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Legal Commentary



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China Expands Disclosure Requirements over Chinese Enterprises' Overseas Investment Activities

--- Brief Commentary on the Set of Forms Related to the Management Rules for Overseas Investment by Enterprises and the Catalogue on Overseas Investment in Sensitive Industries

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On December 26, 2017, China's National Development and Reform Commission ("NDRC") issued the "Management Rules for Overseas Investment by Enterprises", Order No. 11 of 2017 ("Order 11"). On February 11, 2018, the NDRC issued the "Catalogue on Overseas Investment in Sensitive Industries (2018 Edition)" (the "Sensitive Industries List") and the "Set of Forms Related to the Management Rules for Overseas Investment by Enterprises" (the "Standard Forms").

The NDRC will closely scrutinize overseas investment by Chinese enterprises in industries specified in the Sensitive Industries List. The Standard Forms set forth detailed documentation and information requirements that Chinese enterprises will need to submit to the NDRC when making overseas investments, whether such investments require NDRC approval or only a record-filing with the NDRC. Order 11, the Sensitive Industries List and the Standard Forms will all come into effect on March 1, 2018.

It is important to note that, in addition to the approval or record-filing requirements under Order 11, Chinese investors may also need to comply with other pre-existing PRC regulatory requirements when making overseas investments, such as approval or record-filing with the Ministry of Commerce and approval for the remittance of funds out of China.

Order 11 is novel because it effectively creates long-arm jurisdiction over the overseas investment activities of Chinese investors by imposing new regulations and requirements on overseas arms controlled by such Chinese investors. Accordingly, even if these overseas arms are legally independent of a Chinese parent, or have raised funds or generated revenue outside of China, they are still subject to the requirements of Order 11. Accordingly, when these overseas arms intend to conduct other investments outside of China, they will have to

comply with Order 11.

Part I – Sensitive Industries List

Any investment by a Chinese investment in a sensitive industry requires approval under Order 11. This is true even if the investment is made by an overseas arm controlled by a Chinese parent.

The Sensitive Industries List defines the following as sensitive industries:

- Research, development, production or repair of weapons and related equipment
- Development or use of cross-border water resources
- News media
- Real estate
- Hotels
- Cinemas
- Entertainment
- Sports clubs
- Establishment of equity investment funds or investment platforms without a specific industrial project

The Sensitive Industries List includes items that are, to date, not well-defined. For example, “entertainment” is not defined, meaning variants of entertainment such as gaming may fall within the scope of the Sensitive Industries List. For well-defined items such as real estate, the implication for potential sellers and non-Chinese investors is starting to take shape. Starting on March 1, 2018, any overseas investment by a Chinese buyer in a sensitive industry, including a buyer incorporated outside of China that is controlled by Chinese investors, is required to obtain NDRC approval pursuant to Order 11.

Part II – Comprehensive Disclosure Requirements

The Standard Forms expand and more specifically set forth the application and disclosure requirements under Order 11. What is worth noting is that the application materials for transactions requiring NDRC approval and transactions only requiring a record-filing with the NDRC are both expansive as compared to existing requirements.

Below is a detailed list of requirements divided into different categories of Chinese resident persons.

	Individual Chinese Resident	Chinese Enterprise (including companies, partnerships, and financial and non-financial enterprises)	Non-Enterprise Chinese Entity
Disclosure of Ultimate Controlling Shareholders	Not applicable	<ul style="list-style-type: none"> ➤ The five largest direct shareholders of the Chinese investor and shareholders who directly own 10% or more of the Chinese investor (if the Chinese investor is a partnership, the general partner and the five largest limited partners) ➤ If the direct shareholder is a company, the ultimate controlling persons of such shareholder, up to individual persons or the State-owned Assets Supervision and Administration Commission or its local counterpart (the “SASAC”) ➤ If the direct shareholder of the Chinese investor is a partnership, the general partner. If the general partner is a company, the ultimate controlling persons of such general partner, up to individual persons or the SASAC. If the general partner is a partnership, the general partner of such partnership and the ultimate controlling persons of such general partner, up to individual persons or the SASAC ➤ If there is no controlling shareholder in the above “look-through” exercise, the largest shareholder and the ultimate controlling persons of such largest shareholder, up to individual persons or the SASAC <p>The “look-through” exercises set forth above are also required for persons who are proxies of or persons acting-in-concert with the above controlling shareholder, general partner or largest shareholder</p> <ul style="list-style-type: none"> ➤ If control is achieved through contractual arrangements (including management contracts), trusts or other methods, clearly state the controller and the method of control, and the “look-through” exercise will also apply to the controller (look-through to the controlling persons of such controller, up to individual persons or the SASAC) 	Not applicable
Basic Information	Name, identification number, address set forth in the identification card	Name, jurisdiction of incorporation, share capital, legal representative (if applicable), entity type (state-owned or state-controlled, privately-owned or privately-controlled, foreign invested, others), incorporation date, scope of business, and main business	Basic information (including the incorporation or registration certificate or similar documents)
Business Operations	Not applicable	The main operational and financial indicators (such as assets,	Main financial indicators,

	Individual Chinese Resident	Chinese Enterprise (including companies, partnerships, and financial and non-financial enterprises)	Non-Enterprise Chinese Entity
		debt, revenue and profit) for the past two years	consisting of audited financials for the past year or 6 months (calendar year or fiscal year), or if the investing entity cannot provide audited financials because it was only recently incorporated, the most recent audited financials of its controlling shareholder, general partner or ultimate controlling persons, up to individual persons or the SASAC
Credit Information¹	Credit information for the past two years	Credit information of the investing entity, the controlling shareholder of the investing entity, and the ultimate controlling person of the investing entity for the past two years	Credit information for the past two years
Controlled Enterprises (for approvals only)	<ul style="list-style-type: none"> ➤ Basic information about enterprises controlled by the individual ➤ If the individual controls multiple enterprises, the information and operational information of the three most important enterprises 	Not applicable	Not applicable
Requirements for Attachments to be Submitted	<ol style="list-style-type: none"> 1. Identification documents 2. Internal investment approval by the investing entity 	<ol style="list-style-type: none"> 1. Incorporation documents of the investing entity 2. Most recent audited financials of the investing entity, or if the investing entity cannot provide audited financials because it was only recently incorporated, the most recent audited financials of its controlling shareholder, general partner or ultimate controlling persons, up to individual persons or the SASAC 	

¹ "Credit information" means records maintained by different Chinese regulators and authorities that can be used to evaluate the credit-worthiness of Chinese legal entities and individuals, such as non-compliance with overseas investment regulations, failure to comply with court judgments or orders, and tax defaults.

	Individual Chinese Resident	Chinese Enterprise (including companies, partnerships, and financial and non-financial enterprises)	Non-Enterprise Chinese Entity
	<p>3. Legally binding investment agreement or similar document</p> <p>4. Undertaking letter confirming that the investment and the documents provided are authentic</p>	<p>3. Internal investment approval documents of the investing entity</p> <p>4. Legally binding investment agreement or similar document</p> <p>5. Supporting documents proving the source of funds used in the investment is legitimate</p> <p>6. Undertaking letter confirming that the investment and the documents provided are authentic</p>	
		The shareholding structure chart of the investment entity, traced up to the ultimate controlling persons	Not applicable
Internal Investment Approval Documents	Documentation setting forth the decision to make such investment	<ul style="list-style-type: none"> ➤ Board resolution, approval from the investment committee ➤ If the investment decision is made by the controlling shareholder or the ultimate controlling person, documentation of the decision by such controlling shareholder or ultimate controlling person, as applicable, to make such investment 	Documentation as determined by specific circumstances
	If the investment is through an offshore entity controlled by the Chinese investor, the offshore entity's board resolutions or similar documents approving the transaction		
Information about the Investment Destination	<ul style="list-style-type: none"> ➤ Clear disclosures about all jurisdictions involved in the transaction, including: <ul style="list-style-type: none"> • Immediate overseas destination: the jurisdiction of incorporation of the offshore entity directly controlled by the Chinese investor • Final destination: the jurisdiction of the operational target entity • Other countries or jurisdictions: the location of all entities between the above immediate overseas destination and the final destination (such as intermediate holding companies) ➤ Details about each jurisdiction should cover at least the provincial level ➤ Details about each jurisdiction should include (i) the political and security situation, (ii) laws and regulations, (iii) market access and regulatory policies, (iv) the state of the jurisdiction's natural resources, (v) the state of the jurisdiction's infrastructure, (vi) the economic and financial situation of the jurisdiction, and (vii) the state of the jurisdiction's society, culture and environment. Further elaborate whether (i) the transaction is warranted given the jurisdiction's political and security situation, and (ii) whether the jurisdiction's laws and regulations and policies prohibit or restrict the current transaction 		
Information about Intermediate Entities (if the investment is made through an offshore entity controlled by a	<ul style="list-style-type: none"> ➤ Basic information, including name, jurisdiction of incorporation, share capital, legal representative (if applicable), entity type, date of incorporation, scope of business, and main business ➤ Shareholding structure, including basic information about the five largest shareholders (if the target is a partnership, the general partner and the five largest limited partners), such as name, nationality or jurisdiction of incorporation, and shareholding ownership percentage 		

	Individual Chinese Resident	Chinese Enterprise (including companies, partnerships, and financial and non-financial enterprises)	Non-Enterprise Chinese Entity
Chinese individual or enterprise)	<ul style="list-style-type: none"> ➤ The control relationship between the offshore acquiring entity and the Chinese investor ➤ Operational matters: main operational and financial indicators (such as assets, debt, revenue and profit) for the past two years ➤ Criminal or administrative penalties in the past two years (if applicable, provide relevant detail) 		
Legally Binding Investment Agreements	<ul style="list-style-type: none"> ➤ For a tender offer, merger or acquisition, joint venture or joint cooperation transaction, the legally binding investment agreements or similar documents ➤ If binding definitive agreements cannot be obtained, a full and reasonable explanation as to why such binding definitive agreements cannot be obtained 		
Evidence that the Source of Funds is Compliant	<ul style="list-style-type: none"> ➤ If the Chinese enterprise uses its own funds to fund the transaction's consideration, a deposit certificate issued by a bank or a similar document ➤ For intangible consideration such as equity securities, in-kind assets, technology, intellectual property, equity interest, or debt interest, an audited report, asset valuation report, or similar report issued by a qualified accounting firm, asset valuation firm or other intermediary firm, or other documents that can certify the value of the intangible assets ➤ If the Chinese investor uses bank financing to fund the transaction's consideration, a letter of intent or similar document issued by a bank that includes the total financing amount ➤ If the Chinese investor issues equity securities, debt securities, or uses other methods to fund the transaction's consideration, the relevant supporting or explanatory document 		
Investment and Financing Plan	<ul style="list-style-type: none"> ➤ Transaction structure, including (i) the transaction's total consideration, investment valuation (including the total valuation, the basis for calculating such total valuation, and relevant explanations), and (ii) the amount contributed by each party and such party's ownership percentage, the method of contribution, and any joint venture or joint cooperation arrangement ➤ The total consideration paid by the Chinese investor and the composition of the consideration: The total amount invested by the Chinese investor and any offshore entity controlled by the Chinese investor in such transaction, including cash, equity securities, in-kind assets, technology, intellectual property, equity interest and debt interest, as well as the amount of financing and the guarantees provided For each Chinese investor and investment vehicle controlled by the Chinese investor, a description of the method of payment, the investment amount, the source of funds, the currency of payment, and the total consideration amount ➤ A description of how the investment funds will be used, and a plan for the use of such funds ➤ Financial assessment of the transaction, including estimates of key financial indicators such as revenue, profit, internal rate of return, and the investment return period 		
Transaction Background	<ul style="list-style-type: none"> ➤ Reasoning for the transaction ➤ Work carried-out to date: due diligence, feasibility study, negotiations with overseas parties and the investment decision ➤ Approvals for the transaction: national security review for foreign investment, market entry, antitrust, and the progress of the foregoing 		

		Individual Chinese Resident	Chinese Enterprise (including companies, partnerships, and financial and non-financial enterprises)	Non-Enterprise Chinese Entity
Key Terms and Size of the Transaction	New Project	<ul style="list-style-type: none"> ➤ Particulars and the size of the construction, including location, the particulars, the size of the construction, the engineering technical proposal, the length and plan of construction, the scale of main products, and the target markets. With respect to the development of natural resources, a description of the amount of natural resources that may be developed, the grade of the natural resources, the amount of interests in the natural resources that may be attained by the Chinese investor, and the development plan ➤ Status of support conditions, including the status and plans for staffing, land, materials and relevant infrastructure such as roads, railways, ports and natural resource supplies, and whether the transaction fulfills the target jurisdiction's technological, environmental, energy consumption and security requirements 		
	M&A	<ul style="list-style-type: none"> ➤ The target <ul style="list-style-type: none"> • Share Acquisition: the target's basic information such as name, jurisdiction of incorporation, share capital, legal representative (if applicable), entity type, scope of business, basic information of the target's main shareholders, including their names, jurisdictions of incorporation or nationality and shareholding percentages, the location of its main assets (by industry and location), production, operational and financial situation, whether the target is listed and the performance of its stock price (if applicable), the target's industry position in terms of its products, technology and branding • Asset Acquisition: The composition and location of the target assets (by industry and location), the basic information about the owners of the assets (name, jurisdiction of incorporation or nationality and ownership percentage), the price or valuation of the assets by a professional appraiser (if applicable) ➤ Acquisition plan, including the acquisition target, purchase price (including an explanation of the method for calculating the valuation and the main parameters used), the acquisition entity, the transaction structure and plan, and a shareholding structure chart showing the ultimate controlling persons of the target before and after the closing of the transaction 		
Transaction Risks and Mitigation Measures		An analysis of the transaction's main risk factors such as political, security, economic, societal and environmental risks, along with risk mitigation measures		
Impact on National Interest and National Security		<ul style="list-style-type: none"> ➤ The transaction's impact on the development of the industry ➤ The transaction's macroeconomic impact ➤ The transaction's impact on relations between China and the countries involved ➤ Whether the transaction (i) is in an industry prohibited under Order 74 of 2017 (prohibiting investment into certain industries, many of which are the same as those set forth in the Sensitive Industries List), (ii) involves resources, products, technology or services that are subject to export control under relevant PRC law, (iii) constitutes a material adverse effect with respect to China's compliance with its international obligations such as implementing U.N. Security Council sanctions resolutions, or (iv) involves other matters that may threaten the national interest or national security 		

Part III – Practical Observations

The Standard Forms' requirement that applicants submit legally binding agreements means the parties may no longer rely on non-binding term sheets, letters of intent or memorandums of understanding when submitting application materials.

The Standard Forms also require the disclosure of indirect control arrangements, such as contractual control (including management contracts) and trusts, along with the entire investment holding structuring, including all intermediate special purpose vehicles. Accordingly, the Standard Forms increase transparency requirements with respect to ultimate beneficial ownership, which may impact Chinese investors who, for one reason or another, do not wish to disclose such arrangements.

Part IV – The Standard Forms' Requirements are more Comprehensive as Compared to Existing Requirements

Compared with the NDRC's current application documentation requirements for overseas investment, the Standard Forms' requirements are more comprehensive, resulting in increased disclosure obligations for Chinese investors.

One of the consequences of the new requirement to disclose ultimate beneficial owners is that the NDRC will now be able to access the credit records of the applicants. Accordingly, applicants will no longer be able to avoid this evaluation through the establishment of intermediate holding companies or different investment vehicles.

In addition, the Standard Forms codify a recent practice requiring applicants to demonstrate that they have evaluated the risks of the overseas investment and have taken appropriate countermeasures. This requirement may be in response to recent overseas investment activities by large, heavily indebted Chinese conglomerates in industries now labeled as sensitive.

As the Standard Forms impose more comprehensive application documentation requirements, we predict that Chinese enterprises will need more time to prepare these application materials. The new application requirements, such as the need to submit definitive and binding documentation, may result in increased deal costs and uncertainty. Accordingly, non-Chinese sellers should consult qualified PRC counsel with on-the-ground knowledge of law and, more importantly, its practical implementation, when discussing transactions with potential Chinese buyers.

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