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Briefing note January 2015

Uncertain future for VIE structures in China

MOFCOM issues Consultation Draft on Foreign Investment Law

MOFCOM issued a consultation draft of the Foreign Investment Law 《中华人民共和国外国投资法（草案征求意见稿）》 (the "Consultation Draft") on 19 January 2015. If passed into law, the draft would have some far-reaching implications on the foreign investment legal regime in the PRC. For example, the Consultation Draft envisages a "negative list" concept (currently adopted in the Shanghai pilot free trade zone) – if a foreign investor proposes to invest in an underlying business which falls outside the "negative list", then the foreign invested enterprise can be established without MOFCOM approval, which is a radical change from the current regime for foreign investment.

Threat to VIE structure

Whilst we will circulate a separate analysis on the wider impact of the Consultation Draft, this note is to highlight the potential implications on the so-called VIE structures. The VIE structure is very widely used in the PRC, particularly in "restricted" sectors such as Internet and e-commerce, to enable foreign investors or Chinese shareholders investing through offshore entities to have effective control over a domestic company (typically holding the necessary licences for operating in a regulated industry) through a series of contractual arrangements. The VIE structure involves the Chinese shareholders of the domestic company acting as nominee shareholders, with a series of contractual arrangements to allow an offshore holding company and its directly owned subsidiary to have effective control over the domestic company. The VIE structure has been tacitly tolerated by the Chinese government since its emergence in the early 2000s and has been widely adopted by companies seeking offshore financings or listing.

This status quo would be under threat if the Consultation Draft is passed into law. The Consultation Draft provides that a domestic enterprise established in the PRC that is "controlled" by a foreign investor will be deemed to be a foreign invested enterprise, even if the domestic enterprise is directly owned by Chinese shareholders. "Control" is broadly defined to mean:

- the ownership of not less than 50% of the voting rights
- the right to appoint (or the ability to secure) a majority of the board of directors
- the ability to otherwise materially influence the decisions of the board or shareholders meeting of a company, or

- the ability to exercise decisive influence over a company by way of contractual or trust arrangements

By taking a "substance over form" approach, this would mean that foreign investors would no longer be able to adopt a VIE structure to circumvent foreign investment restrictions. On the other hand, the Consultation Draft provides a mechanism for MOFCOM to certify an offshore entity as a Chinese investor as long as it is "controlled" by Chinese investors. If so, an investment made by such offshore entity would not be subject to foreign investment restrictions.

What will happen to existing VIE structures?

If the Consultation Draft is implemented in its current form, this could potentially affect the hundreds of companies that use the VIE structure, including many which are publicly listed. If the domestic enterprise within a VIE structure is operating in a restricted or prohibited sector (to be set out in the "negative list"), and is deemed to be a foreign invested enterprise, this means that it will be in breach of the existing foreign investment restrictions and/or would need to obtain additional approvals.

An explanatory note (the "Explanatory Note") that was published together with the Consultation Draft indicates that MOFCOM is contemplating three possible approaches with respect to domestic companies under existing VIE structures which are in the restricted or prohibited sectors:

- a company under a VIE structure may report to MOFCOM that it is controlled by Chinese investors, with the result that the VIE structure can remain in place
- a company under a VIE structure may apply to MOFCOM for certification that the company is controlled by Chinese investors, and upon such verification, the VIE structure can remain in place, or
- a company under a VIE structure may apply to MOFCOM for foreign investment approval, and MOFCOM would assess the situation (taking into account the actual controlling parties) together with other relevant regulators and make a decision.

The Explanatory Note indicates that the existing VIE structures may not be grandfathered when the Consultation Draft is passed into law. Instead, it appears that MOFCOM is proposing to review existing VIE structures and "validate" as appropriate. However, some comfort can be taken as the Explanatory Note suggests that MOFCOM will not act rashly to shut down existing VIE structures which do not comply with foreign investment restrictions. Much will also depend on what sectors will be covered by the "negative list" which has yet to be published.

It is also worth noting that the Draft Consultation is only a draft published by MOFCOM for public consultation. It is unclear when and in what form the Consultation Draft will be passed by the National People's Congress into law, and whether and how it will seek to address the issue of existing VIE structures. We will continue to monitor the progress and keep you updated on any new development in this regard.

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