COVINGTON

NDRC Releases Draft Enterprise Outbound Investment Regulations for Public Comment

November 24, 2017

China Outbound Investment

Earlier this month, China's National Development and Reform Commission ("**NDRC**") released the draft *Administrative Measures for Enterprise Outbound Investment* ("**Draft ODI Rules**") for public comment. Comments are due on December 3, 2017.

The Draft ODI Rules would replace NDRC's existing outbound investment regulations, set forth in the *Administrative Measure for the Verification and Approval and Record-Filing of Outbound Investment Projects* (境外投资项目核准和备案管理办法) [1], and implement in part the guidance on outbound investment released by China's State Council on August 4, 2017[2] (the "**August Guidance**" as described in Covington's alert here).

The Draft ODI Rules would streamline NDRC's outbound approval process. However, they would also expand the scope of the regulations to cover investments by non-Chinese entities controlled by Chinese investors, allow NDRC to subject a broader range of transactions to "verification and approval" rather than the less onerous "record-filing" process, and leave in place the basic hurdles that prevent outbound investors from using onshore funds to pay reverse termination fees if Chinese or foreign government approvals for a transaction are not obtained, a key stumbling block in many transactions.

Key Changes Introduced

1. Changes to filing process

- "**Roadmap**" **system eliminated**. Outbound investors are currently required to file a project information report and receive a confirmation letter (a "**roadmap**") from NDRC or its local or provincial affiliate prior to beginning substantive work on an outbound project with an investment amount greater than $300 million. The Draft ODI Rules eliminate this requirement.

---

[1] Dated April 8, 2014, and effective May 8, 2014, as amended by Order No. 20 of NDRC, dated December 27, 2014.

[2] Notice of the General Office of the State Council on Forwarding the Guiding Opinions of NDRC, MOFCOM, PBOC and MFA on Further Guiding and Regulating the Direction of Outbound Investments.

- **Codification of NDRC review as a post-signing/pre-closing requirement**. The market practice in large outbound transactions is for investors to apply for record-filing or verification and approval after entering into a definitive purchase agreement and prior to closing. However, NDRC's current rules expressly prohibit investors from entering into a "final and legally-binding" investment agreement prior to completing record-filing or verification and approval unless the agreement provides for effectiveness only upon such procedures being completed. The Draft ODI Rules eliminate this prohibition. Instead, they require that record-filing or verification and approval be completed prior to the project being "implemented." A project is implemented when a Chinese investor or a non-Chinese entity controlled by such investor invests assets or rights or provides financing or a guarantee for the project.

- **Verification and approval maintained for "sensitive" projects; list of "sensitive industries" to be published**. The Draft ODI Rules maintain the structure under current rules that verification and approval is to be used only for projects in sensitive countries, regions, or industries. Sensitive countries and regions are those without diplomatic relations with China, experiencing war or internal strife, or where investment is restricted by China's treaties or accords. Sensitive industries include (i) military equipment development, manufacturing, or maintenance, (ii) cross-border water projects, (iii) news media, and (iv) other industries to be restricted according to China's macro-control policy. The list of sensitive industries is to be set forth on a published schedule.

- **Direct application to national level for verification and approval**. Currently, in outbound transactions subject to verification and approval undertaken by investors other than centrally-managed state-owned entities, review by both NDRC and its provincial counterpart is required. The Draft ODI Rules provide for such transactions to be submitted directly to NDRC and eliminate the requirement of provincial-level review.

2. Expansion of covered transactions

- **Regulations to cover investments through non-Chinese entities controlled by Chinese investors**. In contrast to NDRC's current rules, the Draft ODI Rules expressly cover Chinese investors' use of foreign entities controlled by them ("**controlled foreign entities**") to engage in foreign investment. "Control" is defined as having either a majority of voting power or the power to govern an entity's operations, finances, personnel, or similar important matters. "Use" is not defined, but, if read broadly, the rules would cover transactions where the foreign entity undertakes an investment without any clear involvement by the controlling Chinese investor.

  The Draft ODI Rules provide that (i) if a Chinese investor uses a controlled foreign entity to make a sensitive investment, then the controlling Chinese investor must file the project for verification and approval, and (ii) if a Chinese investor uses a controlled foreign entity to make a non-sensitive investment with an investment amount in excess of $300 million, then the controlling investor must file a "situation report" with NDRC prior to implementing the project. (Neither verification and approval, nor record-filing, nor a situation report would be required for non-sensitive investments by controlled foreign entities of $300 million or less.)

- **Treatment of investments in or from Hong Kong, Macau, and Taiwan**. The Draft ODI Rules indicate that investments in Hong Kong, Macau, and Taiwan by Chinese investors (whether direct or through controlled entities) will be treated in the same manner as investments by Chinese investors in regions outside of Greater China. Similarly, the Draft ODI Rules indicate that investments by Hong Kong, Macau, and Taiwan entities that are controlled by Chinese investors will be treated in the same manner as investments by entities outside of Greater China that are controlled by Chinese investors.

- **Treatment of outbound investment by Chinese individuals**. For the first time, the Draft ODI Rules treat Chinese natural persons in the same manner as Chinese entities when considering foreign investments by such natural persons using their controlled foreign entities (or using Hong Kong, Macau, or Taiwan entities controlled by such individuals). However, the Draft ODI Rules expressly do not apply to direct investments by Chinese natural persons in other countries or in Hong Kong, Macau, or Taiwan.

3. Enhanced supervisory and enforcement tools

- **Significant adverse event report**. When an outbound investment project, whether undertaken by a Chinese investor or a controlled foreign entity, experiences a significant adverse event (such as significant injury or death of employees, significant asset losses, or harm to China's foreign relations with the related country), the Draft ODI Rules require the Chinese investor to report such event to NDRC within five business days thereof.

- **Closing report**. The Draft ODI Rules also require outbound investors, in all projects that undergo record-filing or verification and approval, to submit a closing report within 20 business days following the closing of such projects.

- **Liability for investors and financial institutions, including their responsible persons.** The Draft ODI Rules provide that outbound investors and their "responsible persons" will face penalties and potentially criminal liability for "malicious" inaccuracies in applying for approval, obtaining an approval or record-filing notice through fraud or bribery, engaging in projects without an approval or record-filing notice (when required), failing to provide required reports, unfair competition, or harming national security. In addition, financial institutions and their responsible persons may, based on consultations with applicable regulators, be punished for providing financing or a guarantees to projects prior such projects completing record-filing or verification and approval (when such procedures are required).

- **New supervisory tools**. The Draft ODI Rules instruct NDRC and its provincial counterparts to establish new means to supervise outbound investment, including online supervision, face-to-face meetings, written inquiries, and random verification.

4. Service improvements

- **Establishment of online platform**. The Draft ODI Rules call for NDRC to establish an online platform for investors to submit applications and other reports and for NDRC to inform investors whether such applications have been accepted.

- **Additional services**. The Draft ODI Rules instruct NDRC to provide additional services to a Chinese investors, including publishing information on investment conditions and trends.

Commentary

We note the following features and likely effects of the Draft ODI Rules.

Elimination of roadmap requirement unlikely to have a significant impact on market dynamics. Historically, by granting only one roadmap per project, NDRC used the roadmap requirement to limit competition among Chinese bidders for foreign projects. Some Chinese investors, in turn, would suggest to foreign counterparties that NDRC's issuance of a roadmap bode well for the ultimate approval. The roadmap is no longer effective for such purposes. Multiple Chinese bidders often undertake work on projects before obtaining a roadmap. And targets have come to view the outcome of NDRC's full review (or MOFCOM's or SAFE's) as inherently uncertain, regardless of whether the roadmap has been obtained. Accordingly, though the elimination of the roadmap requirement will save time and costs, we expect it will have little effect on the overall demand for outbound investment.

NDRC's schedule of sensitive industries to influence outbound investment trends. Market participants perceive the verification and approval process as highly-unpredictable in terms of both the timing and eventuality of approval. We thus expect that classifying an industry as "sensitive" will substantially chill interest in Chinese investment among potential investors and potential targets. Chinese investors will be dis-incentivized from incurring the upfront costs of due diligence and negotiations in such sectors, and targets in such sectors will be dis-incentivized from accepting offers from Chinese bidders (further dis-incentivizing Chinese investors). On the other hand, classifying an industry as "non-sensitive" may offer some comfort to investors and targets. Even then, NDRC will retain the ability to amend the list of sensitive industries at any time and to scrutinize individual transactions that it considers inconsistent with "macro-control policy." We thus expect investors and targets to continue to perceive risk in NDRC's review in non-sensitive sectors.

We expect the schedule of sensitive industries to include at least the industries specified in the August Guidance: real estate, hotels, cinemas, entertainment, and sports clubs. These categories are broad, and the consequences of being deemed "sensitive," and thus subject to verification and approval, will be significant—particularly for investments by controlled foreign entities, which, if not sensitive, will face either no record-filing or approval requirements (if $300 million or less in size), or only a reporting requirement (if over $300 million). We accordingly hope that the industries are defined precisely when set forth on the schedule. We also hope that the schedule sets forth minimum size requirements and clarifies how to treat targets that hold both non-sensitive and sensitive assets (such as real estate).

Definition of "control" requires further clarification. By allowing for "control" by minority shareholders, the Draft ODI Rules create the possibility that a non-Chinese entity could have multiple controlling investors. However the rules do not explain how to allocate regulatory obligations (or liabilities) among them. Nor do the Draft ODI Rules address how to view a non-Chinese entity that is controlled by several Chinese investors as a group, but by none individually (such as a non-Chinese entity owned by three or more Chinese investors equally). Such issues will eventually need to be addressed.

General enforceability concerns reduced, **but reverse termination fees remain challenging**. Foreign targets harbor significant doubt as to whether they will be able to enforce in China foreign arbitral awards or judgments related to agreements that are entered into—contrary to current rules—prior to the completion of record-filing or verification and approval. Targets focus in particular on reverse termination fee obligations (including for failure to receive PRC government approvals) and demand that such obligations be backstopped by an offshore escrow account, guarantee, or letter of credit. Targets will welcome the fact that, under the Draft ODI Rules, investors will be able to enter into enforceable agreements prior to completing NDRC's review. But risks will remain. The Draft ODI Rules are silent on whether SAFE may hold up the exchange of RMB for cross-border reverse termination fee payments. If NDRC considers the payment of a reverse termination fees to constitute a partial "implementation" of a project, then, since only projects that complete record-filing or verification and approval can be implemented, investors might be prohibited from paying reverse termination fees tied to the failure a project to complete record-filing or verification and approval. We accordingly expect parties to continue to use escrow accounts, guarantees, and letters of credit to support reverse termination fee obligations.

"Guarantees" from "financial institutions" may also be problematic. Currently, Chinese investors often look to offshore branches of Chinese banks to guarantee or provide letters of credit for their reverse termination fee obligations. This may no longer be possible under the Draft ODI Rules, given the prohibition on "financial institutions" providing "financing or a guarantee" for projects prior to the projects completing verification and approval or record-filing. "Financial institutions" likely includes offshore branches of Chinese banks; it is unclear, however, is whether guaranteeing the payment of a termination fee constitutes guaranteeing *a project* (as with a performance bond). Until such clarity is provided, Chinese banks may resist providing such guarantees, and investors and targets may need to seek other sources of support.

* * *

We will continue to monitor these developments closely, and we are well-positioned to assist clients in understanding how these developments may affect their potential transactions.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our China Outbound Investment practice:

Dan Levine	+86 21 6036 2507	dlevine@cov.com
Scott Anthony	+1 650 632 4703	scanthony@cov.com
Tim Stratford	+86 10 5910 0508	tstratford@cov.com
Ning Lu	+86 10 5910 0502	nlu@cov.com
Li Zhang	+44 20 7067 2056	lzhang@cov.com