



Paul, Weiss Asia Offices

BEIJING

Unit 3601, Office Tower A
Beijing Fortune Plaza
No. 7 Dongsanhuan Zhonglu,
Chaoyang District, Beijing 100020
People's Republic of China
+86 10 5828 6300

HONG KONG

Hong Kong Club Building, 12th Floor
3A Chater Road, Central
Hong Kong
+852 2846 0300

TOKYO

Fukoku Seimei Building 2F
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
+81 3 3597 8101

China's Draft Foreign Investment Law to Revolutionize Foreign Investment Regime in China

On January 19, 2015, the PRC Ministry of Commerce ("MOFCOM") released a draft Foreign Investment Law (the "Draft Law") for public comments. If adopted, the Draft Law will revolutionize the regime for foreign investment in China and have a profound impact on both existing investments and future transactions. We set out below some of the main changes to China's foreign investment regime proposed by the Draft Law.

New Foreign Investment Regime

Currently, foreign investors need to obtain prior approval from MOFCOM (or its local counterparts) in order to invest in China. Under the Draft Law, these approvals are only required for investments in certain industries on a negative list in a "restriction catalogue" ("Restricted Industries") or investments exceeding certain threshold amounts set out in the "restriction catalogue", while industries on a "prohibition catalogue" will remain closed to foreign investors. In all other industries, the initial foreign investment will be subject to the same regime as domestic investment, i.e., registration obligations under the PRC Company Law, and industry specific licensing regimes where applicable.

The Draft Law also creates a new reporting regime. A foreign investment must be reported within 30 days after it is made. Major changes to a foreign-invested enterprise ("FIE") must also be reported within 30 days after they occur. In addition, an annual filing (or a quarterly filing for large FIEs) is required.

The Draft Law removes the distinction in corporate form between foreign and domestic invested corporate entities. The Draft Law permits existing FIEs to continue to operate under their prior approvals, but these existing FIEs will have three years after adoption of the Draft Law to transition from their existing corporate form into a corporation or partnership under relevant PRC regulations.

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Legal Status of variable interest entity (“VIE”) Structures Clarified

Currently, PRC law treats VIE structured investments as domestic investments. VIE structures are commonly adopted by many listed companies such as Alibaba and Sina. However, there is uncertainty over the enforceability of VIE structures, and MOFCOM has not accepted anti-monopoly filing applications for combinations involving VIE structures. The good news is that the Draft Law acknowledges the status of VIE structures under PRC law, which should clarify the types of VIE structures that would be enforceable under PRC law. Presumably, after the Draft Law is adopted, MOFCOM would allow combinations involving VIE structures (assuming that such combinations pass the anti-monopoly review).

The Draft Law clarifies that for future investments in VIE structures, so long as the VIE structure will be controlled by foreign investors after the investment, MOFCOM will treat such investments as foreign investments. If the investor can provide satisfactory evidence to MOFCOM showing that the VIE structure will be controlled by Chinese investors after the investment, MOFCOM will treat such investments as domestic investments. MOFCOM will look at the investor with ultimate control rather than the type of entity used for the investment in determining whether an investment is foreign or domestic.

The Draft Law only contains a placeholder for how existing VIE structures will be handled and MOFCOM is seeking comments from the general public on this issue. MOFCOM raises three possible approaches in its explanations to the Draft Law, being:

- (1) Existing VIE structures where Chinese investors are in control can continue to operate under the same structure if the domestic entity under contractual control (the “VIE Entity”) makes a filing with MOFCOM regarding their Chinese investor-controlled status; or
- (2) Existing VIE structures where Chinese investors are in control can continue to operate under the same structure if the VIE Entity applies to MOFCOM for acknowledgment of its Chinese investor-controlled status and MOFCOM acknowledges this status; or
- (3) Existing VIE Entities should apply to MOFCOM for foreign investment approval and MOFCOM (working together with other relevant governmental authorities) will determine whether to grant such approval based on a variety of factors, including whether the VIE structure is controlled by Chinese investors.

The above approaches suggest that MOFCOM should permit an existing VIE structure to continue to operate under the same structure after the Draft Law is adopted, so long as the FIE which controls the VIE Entity is ultimately controlled by Chinese investors, even if the VIE structure operates in a Restricted Industry or a Prohibited Industry.

Who has “control” is the key to determining which VIE structures operating in Restricted Industries can continue to operate under the same structure after the Draft Law is adopted. Under the Draft Law, “control” exists where any of the following tests is met: (a) at least 50% equity ownership; (b) the right or actual ability to

nominate at least half of the directors; (c) the holding of voting rights sufficient to exercise major influence over shareholders' or directors' decisions; or (d) decisive influence over operations, finances, human resources or technology through contract, trust or other arrangements. However, the current definition of control raises some questions. For example, what if Chinese and foreign investors both satisfy the control definition? What if a founder of a VIE structure has *de facto* control over the business but only holds a small minority interest in the foreign parent entity controlling the VIE structure and does not have special board appointment rights? Furthermore, if MOFCOM determines that an existing VIE structure operating in a Restricted Industry is not controlled by Chinese investors, will MOFCOM impose conditions or insist on changing the structure? These are all questions that need to be clarified.

National Security Review Can be Triggered by All Foreign Investments

Since 2011, foreign acquisitions in specified industries can be reviewed for national security concerns under a circular issued by the PRC State Council (the "Security Review Circular"). The Draft Law not only incorporates this review into a formal statute, but also broadens its scope and increases its impact. Under the Draft Law, a national security review can be triggered by any form of foreign investment (not only by acquisitions) and in any industry. The list of security concerns to be taken into account in the review has also been expanded, enhancing the list that is within the current Security Review Circular.

As is the case under the Security Review Circular, under the Draft Law, foreign investors may apply for national security review on their own initiative. The Draft Law would also allow any interested party (government departments, industry associations, competitors or upstream and downstream businesses in the relevant industry, etc.) to request MOFCOM to conduct a security review.

In addition to the above, when applying for approval for an investment falling under the "restricted catalogue", the foreign investor is required to explain whether the investment should be subject to national security review. This requirement puts the burden on the foreign investor to make an initial national security assessment and encourages the foreign investor to apply for national security review prior to making the investment. If the foreign investor elects not to apply for national security review, the investment can potentially be challenged by other PRC governmental authorities and other interested parties after the investment has been completed.

On the whole, the Draft Law attempts to simplify and reduce uncertainty relating to foreign investment in China by streamlining the approval process, granting national treatment where possible and clarifying the status of VIE structures. However, the Draft Law, in its current form, also raises new issues that need to be clarified in order to avoid unintentional consequences for foreign and domestic investors investing in China. Clients should review their current investment projects in light of the impending change in law. Some transactions should be accelerated and completed before they are impacted by the Draft Law coming into effect. Other transactions may be facilitated or enabled by the new framework.

Paul, Weiss is working with our clients to prepare and submit comments on the Draft Law to MOFCOM within the consultation period, which ends on February 17, 2015. Please contact us if you have comments on the Draft Law that you wish to raise. We look forward to reviewing with you how the future adoption of the Draft Law may impact your industry and your investments.

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This client alert is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this article should be directed to any member of the Paul, Weiss China Practice Group, including:

Jeanette K. Chan	jchan@paulweiss.com	+852 2846 0388/+86 10 5828 6388
Jack Lange	jlange@paulweiss.com	+852 2846 0333
Greg Liu	gliu@paulweiss.com	+8610 5828 6302
Hans-Günther Herrmann	hherrmann@paulweiss.com	+852 2846 0331
David Lee	dklee@paulweiss.com	+852 2846 0376
Spencer Park	spark@paulweiss.com	+852 2846 0313
Corinna Yu	cyu@paulweiss.com	+852 2846 0383