BLOG

China's 2021 Negative List Increases Risks of VIE Investment

FEBRUARY 8, 2022

With the release of the 2021 Negative List for the Market Entry of Foreign Investment[1] ("**2021 Negative List**"), which went into effect on January 1, 2022, China's policy on foreign investment became clear—foreign companies may invest in unrestricted industries or invest passively according to the restrictions in Chinese law. In essence, China has dealt a blow to the Variable Interest Entity ("**VIE**") structure by removing the ability of foreign investors to control the domestic company and their investment.

We previously described the VIE structure here. For a general recap, the VIE has been used by foreign investors in China to engage in restricted industries through investment in an offshore company that controls a Chinese domestic entity and its owners through control contracts. Profits are returned to the foreign investor through other contracts. This is the structure that has been used by Chinese companies that have listed on exchanges outside China. We described the SEC's view here.

The 2021 Negative List includes expanded explanatory notes when compared with previous versions, and in fairness, for five successive years China has reduced the negative list for foreign investment, allowing for foreign participation in more industries. For the 2021 Negative List, note 6 affects the typical VIE structure and control contracts and provides:

> Any domestic enterprise engaging in businesses prohibited by the Negative Lists that issues securities abroad and lists overseas[2] must obtain pre-approval consent from relevant competent regulator; overseas investors must not engage in the operation and management of the enterprise, and the percentage of foreign shareholding is subject to the relevant provisions in the administrative measures for domestic securities investments by foreign investors.[3]

The restrictions from operation and management and the foreign shareholding percentages are explained in draft and current regulations. Taken together, these two restrictions push foreign investment to either unrestricted industries or passive investment in restricted industries.

Restriction from Operation and Management

The restriction from foreign participation in operation and management of enterprises in restricted industries directly impacts the typical VIE structure by limiting the ability of investors to utilize control contracts. Under article 23 of the

Administrative Measures for the Filing of Overseas Securities Offering and Listing by Domestic Companies (Draft for Comments) ("**Draft Administrative Measures**"),[4] "controlling relationship or control right," within the Draft Administrative Measures, means:

1. holding more than 50% equity, voting rights, or other equitable rights and interests;
2. the ability to exert a material impact on decisions of board of directors, shareholders' meetings, the general meeting, or a similar decision-making body of the enterprise; or
3. the ability to exert a material impact on operations, finance, personnel, technology, etc. through contracts, trusts, agreements, or other arrangements or being the beneficial owner.[5]

The explanatory note in the 2021 Negative List and the Draft Administrative Measures both cover overseas listing of a Chinese domestic company, with the Draft Administrative Measures covering the prefiling and approval procedures. Thus, the definition of "control" within the Draft Administrative Measures is instructive and probably authoritative.

As a result, the control contracts for existing VIE structures will need to be addressed before an overseas listing can occur. Moreover, given these policy developments, it is exceedingly possible that local government agencies may examine the VIE structure and disapprove of control contracts, which could affect the investment. Thus, for new investments in a VIE, companies will need to consider whether to include control contracts with an exit strategy or to provide passive investments.

Foreign-Shareholding Restrictions

According to a Q&A with MOFCOM[6] and the NDRC,[7] the "relevant provisions" regarding the percentage of foreign shareholding are governed by the shareholding-ratio requirements for investing in domestic securities markets through Qualified Foreign Institutional Investors ("QFII") and Renminbi Qualified Foreign Institutional Investors ("RQFII"), meaning a single foreign investor and its affiliates may not hold more than 10% of the total shares of the company and the total investment proportion of all foreign investors and their affiliates may not exceed 30% of the total shares of the company.[8]

The shareholding limits will be imputed to indirect overseas listings (those using VIE structures) going forward, meaning that foreign shareholders in a listing VIE must be less than the thresholds or be adjusted before a listing could be approved by the CSRC.[9] For existing investments with an expectation of future overseas listing, this could present a significant challenge.

Future investments should consider an adjustment to the VIE and the possibility of passive investment in China. There is an application process through the CSRC to become a QFII, and the regulations require a decision to be made within 10 days. Upon approval, a securities and futures business license will be issued.[10] After approval, appointment of a local custodian, and other requirements, the QFII can invest in securities listed on a Chinese exchange.

Going Forward

For Chinese entities that have completed the listing process, it currently appears that the relevant agencies will not review the structures or shareholding percentages. In its Q&A, MOFCOM and the NDRC suggest that they will not be scrutinizing the previously listed companies' shareholding ratios, though it is not clear that this position includes the operation and management restriction.[11] However, a Q&A does not have force of law, and the government's position could always change. Investors should watch for developments.

For preexisting investments in VIEs that have yet to be listed, companies need to prepare for changes by reviewing investment agreements, control contracts, and other relevant documents to determine whether potential options exist and to develop strategies for next steps. Preexisting investments in VIEs will face the most complex challenges in the immediate future.

For foreign investors considering investment into restricted industries in China, particularly where the end goal is public listing of the company, the VIE structure may not offer significant added protections when compared to the passive investment allowed for QFII under Chinese law, which is an equity investment. However, the VIE may still provide beneficial profit distributions when compared to the QFII. Thus, investors need to compare the specifics and challenges of a proposed investment in a VIE to options allowed as a QFII.

Winston & Strawn's team can assist with the review of potential investment opportunities in China, including due diligence on companies, key individuals, and review of the entire structure.

---

[1] 外商投资准入特别管理措施（负面清单）（2021年版）。

[2] A listing by an overseas company, typically the Cayman entity in the VIE structure, is not technically a domestic enterprise. However, the *Provisions of the State Council on the Administration of Overseas Securities Offering and Listing by Domestic Companies (Draft for Comments)*, 国务院关于境内企业境外发行证券和上市的管理规定（草案征求意见稿）, defines an "indirect issuance" to include the typical VIE listing, thus requiring the same procedures for either the listing by a domestic entity or an indirect issuance.

[3] 六、从事《外商投资准入负面清单》禁止投资领域业务的境内企业到境外发行股份并上市交易的，应当经国家有关主管部门审核同意，境外投资者不得参与企业经营管理，其持股比例参照境外投资者境内证券投资管理有关规定执行。

[4] 境内企业境外发行证券和上市备案管理办法 (征求意见稿)。

[5] 本办法所称控制关系或控制权，是指单独或者共同、直接或者间接能够实际支配企业生产经营活动或决策的行为，包括以下情形：（一）持有百分之五十以上的股权、表决权或者其他类似权益的；（二）能够对董事会、股东会或者股东大会等类似决策机构的决策产生重大影响的；（三）通过合同、信托、协议等安排对经营活动、财务、人事、技术等施加重大影响或为受益所有人的。 本办法第七条、第八条所称资产，包括证券、实物、技术、知识产权、股权、债权等。

[6] Ministry of Commerce.

[7] The National Development and Reform Commission.

[8] http://12335.mofcom.gov.cn/articledwmy/zcxx/yjwz/202112/1935480_1.html; https://www.ndrc.gov.cn/xwdt/xwfb/202112/t20211227_1309929.html?code=&state=123.

[9] China Securities Regulatory Commission.

[10] *Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors: Measures for the Administration of Domestic Securities and Futures Investments*. 合格境外机构投资者和人民币合格境外机构投资者境内证券期货投资管理办法。

[11] http://12335.mofcom.gov.cn/articledwmy/zcxx/yjwz/202112/1935480_1.html; https://www.ndrc.gov.cn/xwdt/xwfb/202112/t20211227_1309929.html?code=&state=123.

6 Min Read

Authors

Jacob Harding

Cari Stinebower

Related Locations

Los Angeles

Washington, DC

Related Topics

International Trade | China | VIE | Asia | Hong Kong

Related Capabilities

International Trade

Related Regions

North America

Related Professionals

Jacob Harding

Cari Stinebower

This entry has been created for information and planning purposes. It is not intended to be, nor should it be substituted for, legal advice, which turns on specific facts.