Newsletter

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1. China's New Draft Foreign Investment Law and its Potential Impact on the VIE Structure (Authors: Gloria XU, Xi YAN)

On January 19, 2015, China's Ministry of Commerce ("MOFCOM") released the Law of the People's Republic of China on Foreign Investment (Draft for Comments) (the "Draft") and an accompanying explanation, the Explanation of the Law of the People's Republic of China on Foreign Investment (Draft for Comment) (the "Explanation").

The Draft has 11 chapters and 170 articles. The number of articles in the Draft is noteworthy because it exceeds the combined number of articles in the current foreign investment laws, namely the Law on Wholly Foreign-owned Enterprises, the Law on Sino-Foreign Equity Joint Ventures, and the Law on Sino-Foreign Cooperative Joint Ventures(collectively, the "Current Foreign Investment Laws"). Other than the number of articles, there are many other important provisions in the Draft relating to the following:

(i) <u>Who is a Foreign Investor and What is Foreign Investment</u>: The Draft defines a foreign investor not only based on where it is registered, but also by using the standard of "actual control."

(ii) <u>Administrative Ease</u>: The Draft proposes to replace the case-by-case approval system currently in place with an administrative system similar to the "negative list" approach already used in the Shanghai Free Trade Zone ;

(iii) <u>National Security Review</u>: The Draft further clarifies how national security review will be applied to foreign investment;

(iv) <u>Reporting System</u>: The Draft establishes a foreign investment information reporting system; and

(v) <u>Consolidation of Foreign Investment Laws</u>: The Draft integrates the application of laws on foreign direct investment, equity investment, debt investment, and asset investment.

An important highlight of the Draft is its guidance on the law and related issues in connection with contractual control. This article focuses mainly on the relevant provisions in the Draft on contractual control and analyzes their impact.

Contractual Control Under the VIE Structure

Contractual control forms the basis of the variable interest entity structure (the "VIE Structure"). The VIE Structure permits investors to indirectly invest in a PRC enterprise through contractual arrangements rather than through shareholding. The VIE Structure can help achieve the consolidation of the financial statements of all entities that are part of the structure.

The VIE Structure has mainly been used in two ways. First, the VIE Structure has been used by PRC enterprises when they attempt to list or receive financing outside of the PRC. Second, the VIE Structure has been used by foreign investors as a workaround to avoid China's restrictions on foreign investment in certain sectors.

Under a typical VIE Structure, an offshore special purpose vehicle (the "Financing Vehicle") attains indirect control of a PRC entity(the "VIE Company"). This is achieved through a series of control contracts. The Financing Vehicle ordinarily is the 100% owner of a Hong Kong company, which is the 100% owner of a wholly foreign owned enterprise in the PRC (the "WFOE"). The WFOE, along with the founders of the VIE Company, then sign a series of control contracts with the VIE Company that effectively give the WFOE (and by extension the Financing Vehicle) control over the operations, finances, management, personnel, and other relevant parts of the VIE Company.

Though the VIE Structure has been in existence for a long time, it has always been in a legal "gray area." For example, it is unclear whether the Current Foreign Investment Laws and related laws such as the Catalogue Relating to Guidance on Foreign Investment Industries and the Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors apply to the VIE Structure or not. Furthermore, there were only some stipulations in departmental regulations on the VIE Structure, but no PRC laws that defined the legal parameters of the VIE Structure.

With the release of the Draft, there are finally some defined legal parameters set for the VIE Structure.

The Draft's Stipulations about the VIE Structure

There are five articles in the Draft that are closely related to the concept of contractual control, and by extension, the VIE Structure, namely Article 15 (Foreign Investment), Article 18 (Control), Article 45 (Deemed Domestic Investments if there is Actual Domestic Control), Article 149 (Legal Liability for Avoidance), and Article 158 (Further Arrangement for Contractual Control). These definitions of control assist in defining the legal parameters of the VIE Structure, while also removing doubt that previously existed over the validity of the VIE Structure.

1) Who is a Foreign Investor and What is Foreign Investment

With respect to the definition of foreign investors and foreign investment, the Draft specifies that the place of incorporation is not the only factor that is considered. Rather, the Draft introduces the concept of "actual control." Specifically, Article 15 of the Draft specifies that foreign investment include situations where foreign investors obtain control or interests in PRC domestic enterprises (e.g. VIE Companies)through contractual or trust arrangements (e.g. the VIE Structure). Article 11 provides that PRC domestic enterprises controlled by foreign nationals, entities, or other organizations registered abroad will be deemed as foreign investors.

Accordingly, where foreign investors obtain control of a VIE Company via the VIE Structure, the VIE

Company will be deemed as a foreign invested enterprise. Such deemed foreign invested enterprise will be subject to approval requirements, national security review, and information reporting requirements.

Therefore, where foreign investors intend to establish a VIE Structure and control the VIE Company in order to avoid the PRC's restrictions or prohibitions on foreign investment, the Draft unequivocally sets forth that there are legal risks associated with this approach.

With respect to the definition of control, the Draft specifically mentions three scenarios where control exists:

(1) Obtaining over 50% of the shareholding, voting rights, or similar rights of the controlled entity;

(2) Owning less than 50% of the shareholding of the controlled entity, but (i) having the right to determine more than half of the seats of the board of directors of the controlled company, or (ii) having significant influence over the shareholders or the board of directors of the controlled entity; or

(3) Exerting determinative influence over the operations, finances, personnel, technology, or related areas of the controlled entity through methods such as contractual or trust arrangements.

The Draft contemplates a scenario where the above foreign investment maybe deemed to be a domestic investment. Article 45 specifies that where PRC persons actually control the foreign persons in a VIE Structure (including the Financing Vehicle, Hong Kong intermediary, and the WFOE), and the VIE Structure has a VIE Company operating in a sector where foreign investment is restricted, an application can be made to have a foreign investment be deemed as a domestic investment. In these cases, investment into a VIE Structure is deemed to be a domestic investment even if the investment occurred outside of the PRC.

2) Impact on the VIE Structure

The major impact the Draft will have on the VIE Structure are as follows:

(1) Who has Actual Control

In the early stages of a business with a VIE Structure, it may not be difficult to determine who has actual control because the founders own all the shares and shareholding interests in the entities comprising of the VIE Structure, whether foreign or domestic. However, as the business matures and receives private equity investments from investors who subscribe for preferred shares in the Financing Vehicle, actual control may be more difficult to determine, and is subject to the discretion of the regulatory authorities.

Since the Draft does not further specify or define what is meant by "significant influence," "determinative influence," or control where both PRC and foreign investors meet the definition of control, the Draft presents uncertainties over how to determine actual control within a VIE Structure.

(2) Restrictions on Foreign Investment in PRC Enterprises Controlled by PRC Persons

While the Draft states that foreign investment in PRC enterprises may be deemed as domestic investments not subject to the PRC's foreign investment laws where PRC persons control foreign entities in a VIE Structure (including the Financing Vehicle, the Hong Kong intermediary, and the WFOE), there are important limits, as follows:

(i) Article 45 of the Draft stipulates that these types of investments may be deemed as domestic investments where the VIE Company is operating in a sector where foreign investment is restricted. The specific reference in Article 45 to restricted sectors may be interpreted to mean that these types of investments may not made in sectors where foreign investment is prohibited, even if PRC persons control the foreign entities in the VIE Structure.

(ii) The regulatory authorities have discretion when determining whether PRC persons actually control the foreign entities in a VIE Structure.

3) Impact on Existing Companies with Contractual Control Arrangements

In the Explanation that accompanied the Draft, MOFCOM listed three proposals relating to the handling of contractual control issues. We do not know at this time which one of the proposals, or a separate proposal altogether, will ultimately be adopted.

(1) Proposal I- Reporting

Foreign invested PRC enterprises (including VIE Companies) that are contractually controlled by foreign entities (including WFOEs) report to the competent State Council authority on foreign investment that they are actually controlled by PRC persons. Following such reporting, these foreign invested PRC enterprises can keep their contractual control structure and continue with their operations as usual.

If this proposal is implemented, the enterprises established under the VIE structure prior to the promulgation of the Law of the People's Republic of China on Foreign Investment, will only need to report to the authorities that PRC persons actually control foreign investors, meaning this proposal will likely have a minor impact on the existing VIE Structure unless such actual control does not exist.

(2) Proposal II- Reporting and Determination

Foreign invested PRC enterprises (including VIE Companies) that are contractually controlled by foreign entities (including WFOEs) apply to the competent State Council authority on foreign investment for consideration as to whether its PRC persons control foreign investors. If the authorities determine that PRC persons actually control foreign investors, then these foreign invested PRC enterprises can keep their contractual control structure and continue with their operations as usual.

The difference between this proposal and proposal #1 above is that there is a requirement to apply to, and to obtain approval from, the authorities for recognition that the PRC persons associated with such PRC enterprises actually control the foreign investors associated with such enterprises.

(3) Proposal III- Entry Clearance

Foreign invested PRC enterprises (including VIE Companies) that are contractually controlled by foreign entities (including WFOEs) apply to the competent State Council authority on foreign investment for entry clearance. The authorities will consider many factors, only one of which is who has actual control, when deciding whether or not to grant entry clearance.

Comparing with proposal #2, this proposal affords authorities with more discretion when determining whether an existing VIE Structure can be maintained because the existence of actual control is only one factor they may consider, which may result in more uncertainty.

Next Steps for the Draft

In accordance with relevant legislative requirements, the next step is for MOFCOM to gather comments, revise the Draft, and prepare the Draft for examination. MOFCOM will then prepare a bill, which will be deliberated and revised by the National People's Congress, and finally put forward for a vote. If the bill is passed, it will become law. Therefore, there will be some time before the Draft becomes law, and there may be changes between this Draft and the law that is ultimately promulgated. We will keep you updated on all developments related to the Draft as it works its way through the legislative process.

2. Shenzhen's New QDIE Pilot Program Allows Qualified Foreign and Domestic Fund Managers to Raise Funds from Chinese Investors for Overseas Investments (Authors: James WANG, Li YANG)

On December 8, 2014, the General Office of Shenzhen's Municipal Government issued to district governments and its affiliate institutions the Circular Forwarding Provisional Measures Relating to the Shenzhen Pilot Scheme for Overseas Investment by Qualified Domestic Investors formulated by the Shenzhen Financial Development Services Office (Shen Fu Ban Han [2014] No. 161). This circular announced that the Provisional Measures Relating to the Shenzhen Pilot Scheme for *Overseas Investment by Qualified Domestic Investors* formulated by the Shenzhen Financial Development Services Office (the "**Provisional Shenzhen QDIE Measures**") had been approved by the Shenzhen Municipal Government, and instructed local governments and their affiliate institutions to implement the measures. The issuance of the Shen Fu Ban Han [2014] No.161 circular formally launched a program commonly referred to as the "**Shenzhen QDIE Pilot Program**."

Following the launch of the Shenzhen QDIE Pilot Program, a news agency reported that Southern Capital Management Co., Ltd., a subsidiary of the China Southern Fund, was the first financial institution that received a pilot qualification under the program.[1]

This commentary summarizes the policies in the Shenzhen QDIE Pilot Program.

Overview and Comparative Analysis of the QDIE Scheme

"**QDIE**" means a Qualified Domestic Investment Enterprise. Though the term QDIE is frequently used in the Chinese market and in news reports, its exact meaning has not yet been specifically defined in any laws or regulations. In the Chinese market, QDIE is generally understood as an institutional arrangement that enables eligible asset management enterprises approved by the relevant Chinese authorities to raise funds from domestic investors for the purposes of investing in assets overseas. This represents a reform because present Chinese currency controls do not permit the free convertibility of the RMB out of China.

The QDIE scheme is similar to an existing scheme that has been implemented nationwide called the qualified domestic institutional investor scheme ("**QDII**"), which also permits qualified domestic institutions to raise funds from domestic investor for the purposes of investing in overseas securities[2]. The QDII scheme is narrow in its scope, however, only being available to a limited number of qualified institutions such as commercial banks, trust companies, securities companies, fund management companies, insurance companies, and national social security funds. Furthermore, the scope of investments permitted under the QDII program is generally restricted to overseas securities investment. As the demand from domestic investors to invest overseas increases along with global asset allocations, there is great demand in the Chinese market PRC market for an institutional arrangement that is not as narrowly tailored as the QDII scheme in terms of eligibility criteria and investment scope. A more accommodating approach would allow a wider range of investment management institutions to raise funds from domestic investors for the purposes of overseas investments in a broader range of assets.

To date, there are no nationwide laws or policies on the QDIE. However, Shanghai's launch of the Qualified Domestic Limited Partnership ("**QDLP**") pilot program in April 2012 is similar because it enables overseas investment fund management enterprises that receive a pilot qualification to raise funds from qualified domestic limited partnerships in China and thereafter establish an investment fund vehicle in the form of a limited partnership for the purposes of investing in overseas secondary

[1] Shenzhen formally launches QDIE policies. See, http://news.hexun.com/2015-01-16/172432666.html.
[2] The China Securities Regulatory Commission promulgated the *Tentative Measures for the Administration of Overseas Securities Investments by Qualified Domestic Institutional Investors* in June 18, 2007.

markets. Therefore, the essence of Shanghai's QDLP pilot program and the QDIE scheme overlap with each other, but the two programs are not identical since the QDLP scheme could be construed as a subset of the QDIE scheme if we understand QDIE in its broad sense (as the QDIE also permits qualified domestic institutions to raise funds from domestic investors for the purposes of overseas investments). From this perspective, the Shanghai QDLP pilot program may be regarded as the first QDIE scheme that was formally launched in China, despite the fact that the scope of Shanghai's QDLP pilot program is relatively limited according to the market, which has interpreted Shanghai's QDLP program as providing a channel for foreign hedge fund management institutions to access Chinese domestic capital. By contract, the Shenzhen QDIE pilot scheme casts a wider net and contains more reforms on items such as eligibility criteria and investment scope.

Policy Highlights of the Shenzhen QDIE Pilot Program

According to the *Shenzhen QDIE Provisional Measures*, domestic or foreign investment management enterprises in Shenzhen may apply to the Shenzhen QDIE Pilot Program Joint Committee (the "**Joint Committee**") to be qualified as an "**Overseas Investment Fund Management Enterprise**." The Overseas Investment Fund Management Enterprise may then raise funds from "**Qualified Domestic Investors**" in China within an approved foreign exchange quota. After obtaining sufficient funds from Qualified Domestic Investors, the Overseas Investment Enterprise may then establish an "**Overseas Investment Enterprise**" for the purposes of directly investing in overseas assets.

Highlights of the Shenzhen QDIE Pilot Program are as follows:

1) Overseas Investment Fund Management Enterprise

According to the *Shenzhen QDIE Provisional Measures*, both eligible domestic and foreign-invested investment management institutions may apply to be qualified as an Overseas Investment Fund Management Enterprises. Criteria that shall be met by the foreign-invested and domestic institutions applying for the pilot qualification vary in certain aspects and are respectively summarized as follows:

Criteria	Foreign-invested Applicant	Domestic Applicant
Registered Capital / Capital Commitment	- No less than US $2 million or its equivalent (monetary contribution only); - 20% or more of which shall be contributed within 3 months of the issuance of the business license and the remainder of which shall be contributed in 2 years.	- No less than RMB 10 million (monetary contribution only); - 20% or more of which shall be contributed within 3 months of the issuance of the business license and the remainder of which shall be contributed in 2 years.
Criteria for the controlling investor (general	(1) At least 3 continuous years of operational and managerial history in overseas investment funds with good investment performance records;	Criteria (1), (3), and (4), as applied to the controlling investor (general partner) of a foreign-invested applicant, or its affiliated entity, also apply to the controlling investor

Criteria	Foreign-invested Applicant	Domestic Applicant
partner) of the applicant or its affiliated entity	A robust governance structure, sophisticated internal control systems, and standardized operations; Not been the subject of any severe punishment by the authorities in the country or region it is located in the last 2 years, and is not currently the subject of any investigation by a judicial department or regulator in any material respect. (2) Approved by the authorities in the country or region it is located to conduct the investment management business, and has the required licenses required by local regulators. (3) At least 1 investment personnel with over 5 years of overseas asset management experience and relevant qualifications, and at least 2 investment personnel with over 3 years of overseas asset management experience and relevant qualifications. (4) Other conditions that may be required based on prudence.	(general partner) of a domestic applicant or its affiliated entity. In addition, one of the following is required: (1) A financial license issued by the relevant PRC financial regulator; or (2) Be an equity investment fund management enterprise with no less than RMB 1 billion in assets under management and having continuously operated for at least 3 years.

Of note, the *Shenzhen QDIE Provisional Measures* provide that any enterprise qualified as Shenzhen foreign-invested equity investment management enterprise (i.e. QFLP management enterprise), may apply for the QDIE pilot qualification directly, provided that (1) the controlling investor of such enterprise holds an asset management license issued by Hong Kong's Securities and Futures Commission; or (2) such enterprise has successfully raised a fund, and is currently under sound operation.

2) Qualified Domestic Investors

After obtaining its QDIE pilot qualification, an Overseas Investment Fund Management Enterprise may start raising funds from Qualified Domestic Investors. According to the *Shenzhen QDIE Provisional Measures*, Qualified Domestic Investors shall be the investors who possess an adequate ability to identify and bear risk, and they shall have the following qualifications: (1) for any institutional investors, such investor shall have net assets not less than RMB 10 million; or (2) for any individual investors, such investors shall have financial assets not less than RMB 3 million. Capital subscriptions by each Qualified Domestic Investor shall not be less than RMB 2 million (or its equivalent in a foreign currency).

3) Overseas Investment Enterprises

Once sufficient funds have been received from Qualified Domestic Investors, an Overseas Investment Fund Management Enterprise may form an Overseas Investment Enterprise.

According to the *Shenzhen QDIE Provisional Measures*, Overseas Investment Enterprise may take on the form of a corporation, a partnership, a contractual fund, a segregated account, etc. Regardless of its organizational form, the Overseas Investment Enterprises shall not be less than RMB 30 million (or its equivalent in a foreign currency), and the number of investors in such Overseas Investment Enterprises shall comply with relevant regulations.

4) Foreign Exchange Management

As indicated in a posting published on the official website of the Shenzhen Financial Development Services Office[3], the Shenzhen QDIE Pilot Program has been approved, and the first batch of US$1 billion in foreign exchange quota has been authorized by the State Administration of Foreign Exchange. As the *Shenzhen QDIE Provisional Measures* do not specify a precise foreign exchange quota limit, each Overseas Investment Fund Management Enterprise may apply for a foreign exchange quota based on their individual circumstances and market demand. The quota will eventually be determined by the Joint Committee.

While making overseas investments, Overseas Investment Fund Management Enterprises shall complete formalities for foreign exchange remittance with a fund custodian, and shall comply with relevant provisions relating to the purchase of foreign exchange, quota management, and risk disclosures. At any time, the net amount remitted from the Overseas Investment Enterprise's segregated account shall not exceed the aggregate fund size registered with the Shenzhen Financial Development Services Office.

5) Scope of Overseas Investments

The *Shenzhen QDIE Provisional Measures* do not specify the scope of overseas asset investments Overseas Investment Enterprises are allowed to make. Since no prohibitive or restrictive provisions exist, it is generally understood that Overseas Investment Enterprises may, in addition to investing in assets that QDIIs are allowed to invest in, also make private equity investments, and invest in overseas funds (including private equity funds and hedge funds), real assets, and other asset classes, as long as investment in such assets is not explicitly prohibited or limited by the *Administrative Measures on Overseas Investment* or other relevant laws and regulations.

6) Custodial and Administrative Management

The *Shenzhen QDIE Provisional Measures* require Overseas Investment Fund Management Enterprises to appoint a qualified domestic commercial bank to act as its fund custodian, and to open a segregated fund custodian account with such bank. In addition, Overseas Investment Fund Management Enterprises shall also appoint a qualified administrative manager tasked with product assessment, accounting, investment oversight, transfer agency businesses, and other back-office

[3] "Status of Shenzhen's Financial Industry in the Third Quarter of 2014" (2014-11-13), see, http://www.jr.sz.gov.cn/zwgk/tjsj/zxtjxx/201411/t20141113_2677039.htm

administrative management matters for Overseas Investment Enterprises. According to the *Guidance on Outsourcing Services for Fund Businesses (Trial Implementation)* issued by the Asset Management Association of China, (Zhong Ji Xie Fa [2014] No. 25), which will be effective on February 1, 2015, as an outsourcing institution for a fund business, the administrative manager shall register with, and be a member of, the Asset Management Association.

7) Application Process

The applicant shall first submit application materials to the Shenzhen Financial Development Services Office for qualification as an Overseas Investment Fund Management Enterprise. The Shenzhen Financial Development Services Office will then convene a meeting of the Joint Committee to review the application. After obtaining the pilot qualification and an approved quota, the applicant may then raise funds from Qualified Domestic Investors and file a registration application with the Shenzhen Financial Development Services Office for its Overseas Investment Enterprises once the fund raising is completed.

Outlook on the Implementation of the Shenzhen QDIE Pilot Program

Compared with the current institutional framework, the Shenzhen QDIE Pilot Program is a major because it enables a much wider range of investment fund management institutions to apply for a qualification allowing them to raise funds from domestic investors for the purposes of making overseas investments, while at the same time broadening the investment scope for such overseas investments. It is foreseeable that a great number of foreign and domestic asset management institutions will decide to participate in the pilot program and keep a close eye on its implementation. Since the pilot program has only been implemented for a short period of time, the institutions that are reported to have obtained pilot qualifications are mostly subsidiaries of public fund management companies, trust companies, securities companies[4], so it remains to be seen whether foreign institutions and domestic equity investment fund management enterprises may also successfully obtain pilot qualifications as is expected by the market.

Important Announcement:

[4] On January 28, 2015, a news agency reported that a subsidiary of China Credit Trust has obtained QDIE pilot qualification as the first subsidiary of Trust Companies to have obtained such qualification. Before that, a subsidiary of Great wall Securities has also been reported to have been granted the QDIE pilot qualification. see http://finance.qq.com/a/20150128/009728.html

3. China Relaxes Foreign Exchange Regulations for Domestic Companies Listed Overseas (Authors: Bing XUE, Jialin ZHONG)

As part of China's "going global" policy, in an effort to help Chinese enterprises raise capital abroad, Chinese regulatory agencies recently issued a number of documents and policy guidance. These documents and guidance implement the State Council's earlier requirements to simplify administrative procedures and further reform the regulatory environment.

On December 26, 2014, China's State Administration of Foreign Exchange ("SAFE") released the *Circular on Issues Concerning the Administration of Foreign Exchange in Connection with Overseas Listings(Hui Fa [2014] No.54)* ("Circular 54"), effective December 26, 2014. Circular 54 replaced the *Circular on Issues Concerning the Administration of Foreign Exchange in Connection with Overseas Listing (Hui Fa [2013] No.5)*("Circular 5").In general, Circular 54 relaxes regulatory guidelines and improves the administration of foreign exchange in connection with overseas listings by Chinese enterprises. This commentary provides our observations of Circular 54.

Overseas Listings of Chinese Enterprises: Overview and Definitions

Chinese enterprises list overseas directly or indirectly.

A direct overseas listing occurs when the applicant has been examined and approved by the Chinese regulatory authorities. Thereafter, the applicant applies with overseas regulatory authorities in the target jurisdiction to register and issue shares (or other derivative financial instruments) and list on the target's stock exchange[5].In general, direct overseas listings are always conducted in the form of initial public offerings. The curtain on direct overseas listings by Chinese enterprises has been raised since the listing of Tsingtao Brewery Co., Ltd. on the Hong Kong Stock Exchange in July 15, 1993.

An indirect overseas listing occurs when the applicant's shareholders (including individual founders) first form special purpose vehicles("Offshore Enterprises")[6].These Offshore Enterprises become part of a group of companies that includes operational entities in China, such that the assets and interests of these Chinese enterprises can be consolidated with the Offshore Enterprises. The Offshore Enterprise that serves as the listing vehicle will then apply to list on an overseas stock exchange.

[5] The shares of Chinese enterprises listed in Hong Kong are commonly referred to as "H shares." The shares of Chinese enterprises listed in Singapore are commonly referred to as "S shares." The shares of Chinese enterprises listed in New York are commonly referred to as "N shares."

[6] There are two general types of indirect overseas listings. "Large Red Chip Listings" involve the formation of Offshore Enterprises by domestic enterprises and the subsequent listing of the shares of the offshore listing vehicle. "Large Red Chip Listings" typically involves large state owned enterprises such as China Mobile, China Unicom, China Netcom, China National Offshore Oil Corporation and Bank of China. "Small Red-Chip Listings" involve private enterprises (especially in the TMT industry) whose Chinese founders indirectly form Offshore Enterprises for the purposes of overseas listings. In practice, non-governmental enterprises do not usually pursue Large Red Chip Listings due to the complex approvals associated with them.

In Circular 54, "overseas listing" means the following:

(1) The offering of shares (including preferred shares and securities in the form of share derivatives), convertible corporate bonds, and other securities permitted by laws or regulations ("Overseas Shares"),

(2) by joint-stock limited companies incorporated inside China (excluding Hong Kong, Macau, and Taiwan) ("Domestic Companies"),

(3) upon approval by the China Securities Regulatory Commission ("CSRC"), and

(4) the public listing of the Overseas Shares of Domestic Companies on overseas stock exchanges.

According to official statistics released by the CSRC[7], there have been 199 Domestic Companies are listed overseas (including Hong Kong, Singapore, New York and London)as of October,2014.

History of SAFE's Regulation of Overseas Listings by Domestic Companies

Circular 8, released on January 13, 1994, was a basic framework regulating the management of foreign exchange funds for enterprises issuing shares and listing overseas. After 20 years of changes, the regulatory environment for foreign exchange administration of overseas listed Domestic Companies gradually loosened.

Circular 54 officially reflects such reform. According to Circular 54, SAFE and its branch and administrative offices shall supervise, administer, and inspect foreign exchange registration, the opening and use of bank accounts, cross-border payments, and the exchange of funds in connection with overseas listings of the Domestic Companies.

General Foreign Exchange Registration Procedures

The main foreign exchange registration procedures in connection with overseas listings as set forth in Circular 54 are below. Our remarks on certain provisions are also set forth below.

[7] For more detailed information, please refer to the CSRC's website:
http://www.csrc.gov.cn/pub/newsite/gjb/jwss/jwssgsml/201412/t20141205_264763.html AND
http://www.csrc.gov.cn/pub/newsite/gjb/jwss/jwssgsml/201412/t20141205_264762.html

Procedure	Provisions in Circular 54	Our Remarks
Registration of an Overseas Listing	A Domestic Company shall, within 15 working days following the conclusion of its public offering overseas, complete registration formalities for the overseas listing with SAFE using the following materials: (1) a written application attached with the Registration Form for Overseas Listings (Appendix I of Circular 54) (2) documentary evidence proving that the CSRC approved its overseas listing; (3) an announcement on the completion of the overseas offering; and (4) supplemental materials required by SAFE.	SAFE shall complete the registration of such Domestic Company in its capital account information system (the "System"), print out a registration certificate via the System, and issue such certificate to the Domestic Company after affixing its official seal. Using such certificate, the Domestic Company shall handle bank account openings and other related matters in connection with its overseas listing.
Registration of Overseas Shareholding	After a Domestic Company lists overseas, if any of its domestic shareholders intend to increase or decrease its shareholding in the company in accordance with relevant provisions, such domestic shareholders shall, within 20 working days prior to such increase or decrease in its shareholding, complete overseas shareholding registration formalities with SAFE using the following materials: (1) a written application attached with the Overseas Shareholding Registration Form (Appendix II of Circular 54); (2) a board and/or shareholders resolution approving such increase or decrease in shareholding(if any); (3) approval documents issued by the financial department, the state-owned asset administration department, or any other department (if required); and (4) supplemental materials required by SAFE.	SAFE shall complete the registration of such Domestic Company in its System, print out a registration certificate via the System, and issue such certificate to the Domestic Company after affixing its seal. Using such certificate, the Domestic Company shall handle bank account openings and other related matters in connection with the increase or decrease of shareholding in the listed company.
Special Account for an Overseas Listing of a Domestic Company	A Domestic Company (other than banking financial institutions) shall, using its overseas listing registration certificate, open a "foreign exchange account for the overseas listing of the Domestic Company" with a domestic bank in connection with the exchange, remittance, and transfer of funds for its initial public offering (or follow-on offering) and repurchase matters.	See Appendix III of Circular 54 for details on the account type, the scope of receipts relating to such account, payments, and other matters.
Account for Exchange Settlement and Payments	A Domestic Company (other than banking financial institutions) shall open a corresponding account for exchange settlement and payments with the same bank where it opened the *Special Account for an Overseas Listing of a Domestic Company*. This account is used to	See Appendix III of Circular 54 for details on the scope of receipts relating to such account and account payments.

Procedure	Provisions in Circular 54	Our Remarks
	deposit RMB funds generated from the settlement of foreign exchange in the *Special Account for an Overseas Listing of a Domestic Company*, proceeds from the overseas listing that are transferred back to China in the form of RMB, and funds to be remitted outside China for the purposes of repurchasing Overseas Shares, along with surplus funds relating to such repurchases that are to be transferred back to China.	
Special Account for Overseas Shareholding by a Domestic Shareholder	Domestic shareholders of Domestic Companies shall, using their overseas shareholding registration certificate, open a "special account for overseas shareholding by a domestic shareholder" with a domestic bank. This account handles the exchange, remittance, and transfer of funds relating to the increase, decrease, or transfer of shareholding in such listed companies.	See Appendix III of Circular 54 for details on the account type, the scope of receipts relating to such account, payments, and other matters.
Special Overseas Account	Domestic Companies and their domestic shareholders may open a corresponding special-purpose account overseas to handle matters related to the overseas listing.	The scope of receipts and payments relating to such account shall meet the relevant requirements of Appendix III in Circular 54.
Change in Foreign Exchange Registration	Under any of the following circumstances, a Domestic Company shall modify its overseas listing registration with SAFE within 15 working days of the change, by written application using a recently completed Overseas Listing Registration Form and other evidentiary materials proving the authenticity of the transaction: (1) changing the company's name, registered address, or information about its major shareholders; (2) further issuing(including over-allotment) shares or changing the company's capital, such as converting capital reserves, surplus reserves, or undistributed profits to share capital; (3) repurchasing Overseas Shares; (4) converting convertible bonds into shares (the modification or revocation certificate for foreign debt registration is required); (5) completing share exercise schemes under which domestic shareholders may increase, decrease, transfer, or accept Overseas Shares, thereby changing the company's shareholding structure; (6) changing the previously registered utilization plan and the stated purpose for the proceeds generated from the overseas listing; and	In case there is any change that requires an approval by or a filing with a competent authority, the official reply or filing documents from such competent authority shall also be provided.

Procedure	Provisions in Circular 54	Our Remarks
	(7) changing other relevant content that was previously registered.	

Depositing, Transferring, and Paying Proceeds Generated from Overseas Listings

Under Circular 54, proceeds generated by Domestic Companies from their overseas listings may either be transferred back to China or deposited overseas. Use of such proceeds is required to be consistent with the publicly disclosed content the Domestic Companies issue, such as their prospectuses, offering documents for corporate bonds, circulars and announcements to shareholders, securities filings, and board and shareholders' resolutions ("Publicly Disclosed Documents").

To remit proceeds from the issuance of convertible corporate bonds back to China, a Domestic Company shall transfer such proceeds to its special domestic account for foreign debt and handle the relevant formalities in accordance with the provisions on foreign debt administration. To remit proceeds from the issuance of securities in other forms back to China, a Domestic Company shall transfer such proceeds to its *Special Account for the Overseas Listing of Domestic Companies* (foreign exchange) or its *Account for Exchange Settlement and Payment* (RMB).

Foreign Exchange Regulation of Repurchases by Domestic Companies of their Overseas Listed Shares

Under Circular 54, when a Domestic Company intends to repurchase its Overseas Shares, it may use the overseas and domestic funds generated from the repurchase, provided that it conforms to relevant law. To use or remit domestic funds, the Domestic Company shall complete the corresponding foreign exchange registration procedures.

Income Derived by Domestic Shareholders from Share Sales or Share Transfers of Overseas Listed Shares

Under Circular 54,when a domestic shareholder decreases his or her's holding of Overseas Shares, transfers Overseas Shares held in a Domestic Company, or receives income from the delisting of a Domestic Company from the overseas stock market, the proceeds may be kept overseas or transferred back via the *Special Account for Overseas Shareholding*. If such proceeds is transferred back to a domestic account, the domestic shareholder may handle the domestic funds transfer or exchange settlement formalities with the bank using its overseas shareholding registration certificate. Of note, pursuant to the provisions of Circular5, released in 2013, capital gains are due on the above transactions within 2 years after the acquisitions of such gains. These capital gains are to be repatriated to a special domestic bank account for shareholding decreases.

Han Kun Commentary

Circular 54 demonstrates that SAFE is gradually creating a more relaxed regulatory environment for foreign exchange in connection with the overseas listings of Domestic Companies. Of note, on the same day Circular 54 was promulgated, the CSRC, during a regular news conference[8] indicated that it had made corresponding adjustments to its directory of application materials. Such adjustments include canceling financial audits for overseas listings and removing environmental protection supporting documents from the original application directory. There will be further reform to the regulatory environment when SAFE and the CSRC further decentralize and simply approval procedures in relation to foreign exchange. We look forward to the release of clearer and more accommodating policies that can support indirect overseas listings of private enterprises.

4. New Tax Policies Further Encourage M&A Transactions (Authors: Bing Xue , Bihong QIU)

Based on the new Enterprise Income Tax Law implemented since 2008and the following tax collection and administration documents issued by the State Administration of Taxation ("SAT")on their own or in combination with the Ministry of Finance("MOF"),the enterprise income tax ("EIT")policies and management system on corporate restructuring transactions have been initially established.

On January 8, 2015, the SAT officially released the *Notice of the MOF and the SAT on Issues concerning the EIT Treatment for the Promotion of Enterprise Restructurings* (Caishui [2014] No.109, "Circular 109") and the *Notice of the MOF and the SAT on Issues concerning the EIT Policies for Non-Monetary Asset Investments* (Caisui [2014] No.116, "Circular 116").Both Circular 109 and Circular 116 took effect on January 1, 2014 apply to previous cases that are not yet concluded on their tax treatments. The release of Circular 109 and Circular 116 is a significant improvement to corporate merger and acquisition ("M&A") transactions. As follows, we will make general analysis of China's M&A tax environment under the current tax system in connection with Circular 109 and Circular 116 for your reference.

M&A Policy Environment is Increasingly Improving

Although the capital transactions have become increasingly diversified and the market innovations have become more active in recent years, the updating of finance and tax policies on corporate restructuring transactions has not fully met the expectations of market participants yet. Year 2014 witnessed the firm steps taken by the State Council and its ministries in the decentralization and regulatory transition, which contributed to the improvement of the overall supervision environment for corporate M&As.

[8] For more detailed information, please refer to the CSRC's (News Conference on December 26, 2014): http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwfbh/201412/t20141226_265703.html

On March 7, 2014, the State Council issued the *Opinions on Further Improvement of Market Environment for Corporate M&As*(Guofa[2014] No.14), which proposes to let the enterprises play the key functions in conducting M&As, to amend and improve the policies of special tax treatment for corporate restructurings, to relax the threshold on the proportion of equity (assets) acquired in the total equity (assets) of the target company in order to broaden the applicable scope of special tax treatment policies, and to study and improve the EIT policies related to non-monetary asset investment transactions and the land value-added tax policies related to corporate restructurings.

Existing Tax Collection and Management Policy System for Corporate M&As

Based on the tax resident enterprise ("TRE") and non-tax resident enterprise ("non-TRE") taxation collection and management system built under the new *EIT Law*, the following documents formed the existing tax collection system for domestic and cross-border M&As.

Tax Collection and Management Rules	Release Date	Effective Date	Salient Points
Notice of the MOF and the SAT on Several Issues concerning the EIT Treatment on Enterprise Reorganization (Caishui[2009]No.59,"**Circular 59**")	Apr. 30,2009	Jan. 1,2008	for the first time clarify the applicable principles of general tax treatment and special tax treatment
Notice of the SAT on Improving the EIT Administration on Non-TREs' Equity Transfer Income (Guoshuihan[2009]No.698)	Dec. 10,2009	Jan.1,2008	put the offshore indirect transfer by means of abuse of organizational forms and other arrangement subject to China's collection and management system
Measures for the EIT Administration of Enterprise Reorganizations (SAT Announcement [2010] No. 4)	Jul. 26,2010	Jan. 1,2010	further explains issues concerning collection and management of special tax treatment
Announcement of the SAT on Issues concerning the Application of Special Tax Treatment in the Equity Transfer of Non-TREs (SAT Announcement [2013] No. 72)	Dec. 12,2013	Dec. 12,2013	clarify the application of special tax treatment in the equity transfer of non-TREs

Analysis of the Preferential Tax Policies under Circular 109

(1) Relaxation of the Threshold for Application of Special Tax Treatment in Equity Acquisitions

Article 6(2)of Circular59 stipulates that in the event of equity acquisition, the application of special tax treatment requires the equities purchased by the acquiring enterprise be no less than 75% of the total equities of the acquired enterprise. Circular 109 relax the threshold to 50%.

(2) Relaxation of the Threshold for Application of Special Tax Treatment in Assets Acquisitions

Article 6(3)of Circular 59 stipulates that in the event of asset acquisition, the application of special tax treatment requires the assets acquired by the receiving enterprise be no less than 75% of the transferring enterprise's total assets. Circular 109 relax the threshold to 50%.

Han Kun Analysis:

EIT collection on M&As consists of general tax treatment or special tax treatment. M&As subject to general tax treatment are taxable when the transaction occurs, while M&As subject to special tax treatment could thereby qualify for deferral tax treatment.

Under common classification standards, M&A transactions are generally divided into the equity deal and the asset deal. Circular 109 has relaxed the minimum threshold of application of special treatment in both equity and asset acquisitions from 75% to 50%, a decline of as much as 1/3. This reduction actually lowers the threshold for enterprises to enjoy the benefits of deferred tax treatment in corporate restructurings, and provides the M&A participants with more flexibility in their tax planning.

(3) Special Tax Treatment for Equity and Asset Assignments

The arm's length principle prescribed in the new EIT Law has posed significant challenges for tax arrangements in intra-group restructuring transactions. Circular 59 was unclear on whether the transaction prices in intra-group restructurings must comply with the arm's length principle and thereby caused uncertainty in transaction structure designs and tax collection and administration practices.

Circular 109 now clearly stipulates that in equity or asset transfer transactions where(1)the transfer happens between TREs who have 100% direct investment relationship with each other or are 100% owned by the same TRE holder or the same group of TRE holders; (2) the assignment of equity or assets is effected at net book value; (3) the transaction is conducted for reasonable commercial reasons, not for tax purposes such as tax deduction, exemption or delay); (3)there is no change in the transferor's original operating activities within 12 months after the transaction; and (4)neither the transferor nor the transferee has recognized profit/loss for accounting purposes, such transactions could be subject to the following tax treatment: (1) neither the transferor nor transferee need to recognize any income derived from the transfer; (2) the tax basis of the assets or equity received by the transferee shall be determined based on the original net book value in the hands of the transferor; (3) the depreciation deduction of the assets received by the transferee shall be calculated based on the original net book value.

Han Kun Analysis:

*Under the EIT Law of the People's Republic of China for Foreign-Invested Enterprises and Foreign Enterprises (expired on January 1, 2008), the SAT had released the Notice on EIT Treatment on Equity Transfers of Foreign-Invested Enterprises and Foreign Enterprises(Guoshuihan[1997]No.207,"**Circular 207**"), which provided that in group restructurings for reasonable business purposes, if the foreign enterprise transfers its equity in a Chinese domestic enterprise, or a foreign-invested enterprise transfers its equity in a Chinese or foreign enterprise, to an enterprise(including domestic investment enterprises) with which it has 100% direct or indirect holding investment relationship or are 100% owned by the same person, the transfer price could be the cost price of the equity and be exempted from EIT since no profit or loss is recognized in the transaction.*

Circular 207 gave rise to a wave of equity transfers at cost price in multinational enterprises in 2007. After the new EIT Law became effective, equity transfers at cost price has lost its taxation rules basis.

Circular 109 now clearly sets out that the intra-group assignment of equity or assets at net book value between Chinese TREs with 100% investment holding relationship could be subject to special tax treatment, and that neither the transferor nor transferee needs to recognize profit. This new policy will produce positive impacts on the tax cost controls in intra-group transactions and promote the corporate resource combinations and business restructurings in a healthy way.

Analysis of Preferential Tax Policies under Circular 116

Circular 116 expands the application scope of the deferred tax treatments for non-monetary asset investments from the Shanghai Pilot Free Trade Zone to the rest of China.

(1) Categories of Non-Monetary Assets and Non-Monetary Asset Investments

Under Circular 116, non-monetary assets include assets other than cash, bank deposits, accounts receivable, notes receivable, bonds held until maturity or monetary assets in other forms.

Non-monetary asset investments occur only when non-monetary assets are invested to establish new TREs or injected into existing TREs.

(2) Tax Treatment for TRE Non-Monetary Asset Investment

According to Circular 116, the income arising from non-monetary asset transfer recognized by a TRE that makes non-monetary asset investment may be included in the taxable income of the corresponding year by equal installments within 5 years, and the EIT shall be calculated and paid in accordance with such deferral.

Recognition of Taxable Income

An enterprise that makes non-monetary asset investment shall evaluate the non-monetary assets and calculate and recognize the income from non-monetary asset transfer based on the balance of the fair value as evaluated after deduction of the tax basis.

<u>Determination of Time of Revenues Recognition</u>

An enterprise that makes non-monetary asset investment shall recognize the income from non-monetary asset transfer when the investment agreement becomes effective and the equity registration is completed.

(3) Tax Basis of Income arising from Non-Monetary Asset Investment

According to Circular 106, for an enterprise acquiring equity in the invested enterprise with non-monetary asset investment, the tax basis shall be subject to yearly adjustment by combining the original tax basis of the non-monetary assets and the income from the transfer of non-monetary assets recognized yearly. As for the invested enterprises, the tax basis for acquisition of the non-monetary assets shall be based on the fair market value of such assets.

(4) Adjustment of Tax Treatment if Changes Occur to the Original Transaction within Five Years

The deferred tax treatment over a period of up to five years will produce a preferential tax environment for TREs. Notwithstanding, if the enterprise transfers the acquired equity or recoup such investment within five years from the investment, the deferred tax treatment shall be ceased and the EIT on unconfirmed gains for remaining deferral period shall be calculated and paid in a lump sum at the annual EIT filing in the year when such transfer of equity or recouping of investment occurs. The tax basis of income derived from the equity transfer shall be recognized based upon the original tax basis of the non-monetary assets.

If the enterprise is deregistered within five years, the deferred tax treatment shall be ceased and the EIT on unconfirmed gains for remaining deferral period shall be calculated and paid in a lump sum at the annual EIT filing in the year of the deregistration.

Han Kun Comments:

The promulgation of Circulars 109 and 106 definitely are welcomed by business communities as they brought over relaxed requirements and new favorable tax treatment for corporate M&A transactions. Tax preferential treatments will provide support and guidance for Chinese enterprises in updating the industrial structures and enhancing their competitiveness. Since the two circulars took effectretroactivelyonJanuary1, 2014, we recommend corporate executives to reassess the on-going transactions to explore more favorable tax benefits.

Important Announcement

If you have any questions regarding this publication, please contact:

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