Around Asia Pacific – Greater China (including Hong Kong)

Contents

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The big picture

"Around Asia Pacific" is Hogan Lovells' new periodic overview of the private equity landscape in Asia Pacific and supplements our "Around Europe" series which focuses on the European private equity industry. In this inaugural Asia-Pacific edition, we shine the spotlight on the private equity market in Greater China (including Hong Kong). Future editions in the series will look at other private equity markets in the Asia-Pacific region.

Private equity in Greater China had a strong year in 2014 – deal volumes and values both reached record levels, driven by significant activity in the bulge bracket end of the market as well as good volumes in the middle market. Buyout activity was also significant in a market that has historically seen more growth capital and PIPE deals, which signals a maturing market.

We highlight some significant Greater China private equity deals in 2014, including the LBO of Giant Interactive and Temasek's investment in A.S. Watson, as well as private equity-led deals resulting from the ongoing reform and restructuring of China's state-owned enterprises.

Fundraising by Greater China-focused funds remained healthy in 2014, and while overall volumes were down slightly, the total amount raised (both onshore and offshore) was up. Perhaps, related to the abundance of dry powder in the region, China outbound private equity deals appear to be on the increase.

Looking forward as 2015 unfolds, our expectation is that valuations will continue to see upward pressure as a greater number of investors continue to chase fewer deals. GPs will also see increased pressure from LPs as LPs look to exert influence through co-investments and are more selective as to where they put their money. Distressed investment opportunities for private equity funds could also be on the rise as businesses adjust to the "new normal" Chinese economy.

Private equity investors should be aware of a number of recent legal developments in Greater China that may be relevant to their activities. In Hong Kong, the new Competition Ordinance is progressing towards full implementation this year, and the proposed extension of Hong Kong's offshore fund profits tax exemption regime has now been presented to the Hong Kong legislature. Meanwhile in China, significant new rules have been promulgated with regard to the New Indirect Transfer Rules (Bulletin 7), the draft Foreign Investment Law and the new Foreign Investment Industrial Guidance Catalogue.

The deals

Giant Interactive LBO

One of the highest profile private equity transactions of 2014 in China was the US$3 billion LBO of Giant Interactive, completed in July 2014. Giant Interactive is an online gaming company known for its portfolio of "massively multiplayer online" (MMO) games in China.

This deal was notable not only for its size, but also for the financing structure and the emerging sector (online gaming) in which the target operates. As the gaming sector in China is subject to foreign investment restrictions, a variable interest entity (VIE) structure was necessary for Giant Interactive's listing in New York. While most private equity investors with China deal experience will be familiar with VIE structures, the VIE structure was particularly notable on this deal because the syndicate of lenders which part-funded the LBO was not discouraged by the existence of a VIE structure and, instead, assessed the overall performance of the entire business for the purposes of their lending decision. This suggests that lenders are becoming more comfortable with and accepting of VIE structures. However, the clear attempt in the draft Foreign Investment Laws (discussed further below) to legislate against the use of VIE structures in certain circumstances may cause a re-think for future deals.

Temasek's investment in A.S. Watson

In Hong Kong, Temasek's acquisition of a 24.95% interest in retail group, A.S. Watson, for HK$44 billion (US$5.67 billion) from Li Ka-Shing-controlled Hutchison Whampoa in April 2014 was the largest deal in the private equity space in Hong Kong last year and reportedly also the biggest investment for Temasek to-date. Watsons is the largest health and beauty retailer in Asia and Europe with 10,500 stores in 25 countries, as well as the largest pharmacy chain in China holding a 20% market share. In addition to Watsons, the A.S. Watson group also includes the Fortress electrical goods chain as well as the ParknShop supermarket chain. The deal valued A.S. Watson at nearly US$23 billion.

Prior to Temasek's investment, Hutchison Whampoa had previously been considering an IPO of A.S. Watson in Hong Kong and London. Temasek's investment is widely viewed as a play towards a recovering European consumer sector and the growing Chinese middle class. Temasek and Hutchison Whampoa plan to list A.S. Watson in Hong Kong and Singapore in two to three years.

Sinopec sale

The continued reform and restructuring of China's state-owned enterprises as announced by the Chinese leadership in November 2013 has presented (and will continue to present) opportunities in China for private equity investors.

Headline amongst deals in this space during 2014 was the US$17.4 billion sale of a 29.99% interest in Sinopec's retail business (which includes a network of over 30,000 petrol stations and 23,000 convenience stores) to a group of 25 deep-pocketed Chinese investment companies (including Tencent, Harvest Fund Management, Fosun Group, Haier Electronics, China Life Insurance, Hopu, ICBC, Bank of China, CICC and China Cinda Asset Management) and Hong Kong-based private equity investor, RRJ Capital. The sale was driven by Sinopec's desire for greater efficiency and better returns from its weaker performing units. It will be interesting to see whether the investment by such a large number of banks and financial investors will be able to boost the performance of the underlying business.

Huarong Asset Management pre-IPO investment

Also of note in 2014 was the RMB14.5 billion (US$2.4 billion) pre-IPO investment in China Huarong Asset Management by a group of investors comprising Warburg Pincus, Goldman Sachs Group, Khazanah Nasional, China Life Insurance, CITIC Securities International, CICC, Cofco Corp and Fosun Group, via an acquisition of a 20.98% stake in Huarong. Huarong is the largest (by assets) of China's four bad-loan asset management companies. The slowing Chinese economy has fuelled a surge in bad debts and consequently generated interest in the sector. Cinda Asset Management, another one of China's bad-loan asset management companies, raised US$2.5 billion in its listing in Hong Kong in December 2013. Huarong is also expected to IPO later this year.

Market commentary and analysis

Record year for Greater China PE in deal volume and value

Private equity transactions in Greater China experienced a record year in 2014. PricewaterhouseCoopers (PwC) reported that deal volume was up 51% (from 392 deals in 2013 to 593 deals in 2014) and aggregate deal value up 101% (from US$36.4 billion to US$73.2 billion). PwC notes that this is consistent with an improvement in the overall M&A market in Greater China where M&A volume and value have surged by 55% in 2014.

Mergermarket data also indicates that buyout activity in Greater China increased by 78% year-on-year, with 130 buyout deals in 2014 compared with 70 buyout deals in 2013. Much of the buyout activity in Greater China last year was driven by the restructuring of China's state-owned enterprises which is making them attractive for buyout private equity firms that have a significant amount of dry powder to put to work.

The re-opening of the Chinese IPO market in January 2014 will once again provide private equity investors with this preferred exit route in China (although the backlog of companies waiting to IPO and the cautious approach of Chinese regulators in approving new listings may mean years before the China IPO pipeline normalises), thereby facilitating the recycling of capital which has provided further impetus to the market. We do not have Greater China-specific data on this point but, according to Bain & Company, buyout-backed exits across the Asia-Pacific region in 2014 increased by 120% to nearly US$53 billion and the value of buyout-backed IPOs almost quintupled with US$63 billion of shares offered to public markets. Significant private equity exits last year include Chinese online retailer

JD.com's US$1.78 billion IPO, and Carlyle's US$285 million sale of its shares in Haier Electronics Group (Carlyle achieved a full exit from its investment in Haier in April this year via a US$424 million sale of its remaining stake through a block trade).

China-focused fundraising healthy

Fundraising by Greater China-focused funds in 2014 was healthy, although not as buoyant as was the case in 2011. According to a PwC report, while there were only 96 China-specific funds closed in 2014 compared to 130 such funds in 2013, the market was able to raise approximately US$44 billion in commitments compared with US$33.1 billion in 2013 (ie, 33% more funds raised in 26% fewer funds). Of that US$44 billion, US$28.4 billion (65%) was committed to non-RMB funds and US$15.6 billion to RMB funds. As a percentage of total funds raised, RMB fundraising has shown a decreasing trend since 2011 when it peaked at 64% of total funds raised.

Examples of China-focused fundraising during 2014 include Venator Real Estate Capital Partners' US$1 billion China-focused private equity real-estate fund and CDH Investments' US$2.55 billion China-specific private equity fund. More recently in March 2015, CICC commenced the process of raising up to RMB30 billion (US$4.89 billion) for a new private equity fund called CICC Reform and Development Fund, which will seek to participate in China's reform and restructuring of its state-owned enterprises.

China outbound investments from PE investors increasing

China outbound deal value hit a record high in 2014 with PwC reporting that US$14.3 billion was spent overseas by China-based investors over the course of 49 transactions last year. While this appears to be part of a broader trend of increasing outbound investment by Chinese capital, it is noteworthy that China-based private equity investors are playing their part as well.

One prominent example of this was Hony Capital's US$1.54 billion acquisition of PizzaExpress in the UK from Cinven in July 2014. Hony Capital intends to utilise its experience and local expertise to accelerate PizzaExpress's growth in the Chinese market. At the time of the acquisition, PizzaExpress had 436 restaurants in the UK and 68 restaurants internationally, including in Hong Kong and China. In March this year, Hony Capital announced plans to buy out PizzaExpress's franchise partner in Hong Kong and is reported to be currently in discussions to acquire 26 PizzaExpress restaurants in Hong Kong, Shanghai and other cities in China.

PE deals in the technology and consumer sectors account for majority of PE deal volume

According to a PwC report, technology and consumer deals accounted for 361 out of the 593 private equity deals in Greater China announced in 2014 (constituting US$39.7 billion out of US$73.2 billion in total deal value). This appears to reflect the wider strategic direction of the Chinese economy away from the historic industrials and towards services, new technology and the Chinese domestic consumer economy. As the Chinese domestic economy develops and matures, it is likely that private equity investments will follow this trend as well.

Examples of deals in these sectors include the Giant Interactive and Sinopec deals mentioned above, Xiaomi's US$1.1 billion capital raising (which included investments from PE investors such as Hopu Investment and Yunfeng Capital), as well as smaller deals such as Sequoia Capital's US$15 million investment in Cloudwise Technology at the end of 2014.

Crystal ball gazing: Expectations for 2015

More money going to fewer funds

Asia-Pacific focused funds had significant turnaround years in 2013 and 2014 as distributions exceeded capital contributions following seven years of negative net cashflows. This positive cashflow will in turn help to generate momentum and motivation for GPs to reinvest and recycle their capital.

At the same time, however, there are many GPs in the market looking to raise funds. Bain & Company has observed that over 2,000 funds were launched globally last year seeking over US$740 billion in commitments. A possible imbalance between GP supply and LP demand may consequently make fundraising challenging in the year ahead.

Such demand/supply imbalance combined with a competitive deal environment may see LPs increasingly looking to place their money with those GPs who have performed well for them in the past and shy away from recommitting to GPs whose track record has not been as positive. Looking ahead as 2015 unfolds, we expect to see investors committing larger amounts of money to a small number of better performing funds in order to maintain their expected returns.

Lots of money chasing too few deals

Data from Preqin indicates that, globally, private equity and venture capital investors have over US$1.2 trillion of dry powder to invest, of which US$125 billion was for investments in the Asia-Pacific region (a significant proportion of which is likely to be earmarked for Greater China).

Strategic buyers also have healthy balance sheets at present – Chinese and foreign financial institutions, sovereign wealth funds, investment companies (such as Dalian Wanda and Fosun), as well as aggressively expanding technology companies (such as Alibaba, Baidu, Xiaomi, Tencent and increasingly Google, Apple and other foreign buyers), are all looking for acquisitions in Greater China. Further, the financial crisis in Europe and a slow recovery in the US have dissuaded central banks from raising interest rates significantly, so debt continues to be cheap.

Simply put – there is a lot of money chasing after the deals that are out there.

This overhang of capital is consequently putting upward pressure on valuations. An increase in valuations that is not attributable to earnings growth could create risks for GPs as they increasingly find it difficult to achieve the returns that their investors are seeking (and expecting) from them.

This potent combination of high valuations from demanding sellers and increased competition from strategic buyers may mean a tough deal-making environment ahead for private investors in Greater China. GPs have raised a lot of money and face pressure to deploy those funds; in order to do so, they may find themselves having to pay more to close deals which may in turn affect returns.

Co-investments to increase

A growing trend in the Greater China private equity space (and one that is reflective of a broader global trend) is the increase in co-investments by LPs and other institutional investors such as sovereign wealth funds and pension funds. LPs are growing beyond the conventional constraints of being passive investors in GPs' funds and are now more than ever looking to enhance their returns by co-investing directly in larger transactions. This tendency, combined with the number of GPs looking to raise funds, means that LPs will continue to be able to leverage their power to obtain better terms from GPs.

Recent examples of co-investments on Greater China deals include CPPIB's acquisition of a majority interest in Neusoft Medical Systems alongside Goldman Sachs, and the growth capital investment by Temasek in Innovent Biologics alongside Hony Capital, Legend Capital and others.

Co-investing allows LPs to increase their exposure to private equity as an asset class and improve the prospects of boosting returns at lower cost. Co-investing also gives LPs more control over where their money is deployed, allows LPs to develop closer relationships with their GPs, as well as the opportunity to develop internal capabilities and experience in making direct investments.

Co-investments can be positive for GPs also, as co-investments allow GPs to equally develop closer relationships with their LPs, and can be used as an incentive for new LPs to sign onto (or for existing LPs to make) larger commitments.

However, co-investments can create difficulties for GPs as it means more capital is being injected into markets that are already flush with cash and increases competition overall for everybody.

Increasing distressed-focused PE opportunities

Historically, the Chinese government has bailed out troubled companies in order to preserve confidence in debt markets. However, the first onshore corporate debt default by Shanghai Chaori Solar Energy Science & Technology in March 2014 (quickly followed by Haixin Steel's default on its bank loans) ushered in a new era, and the start of 2015 has seen further fragility in Chinese bond issuers with the default of Kaisa Group's US dollar denominated offshore bonds.

Political, economic and regulatory factors in China now appear to be coming together such that there is a greater likelihood for further defaults in 2015. The Chinese central bank and government has indicated that it may permit defaults to occur in order to avoid "moral hazard" and develop the corporate debt markets. This apparent about-face from the approach that China had historically adopted, together with a slowing Chinese economy, suggests that the weaker Chinese companies may find themselves unable to meet their payment obligations.

While distressed companies and distressed debt may not typically make it onto the radars of most Greater China-focused PE funds, we expect that those with wider mandates may see opportunities arise from these distressed situations. In particular, we have seen several deals in Asia in the past few months with private equity investors acquiring debt and equity positions in transactions from traditional senior lenders.

Doing deals in Greater China: Key issues and considerations

Onshore/Offshore structuring

One of the threshold considerations for foreign private equity investors looking to invest in China is whether the investment can or should be structured through an offshore entity. Generally speaking, an offshore structured investment offers a legal framework that affords foreign investors more flexibility and certainty in terms of legal protections. Many of the investor protection rights commonly sought by private equity investors are simply not enforceable as a matter of Chinese law; or even if enforceable, require regulatory approval thereby empowering the government to indirectly influence the commercial and financial terms of the deal. An offshore structured investment will also more often than not circumvent the need to obtain many of the government approvals that so often increase the risk that a deal won't close in China and considerably lengthen the deal process.

In the past, it was not uncommon to structure an investment offshore by having the Chinese enterprise owners convert their PRC domestic business into a "foreign-owned" business by setting up an offshore holding company and using such holding company to purchase their PRC owned business (a so-called "round-trip investment" or "red-chip structure").

The viability of the red-chip structure was, however, firmly brought into question when China's Ministry of Commerce (MOFCOM) issued the Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (M&A Rules) in 2006. The M&A Rules created a major legal hurdle for the red-chip structure by requiring central MOFCOM's approval for any round-trip investment; an approval which has been difficult (if not impossible) to obtain. As a result, private equity investors have been forced to invest either directly onshore through a Chinese joint venture structure governed under Chinese law or consider other structures such as the VIE structure, which uses various contractual arrangements to avoid direct foreign ownership that might trigger restrictions or a prohibition, not to mention government approvals.

The VIE structure has been the subject of much government and legislative scrutiny in China, such that the appetite amongst foreign private equity investors is somewhat bifurcated. On the one hand, there are those who see no other choice but to invest through a VIE structure and are comforted by the fact that so many investments (including some of the largest and most successful Chinese technology companies such as Alibaba and Tencent) have been made to-date with minimal adverse consequence. On the other hand, there are the more conservative and sceptical investors who explore all other means of structuring before using a VIE structure and even passing on investments where a VIE structure is either already in place or may be put in place; they are aware of those instances where the VIE structure has resulted in adverse and sometimes calamitous consequences for the foreign investor and are concerned by the ground swell of government and regulatory opposition to the use of VIE structures. The draft Foreign Investment Law addresses the issue head-on for the first time, and will hopefully lead to more certainty over the use of VIE structures.

Government approvals

Government and regulatory approvals will often have a major impact on any transaction in China both in terms of deal certainty and timing. The ability to structure an investment through an offshore entity will invariably remove the need to obtain many of the approvals required for a direct onshore foreign investment; merger control filing and national security review (which are described below) need to be considered irrespective of whether the deal is structured offshore or onshore.

MOFCOM or its local counterpart is the main authority to approve foreign investments in China. Major investment documents (such as the equity purchase agreement, shareholders' agreement and articles of association of the Chinese target company) will only become effective upon approval from MOFCOM. Approval of the National

Development and Reform Commission (NDRC) or its local counterpart is usually also required where a transaction involves an investment in a fixed asset project. Once MOFCOM and/or NDRC approve such transaction, the investment needs to be registered with the State Administration of Industry and Commerce (or its local branch). The entire approval and registration process can take several months to complete and therefore needs to be factored into the transaction timeline.

Foreign investment approval from MOFCOM and/or NDRC needs to also be considered along- side other approvals such as:

- Industry-specific approvals from industry regulators in certain regulated sectors such as telecommunications, publishing, banking, insurance and securities; such approvals will generally be required prior to MOFCOM's approval.
- If investing in a Chinese state-owned enterprise, special procedures need to be followed, including obtaining prior approvals from the authorities supervising state-owned assets, appointing a qualified institution to conduct an asset appraisal, and carrying out such transaction at one of China's property rights exchanges, for purposes of increasing transparency in the sale of state-owned assets.
- The scope of China's merger control rules mean that most acquisitions require some anti-trust analysis to determine whether the acquisition may result in a "concentration of undertakings" that meets the relevant thresholds thus triggering a reporting obligation to the Anti-Monopoly Bureau of MOFCOM prior to completion of the acquisition. As the definition of the concentration and the thresholds are interpreted in a very broad way involving MOFCOM's discretion on a case-by-case basis, there is no safe harbour that would not trigger a filing. The initial review period is 30 days from acceptance by MOFCOM of a complete filing. If MOFCOM decides that an in-depth investigation is needed, another 90 to 150 days for investigation will be required. In practice, however, it may take more time to obtain a clearance from MOFCOM.
- National security review approval is yet another consideration if foreign investors merge with or acquire Chinese business in certain sensitive sectors, such as national defence and security, key energy and natural resources, critical infrastructure, major transport services, key technologies within China, and where the foreign investor is likely to acquire actual control over such business. Whilst it is less of a concern for minority investments, "control" is rather broadly defined and may include decisive influence through contractual arrangements (e.g. veto rights), which private equity investors typically wish to put in place for their minority investments.

Anti-corruption/FCPA

In China, where corruption risk is high, foreign investors need to pay particular attention to the risk of successor liability. The concept, recognized in some form under the United States Foreign Corrupt Practices Act (FCPA), the United Kingdom Bribery Act (UKBA), as well as local Chinese law, holds that an acquirer, such as a private equity fund, may be held liable for civil and criminal bribe conduct committed by the target company even if those acts occurred prior to the acquisition or merger and were entirely unknown to the acquirer.

As a result, private equity investors need to pay close attention to their pre-purchase due diligence. All too often, compliance due diligence takes a back seat to legal and financial due diligence – to the acquirer's detriment. A far more efficient and cost-effective approach is to plan for and integrate compliance into the overall due diligence plan, allowing the compliance specialists to work alongside and take advantage of legal/financial due diligence, and discover potential deal-breakers early in the process.

Once potential corruption risks are identified, the acquirer and target company may voluntarily disclose such violations to the relevant regulatory authorities (e.g. the US Justice Department and Securities Exchange Commission) to allow the opportunity to resolve any potential liabilities. The impact of compliance liability in the mergers and acquisitions context is wide-ranging. Bribe conduct that has been detected may impact the transaction price and deal structure, and require specific warranties and indemnities in the acquisition agreement. Additionally, the discovery of significant corrupt acts may cause delay for the purposes of further investigation, or even the termination of the proposed deal.

Key legal developments

Hong Kong's new Competition Ordinance

The new Hong Kong Competition Ordinance is on track for implementation in the second half of 2015. At its core, the Competition Ordinance prohibits:

- anti-competitive agreements;
- abuse of substantial market power; and
- mergers that substantially lessen competition (currently, merger control only applies to licensed telecommunications carriers).

These three core rules apply to all undertakings inside and outside Hong Kong, where their conduct has the object or effect of restricting competition in Hong Kong.

Private equity Investors need to be aware of the impact of the new Ordinance on existing portfolio companies and potential new investments whose operations could restrict competition in Hong Kong. Once the new Ordinance comes into effect, the business activities of current portfolio companies and prospective investments may need to be diligenced for anti-competitive conduct.

Progress towards implementation of the new Ordinance has continued with the closing in December 2014 of the deadline for submissions in respect of the draft guidelines to the Ordinance. Submissions from 64 respondents were received by the Hong Kong Competition Authority and final versions of the guidelines are expected in the first half of 2015 prior to implementation of the Ordinance itself.

On 18 February 2015, the Hong Kong government took further steps towards implementation of the new Ordinance through the publication of several new regulations. Of these, perhaps the most important is the Competition (Turnover) Regulation, which sets out the method for determining the turnover of an undertaking for the purpose of pecuniary penalties pursuant to enforcement actions (which are capped at 10% of an undertaking's annual turnover), as well as the method for determining whether the statutory exclusions for agreements and conduct of lesser significance apply.

Hong Kong to extend offshore fund profits tax exemption regime to cover PE funds

Progress has been made in Hong Kong with the proposed extension of the offshore fund profits tax exemption regime to cover offshore private equity funds. Since being announced in the 2013/2014 Budget, the Hong Kong government has undertaken a series of industry consultations and in March this year introduced legislation to implement the proposal.

The Hong Kong government has stated its desire to grow Hong Kong's private equity industry, which currently has assets under management of US$114.6 billion, accounting for 21% of Asia's total capital managed by private equity.

The bill to extend the profits tax exemption for offshore funds to also cover private equity funds is expected to be passed by the Hong Kong Legislative Council during 2015.

The exemption will exempt qualifying funds investing in specified transactions in offshore private companies from liability to pay profits tax in Hong Kong. It is hoped that the extension of the profits tax exemption to private equity funds will make Hong Kong a more competitive and desirable location to manage offshore funds and strengthen Hong Kong's position as an international asset management centre.

China's new Indirect Transfer Rules

In 2009, the Chinese government issued the State Administration of Taxation Circular on Strengthening the Administration of Enterprise Income Tax on Income From Transfer of Equity Interest by Non-resident Enterprises (Circular 698) targeting offshore share transfer transactions involving an indirect transfer of a PRC enterprise. In February 2015, the Chinese government issued the Indirect Transfer Rules (Bulletin 7), which are a further attempt by the Chinese government, following Circular 698, to better implement its anti-tax avoidance regime. Under Bulletin 7, PRC tax may be imposed on an offshore transaction involving an indirect transfer of a PRC-based asset (an “Indirect Transfer”).

While there are some changes which are welcome, overall, Bulletin 7 appears to throw an even wider net to catch offshore transfers than was the case under Circular 698 and will be at least as troubling as Circular 698 for parties investing in, and exiting from, investments in China.

Bulletin 7 imposes a tax withholding obligation on the purchaser (and a tax payment obligation on the seller in the event that the purchaser fails to withhold). Failure by a purchaser to make a withholding (and a failure by the seller to pay the relevant income tax in a taxable Indirect Transfer transaction) may result in a penalty being imposed on the purchaser, unless the purchaser has reported the Indirect Transfer to the PRC tax authority within a prescribed period after the execution of the relevant sale and purchase agreement (in which case the penalty may be reduced or waived). The penalty can range from 50% of, to three times, the unpaid tax. This is designed to encourage the purchaser to report voluntarily any Indirect Transfer.

Bulletin 7 should, therefore, be carefully considered in any cross-border private equity transaction where the target group includes PRC-based asset. Whilst the impact of Bulletin 7 would appear to be primarily a purchaser risk, sellers are not free from potential liability and parties should accordingly ensure that this issue is discussed in the early stages of any transaction involving PRC-based assets so that the potential risks can be reviewed and, where a withholding risk exists, to ensure that the relevant reporting requirement for the Indirect Transfer is properly addressed.

China to unify inbound foreign investment laws

MOFCOM issued a draft of the Foreign Investment Law for public comment on 19 January 2015. The period of soliciting public comment expired on 17 February 2015. If enacted as currently drafted, the draft law will have far-reaching implications for foreign investment into China, including offshore private equity funds.

At a basic level, the draft law promises to unify China's current legal regime on inbound foreign direct investment, which currently consists of three separate bodies of laws together with their respective implementing rules, and applicable provisions scattered throughout numerous other laws, regulations and departmental rules. Although the draft will take time to come into effect and multiple rounds of revision are expected to be carried out before the law is finalized, it has already demonstrated China's strong commitment to providing a level playing field for both domestic and foreign companies, streamlining market entry but strengthening investment scrutiny in line with international practices and overhauling of the old foreign investment regime.

The draft law contains quite a few innovations and breakthroughs, some of which promise to help ease FDI restrictions. However, in many respects, the draft law also imposes new and onerous obligations on foreign investors, particularly in terms of information disclosure. In a nutshell, the draft law:

- appears to forbid a broad swathe of VIE participation in prohibited sectors (unfortunately, without any indication that these sectors will otherwise ever be liberalised, and therefore likely stymying development and growth in these areas);
- takes a new approach to the definition of Foreign Investment and Foreign Investors, which may have a substantial impact on VIE structures. In particular, the draft law introduces for the first time a "control" concept to determine the foreign or domestic nature of an investment or investor. Control is very broadly defined and includes control through contract (which is at the core of a VIE structure). This may be alarming to those foreign investors who use a VIE structure to "control" a business in China which is subject to prohibition or restriction in foreign shareholding;
- does not make clear how MOFCOM proposes to deal with existing VIEs. MOFCOM has proposed three different approaches for public comment as part of the draft law and is keen to receive suggestions;
- substantially expands the types of activities that are considered to be foreign investment and consequently subject to Chinese foreign investment laws;
- proposes to replace the current mandatory MOFCOM approval system for the establishment of any foreign invested enterprise with a "market entry permit system", which will only be required for companies that will operate in a "restricted" sector, thereby streamlining and simplifying the establishing process for foreign invested enterprises that are not operating in restricted or prohibited sectors;

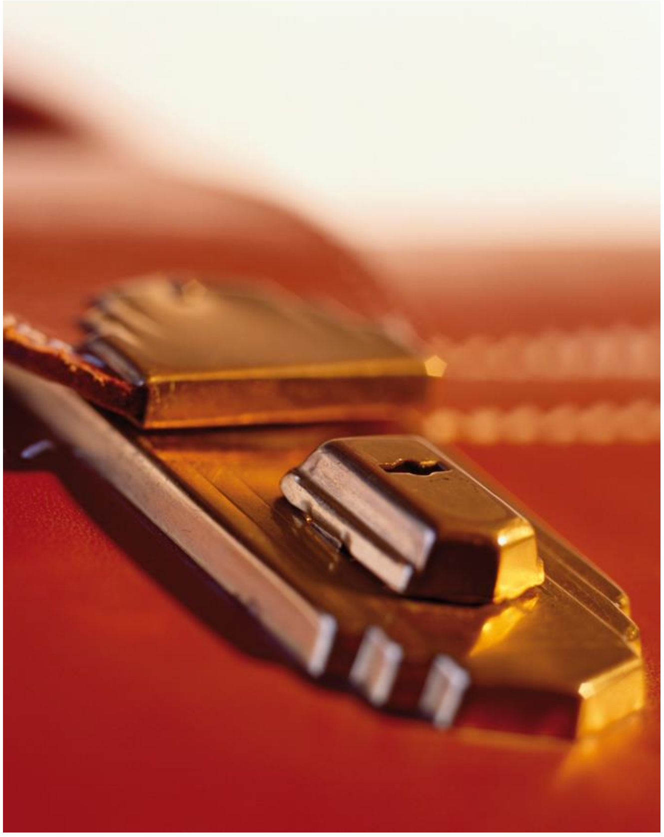
- adopts a "Negative List" approach listing only restricted and prohibited sectors to replace the current Guidance Catalogue for Foreign Investment Industries, an approach modelled on the system in place in the Shanghai Free Trade Zone;
- authorizes MOFCOM, for the first time, to attach restrictive conditions to its approvals;
- adopts a reporting mechanism to replace MOFCOM approvals for post-establishment changes in equity interests, thereby eliminating investor uncertainty from certain transactions currently subject to discretionary MOFCOM approvals;
- substantially increases the reporting burden on foreign investors and foreign invested enterprises through this same reporting mechanism, and raises concerns about the publication of sensitive business information that could be valuable to competitors of foreign invested enterprises;
- expands the scope of potential national security review, eliminating the previous approach, which was limited by transaction type and sector;
- lays out various administrative (and even criminal) sanctions for non-compliance with the new law, including stiff penalties for failure to comply with the new reporting obligations; and
- establishes a new mechanism for foreign investors to make complaints to a third party agency about mistreatment by any relevant government departments.

China's revised Foreign Investment Industrial Guidance Catalogue

Since 1995, China has published a Foreign Investment Industrial Guidance Catalogue to guide the entrance of foreign investment into China, and has been amending the Catalogue regularly to reflect changes in economic and political policy. A revised version of the Catalogue has been jointly released by the NDRC and MOFCOM, effective on 10 April 2015.

The revised Catalogue has 349 "encouraged", 38 "restricted" (80 "restricted" in the previous Catalogue) and 36 "prohibited" (39 "restricted" in the previous Catalogue) industries; with any industry not categorized as any of the above considered "permitted".

Notably, foreign investment in some industries is no longer "restricted" and is now "permitted", for instance: e-commerce; direct sales; mail order and online sales; purchase of grain; wholesale, retail and distribution of grain, cotton, vegetable oil, sugar, crude oil, agricultural chemicals, agricultural plastic film and fertilisers; transportation of goods by rail; distribution of sound and video recordings (excluding films); carrying on business as a finance company, trust company or currency brokerage company; and operation of recreation facilities. Foreign investment in some industries is no longer "prohibited" and is now "permitted", for instance: establishing and operating cinema chains; research and development into and using transgenic plants and animals; and the operation of golf courses and villas.



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