

Proposed Foreign Investment Law

On January 19, 2015, China's Ministry of Commerce ("MOFCOM") published for public comment a draft of the proposed Foreign Investment Law (the "Draft FIL"). In addition, MOFCOM released an explanatory note on the Draft FIL (关于《中华人民共和国外国投资法（草案征求意见稿）》等问题的说明) (the "Note").

The Draft FIL contains 11 chapters and 170 articles, while the Note summarizes the main content of the Draft FIL, including (1) the new definition for "foreign investors" and "foreign investments"; (2) market access administration; (3) national security censorship; (4) foreign-invested company reporting regime; (5) foreign investment promotion regime; (6) foreign investment protection regime; (7) coordinating complaints; (8) legal liabilities, and (9) various miscellaneous provisions.¹

When this Draft FIL is implemented, it will replace the existing foreign investment laws, including the Sino-Foreign Equity Joint Venture Enterprise Law (中外合资经营企业法), the Sino-Foreign Cooperative Joint Venture Law (中外合作经营企业法), the Wholly Foreign Invested Enterprise Law (外资企业法) and the various implementation rules and ancillary regulations associated with these laws (the "Existing FIE Laws"). In addition, the organization forms and the business operation of foreign-invested companies will become subject to the Company Law of the People's Republic of China (中华人民共和国公司法) as amended in 2013 (the "Company Law"). As a result, wholly foreign-owned enterprises and foreign-invested joint ventures will no longer be subject to a separate legal regime as they currently are under the Existing FIE Laws.

A. Material Changes to the Definition of Foreign Investors.

Even though current laws and regulations do not provide clear definitions for foreign investments or foreign investors, generally a company in China is classified as foreign or domestic based upon the citizenship or organizational jurisdiction of the company's registered equity interest holders. The Draft FIL retains this traditional approach, but also introduces a new classification method based on "actual control".

According to the definition of "Chinese Investors" set forth in the Draft FIL, citizens of the People's Republic of China (the "PRC") and domestic companies under their control will be deemed to be Chinese Investors.² The definition of "Foreign Investors" set forth in the Draft FIL includes (i) natural persons without Chinese nationality; (2) entities incorporated under the laws of other countries or regions; (3) governments of other countries or regions and their departments or agencies; and (4)

¹ See the Note.

² See Section 12 of the Draft FIL.

international organizations.³

The Draft FIL indicates that the domestic companies under the control of foreign natural persons or entities will be treated as the Foreign Investors.⁴ In addition, the Draft FIL states that if a Foreign Investor consisting of an entity incorporated outside of the PRC is controlled by Chinese Investors, after receiving the approval of MOFCOM, such Foreign Investor could be deemed to be a Chinese Investor.⁵

The Draft FIL defines “control” to include any of the following: (1) holding equity ownership over 50%; (2) having a right to appoint a majority of board members, to ensure its nominee can occupy a majority of the board seats, or to exert a significant impact on the resolutions of shareholders’ meetings or board meetings; or (3) having significant influence over the company management, finances or personnel through contract or trust.⁶

These new definitions that implement the “actual control” approach to foreign investment classification suggest that MOFCOM is trying to prevent Foreign Investors from evading China’s foreign investment restrictions through the use of a variable interest entity (“VIE”) structure or other means. A detailed discussion of the impact on the VIE structures is set forth below.

B. Negative List

Pursuant to Section 6 of the Draft FIL, Foreign Investors are entitled to national treatment when making investment within China, unless such investments are in industries listed in the forthcoming catalogue of special administrative measures for foreign investment (外国投资特别管理措施目录) (the “Negative List”). Unlike the current Industry Catalogue for the Guidance of Foreign Investments (外商投资指导目录), the Negative List will only consist of two categories: prohibited industries and restricted industries. If the foreign investment is in an industry other than those listed as restricted or prohibited industries on the Negative List, such foreign investment will not require pre-approval by MOFCOM and will only require submission of an information report to MOFCOM.

Chapter 5 of the Draft FIL establishes a new information report regime for foreign-invested companies. Under the new regime, foreign-invested companies will be required to submit an information report to MOFCOM:

- (1) Before or within thirty (30) days after completion of the foreign investment;

³ See Section 11 of the Draft FIL.

⁴ See Section 11 of the Draft FIL.

⁵ See Section 45 of the Draft FIL.

⁶ See Section 18 of the Draft FIL.

- (2) Within thirty (30) days after completion of any changes to such foreign investment, e.g. share transfer, share pledge, capital increase, etc.; and
- (3) On an annual and quarterly basis if the foreign-invested company's total assets, sales or revenues are over RMB10 billion or if the foreign-invested company has more than ten (10) subsidiaries in China.

In addition, it is worth noting that pursuant to the Reform Proposals for the Register Capital Registration System (注册资本登记制度改革方案) issued by the State Council (国务院) on February 7, 2014, all companies in China (including foreign-invested companies) will no longer be required to complete the annual inspection process with the State Administration for Industry and Commerce (国家工商总局) (the “SAIC”), but shall instead only be required to submit an annual information report to SAIC through the regulator's website. It is not yet clear how the MOFCOM foreign-invested company reporting system will interact with the SAIC reporting system that will apply to all companies. It appears, however, that foreign-invested companies will be required to comply with both the MOFCOM and the SAIC reporting requirements.

Section 23 of the Draft FIL indicates that the State Council will publish the Negative List in the future. As a result, it is not yet clear which industries will continue to be subject to foreign ownership restrictions. It is worth noting, however, that on November 4, 2014, the National Development and Reform Commission of the PRC (国家发展与改革委员会) published for public comment an updated Industry Catalogue for the Guidance of Foreign Investments (the “Draft Industry Catalogue”). It is not yet clear how the Draft Industry Catalogue will interact with the Negative List, or whether the Negative List would replace the Draft Industry Catalogue.

C. Material Changes to the Operation of WFOE.

Pursuant to Section 217 of the Company Law, the Company Law applies to all foreign-invested limited liability companies and joint stock companies, however, if any provision conflicts with the Existing FIE Laws, then the Existing FIE Laws will prevail. Since there are contradictions between the Company Law and the Existing FIE Laws, foreign investors are often confused when attempting to reconcile these conflicting legal requirements. However, as mentioned above, when this Draft FIL is implemented, the Existing FIE Laws will be replaced, and the Company Law will unconditionally apply to all foreign-invested companies.

For example, the table below shows the key changes to the operation of WFOE that will be implemented where the FIL becomes effective.

Item	Current Rule	After Draft FIL Effective
Pre-Approval for the Establishment of a WFOE	Pre-approvals from MOFCOM and other government authorities are required. ⁷	No pre-approval required unless the WFOE's business falls under the Negative List. ⁸
Articles of Association	The following content shall be included in the articles of association: (1) company name and address; (2) purpose of the company and the business scope; (3) total investment amount, registered capital and date of the investment; (4) form of organization; (5) company institutions and their functions and procedural rules, legal representative, general manager and other key manager; (6) financial, accounting and audit principal and system; (7) labor management; (8) business period, termination and company liquidation; and (9) the procedure to modify the articles. ⁹	The following content shall be included in the articles of association: (1) company name and address; (2) the business scope; (3) registered capital; (4) shareholders; (5) forms, amount and date of the registered capital; (6) company institutions and their functions and procedural rules; (7) legal representative; (8) other matters deemed necessary by the board or shareholders. ¹⁰
Increase or Decrease of Register Capital	Pre-approval from MOFCOM required, and such increase or decrease shall be registered with SAIC. ¹¹	No pre-approval required, but such increase or decrease still needs to be registered with SAIC. ¹²

⁷ See Chapter II of the Implementation Regulations on Wholly Foreign Invested Enterprise Law (《外资企业法实施细则》) (the “Implementation Regulations”).

⁸ See Section 26 of the Draft FIL.

⁹ See Section 15 of the Implementation Regulations.

¹⁰ See Section 25 of the Company Law.

¹¹ See Section 21 and 22 of the Implementation Regulations.

¹² See Section 179 of the Company Law.

Equity Transfer	Pre-approval from MOFCOM required, and such equity transfer shall be registered with SAIC. ¹³	No pre-approval required, but such equity transfer still needs to be registered with SAIC. ¹⁴
Information Report	Annual information report to SAIC is required. ¹⁵	Annual information report to SAIC and information reports to MOFCOM required. ¹⁶
Legal Representative	Determined by the articles of association of the company. ¹⁷	As determined by the company's articles of association, the legal representative may be the chairman of the board, the executive director, or the general manager of the company. ¹⁸

Overall, if the Draft FIL is passed, it will be easier for foreign investors to do business and operate companies in China. However, it is also worth noting that if the Draft FIL is passed, WFOEs might be required to update their articles of association and adjust their legal representative to comply with the Company Law.

D. Potential Impact on the VIE Structure

Under China's current laws and regulations, foreign investment is prohibited or restricted in a variety of industries, including banking, natural resources, telecommunications and the internet. Notwithstanding these foreign investment restrictions, many foreign-invested companies have achieved what they believe to be technical compliance with the foreign ownership restrictions by establishing a VIE structure in which the foreign-invested entity does not have a direct ownership interest in the domestic operating company that holds the licenses required to operate the restricted industries in China. However, Section 149 of the Draft FIL imposes heavy penalties for using contractual control mechanisms to evade the foreign investment restrictions, including fines, confiscation of illegal gains and imprisonment of up to

¹³ See Section 23 of the Implementation Regulations.

¹⁴ See Section 32 of the Company Law.

¹⁵ See the Reform Proposals for the Register Capital Registration System (注册资本登记制度改革方案).

¹⁶ See analysis in Section B of this article for reference.

¹⁷ See Section 24 of the Implementation Regulations.

¹⁸ See Section 13 of the Company Law.

one year for the person-in-charge.

As discussed above, once the “actual control” principle is adopted, a company under the actual control of Foreign Investors will be treated as a foreign-invested company, and a company whose equity interest holder is a foreign entity under the actual control of Chinese Investors will be treated as a domestic company. As a result, the Draft FIL will not affect the validity of existing VIE structures where PRC citizens control the foreign-invested company in the VIE structure. However, if a company is controlled by non-PRC citizens or non-PRC entities, then such company will not be allowed to operate a business in a restricted or prohibited industry by establishing a VIE structure.

Although this appears to be a material change in China’s foreign investment rules, we view the Draft FIL as implementing a well understood policy, which is that the VIE structure is a viable means for Chinese nationals to raise foreign capital, but the VIE structure is not an avenue for foreign companies to enter China’s market in industries where foreign investment is restricted or prohibited. As discussed in greater detail below, one important question raised by the Draft FIL’s implementation of this longstanding policy is how to treat companies that were once controlled by Chinese nationals, but due to dilution over time are now controlled by Foreign Investors.

The Draft FIL is clear that existing VIE structures will not be permitted if the foreign-invested company in the VIE structure is under the actual control of Foreign Investors. The Draft FIL is not clear, however, on what procedure will be used to determine whether the foreign-invested company in a VIE structure is under the actual control of Foreign Investors or Chinese Investors. The Note indicates that MOFCOM is considering how to address this issue and provides several potential solutions that might be adopted. Each of the potential solutions involve a registration or application procedure with MOFCOM and various degrees of MOFCOM investigation to determine whether the actual controlling party of a foreign-invested entity is a Foreign Investor or a Chinese Investor.

The VIE structure is often used by Chinese companies in order to obtain foreign venture capital investment or when listing their shares on foreign stock markets. In fact, over half of all Chinese companies listed on overseas stock exchanges use the VIE structure.¹⁹ As a result, the Draft FIL could have a very material impact on many Chinese companies listed on foreign stock exchanges if it is determined that the actual controlling parties of those entities are Foreign Investors and not Chinese Investors. The Draft FIL, however, might not affect Chinese companies listed on foreign stock exchanges if the company’s actual controller is determined to be Chinese Investors pursuant to the “actual control” principle.

¹⁹ Accounting Matters: Variable Interest Entities in China, by Paul L. Gilles, September 2012.

For example, Robin Yanhong Li (“Mr. Li”), the founder of Baidu, Inc., China’s leading internet search company (“Baidu”), only owns approximately 15.9% of the company’s ordinary shares. However, based on Baidu dual-class share structure, the company’s ordinary shares are divided into Class A ordinary shares and Class B ordinary shares, and holders of Class A ordinary shares are entitled to one vote per share, while holders of Class B ordinary shares are entitled to ten votes per share. According to Baidu’s public disclosure, as of February 28, 2014, the total amount of Baidu outstanding shares was approximately 35 million, consisting of approximately 27.5 million Class A ordinary shares and approximately 7.5 million Class B ordinary shares. Mr. Li and his wife hold all of the Class B ordinary shares and therefore control approximately 67% of Baidu’s voting power.²⁰ Since Mr. Li is a PRC citizen and assuming Mrs. Li is a PRC citizen, Baidu would be deemed to be controlled by Chinese Investors, and able to retain its VIE structure.

Alibaba Group Holding Limited, China’s leading e-commerce company (“Alibaba”), is another example where the Draft FIL might not affect the VIE structure.²¹ According to Alibaba’s public filings, after their initial public offering, only approximately 13% of Alibaba shares are held by the company’s founders, while major foreign shareholders such as SoftBank and Yahoo hold approximately 32% and 16% of Alibaba shares respectively.²² Prior to the initial public offering, however, Alibaba established a partnership (the “Alibaba Partnership”), which has effective control over the Alibaba board of directors through its right to nominate up to a simple majority of the Alibaba directors, subject to shareholder approval.²³ As a result, if the Alibaba Partnership, which currently includes 30 members, is controlled by Chinese nationals, then Alibaba will mostly likely be deemed to be controlled by Chinese Investors, and will be able to retain its existing VIE structures. Although the identity of the 30 Alibaba Partnership members is not clear from the company’s public filings, there is a very high probability that the majority of these members are PRC nationals.

In contrast, the VIE structures of some companies listed overseas could be affected by the Draft FIL depending on the company’s corporate governance structure. According to public filings of Sina Corporation (“Sina”), as of March 31, 2014, only approximately 2.8% of the outstanding Sina shares are held by the founders, while other major shareholders such as BlackRock and Thomburg hold approximately 8.3% and 7.0% of Sina’s shares respectively²⁴. Here, unlike with Alibaba, the major

²⁰ See Page 106 of Baidu’s annual report on the Form 20-F for the year ended on December 31, 2013 at the [SEC website](#).

²¹ [Alibaba Claims Title for Largest Global IPO Ever with Extra Share Sale](#), Forbes, September 22, 2014.

²² See Page 250 of the Amendment No.7 to Alibaba’s registration statement on Form F-1 at the [SEC website](#).

²³ See Page 7-8 and 230 of the Amendment No.7 to Alibaba’s registration statement on Form F-1 at the [SEC website](#).

²⁴ See Page 101-102 of Sina’s annual report on Form 20-F for the year ended on December 31, 2013 at the [SEC website](#).

shareholders (including the founders) do not have different voting rights from other shareholders²⁵. In addition, Sina's public disclosure did not indicate any special board appointment rights held by particular shareholders, which would need to be disclosed if present. As a result, the actual controller of Sina could be deemed to be Foreign Investors under the Draft FIL, and if so, could jeopardize the legality of Sina's VIE structure.

Although we have not conducted a comprehensive review of the public filings for Chinese companies that have VIE structures and are listed on overseas stock exchanges, we suspect that many of these companies do not have dual voting arrangements like Baidu or partnership control arrangements like Alibaba. As a result, the validity of the VIE structures for many Chinese companies listed on the New York Stock Exchange, Nasdaq and elsewhere could be called into question if the Draft FIL is adopted in its current form. Given the material damage that this could cause to many of China's leading internet companies, such as Tencent, it would not be surprising to see MOFCOM take a cautious approach with implementing the Draft FIL, particularly with respect to Chinese companies with VIE structures that are already listed on overseas stock exchanges.

Going forward, if the Draft FIL is adopted in its current form, we expect to see changes in the corporate governance arrangements for Chinese companies in industries where foreign investment is restricted or prohibited to ensure that Chinese Investors maintain actual control over these companies. From this perspective, the Draft FIL could be viewed as formally opening many more sectors of China's economy to foreign investment, provided that Chinese Investors maintain actual control over the foreign-invested companies.

²⁵ See Page 102 of Sina's annual report on Form 20-F for the year ended on December 31, 2013 at the [SEC website](#).