

# Asia Alert

## Draft PRC Foreign Investment Law Signals New Regulatory Efforts to Formally Regulate VIE Structure in China

By Wenfeng Li (counsel, Beijing), Daniel Yeh (counsel, Hong Kong) and Steven Xiang (partner, Head of China Practice)

On January 19, 2015, China's Ministry of Commerce ("MOFCOM") posted on its website for public comment the draft Foreign Investment Law of the People's Republic of China (the "**Draft Foreign Investment Law**"). According to the Draft Foreign Investment Law and the explanatory notes posted concurrently on MOFCOM's website (the "**Explanatory Notes**"), the Draft Foreign Investment Law would supersede and replace certain existing PRC laws and regulations on foreign investment, including the PRC Law on Sino-Foreign Equity Joint Venture Enterprises, the PRC Law on Sino-Foreign Cooperative Joint Venture Enterprises and the PRC Law on Wholly-Foreign Invested Enterprises.

### 1. Background

The proposed Draft Foreign Investment Law would bring significant changes to various aspects of the PRC regulatory regime for foreign investments, the most important of which would be its proposed formal regulation of the use of "variable interest entity" (VIE) structures in foreign investments (including offshore equity offerings and other offshore financings) in PRC companies that operate in industries where foreign investment is restricted or prohibited under PRC law (including telecommunications, media, Internet, education and others).<sup>1</sup>

In the past, despite the issuance of certain ad hoc ministerial rules that aimed to regulate specific aspects of the use of VIE structures in industries such as online gaming and value-added telecom business, the market and transaction professionals have generally viewed the PRC regulatory authorities as having tacitly and provisionally allowed for the use of VIE structures in foreign investments involving restricted industries. Such regulatory uncertainty is often a cause for concern among foreign investors.

### 2. Three Regulatory Options for VIE Structure

According to the Explanatory Notes, the Draft Foreign Investment Law would formally regulate "contractual control" or "*Xie Yi Kong Zhi*" (which is the Chinese terminology for VIE structures) as one form of foreign investment. With respect to existing VIE structures in restricted industries that remain restrictive after the Draft Foreign Investment Law comes into effect, the Explanatory Notes state that the following three regulatory options are currently being considered with respect to foreign invested companies that control PRC operating companies through VIE structures:

- (i) Option A: These companies would be required to formally report to MOFCOM that they are subject to the actual control of Chinese investors (*i.e.*, PRC citizens, PRC companies or the PRC government). Following such reporting, these companies may retain their VIE structures and continue their business operations.

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- (ii) Option B: These companies would be required to apply to MOFCOM for recognition that they are subject to the actual control of Chinese investors. Once such recognition has been granted by MOFCOM, these companies may retain their VIE structures and continue their business operations.
- (iii) Option C: These companies would be required to apply for market entry approval from MOFCOM. MOFCOM and other relevant PRC regulatory authorities would then review these applications and decide on a case-by-case basis whether to grant approval, taking into account various factors, including the actual controlling person(s) of these companies.

The Explanatory Notes state that MOFCOM would further study VIE structure-related issues after its receipt and consideration of public comments and may present additional or amended proposals on the regulation of these structures.

### 3. Preliminary Observations and Comments

The Draft Foreign Investment Law represents a major step towards the formal regulation of the use of VIE structures in foreign investments in China. When this law goes into effect, it could provide welcome regulatory certainty to foreign investors and PRC companies using VIE structures, but also could result in substantive and procedural restrictions on the use of such structures that would impact existing and future foreign investments. The public comment process and the next steps of this legislative process will be closely watched by the market. Based on our understanding of the Draft Foreign Investment Law and the Explanatory Notes published by MOFCOM, we note that:

- (i) The adoption of the Draft Foreign Investment Law as an important national statute would require the approval of the plenary session of the PRC National People's Congress (the "NPC"), and the next plenary session of the NPC is expected to convene in March 2015. We would therefore expect that under the typical PRC legislative process the Draft

Foreign Investment Law could, at the earliest, come into effect by the first half of 2016.

- (ii) With respect to the three regulatory options, Option A would likely be helpful to ease the concerns of foreign investors participating in investments utilizing VIE structures, whereas Option C could have a chilling effect on potential foreign investments if there is not sufficient transparency in the review process or certainty with respect to approval criteria.
- (iii) While the Draft Foreign Investment Law provides for a broad definition of "control"<sup>2</sup>, the market also will be focused on how the Draft Foreign Investment Law would regulate companies that have implemented VIE structures but are not controlled by their Chinese shareholders.

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1. In a typical VIE structure, a domestic company ("**OpCo**") is established in China by Chinese founders and typically holds the necessary licenses and permits to operate the business that is subject to foreign ownership restrictions. The Chinese founders then invest along with foreign investors in an offshore holding company ("**HoldCo**"). HoldCo separately establishes a wholly-owned subsidiary in China (referred to as a wholly foreign-owned enterprise or "**WFOE**") to enter into captive contractual arrangements with OpCo that provide HoldCo with economic interests and control over OpCo that replicate the economic interests and control of direct ownership. These contractual arrangements typically involve profit transfer arrangements, loan agreements, share pledges, voting proxies and unilateral call options for equity interests in OpCo.
  2. The Draft Foreign Investment Law defines "control" as, with respect to a company, (a) the direct or indirect holding of 50% or more of the stock, equity, property interests, voting rights or other similar rights or interests; (b) any of the following: (i) having the right to appoint 50% or more of the members of the board or similar governing body, (ii) having the ability to ensure the election of its nominees as 50% or more of the members of the board or similar governing body, or (iii) having the voting right to exert significant influence over decisions that are made via board or shareholder meetings; or (c) having the ability to exert decisive influence over operational, financial, technical or human resource matters of the company through contract, trust or any other means.

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**For more information, please contact the following attorneys:**

Steven Xiang	<a href="#">Bio Page</a>	<a href="mailto:steve.xiang@weil.com">steve.xiang@weil.com</a>	+86 21 6016 6300 (Shanghai) +86 10 6535 5288 (Beijing)
Wenfeng Li	<a href="#">Bio Page</a>	<a href="mailto:wenfeng.li@weil.com">wenfeng.li@weil.com</a>	+86 10 6535 5200 (Beijing)
Daniel Yeh	<a href="#">Bio Page</a>	<a href="mailto:daniel.yeh@weil.com">daniel.yeh@weil.com</a>	+852 3476 9239 (Hong Kong)

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