of some foreign-listed Chinese companies) satisfy the "control" definition?

Providing Greater Commercial Flexibility

Under the current system, MOFCOM (or its local counterparts) reviews, as part of the application package for foreign investment approval, the main transaction documents for a proposed investment, including the equity/asset purchase agreements, the joint venture contracts and the articles of association. It is not uncommon for an approval authority to challenge some of the contractual provisions that have been negotiated and agreed-upon between the parties to a transaction. This limits the parties' freedom and ability to include deal-specific terms in the main transaction documents, such as closing conditions, price adjustments, etc.[3] Such practice will be changed per the Draft Foreign Investment Law, which does not include transaction documents in the list of application information and materials required to be submitted to the approval authority. Further, MOFCOM has made it clear in the Explanatory Notes that it will focus its review on the nature of the investor and the investment, but that it will not scrutinize the underlying agreements. This will give foreign investors greater flexibility to negotiate the terms of their investments and include such terms in the main transaction documents.

Regulation of VIE Structures

VIE (variable interest entity) is a term used by the U.S. Financial Accounting Standards Board to refer to an entity (the VIE) that is required to be consolidated by another entity (the primary beneficiary) which possesses a controlling financial interest in the VIE, although the primary beneficiary does not have a majority or even any of the equity interest in the VIE. In the Chinese context, the VIE structure can be used to enable an offshore entity that, due to foreign ownership restrictions, does not own a majority stake in a Chinese entity, to nonetheless consolidate such Chinese entity. In a typical Chinese structure, the VIE is owned by Chinese founders and holds the necessary licenses/permits to operate the business that is subject to foreign ownership restrictions. The Chinese founders invest along with foreign investors in an offshore holdco, which separately establishes a wholly-owned subsidiary in China to enter into captive contractual arrangements with the VIE which provide such wholly-owned subsidiary, and indirectly the offshore holdco, with economic benefits of and control over the VIE that replicate the economic benefits and control of direct ownership.

The VIE structure was initially introduced in China by Internet companies in the early 2000s. Since

3 This has prompted the popular use of side agreements to document certain agreement between the parties that cannot be included in the documents required to be submitted to and reviewed by the approval authority. The PRC Supreme Court has upheld the validity of such side agreements, even if they have not been approved by the authority, so long as they do not contain any material changes to the documents that have been submitted to and approved by the authority (e.g., registered capital, business scope, term of operation and capital contributions).

then, nearly all overseas-listed Chinese Internet and technology companies have operated under this structure. Despite the prevalent use of the structure, and except for the issuance of certain ad hoc ministerial rules that aimed to regulate the use of the structure in specific industries, PRC law is unclear about the legality of the VIE structure. Such regulatory uncertainty is often a cause for concern among foreign investors.

The Draft Foreign Investment Law represents a major step towards the formal regulation of VIE structures. "Contractual control", which has become a synonym for the VIE structure, is expressly listed as one form of foreign investment. MOFCOM will treat an investment through the VIE structure as a foreign investment, if the VIE, although 100% Chinese-owned, is ultimately controlled by foreign investors.

It leaves a placeholder on how pre-existing VIE structures in restricted or prohibited industries should be handled. MOFCOM discusses three possible approaches in the Explanatory Notes:

1. *Reporting*. A pre-existing VIE can continue to operate its business under the same structure if it notifies MOFCOM that it is controlled by Chinese investors.

2. *Reporting and Verification*. A pre-existing VIE can continue to operate its business under the same structure if it requests MOFCOM to verify its Chinese-controlled status *and* MOFCOM so verifies.

3. *Approval*. A pre-existing VIE should apply to MOFCOM for foreign investment approval, and MOFCOM would decide whether to grant such approval based on various factors including the identity of the VIE's *de facto* controller.

The above approaches suggest that after the Draft Foreign Investment Law is adopted, MOFCOM will likely permit a VIE structure to continue to operate, even in a restricted or prohibited industry, if the VIE is ultimately controlled by Chinese investors. However, if a pre-existing VIE structure engaged in "restricted" or "prohibited" business is not controlled by Chinese investors[4], the potential impact of the Draft Foreign Investment Law may be severe and also hard to predict. Grandfathering all of them may sound too good to be true, whereas forcing all such VIEs to be unwound seems too harsh and draconian. MOFCOM indicates in the Explanatory Notes that it is keen to seek public opinions on the treatment of pre-existing VIEs.

Once the Draft Foreign Investment Law is adopted (assuming substantially in its current form), foreign investors will no longer be able to use the VIE structure to bypass foreign investment restrictions and to operate in prohibited (and certain restricted) industries via the structure. Therefore, we could expect significantly less use of VIE structures in this context. For future investments in "restricted" businesses involving VIEs that are ultimately controlled by Chinese investors,[5] MOFCOM may treat such investments as domestic. However, the Draft Foreign Investment Law does not provide for such "domestic treatment" in respect of investments in "prohibited" businesses through VIEs and offshore entities controlled by Chinese investors. Apparently, the Chinese government will not allow Chinese investors to make "round-trip" investments in "prohibited" businesses, which seems to make sense because foreign investment in "prohibited" industries is supposed to be banned completely.

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4 Such VIE structure could have been controlled by foreign investors from the beginning or could have been formed initially by Chinese founders whose interests were subsequently diluted as a result of overseas capital raisings.

5 One may wonder why Chinese investors would want to use VIE structures after the adoption of the Draft Foreign Investment Law. VIE structures have also been used to address a different regulatory issue in China. Circular 10, which came into effect in September 2006, has made it nearly impossible in practice for Chinese founders to set up an offshore structure enabling overseas financings with the offshore holding companies owning the Chinese operating company. The VIE structure is one of the ways to overcome Circular 10 hurdles. If MOFCOM's practice under Circular 10 remains unchanged after the promulgation of the Draft Foreign Investment Law, Chinese founders may in some circumstances still use VIEs for purposes of dealing with the Circular 10 issue.

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If adopted substantially in its current form, the Draft Foreign Investment Law will modernize the existing regime for foreign investment in China and have a profound impact on both existing investments and future transactions. In summary, foreign investors may no longer be able to use the VIE structure, which will be regulated under the new law as one form of foreign investment, to circumvent foreign investment restrictions. At the same time, foreign investments in a vast majority of businesses that are not on the "restricted" and "prohibited" catalogues will be facilitated by the new law, as approval from MOFCOM (or its local counterparts) will no longer be required.

There is no anticipated timetable with regard to the formal promulgation and effective date of the Draft Foreign Investment Law. As a procedural matter, the adoption of the Draft Foreign Investment Law would require the approval of the plenary session of the PRC National People's Congress. Given the priority of the Draft Foreign Investment Law in relation to the other pending legislations as well as the legislative process of the National People's Congress, it is unlikely that the Draft Foreign Investment Law will come into effect within one year. Moreover, several rounds of consultations among different ministries and interest groups are required before the new law can be finalized, and certain key accompanying legislation, such as the "restricted" and "prohibited" catalogues to be issued by the State Council, will need to be in place. We, as well as the legal and business market in China, will closely watch and follow the legislative process of this important law on foreign investment.

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