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## Foreign Direct Investment Law

### China's New Draft Foreign Investment Law and its Potential Impact on the VIE Structure

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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) Who is a Foreign Investor and What is Foreign Investment: The Draft defines a foreign investor not only based on where it is registered, but also by using the standard of "actual control."
- (ii) Administrative Ease: 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) National Security Review: The Draft further clarifies how national security review will be applied to foreign investment;
- (iv) Reporting System: The Draft establishes a foreign investment information reporting system; and
- (v) Consolidation of Foreign Investment Laws: 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 be 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..

## ● **Important Announcement**

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