

China's MOFCOM Aims to Fundamentally Change the Legal Landscape on Foreign Investments

February 2015

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or your regular Skadden contact.

Contributing Attorneys

Gregory G.H. Miao
Shanghai
86.21.6193.8282
greg.miao@skadden.com

Z. Julie Gao
Hong Kong
852.3740.4863
julie.gao@skadden.com

Christopher Betts
Hong Kong
852.3740.4827
christopher.betts@skadden.com

Will H. Cai
Hong Kong
852.3740.4891
will.cai@skadden.com

Alexandra Yin
Shanghai
86.21.6193.8233
alexandra.yin@skadden.com

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

42/F, Edinburgh Tower, The Landmark
15 Queen's Road Central, Hong Kong

JingAn Kerry Centre, Tower II,
46th Floor
1539 Nanjing West Road
Shanghai 200040, China

30/F, China World Office 2
No. 1, Jian Guo Men Wai Avenue
Beijing 100004, China

4 Times Square
New York, NY 10036

skadden.com

In January 2015, China's Ministry of Commerce (MOFCOM) released a discussion draft of the proposed Foreign Investment Law (Discussion Draft), soliciting comments from the public. The Discussion Draft is aimed to, upon its enactment, replace the existing laws regulating foreign investments in China with a uniform law and is expected to affect a wide range of foreign entities and investments in China. The Discussion Draft generally is seen as a welcome change to China's existing legal system and embodies an expected trend to rationalize China's foreign investment regulatory regime in line with prevailing international practice.

The Discussion Draft intends to consolidate the existing laws regulating foreign investments into one uniform statutory regime and unify the corporate legal requirements for both foreign and domestic investments in China. Its 11 chapters cover topics such as foreign investments, market entry, national security review, information reporting, foreign investment protection and regulatory oversight. MOFCOM also released an explanatory note to further illustrate the efforts to unify the corporate legal requirements for both foreign and domestic investments in China.

We set forth some of the key proposed changes below.

Pre-Establishment National Treatment and Negative List Approach

The Discussion Draft proposes a default norm of "national treatment" for foreign investment, which allows foreign investors to make investments on the same terms as Chinese investors, without additional approvals or sector restrictions except as otherwise required by law. In addition, the Discussion Draft abolishes the general requirement of government approval for all foreign investments, which currently include pre-approval from MOFCOM and/or the National Development and Reform Commission.

However, if the underlying business of a foreign-invested enterprise (FIE) falls within the "negative list" or the investment exceeds certain amount, market entry clearance by MOFCOM or its local counterparts would be required. The "negative list" is expected to set forth "restricted" and "prohibited" investments and will be issued separately by the State Council, China's chief administrative authority. Investors with restricted investments must apply for foreign investment approval by submitting required materials while prohibited investments may have little chance to obtain market entry approval.

Under the Discussion Draft, all foreign investment will use one of the general statutory vehicles for business associations allowed under China's Companies Law, such as a limited liability company. The current corporate forms for foreign investments, including equity joint venture, contractual joint venture and the wholly foreign-owned enterprise, no longer will be used. If the draft Foreign Investment Law is enacted in its current form, existing joint ventures or wholly owned foreign entities will have three years to convert to a new corporate form under the new regulatory regime.

In short, foreign investments in China generally are expected to follow the Companies Laws in terms of corporate formality under the Discussion Draft.

China's MOFCOM Aims to Fundamentally Change the Legal Landscape on Foreign Investments

Continued

National Security Review and Reporting Obligations

The Discussion Draft proposes to set up a national security review system on foreign investments that harm or may harm China's national security. This approach seems similar to the review by the Committee on Foreign Investment in the United States (CFIUS).

Since 2011, foreign acquisitions of a controlling stake in PRC domestic enterprises in certain industries are subject to national security review under State Council regulations, but there is no formal statute on this issue. If enacted, the Discussion Draft formally codifies the national security review system and further broadens the scope of review to any foreign investment in any industry. Because the Discussion Draft only sets forth the principal for national security review, it is generally expected that implementation rules will be subsequently adopted to further illustrate the scope and procedure of review. Under the existing administrative rules, foreign mergers or acquisitions are subject to national security review if they involve sensitive military facilities, national defense, agriculture, energy and resources, infrastructure, transport and other matters. Therefore, national security review is expected to become a potential issue for future mergers and acquisitions after the Foreign Investment Law is enacted.

The Discussion Draft allows foreign investors to consult with the State Council by appointment on procedural matters before applying for national security review. However, once government rulings on any national security review cases have been issued, they may not be appealed by foreign investors.

In addition, the Discussion Draft further proposes to set up an information reporting system and requires foreign investors and FIEs to make *ad hoc* and periodic reports. In addition to an investment implementation report or an investment amendment report, an annual report is also mandatory. Large foreign investors meeting certain criteria are required to report on a quarterly basis.

The De Facto Control Test

The Discussion Draft introduces the principle of "actual control" in determining whether a company should be treated as an FIE. The Discussion Draft specifically provides that entities established in China but "controlled" by foreign investors will be treated as FIEs, whereas an entity set up in a foreign jurisdiction would nonetheless be, upon market entry clearance by the MOFCOM, treated as a PRC domestic investor, if such entity is "controlled" by PRC entities and/or citizens.

"Control" is broadly defined in the Discussion Draft to cover the following :

- (i) holding 50 percent or more of the voting rights or similar equities of the subject entity;
- (ii) holding less than 50 percent of the voting rights or similar equities of the subject entity but having the power to secure at least 50 percent of the seats on the board or other equivalent decision-making bodies, or having the voting power to exert material influence on the board, the shareholders' meeting or other equivalent decision-making bodies; or

China's MOFCOM Aims to Fundamentally Change the Legal Landscape on Foreign Investments

Continued

(iii) having the power to exert decisive influence, via contractual or trust arrangements, over the subject entity's operations, financial matters or other key aspects of business operations.

The criteria for determining the "material influence" or "decisive influence" may be specified in the Entrance Approval Guidance for Foreign Investments, which is to be separately issued by MOFCOM.

Impact on Variable Interest Entities

The so-called "variable interest entity" (VIE) structure has been adopted by many PRC-based companies incorporated offshore to obtain necessary licenses and permits in the industries that currently are subject to foreign investment restrictions in China. Under the Discussion Draft, variable interest entities that are controlled via contractual arrangements also could be deemed as FIEs if they are ultimately "controlled" by foreign investors. Therefore, for a company with a VIE structure in an industry that is on the "negative list," the VIE structure may be deemed legitimate if the ultimate controlling person(s) is/are of PRC nationality (either PRC entities or PRC citizens). Conversely, if the actual controlling person(s) is/are of foreign nationalities, then the variable interest entities may be treated as FIEs and, as such, operation in the industry on the "negative list" may require market entry clearance.

With respect to the existing VIE structure used by many China-based companies listed overseas or controlled by foreign investors, the Discussion Draft does not propose a new set of rules. Instead, MOFCOM provides three potential solutions that are being evaluated in its explanation note:

- (i) existing FIEs exercising control through VIE structures may retain such structure and continue business activities if they can report to and show the State Council that they ultimately are controlled by PRC entities and/or citizens;
- (ii) existing FIEs exercising control through VIE structures shall apply to the State Council to verify that they ultimately are controlled by PRC entities and/or citizens, and upon confirmation by the State Council they may retain such structure and continue business activities; or
- (iii) existing FIEs exercising control through VIE structures shall apply to the State Council for market entry permission, and the State Council shall discuss the application with relevant departments, consider various factors and determine the actual ultimate control of such FIEs.

If an existing VIE structure falls in an industry on the "negative list," it is unclear whether the Foreign Investment Law will have a grandfather clause that exempts such existing VIE structure from the new law.

Although the release of the Discussion Draft is seen as a welcome change, it is unclear when MOFCOM will submit the final version of the proposed Foreign Investment Law to China's National People's Congress for review and adoption and whether the version to be submitted will be significantly different from the Discussion Draft. It also raises other issues, such as

China's MOFCOM Aims to Fundamentally Change the Legal Landscape on Foreign Investments

Continued

how to transition into the proposed legal regime in a smooth fashion and how to address pre-existing corporate structures and related issues.

Substantial uncertainties exist with respect to the enactment timetable, interpretation and implementation of the Discussion Draft and how it may impact foreign investments in China and the corporate structure, corporate governance and business operations of China-based companies. In the meantime, we recommend that clients review the corporate structures of their current or potential investments in China and work with their advisers to formulate strategies to minimize potential impact on those investments should significant changes to the existing laws materialize.