

KIRKLAND ALERT

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Draft Foreign Investment Law Proposes Fundamental Changes to the PRC Foreign Investment Regime

On January 19, 2015, the PRC Ministry of Commerce (“MOFCOM”) published a draft of the proposed new Foreign Investment Law (the “Draft FIL”), which is open for public comments until February 17, 2015. At the same time, MOFCOM published an accompanying explanatory note of the Draft FIL (the “Explanatory Note”), which contains important information about the Draft FIL, including its drafting philosophy and principles, main content, plans to transition to the new legal regime and treatment of the variable interest entity (“VIE”) structure.

The Draft FIL is intended to replace the current foreign investment legal regime consisting of three laws: the Sino-Foreign Equity Joint Venture Enterprise Law, the Sino-Foreign Cooperative Joint Venture Enterprise Law and the Wholly Foreign-Invested Enterprise Law, as well as detailed implementing rules (collectively, the “Current FIE Laws”). The Draft FIL proposes sweeping changes to the PRC foreign investment legal regime and may have a profound impact on Chinese companies listed or to be listed overseas and foreign companies investing in China. This note explains the major provisions of the law and highlights the potential impact of the Draft FIL if it were to be adopted as well as outstanding questions that will need to be answered either by PRC regulators or by market practice.

Fundamental Changes in the Draft FIL

If adopted in its entirety, the Draft FIL would make the following fundamental changes to current PRC law:

1. Default National Treatment and the Negative List

The default rule under the Draft FIL is to treat foreign-invested enterprises (“FIEs”) the same as PRC domestic entities. The exception is for those FIEs that operate in industries deemed to be either “restricted” or “prohibited” in a “Negative List.” Because the Negative List has yet to be published, it is unclear whether it will differ from the current list of industries subject to restrictions or prohibitions on foreign investment. The legal regime under the Current FIE Laws requires numerous governmental approvals specific to FIEs. In comparison, the Draft FIL provides that only FIEs operating in industries on the Negative List will require “Entry Clearance” and other approvals that are not required of PRC domestic entities.

The main focus of the Entry Clearance approval process is to consider the impact of foreign investment on matters of public interest, including national security, energy resources and technological innovation. FIEs wishing to operate in industries on the Negative List will be required to file an Entry Clearance application to provide such information as the identities of the foreign investors and actual controlling parties, investment amounts, and the investment’s impact on matters of public interest. However, investment transaction documents, such as partnership, joint venture or share purchase agreements, need not be provided.

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2. De Facto Control

One of the core concepts of the Draft FIL is “de facto control,” which emphasizes substance over form in determining whether an entity will be treated as an FIE or a PRC domestic entity. This determination requires considering the nature of the investors that exercise control over the entity.

- *Nature of investors.* Under the Draft FIL, investors will either be Chinese or foreign. “Chinese investors” are natural persons who are Chinese nationals, Chinese government agencies and any domestic enterprise controlled by Chinese nationals or government agencies. “Foreign investors” are foreign citizens, foreign governments, international organizations and entities controlled by foreign citizens and entities.
- *Control.* An investor will be deemed to have “control” over an entity if it either (i) directly or indirectly holds 50% or more of the equity interests, assets, or voting or similar rights, (ii) possesses the power to appoint or secure at least 50% of the board of directors or the power to “materially influence” the vote of the board of directors or the shareholders, or (iii) possesses “decisive influence” (via contractual, trust or “other arrangements”) over the operations, finances, human resources, technology or “other aspects.” The last scenario would appear to attribute control over a VIE to the wholly-foreign owned enterprise and its owners under a typical VIE structure.

Foreign entities controlled by Chinese investors can request to be treated as Chinese investors by submitting supporting documents to MOFCOM in their Entry Clearance application.

3. Three Potential Approaches to the VIE Structure

Under the current legal regime, the VIE structure exists in a gray area and is often used by foreign investors to invest in Chinese companies operating in industries deemed to be “restricted” or “prohibited.” In some instances, the VIE structure is also used by domestic companies to restructure under an offshore holding structure while avoiding PRC legal restrictions on “round tripping” structures. The Draft FIL attempts to address the treatment of VIE structures through the concept of de facto control, as discussed above. Article 158 of the Draft FIL is titled “Treatment of Contractual Control,” though it contains only a reference to the Explanatory Note, which proposes three possible approaches for dealing with businesses that employ the VIE structure.

- *Approach One: Notice Filing.* FIEs with a VIE structure that are de facto controlled by Chinese investors would file a notice with an agency of the State Council (the “Agency”). There would be no substantive review and filings could be optional for certain FIEs.
- *Approach Two: Certification Application.* FIEs with a VIE structure would be required to apply to the Agency for affirmative certification of de facto control by Chinese investors. The Agency would only consider the nature of investors exercising de facto control.
- *Approach Three: Entry Clearance Application.* FIEs with a VIE structure would be required to apply to the Agency for Entry Clearance and the Agency would base

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its decision on the nature of the investors exercising de facto control as well as other factors considered in the Entry Clearance application process.

4. National Security Review and Information Reporting System

The Draft FIL proposes to set the scope for national security review of foreign investments into the PRC to broadly cover “any foreign investment that harms or likely endangers national security.” It would also establish a comprehensive information reporting system requiring foreign investors and FIEs to file reports within 30 days of a foreign investment and upon changes in the foreign investment. FIEs would also be required to file annual reports and large FIEs would be required to file quarterly reports. Failure to file timely reports or material misstatements or omissions in a report could result in severe penalties, including fines and imprisonment for those responsible.

Impact of the Draft FIL

If the Draft FIL is adopted in its current form, it could have a profound impact on the ability of foreign investors to participate in key sectors of the Chinese economy. It could affect the ability of Chinese companies to raise capital from foreign investors as well as investment options for foreign investors. Some of our observations concerning the potential impact of the Draft FIL include:

- The Draft FIL would streamline the Chinese government’s oversight of foreign investment into the PRC, and should make investment easier and increase investment opportunities for foreign investors, both of which should increase foreign investment into China.
- The Draft FIL could help resolve uncertainties surrounding the VIE structure. Since the Draft FIL uses de facto control in determining whether an entity may participate in restricted or prohibited industries, companies with VIE structures will want to assess whether keeping that structures is necessary or advisable. Some industries deemed restricted or prohibited under the current regime may not be on the Negative List, which would render the VIE structure unnecessary for companies in those industries. Companies controlled by foreign investors and operating in industries included on the Negative List may no longer be shielded by their VIE structures and would not be permitted to continue operating with their current level of foreign control. Given the uncertainties that the VIE structure creates for investors, companies de facto controlled by Chinese investors may choose (and some investors may request companies) to terminate or replace their VIE structure.
- Given that a foreign entity could be deemed to be de facto controlled by Chinese investors under the Draft FIL, some companies that operate in industries on the Negative List, especially those listed or planning to list overseas, will want to evaluate the nature of their investors and control structures. Those that are currently under the de facto control of foreign investors may consider changes to their structure or corporate governance that would put them under de facto control of Chinese investors. Some of these changes, however, such as structures that give certain shareholders greater voting rights than others, may not be permitted by the listing rules of some stock exchanges.
- As the Draft FIL would clarify the legal status of VIE structures, their presence

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may no longer impact MOFCOM's anti-trust review of M&A deals. This would clear a roadblock that currently holds back sizeable transactions, as parties are generally unable to receive anti-trust clearance without first removing their VIE structure. If the Draft FIL Law changes MOFCOM's antitrust review practice, it may facilitate control mergers and acquisitions in some industries, most notably the internet and high-technology industries. The Draft FIL may also create more M&A opportunities for foreign private equity investors that currently refrain from investing in companies with VIE structures.

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- Compared to the information reporting systems of other developed countries, the reporting obligations under the Draft FIL are significantly more burdensome and require sensitive information, such as the identity of the actual controlling party, which can be hard to identify, and the source of investment funds. The manner in which these reporting obligations are implemented and enforced could have a significant impact on whether the Draft FIL actually attracts more foreign investors to the PRC.
- China's foreign exchange control system is highly regulated and may need to be revised in order to accommodate the changes introduced by the Draft FIL.
- The Draft FIL proposes a three-year period during which FIEs established under the Current FIE Laws can transition their legal form and governance structure to comply with the relevant laws under the new regime. During this transition period, it is possible that implementing rules and regulations may make substantial accommodations to facilitate successful transitions.

Uncertainties Raised by the Draft FIL

The Draft FIL introduces new legal uncertainties and administrative procedures, some of which include severe administrative and criminal liabilities for companies and individuals. It may take investors some time to become comfortable with these risks and uncertainties, especially if the PRC government fails to clarify a number of matters. The resolution of these uncertainties will play a significant role in determining the eventual impact of the Draft FIL. Some of these uncertainties include:

- the content of the Negative List, and to what extent Chinese regulators will use this opportunity to reduce the number of restricted or prohibited industries;
- what will constitute de facto control, and the meanings of "materially influence" the vote of the board or shareholders and "decisive influence" on a company;
- how much discretion PRC regulators will take in finding de facto control in the case of individual companies and factual circumstances;
- how the rights of foreign investors might impact the determination of de facto control, especially negative control rights such as veto rights, and how situations in which both Chinese and foreign investors possess elements of de facto control will be handled;
- whether companies will restrict Chinese shareholders from transferring their shares to foreign investors in order to maintain control by Chinese investors, as such restrictions would reduce the liquidity of the shares and the valuation of the company, and would also prevent companies from conducting multiple financ-

ings that might dilute the interest of their Chinese shareholders;

- what “other factors” will be considered in the Entry Clearance application process and how much discretion PRC regulators will have in determining which factors to use in evaluating the VIE structures of individual companies;
- whether companies with VIE structures established before the Draft FIL becomes effective would have to comply with all of its requirements;
- whether clearer standards for national security review will be adopted, or whether the broad definition of “any foreign investment that harms or likely endangers national security” will give MOFCOM too much discretion in reviewing the cases of individual companies;
- whether Chinese founders or other major shareholders would be able to change their personal nationality without affecting whether the company is under de facto control of Chinese investors; and
- how to structure private equity investment agreements and articles of association to ensure that de facto control remains with Chinese investors.

We will continue to monitor updates to the Draft FIL and the eventual adoption and implementation of the new legal regime.

Conclusion

The Draft FIL would introduce fundamental changes to the current legal regime and have a profound impact on Chinese companies listed or planning to list overseas as well as foreign companies investing in China. MOFCOM understands the sensitivities of certain issues and has left room for public comments. We will continue to monitor updates to the Draft FIL and the eventual adoption and implementation of the new legal regime.

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