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Explaining Order 11 - Comments on the Latest NDRC Q&A

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Investors engaged in overseas investment have been closely watching the National Development and Reform Commission's ("**NDRC**") *Measures for Administration of Overseas Investments by Enterprises* ("**Order 11**") since its effectiveness on March 1, 2018. To coordinate the implementation of Order 11, NDRC has promulgated *Circular of the National Development and Reform Commission on Issuing the Catalog for Overseas Investment in Sensitive Industries* (Fa Gai Wai Zi [2018] No.251, "**Sensitive Industries List**") and *Circular of the National Development and Reform Commission on Issuing Standard Forms in Support of the Measures for Administration of Overseas Investments by Enterprises (2018 Edition)* (Fa Gai Wai Zi [2018] No. 252 "**Standard Forms**"). Despite this regulatory guidance, however, investors still face many issues regarding how Order 11 is to be implemented and interpreted, such as the specific scope of sensitive industries, NDRC review standards for approving overseas investments in sensitive industries, and whether Order 11 approval is required when the overseas investment funds are entirely sourced from outside of China.

On June 5, 2018, NDRC released the *Questions and Answers Regarding Common Issues in Overseas Investment* ("**Q&A**") on its national overseas investment administration and service network system. The Q&A focuses on questions that NDRC has routinely encountered, clarifies certain ambiguities in Order 11 and is expected to provide clear, practical guidance to facilitate overseas investment. In this article, we will briefly comment on and analyze the key aspects of the Q&A.

I. Further clarifying the scope of "overseas investment"

NDRC defines overseas investment in Article 2 of Order 11 by providing both a general definition and listing examples. However, questions still arise in practice with respect to classifying overseas investments. The Q&A provides further explanations in this respect.

i. Investors

In the Q&A, NDRC makes two clear interpretations of investors. First, Q28 of the Q&A clarifies that the term “domestic natural persons” referenced in Order 11 at Article 63 refers to Chinese nationals residing in China (“**domestic individuals**”). This means that Order 11 may not apply to the overseas investments of a non-domestic individual if, for example, the investment is made through an offshore enterprise under his or her control. However, the provisions on overseas investment by domestic entities that control offshore enterprises *will* apply to a non-domestic individual that makes an overseas investment through the offshore subsidiary of a domestic entity that he or she controls (specifically, sensitive investment projects are subject to approval; non-sensitive investments projects that exceed USD 300 million are subject to high-value, non-sensitive industry reporting procedures).

Next, Order 11 at Article 2 references “overseas controlled enterprises,” which, during NDRC review, are subject to “look-through under the principle of substance over form.” This means that it is necessary to look through the chain of ownership of an enterprise to the actual controller who directly or indirectly holds 50% or more of the voting rights of the enterprise, or who does not hold 50% or more of the voting rights, but controls the business, financial, personnel, technology and other important affairs of the enterprise (see Q1 and Q35 of the Q&A for details). Combined with the content listed in the Standard Forms, we believe that NDRC will require control methods such as VIE structures and trusts to be subject to look-through to confirm whether the actual controller is a domestic entity or individual (for details, please refer to our article entitled *China Expands Disclosure Requirements over Chinese Enterprises’ Overseas Investment Activities* (Chinese) , dated February 23, 2018).

ii. Types and sources of invested assets

Order 11 stipulates that overseas investments may be in the form of “assets or equity, or providing financing, guarantees, etc.” but fails to clarify the scope of “assets or equity.” Q13 of the Q&A clearly specifies the scope of “assets or equities” to include “currency, securities, tangible goods, technology, intellectual property, equity, creditor’s rights, and other assets and rights.” This is a quite broad definition, covering almost all types of assets and equities that may be used in overseas investment. Together with the catch-all phrase “...and other assets and rights,” we presume that nearly all forms of overseas investment in practice will be subject to the supervision of Order 11. In addition, we believe that “providing financing or guarantees” includes domestic loans, guarantees, mortgages and pledges. Thus, Order 11 may also govern so-called “onshore guarantees for offshore loans” and “domestic enterprises extending loans to offshore enterprises.”

It is worth noting that NDRC, in the Q&A, has included “equity” investment as one form of “asset or equity” in overseas investment. Based on our experience, it is difficult to use equity as a form of capital contribution when acquiring ownership in a foreign investee, since non-public companies are currently prohibited from engaging in cross-border share swaps. The

inclusion of equity as a form of overseas investment in the Q&A may indicate a relaxing of restrictions on cross-border share swaps. We will keep an eye on this issue.

iii. Scope of “investment activities”

In practice, we often encounter questions from investors as to whether a certain investment project is an overseas investment subject to NDRC approval or record-filing. The reason for uncertainty with these projects is because while the investment may involve the establishment of an offshore entity or the cross-border flow of funds, in many cases, these projects either may not inherently be investments or the equity to be obtained from the project may ultimately be regarded as a domestic asset. In light of these issues, NDRC has given the following explanation:

First, in the case of bond issuances by domestic enterprise-controlled offshore entities, the Q&A clearly specifies that Order 11 will not apply if the proceeds from an issuance is not used for overseas investment activities. However, Order 11 will apply if the proceeds are used for overseas investment activities, in which case the overseas investment project will be subject to approval or record-filing administration.

Based on the same logic, a shareholder loan from a domestic entity to its offshore entity will not be regarded as an overseas investment where the loan is only to be used for the entity’s general corporate operations, payment of service fees, etc. However, Order 11 will apply if the shareholder loan proceeds are used for overseas investment activities, in which case the project will be subject to NDRC approval or record-filing administration.

II. Clarifying the scope of sensitive industries

Investors have encountered some confusion in practice regarding the scope of sensitive industries since Order 11 and the Sensitive Industries List only generally name the sensitive industries but do not determine a detailed scope of those industries. Q16 to Q24 of the Q&A further explains the scope of sensitive industries.

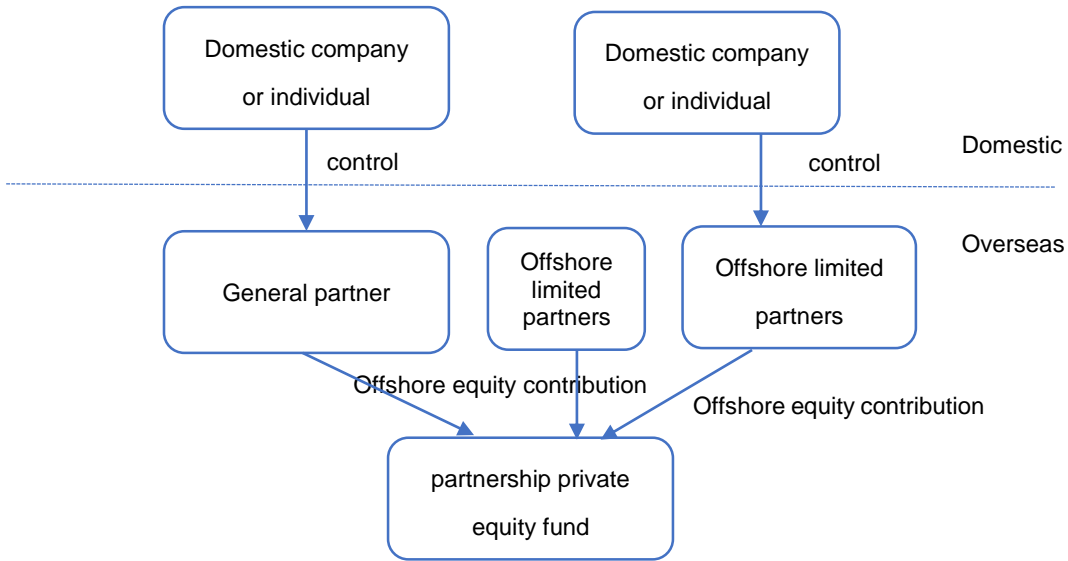
i. Equity investment funds or investment platforms without specific industrial projects

According to the Q&A, “an equity investment fund or investment platform established overseas without any specific industrial project” does not include the following two cases:

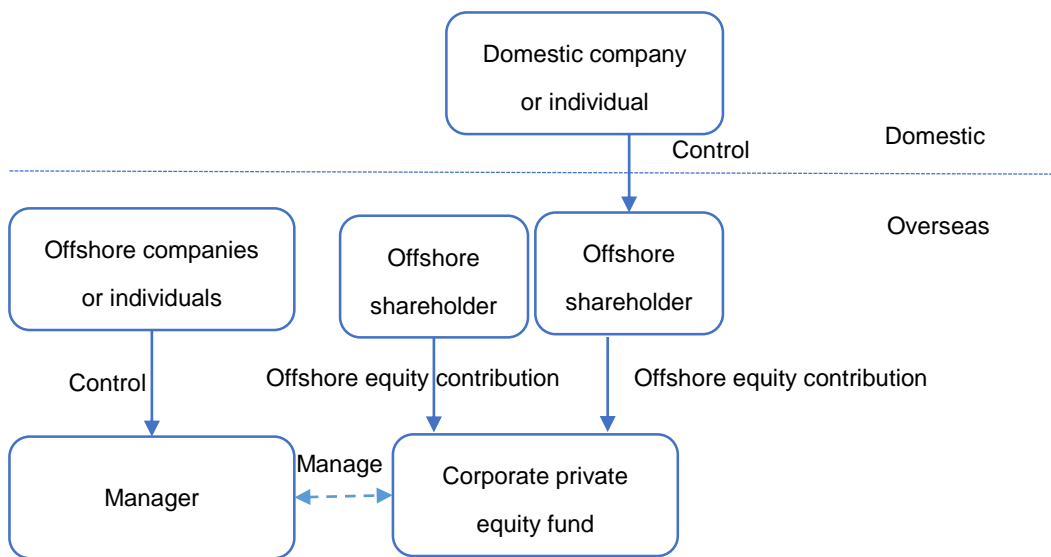
1. Equity investment funds or investment platforms with all funds are raised purely overseas and without any domestic investment in its assets or equities, nor domestic financing or guarantees, etc.;
2. Such offshore equity investment funds or investment platforms that do not engage in specific industrial projects are established by a domestic financial enterprise with the approval of a domestic financial regulatory authority.

With respect to the first case above, we believe that the following two common offshore fund structures may not be regarded as “equity investment funds or investment platforms established overseas without specific industrial projects”:

- a. A domestic enterprise or individual directly or indirectly establishes an offshore general partner or management entity that raises funds from offshore investors to establish a partnership or corporate private equity fund (for illustration purposes, the following structure chart is a partnership private equity fund model)



- b. An offshore enterprise or individual directly or indirectly establishes an offshore general partner or management entity that raises funds from offshore investors to establish a partnership or corporate private equity fund (for illustration purposes, the following is a corporate private equity fund model)



The following conditions must be met for the two structures described above:¹

- a. General partner or manager: the general partner or manager of an equity investment fund or investment platform without a specific industrial project is an enterprise or individual that is: (1) offshore, or (2) controlled by a domestic enterprise or individual but has not invested any domestic assets or equities in the offshore private equity fund. In addition, the general partner or manager has not accepted any form of domestic financing or guarantees.
- b. Limited partner or shareholder: all limited partners or shareholders (as appropriate) are offshore institutions or individuals that have invested offshore assets or equities in the offshore private equity fund. In addition, all limited partners or shareholders (as appropriate) have not accepted financing or any form of guarantee provided by entities located within China.
- c. Offshore private equity funds: the funds have not accepted assets or equity invested by domestic entities or any financing or any form of guarantee from within China.

NDRC approval based on the Sensitive Industries List is not required for equity investment funds and investment platforms established overseas without specific industrial projects that meet the above conditions from the perspective of having a general partner or manager that is: (1) a domestic enterprise, or (2) an offshore enterprise controlled by a domestic enterprise or individual. In addition, NDRC approval based on the Sensitive Industries List is not required for investments that domestic enterprises or domestic-overseas controlled enterprises make in such equity investment funds or investment platforms.

Regarding the “domestic financial regulatory authority” referenced in the second case, according to our consultation with NRDC, the authority primarily refers to regulators such as the China Securities Regulatory Commission and the China Banking and Insurance Regulatory Commission. Therefore, an investment project could still be considered sensitive even if it has obtained approval from a local financial authority.

ii. Other sensitive industries

The Q&A also further clarifies the scope of other sensitive industries (for details, please see the attached Description of Sensitive Industries). The key points are summarized as follows:

1. The Q&A clearly states that some industries, such as real estate and hotels, should not be regarded as sensitive industries if the investment funds are raised from overseas and do not involve domestically-invested assets or equity and do not involve domestic financing or guarantees. According to our consultation with

¹ Under these two structures, popular legal forms for offshore private equity funds include Cayman exempted limited partnerships, Cayman limited liability companies, Delaware limited partnerships, Delaware limited liability companies, BVI companies limited by shares, etc.

NDRC, attention will be paid to the source of the investment funds (that is, whether the funds are sourced from overseas) in order to determine whether the funds are raised from overseas, rather than examining the nature of the funder (i.e., whether it is a domestic entity or an offshore entity under its control). Therefore, making offshore investments in those industries with funds sourced from overseas will not be subject to approval procedures applicable to sensitive industries. However, it remains to be seen whether making overseas investments through a QDIE (Qualified Domestic Investment Enterprise) or QDLP (Qualified Domestic Limited Partner,) will be regarded as an investment involving assets or equity provided by entities located within China.

2. The Q&A clearly defines the scope of “entertainment industry,” which mainly refers to the traditional offline entertainment industry. Other Internet-based entertainment business types such as games, culture and music are not classified as sensitive.
3. The Q&A clearly defines “news media” as “offshore news organizations (including news websites), publishing agencies, and broadcast and television organizations that both involve current political affairs and have a major impact on national security.” Other media that do not relate to current political affairs are not classified as sensitive.

It should be noted that industries that are excluded from the scope of sensitive projects are not entirely exempted from Order 11. Investments in these industries are still subject to the regulatory rules applicable to non-sensitive projects.

III. Clarifying the approval criteria for overseas investments in sensitive industries

Order 11 clearly requires NDRC approval for overseas investments that domestic investors directly or indirectly make in sensitive industries, and NDRC has released the Standard Forms to supplement these requirements. In practice, however, investors continue to feel uncertain about what information and materials required to be submitted, and which content is required to be disclosed in an approval application because NDRC has been unclear about its review standards. Q25 of the Q&A partially answers these questions.

The Q&A reiterates the Order 11 review and approval standards for investment projects subject to review, namely: (1) the project is not in violation of PRC laws and regulations; (2) the project is not in violation of China's relevant development plans, macro-control policies, industrial policies and opening-up policies; (3) the project does not violate international treaties and agreements concluded or acceded to by China; (4) the project does not threaten or harm China's national interests and national security.

Due to ambiguity in Order 11 about the scope of “macro-control policies,” the Q&A provides a list of projects that will not be deemed to violate macro-control policies, which include: (1) inter-

governmental cooperation projects; and (2) projects for which relevant industry authorities and embassies have clearly expressed their support during the process of soliciting opinions. Therefore, inter-governmental cooperation projects, even those in sensitive industries, will still stand a good chance of approval. For non-governmental cooperation projects, investors may wish to seek support for the investment by communicating in advance with industry regulators and the Chinese embassy where the investment is to be made, which will help to increase the chances for approval.

IV. Further clarifying the content to be disclosed in applications and the form of application materials

In addition to the questions related to substantive issues, the Q&A also answers some questions frequently asked in practice in relation to what content is required to be disclosed in the application as well as the form of the application materials.

For applications by state-owned enterprise subsidiaries, the Q&A clearly specifies that such subsidiaries should apply through the enterprise's group for record-filing and reporting procedures. Such applications are to be made through the group's or parent enterprise's account on the "National Overseas Investment Management and Service Network System."

In addition, the Q&A clarifies that investors are required to submit their latest audited financial statements for approval or record-filing of the overseas investment, i.e., the investor's most recent annual or semi-annual audited financial statements. If the investor is recently established and cannot provide audited financial statements, the latest audited financial statements of the controlling shareholder, general partner or actual controller of the investor should be provided. If the investor has been registered for fewer than two years, it may only provide its credit information for the period from establishment to the date of application, but the investor's controlling shareholder (or general partner) and ultimate controller will also need to submit credit information for the preceding two years.

In addition, in principle, it is not necessary to submit paper materials if the application has been submitted through the Internet. However, investors may apply with paper forms if the relevant project or information involves state secrets or it is not suitable to submit the application through the Internet system.

V. Summary

The Q&A answers many questions that are frequently asked in practice regarding Order 11, especially in terms of the scope of sensitive industries and the scope of "investment activities." However, issues remain that await further NDRC clarification with respect to implementing Order 11 and its supporting documents. For example, NDRC has not explained the purpose of the requirement in Order 11 that investors must provide credit information regarding themselves and

of their actual controllers and controlling shareholders. It is not yet clear how this credit information will affect investor applications for overseas investment.

We will continue to closely monitor any new issues that arise in practice and how NDRC deals with these issues, and timely share our opinions with you.

Attachment: Description of Sensitive Industries

Sensitive Industries	Sensitive Investment Projects	Non-sensitive Investment Projects
equity investment funds or investment platforms established offshore without a specific industrial project	Equity investment funds or investment platforms established overseas without specific industrial projects, funded by assets or equities invested by entities located within the territory of China or by financing or guarantees provided by entities located within the territory of China.	<ol style="list-style-type: none"> (1) Equity investment funds or investment platforms whose funds are raised entirely overseas and which do not involve domestic investment in assets or equities, nor involve domestic financing or guarantees, etc. (2) Offshore equity investment funds or investment platforms that do not engage in any specific industrial projects and which are established by a domestic financial enterprise upon the approval of a domestic financial regulatory authority.
Real estate	<ol style="list-style-type: none"> (1) Construction or acquisition of residential or commercial real estate projects, or acquisition of land for construction of residential or commercial real estate, funded by assets or equities invested by entities located within the territory of China or by financing or guarantees provided by entities located within the territory of China; (2) Establishment or acquisition of offshore real estate enterprises, increases in capital to existing offshore real estate enterprises, or investments in offshore real estate funds, funded by assets or equities invested by entities located within the territory of China or by financing or guarantees provided by entities located within the territory of China. 	<ol style="list-style-type: none"> (1) Investments in property managers or real estate agency services; (2) Construction or acquisition of office space, staff company dormitories for self-use; (3) Investments in the construction of infrastructure and development of buildings that will be used for physical business operations, such as industrial parks, science parks, warehouse logistics parks, etc. (4) Construction enterprises may make small scale investments in planned construction projects for the purposes of obtaining project contracts. (5) Projects for which NDRC has issued approval documents or record-filing notices in accordance with law, but which have not yet been completed; (6) Projects that raise funds entirely from overseas without involving assets or equities invested by domestic entities nor involving financing or guarantees provided by domestic entities.
Hotels	Construction or acquisition of star-rated hotels, tourist resorts, business hotels or ordinary hotels funded by assets or equities invested by entities located within the territory of China or by financing or guarantees provided by entities located within the territory of China.	<ol style="list-style-type: none"> (1) Investments in the hotel management industry that do not hold hotel property assets; (2) Investments in the catering industry that do not include accommodation; (3) Projects for which NDRC has issued approval documents or

		record-filing notices in accordance with law, but which have not yet been completed; (4) Projects that raise funds entirely from overseas without involving assets or equities invested by domestic entities nor involving financing or guarantees provided by domestic entities.
Entertainment industry	(1) Construction or acquisition of offshore indoor entertainment facilities (song and dance halls, electronic entertainment halls, Internet cafes, etc.); (2) Construction or acquisition of offshore amusement parks, theme parks, etc.; (3) Construction or acquisition of offshore lottery enterprises;	-
News media	Establishment or acquisition of offshore news organizations (including news websites), publishing agencies, and broadcast and television organizations that both involve current political affairs and have a major impact on national security.	-
Studios	Construction or acquisition of offshore cinemas and cinema companies.	-
Sports clubs	Establishment or acquisition of organizations, institutions and enterprises that engage (or rent) athletes for sports competitions, performances, training, counseling, management, etc.	-
Cross-border water resources development	Development and use of water resources of rivers that pass through two or more countries.	-
Development, production and maintenance of weaponry	R&D, production, maintenance, safeguarding of weapons.	-

● **Important Announcement**

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