Growth, Consolidation and Liberalization: China's PE/VC Sector in 2020

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Zaiguang Lu and Charles Wu of Han Kun Law Offices review 2020's significant legislative developments affecting China's private equity and venture capital industry, and offer insights on the key trends, challenges and opportunities in the sector.

2020 was a year of both change and continuity in China's private equity/venture capital (PE/VC) sector. China proposed significant antitrust legislation and began undertaking a series of antitrust enforcement actions against large internet companies. China also passed export control and foreign investment national security review legislation, which mirrored developments in other jurisdictions. The impact of this legislation will create both opportunities and challenges for market participants in the country's PE/VC sector. China also accelerated the implementation of its onshore capital markets reforms through the Science and Technology Innovation Board (STAR Market) and the ChiNext Board, paving the way for secondary listings of existing Hong Kong listed companies and primary listing for companies incorporated outside of China. At the same time, Chinese companies continued to list in the United States in advance of a de-listing bill that has now passed both the U.S. Senate and House by unanimous voice vote and has been signed into law. Over time, the trend towards more local listings in both Hong Kong and mainland China is likely to accelerate the shift in investment structures used by both Chinese and non-Chinese investors.

Key Legislation in 2020 Impacting China's PE/VC Industry

Following the trend in other jurisdictions, China proposed major antitrust legislation and implemented export controls, both of which will present both opportunities and challenges for market participants in China's PE/VC industry.

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Platform Anti-Monopoly Guidelines

On Oct. 10, 2020, the State Administration for Market Regulation issued the *Anti-Monopoly Guidelines for the Platform Economy Sector (Draft for Comments)* (the Platform Anti-Monopoly Guidelines) (关于平台经济领域的反垄断指南（征求意见稿）)Anti-Monopoly. If enacted in its current form, the Platform Anti-Monopoly Guidelines will further regulate price discrimination, exclusivity arrangements on platforms, and the use of big data, in line with related antitrust investigations and actions in Western jurisdictions. These policies may impact the investment and

acquisition activities of big platform companies, who have become active in recent years in the PE/VC market investing and acquiring companies and rolling them into a vast ecosystem for users.

Another important provision of the Platform Anti-Monopoly Guidelines is the clarity and certainty which it will bring in relation to the filing obligations of entities with a variable interest entity (VIE) structure. Previously, the State Administration of Market Regulation and its predecessor the Ministry of Commerce did not accept filings from transaction parties with VIE structures, even if the transaction itself otherwise satisfied merger review thresholds. The resulting uncertainty led to creative structuring and risk allocation in both venture capital and acquisition transactions involving parties with VIE structures.

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The Platform Anti-Monopoly Guidelines unequivocally require transaction parties with VIE structures to file merger review applications where merger review thresholds are satisfied. This represents a breakthrough, in the sense that the State Administration of Market Regulation now accepts the concept of transaction parties with VIE structures being permitted to file merger review applications and receive clearances. In fact, on July 16, 2020, the State Administration of Market Regulation granted, on an unconditional basis, a merger review application involving a joint venture where a transaction party had a VIE structure. While more clarity will be needed about the handling of past transactions where a merger review filing may have been required but was not submitted due to non-acceptance by the Ministry of Commerce, there is now welcome acceptance of transaction parties with VIE structures and certainty as to their filing obligations going forward.

While not yet enacted, the principles of the Platform Anti-Monopoly Guidelines have already been felt in the market. Beginning with the suspension of Ant Financial's IPO on Nov. 3, 2020, there has been a series of antitrust enforcement investigations and actions taken by various Chinese regulators against large internet companies, including Alibaba as well as Ant Financial. The extent and scope of these actions may continue to ripple through the market in 2021.

Export Controls

On Aug. 28, 2020, the Ministry of Commerce and the Ministry of Science and Technology jointly published the revised *Catalogue of Technologies the Export of Which Is Prohibited or Restricted in China* (the Catalogue) (中国禁止出口限制出口技术目录), which expanded the list of items subject to export controls. The Catalogue now includes items such as drones, 3-D printing, autonomous driving, sensors, artificial intelligence, pharmaceutical manufacturing, telecommunications equipment, and computer software. Export of such items now requires a license. The Catalogue covers export controlled items proposed to be exported by Chinese entities, but it can, based on a literal interpretation, also apply to the export of such items by the Chinese subsidiaries of multinational technology companies. If following further implementation and

clarification, the Catalogue covers export-controlled items proposed to be exported by the Chinese subsidiaries of multinational technology companies to headquarters or another location outside of China, then there may be a decline in investment and acquisition activity by such multinational technology companies in Chinese targets that produce export-controlled items.

Foreign Investment National Security Review

On Dec. 19, 2020, the Ministry of Commerce and the National Development and Reform Commission jointly promulgated the *Measures for Security Review of Foreign Investments* (外商投资安全审查办法) (the FISR Measures), which will take effect on Jan. 18, 2021. The FISR Measures establish a working mechanism office led by the Ministry of Commerce and the National Development and Reform Commission, which will be tasked with reviewing the national security aspects of foreign investment transactions into China. The structure of the working mechanism office is similar to that of the Committee on Foreign Investment in the United States.

Foreign investment transactions relating to the military, as well as "important" sectors (including information technology and online products and services, financial services, and "critical" technologies) where actual control over the invested enterprise is obtained, are required to be filed for national security review. Under the FISR Measures, actual control exists in the following situations: (i) at least 50% shareholding; (ii) less than 50% shareholding but where voting rights "significantly influence" the resolutions of the board and shareholders; or (iii) other means whereby the foreign investor exercises "significant influence" over business decisions, personnel, finance, technology of the enterprise. The FISR Measures include a number of undefined terms, such as "important", "critical technologies", "actual control" and "significant influence", which will hopefully be clarified in subsequent guidelines. The way in which the FISR Measures are implemented in practice will determine their impact on the market.

> In the Chinese capital markets, 2020 represented a unique paradigm

Trends in 2020

2020's Unique IPO Paradigm

In the Chinese capital markets, 2020 represented a unique paradigm. In 2019, China introduced the STAR Market to much fanfare, but doubt remained about whether it would be a viable public fundraising channel for Chinese companies, especially given that the pipeline for U.S. and Hong Kong IPOs was more mature. In 2020, China followed through on its promises by approving STAR Market listings at a record pace, including:

- Approval of the application by Ninebot (an applicant with an offshore VIE Structure) to list China depository receipts on the STAR Market;

- The STAR Market listing of SMIC, an existing Hong Kong listed company;
- Approval by the Shanghai Stock Exchange of the secondary STAR listing of Geely, an existing Hong Kong listed company; and
- 104 market debuts by successful STAR Markets applicants in the year up to Nov. 13, 2020.

Furthermore, beginning in June 2021, pre-profit applicants will be eligible to list on the ChiNext Board of the Shenzhen Stock Exchange pursuant to a registration based system, thereby providing applicants with an alternative to the STAR Market.

> With the China De-Listing Law now a reality, the market will have to grapple with the uncertainty around the timing and particulars of any potential resolution

On Dec. 18, 2020, President Trump signed the Holding Foreign Companies Accountable Act (the China De-Listing Law) into law, which passed both the U.S. House of Representatives and the U.S. Senate by unanimous voice vote on Dec. 2, 2020 and May 20, 2020, respectively. The China De-Listing Law purports to address the inability of the Public Company Accounting Oversight Board (PCAOB) to inspect the Hong Kong and mainland China based auditors of Chinese companies listed in the U.S. The issue is not new, and has been raised by the U.S. Securities and Exchange Commission during three Presidential administrations (Trump, Obama, Bush). Under the China De-Listing Law, if the two sides do not resolve the PCAOB inspection issue within three years, Chinese companies listed in the U.S. will be forced to de-list from U.S. exchanges. With the China De-Listing Law now a reality, the market will have to grapple with the uncertainty around the timing and particulars of any potential resolution. In 2019, large Chinese companies that were already listed in the U.S., such as JD.com and Netease, completed secondary listings in Hong Kong, potentially as a way to hedge against U.S. regulatory headwinds.

Trends in Investment Structures

The 2020 IPO paradigm appears to be a part of a broader gradual shift in investment structures. While existing venture-backed Chinese start-ups continue to look towards offshore capital markets as an exit opportunity, as part of a business plan spanning back a few years, new Chinese start-ups will have a greater menu of options to choose from. An important consideration is the listing standards for the STAR Market for applicants incorporated in China as compared to those incorporated outside of China. For Chinese incorporated applicants, pre-profit applicants that meet other listing standards can list with market capitalization of as low as Rmb1 billion. For non-Chinese incorporated applicants (such as ones with a VIE structure), the market capitalization threshold increases to Rmb20 billion. Accordingly, this paradigm, along with the China De-Listing Law, may result in Chinese start-ups and investors gravitating towards capital markets in mainland China by seriously considering onshore structures to preserve the lower thresholds in the STAR Market for Chinese incorporated applicants. At the same time, these applicants can apply to list in

Hong Kong, though they will not be eligible to list in the U.S. as the U.S. does not recognize Chinese incorporated companies (but this point may be moot in light of the China De-Listing Law).

There are three main structures used by non-Chinese investors, as described below along with a discussion of their rationale and purpose.

JV Structure – Rationale and Purpose

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Direct Investment (JV Structure)

USD Investor
Offshore
Onshore
Founder
Target

Rationale and Purpose

- Direct investment into an onshore target. Target may receive USD, which is converted to RMB from a capital account into a current account. USD investment may only be used for intended purposes
- Applies to industries that are not restricted to foreign investment
- Target converts into a joint venture upon receipt of foreign investment
- Target may list onshore (including the STAR market and ChiNext with much lower thresholds than offshore targets)
- Continued status as an onshore company permits the target to more easily receive funds from RMB investors in the future (without the need to apply for foreign exchange conversion through the overseas direct investment regime)

Foreign Direct Investment in China

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Wholly Foreign Owned Entity (WFOE) Structure – Rationale and Purpose

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WFOE Structure

Founder
USD Investor
Cayman
Hong Kong
Offshore
Onshore
WFOE

Rationale and Purpose

- Applies to industries that are not restricted to foreign investment (in particular, health care and life sciences companies)
- Operating entity is a wholly foreign owned entity directly owned by a Cayman parent. Hong Kong intermediary for tax purposes (dividend repatriation benefits)
- Structure allows foreign investors to directly invest USD without the need to convert USD to RMB
- Ability to freely list offshore (U.S. and Hong Kong); onshore listing through CDRs possible but much higher thresholds
- RMB investors will have to obtain overseas direct investment (ODI) approvals

Foreign Direct Investment in China

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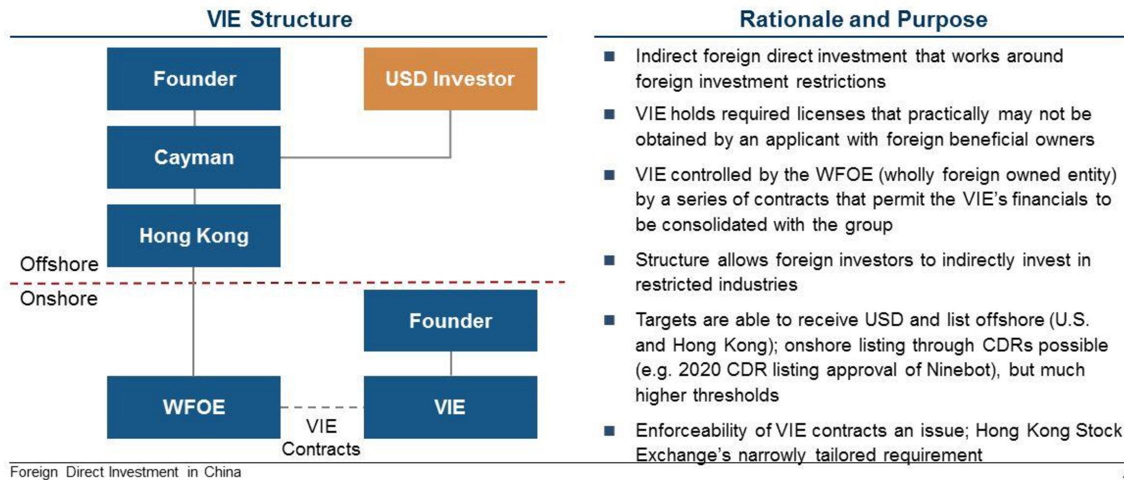

Role of International Private Equity Funds

International private equity investors have always been active in the Chinese market. However, they have up until now largely focused on investing in non-Chinese incorporated targets (including VIE structures) where they receive rights and protections similar to other Western jurisdictions through Cayman Islands parent entities and Hong Kong governing law documents, with an eye towards an eventual listing or exit outside of China. With the convergence of U.S. regulatory uncertainty and the rapid development of onshore capital markets, an interesting dynamic to watch will be investment by these private equity investors in domestically incorporated Chinese companies subject to PRC governing law documents and the *PRC Company Law* (中华人民共和国公司法). Investors' appetite for such targets is growing, slowly but steadily. These investments will differ from those that have typified the market in the last 15 to 20 years. The trend will accelerate even further if China gradually permits these domestically incorporated Chinese companies to hold operating licenses that previously could only be held through a VIE structure.

Impact of Foreign Investment Reviews on Chinese Outbound Investment

With the advent of the final CFIUS regulations, new regulations expanding the list of "critical technology" subject to the CFIUS regulations and export controls, and high profile enforcement cases, 2020 cemented a new foreign investment review regime for Chinese investors in U.S. interests that will most likely endure into the Biden administration. Furthermore, 2020 saw the introduction or implementation of foreign investment review laws similar to CFIUS in a multitude of jurisdictions aligned with the U.S., such as Canada, Australia, the UK, the EU, France and Germany.

While a more pragmatic Biden administration may lead to increased interest in U.S. assets from Chinese investors and the thawing of tensions between Europe and China, the "dry powder" of Chinese strategic investors, Chinese investment funds, and the Asia based funds of international investors will likely continue to focus on growth opportunities in China.

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Outlook for 2021

2021 is expected to be the start of a transition in China's PE/VC market to one that is more oriented towards an IPO exit in mainland China and Hong Kong. With looming U.S. uncertainty and the continued determination by market regulators in China to make its capital markets a viable option for Chinese start-ups, it is forecasted that 2021 will see more Chinese onshore structures and investment activity by foreign investors tailored towards this trend. At the same time, with the certainty provided by the Platform Anti-Monopoly Guidelines with respect to the VIE structure, there may be consolidation amongst industry participants with VIE structures now that merger review filings are accepted and approved. Finally, China is expected to continue the process of liberalization, which may lead to further breakthroughs in investment access and options for non-PRC investors.

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