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MEMORANDUM

TO: TerraLex Strategic Communications Committee
FROM: Steve Zhao, Zhong Lun Law Firm
DATE: July 31, 2015
SUBJECT: TerraLex e-Newsletter Proposed 2015 Publication Schedule

FIRST QUARTER 2015

Article Solicitation – January 12, 2015
Article Deadline – February 9, 2015
Publication Deadline – March 25-27, 2015

SECOND QUARTER 2015

Article Solicitation – April 13, 2015
Article Deadline – May 11, 2015
Publication Deadline – June 24-26, 2015

MUNICH, GERMANY GLOBAL MEETING (JUNE 10-13, 2015)

THIRD QUARTER 2015

Article Solicitation – July 14, 2015
Article Deadline – August 3, 2015
Publication Deadline – September 16-18, 2015

NASHVILLE, TENNESSEE GLOBAL MEETING (NOVEMBER 11-14, 2015)

FOURTH QUARTER 2015

Article Solicitation – October 5, 2014
Article Deadline – November 2, 2015
Publication Deadline – December 9-11, 2015

POTENTIAL CHANGE OF CHINA'S FOREIGN INVESTMENT LAWS AND ITS EFFECT ON VIE STRUCTURES

By Steve Zhao

1. Introduction

On 19 January 2015, the Chinese Ministry of Commerce (MOFCOM) announced the Foreign Investment Law of the People's Republic of China (Draft for Public Opinions) (the *Draft for Public Opinions*), publicly seeking input from society at large. Any interested party may put forth opinions and recommendations on the draft prior to 17 February 2015. As soon as this law (the *Foreign Investment Law*) is passed, it will combine the former three foreign investment laws into one and bring the case-by-case approval and management model for foreign investment to an end, and China will enter a new era of "limited approvals with full-scale reporting" for the regulation of foreign investment. That is to say, foreign investors making investments in items on the negative list will need to apply for an investment entry approval; at the same time, foreign investors making investments in Chinese territory will all need to fulfill reporting obligations, regardless of whether the investment is in an area on the negative list.

2. Drafting Principles/Main Characteristics

Fundamental Status: The Foreign Investment Law is positioned as the fundamental law for the unified management and encouragement of foreign investment.

Innovation: This Foreign Investment Law abrogates the system for case-by-case review/approval of foreign investment currently in effect and adopts a management model for foreign investment with pre-establishment national treatment plus a negative list, greatly reducing measures constricting foreign investment, broadening the entry for foreign investment and strengthening the regulation on information reporting.

Enhancement: Important institutions like the examination of mergers and acquisitions by foreign investors and national security review are incorporated into this Foreign Investment Law and have been enhanced.

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Shift: The regulatory focus under the Foreign Investment Law shifts from the current strict approval before entry to "providing public services and strengthening supervision during and after the entry"; along with elimination of most administrative examinations and approvals currently in place, the Foreign Investment Law strengthens institutions like the encouragement and protection of investment as well as supervisory examinations.

3. Key Contents

The Draft for Public Opinions has a total of 170 articles divided into 11 chapters, primarily composed of rules on the following nine aspects: foreign investor and foreign investment, entry management, national security review, information reporting, investment promotion, investment protection, coordination and handling of complaints, supervisory examinations, and legal liabilities and supplementary provisions. The key contents are summarized below:

Definition of “Foreign Investor” and “Foreign Investment”

Regarding foreign investor, the Draft for Public Opinions draws upon the “actual control” criteria when providing a definition of “foreign investor” based on registration criteria. In one respect, it stipulates that domestic enterprises under the control of “foreign investors” be viewed the same as “foreign investors”; in another respect, it stipulates that investments within Chinese territory made by “foreign investors” that are under the control of Chinese investors may be viewed as domestic investments.

Entry Management System

The Draft for Public Opinions abolishes the “case by case” approval system established by the three laws for foreign investment and designs a new entry management system which is compatible with a management model of “pre-establishment national treatment plus negative list”. The competent authority of foreign investment will only implement entry permission regulations on those foreign investments in the areas/industries expressly listed in a catalogue for special regulation measures. For such foreign investments, the foreign investment authority will no longer examine constitutional documentations such as contracts and articles of association, but rather the foreign investors themselves and their investment activities. Under such management model of “negative list”, the majority of the foreign investment inflows will no longer be subject to and hindered by the entry approval.

National Security Review System

In order to prevent damage or possible damage to national security from foreign investment, the Draft for Public Opinions has a dedicated chapter that provides for a national security review mechanism. In targeting the national security review mechanism currently in place (whose effectiveness is relatively low and which has structural imperfections and deficiencies) and building on the foundation of the Notice of the General Office of the State Council on Launching the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors promulgated by the State Council after drawing ample lessons from the practice of relevant foreign countries/jurisdictions, the Draft for Public Opinions further improves the investigative factors and procedures of national security reviews while explaining contents like measures that may be taken to eliminate hidden dangers/threats to national security. Additionally, the Draft for Public Opinions stipulates that no application for administrative reconsideration or administrative litigation may be submitted against national security review decisions that have been made.

Information Reporting System

In order to promptly, accurately and fully grasp the situations of foreign investment and the operational status of the foreign invested enterprises, the Draft for Public Opinions stipulates an information reporting system for foreign investment. Foreign investors or the foreign invested enterprise must fulfill the information reporting obligations to the competent department for their respective investment and operation activities, regardless of whether the areas or industries in which the concerned foreign

investment is made are those areas or industries listed in the catalogue for special regulation measures. All information reported must be true, accurate and complete, and it may not contain any falsehoods, misleading statements or substantive omissions. The Draft for Public Opinions sets out three categories of information reporting (information reporting of foreign investment projects, information reporting on changes in foreign investment projects and periodic reporting) while also stipulating the relevant content and timeframe for such reporting.

Mechanism for Encouraging Investment

The strengthening of a government's function to encourage investment is currently a new legislative and policy trend in countries all over the world. In order to establish a robust mechanism for encouraging investment while increasing the level of the professionalism with which investment is encouraged as well as raising the quality and level of utilizing foreign investment, the Draft for Public Opinions standardizes various aspects of stimulating investment like investment incentive policies, incentive structures and special economic zones.

Mechanism for Protecting Investment

In order to protect foreign investors and their legitimate rights and interests, the Draft for Public Opinions comprehensively strengthens the system of protection for foreign investors and their interests in aspects like expropriation, requisition, State compensation, transfers, transparency and intellectual property rights.

Mechanism for Coordinating and Handling Complaints

In order to promptly and efficiently settle the disputes related to foreign investment, the Draft for Public Opinions stipulates a mechanism for coordinating and handling complaints, which strengthens the working functions of the relevant agency for coordinating and handling disputes between foreign investors, foreign invested enterprises and administrative bodies.

Mechanism for Supervisory Examinations

Simultaneously broadening market access and reducing administrative reviews/approvals while strengthening oversight both during and after the entry is "the priority among priorities" for the new administration of China in its transition to new governmental functions. The Draft for Public Opinions makes comprehensive stipulations with respect to the initiation of supervisory investigations, the form of investigations, the content of investigations and the outcome of investigations. At the same time, it will strengthen the self-disciplinary awareness of foreign investors and foreign invested enterprises through the establishment of mechanism for recording dishonest behaviors of foreign investors.

System of Legal Liability

The Draft for Public Opinions stipulates a system of legal liability, elucidating the administrative and criminal legal liabilities that shall be borne under circumstances like investing in prohibited areas, investing in a restricted area without approval or in a way that violates conditions for approval, violating information reporting obligations, violating the provisions of national security reviews and evading provisions with legal force.

4. Explanation of Several Issues

Arrangement of a Transitional Period

After the Foreign Investment Law comes into effect, the original three laws for foreign investment will be abolished and annulled. The Draft for Public Opinions provides that the foreign investment enterprises duly incorporated and existing prior to the effectiveness of this Foreign Investment Law shall make appropriate adjustments or changes within three years to ensure that their organizational forms and organizational structures comply with the requirements of the Company Law of the People's Republic of China.

Treatment on Investors from Hong Kong, Macau and Taiwan

According to the provisions of the Draft for Public Opinions, the Foreign Investment Law is also applicable by reference to the investment of those investors from Hong Kong, Macau and Taiwan. The special treatment pertaining to the investments of investors from Hong Kong, Macao and Taiwan have been advised to be separately prescribed by the State Council.

Relationship between Foreign Investment Entry Approval, AIC Registration and Industry Permits

The Draft for Public Opinions stipulates that when a foreign investor is going to invest in an area listed in the catalogue for special regulation measures, the foreign investor must submit the relevant certificates for industry permits if the investment involves an area that requires industry permits before its application for entry approval. However, if no prior industry permit is required, the competent authority of foreign investment shall enquire and consult with the relevant industry authority for their opinion and comments during its review of the foreign investor's application for foreign investment entry approval. Only after obtaining the foreign investment entry approval may the foreign investor proceed to the AIC registration.

5. The Effect of the New Foreign Investment Law on "VIE" Structures

Variable interest entities or "VIE" structures are widely used for foreign investors to invest in China in areas not fully open to foreign investment, using contractual control to bypass the legal or practical hurdles on foreign investment in those areas. VIE structures have in reality become the foundational mechanism for China's booming Internet industry. The new Foreign Investment Law, with its new definition of "foreign investment" as shown in the Draft for Public Opinions, will likely have a profound effect on the utilization of VIE structures by foreign investors in their investment into China.

The Draft for Public Opinions expressly acknowledges the VIE structure as a form of foreign investment, and the foreign investment via this VIE structure will be governed by the Foreign Investment Law after it comes into effect. However, the Draft for Public Opinions does not specify how to handle VIE structures in existence prior to the law taking effect. Currently, the theoretical and experiential viewpoints in this regard can be generally classified as follows:

New Investments After the Effectiveness of the Foreign Investment Law

- Prohibited Category in the Negative List

No foreign investment allowed whether or not using VIE structure or whether or not the actually controller is Chinese by nationality.

- Restricted Category in the Negative List

If the actual controller is foreign, foreign investment approval is required whether or not using VIE structure.

If the actual controller is Chinese, the investor may apply for the investment to be “deemed as a domestic investment” and for the foreign investment approval at the same time. If the investment is deemed as a domestic investment, the likelihood of obtaining the foreign investment approval is expected to be high.

- Not in the Negative List:

No foreign investment approval required. Unless the investor is investing in an area that is legally permitted for foreign investment but closed off in reality, there is no need to use the VIE structure.

Foreign Investment Using VIE Structure Existing Before the Effectiveness of the Foreign Investment Law

Opinion 1:

- Prohibited Category in the Negative List

If the actual controller is foreign, the situation is not specified in the draft but it is expected that the operation cannot continue.

If the actual controller is Chinese and such situation be reported to the foreign investment authority, the invested company can continue operation under the VIE structure.

- Restricted Category in the Negative List

If the actual controller is foreign, the situation is not specified in the draft but it is expected that the investor may apply for foreign investment approval and the operation cannot continue unless approved.

If the actual controller is Chinese and such situation be reported to the foreign investment authority, the invested company can continue operation under the VIE structure.

- Not in the Negative List:

No foreign investment approval required. Unless the investor is investing in an area that is legally permitted for foreign investment but closed off in reality, there is no need to use the VIE structure.

Opinion 2:

- Prohibited Category in the Negative List

If the actual controller is foreign, the situation is not specified in the draft but it is expected that the operation cannot continue.

If the actual controller is Chinese, the investor shall apply for recognition of the same by the foreign investment authority. If recognized, the invested company can continue operation under the VIE structure.

- Restricted Category in the Negative List

If the actual controller is foreign, the situation is not specified in the draft but it is expected that the investor may apply for foreign investment approval and the operation cannot continue unless approved.

If the actual controller is Chinese, the investor shall apply for recognition of the same by the foreign investment authority. If recognized, the invested company can continue operation under the VIE structure.

- Not in the Negative List:

No foreign investment approval required. Unless the investor is investing in an area that is legally permitted for foreign investment but closed off in reality, there is no need to use the VIE structure.

Opinion 3:

- Prohibited Category in the Negative List

If the actual controller is foreign, the investor may apply for foreign investment approval but the expectation is that it is unlikely to be approved.

If the actual controller is Chinese, the investor shall apply for foreign investment approval and state the identity of the actual controller. If approved, the invested company can continue operation under the VIE structure.

- Restricted Category in the Negative List

If the actual controller is foreign, the investor may apply for foreign investment approval and the operation cannot continue unless approved.

If the actual controller is Chinese, the investor shall apply for foreign investment approval and state the identity of the actual controller. If approved, the invested company can continue operation under the VIE structure.

- Not in the Negative List:

No foreign investment approval required. Unless the investor is investing in an area that is legally permitted for foreign investment but closed off in reality, there is no need to use the VIE structure.