Is China Investable? Yes, if you invest by the rules—and invest smart

The Chinese government's recent regulatory actions against major private sector companies have sparked concerns among investors. Some even bluntly asked: "Who the hell now wants to invest in a Chinese company, if all of a sudden, China's going to pull a company out of whatever exchange it's on?"[1]

From a legal standpoint, we believe that the answer to the question "Is China investable?" remains "yes." The recent regulatory crackdown was not as arbitrary as some have claimed. Nor is it inconsistent with regulatory trends in other countries. In fact, China's regulatory moves share some of the same goals in other jurisdictions—primarily data security and antitrust. The regulatory frameworks and enforcement actions applied to rein in Chinese Internet giants, while aggressive, have had the objective of ensuring data security and curbing market dominance, and thus should not be interpreted as unwelcome signs for foreign investment.

Despite occasionally conflicting rhetoric, China took concrete steps in 2021 to make foreign investment ***more*** attractive. The government is likely to continue to do so in 2022. Investors can manage the changing regulatory landscape by having robust investment compliance programs. Therefore, despite the noise, China remains subject to the conventional wisdom: choose your investments wisely and manage the risks.

I. China's Tightened Regulation of Internet Companies Is in Line with Regulation in Other Countries

Over the last year the Chinese government tightened its regulation of Internet companies. On February 7, 2021, regulators unveiled new anti-monopoly guidelines aimed at the country's biggest tech companies. Since then, many of the major Internet companies, including Meituan, Tencent, and Pinduoduo, have been investigated or fined for alleged anti-competitive behavior. In the second half of 2021, China ramped up efforts to build a comprehensive data protection, privacy, and cybersecurity legal framework, with the promulgation of the Data Security Law (the "DSL") and the Personal Information Protection Law (the "PIPL"). Their impact goes beyond the Internet giants who collect, store, and process enormous amounts of personal data as an essential part of their businesses.

China's regulators are not alone in reining in powerful Internet companies. Their concerns about data security and antitrust echo the legislative agenda and enforcement priorities in the EU and the U.S.

Data Security and Personal Information Regulation

China has been enhancing data protection and tightening cross-border data transfer control since the passage of the Cybersecurity Law of 2017. The pace of rulemaking accelerated in 2021. In April 2021, regulators at different levels of the Chinese government proposed measures to ensure data security and protect personal information:[2] The State Council proposed the Guideline to Safeguard Critical Information Infrastructure Operators on July 30, 2021.[3] Four departments—Cyberspace Administration of China

("CAC"), Ministry of Industry and Information Technology ("MIIT"), Ministry of Public Security, and State Administration for Market Regulation ("SAMR")—then jointly published temporary measures to protect personal information collected via mobile applications.[4] On June 10, 2021, the Standing Committee of the National People's Congress passed the DSL, which became effective on September 1, 2021. The other pillar of the new regulatory framework, the PIPL, passed on August 20, 2021, and became effective on November 1, 2021.

Despite the speed of these regulatory actions, the substance is not peculiar in the global context. For example, the most recent enactment, PIPL, is largely analogous to the EU's General Data Protection Regulation ("GDPR"). Both recognize individual rights to personal information, including rights to information, to access and copy, to correction and rectification, to erasure, and to object or restrict processing.[5] Both impose limits on cross-border data transfer, with technical differences in the decision-making mechanism and authorization process.[6] Both provide a private cause of action against data controllers and processors, in addition to governmental enforcement.[7] Moreover, the EU has been active in enforcing the GDPR against tech companies, including fining Amazon $877 million[8] and WhatsApp $255 million[9] in 2021.

In the U.S., although no federal regulation is yet in place, some state laws have been inspired by the GDPR, notably the California Consumer Privacy Act, which shares many common traits with PIPL.[10] U.S. regulators have imposed record-setting fines on tech companies that failed to protect their users' data security. For example, the consumer credit reporting agency Equifax was fined $575 million in connection with its 2017 data breach that resulted in almost 148 million compromised data records.[11]

Antitrust Enforcement

In recent years China also has aimed to curb the leading Internet companies' anti-competitive behavior. In 2020, SAMR closed 109 monopoly cases with penalties totaling US$70.6 million.[12] In April 2021, SAMR reportedly contacted 34 major Chinese Internet companies, including Tencent and ByteDance, asking them to conduct self-inspections regarding compliance with antitrust rules.[13] On July 7, 2021, several leading Chinese Internet companies were fined for allegedly anti-competitive conduct.

China is not the only country taking such actions. In the U.S., a bipartisan group of federal lawmakers recently introduced a bill that would bar Internet companies, such as Amazon and Google, from favoring their products and services over those of their competitors.[14] Similarly, the EU has issued multi-billion-dollar rulings against major Internet companies for antitrust violations.[15] Most recently, the EU has incorporated antitrust principles into its regulation of tech companies: In November 2021, the European Parliament enacted a legislative proposal to limit anti-competitive practices in the digital economy, targeting U.S. tech companies such as Alphabet, Google, Amazon, Apple, Facebook, and Microsoft.[16] Antitrust regulators in South Korea, India, Australia, and post-Brexit UK have also launched investigations and levied fines to regulate tech companies' business practices.

Antitrust regulation in China has been analogous to regulation in other countries. Both China and the U.S. seek to strengthen their antitrust mechanisms. China's recent nomination of SAMR's vice minister as Head of the National Anti-Monopoly Bureau (NAMB) has been interpreted as granting NAMB a semi-autonomous status under SAMR instead of making it a mere division.[17] The FTC's decoupling from the Sherman Act has also been viewed as a step towards a broader discretion in regulating unfair competition.[18] As a practical matter, the nature of the major Internet companies' businesses and concentrated power has made them the common targets of antitrust initiatives worldwide. The FTC has made "technology companies and digital platforms" priority targets of its investigation[19] in ways similar to

China's cybersecurity review of multiple U.S.-listed Chinese public companies and the EU's continuous and coordinated investigations by its member states' competition authorities

<u>Regulating U.S.-Listed Chinese Companies</u>

Recently, U.S.-listed Chinese stocks have been on a roller coaster. Chinese companies have faced tightened regulation and been caught in the regulatory crossfire between the U.S. and China. Chinese authorities have been seeking resolutions that would permit Chinese companies to continue to participate in U.S. capital markets, instead of forcing them to exit.

Chinese regulators have addressed investors' concerns. In December 2021, investors expressed concerns about the viability of the variable interest entities ("VIE") structure. The VIE structure is a complex offshore structure used by Chinese companies, especially in the technology sector, to get listed in the U.S. China's tightening of its data security regulations, as well as its concern about technology companies leaking data to the U.S. regulators, led to speculation that China will ban the VIE structure.[20] However, the China Securities Regulatory Commission ("CSRC") assured investors' concerns when it reaffirmed at its Dec. 24 press conference that VIE-structured Chinese companies can be listed overseas if they comply with domestic laws and first register with the CSRC.[21] On the same day, the CSRC unveiled a new regulatory framework for companies that seek to sell shares abroad, requiring them register with the CSRC within three working days after the first filing for an overseas IPO.[22] The draft rules aim to "encourage more overseas listings to take place in a sustainable and healthy manner."[23] Although uncertainty remains over how this framework will be implemented and to what extent the Chinese and U.S. regulators will cooperate, the trend is against a drastic detachment of these two capital markets from each other, as some had speculated.

More recently, on March 10, the SEC identified five Chinese companies listed in the U.S. that had failed to adhere to the Holding Foreign Companies Accountability Act ("HFCAA"), which led to a plunge in the share price of U.S.-listed Chinese stocks out of concerns about potential delisting.[24] On March 11, the CSRC responded promptly by stating that it has been making progress with the Public Company Accounting Oversight Board ("PCAOB") on related issues, namely, the rights of regulators to inspect financial audits in China.[25] The PCAOB reportedly confirmed this collaborative approach.[26] A week later, on March 16, Liu He, the Vice Premier and China's lead economic advisor, stated at the Financial Stability and Development Committee ("FSDC") conference that a cooperative plan between the U.S. and Chinese regulators is in the making, while supporting Chinese companies' IPOs abroad.[27] As a result, the downward trend of the U.S.-listed Chinese stocks halted and the market soared.[28]

Both CSRC's and Liu He's words were reinforced by a March 22 Reuters report that Chinese regulators have advised some of the major U.S.-listed Chinese companies, including Alibaba, Baidu, and JD.com, to prepare for more audit disclosures.[29] Relatedly, entering 2022, several Chinese companies filed for New York listings, sending positive signals to investors while furthering the belief that Chinese regulators do not seek to force its companies to withdraw from overseas capital markets.[30]

The most recent signal of openness to cooperation took place on April 2, when the CSRC called for public comments on the revised Provisions on Strengthening Confidentiality and Archives Administration of Overseas Securities Offering and Listing by Domestic Companies (draft for comments) (the "Revised Provisions").[31] The Revised Provisions reaffirm that foreign regulators can request to investigate, collect evidence from, and inspect domestic issuers, as well as related service providers, such as audit firms, through a cross-border regulatory cooperation mechanism.[32] The CSRC and other competent Chinese authorities will provide necessary assistance.[33] Notably, the CSRC highlighted its removal of requirements that on-site inspections be led by domestic regulators.[34] This will remove a hurdle that has rendered the prior cooperation mechanism futile and will further incentivize U.S. regulators to resort to bilateral cooperation, so that U.S. listed Chinese companies are no longer caught between conflicting regulatory schemes.[35]

II. Foreign Investment Is Part of China's Plan for Social and Economic Stability

Stability lies at the core of China's 2022 policy. On March 5, China held one of its most important political events of the year. The 13th National People's Congress convened for its fifth annual Two Sessions to vote on key policies.[36] Premier Li Keqiang delivered the Government Work Report, highlighting economic stability on macro level as the guiding principle for 2022 social and economic policy.[37] Notably, Premier Li Keqiang recognized in the Government Work Report that sporadic COVID outbreaks have had significant impact on industries and the population.[38] Although the Government Work Report does not suggest any change in China's zero-COVID policy, stability is a key part of balancing between COVID containment and economic growth.[39] Notably, Premier Li Keqiang did not discuss how China plans to address the situation in Ukraine.[40] Although it customary to not discuss foreign policy in the Government Work Report, it is not unreasonable to infer from its absence that China plans in 2022 to prioritize its domestic economic growth.[41]

China has viewed "open-up" as one major way to achieve stability. After Premier Li Keqiang's Government Work Report, the State Council Information Office held a press conference to elaborate on five general policies to stabilize the market, one of which is accelerating the open-up to foreign investment.[42] Although from time to time the Chinese government can send signals about foreign investments that conflict and be confusing , China's overall welcoming attitude towards foreign investment has been largely consistent. As early as May 2021, the Ministry of Commerce released its plan to revise foreign investment guidelines to "ease restrictions" and to meet the country's business development needs.[43] The revision is expected to include terms that reduce asset requirements, shorten the lock-up period for foreign shareholders' stocks, and remove shareholding limits on foreign strategic investment.[44] On Dec. 15, 2021, Premier Li Keqiang said at the Global CEO Council that "companies from all over the world are welcome to expand investment in China further and deepen cooperation in various fields to achieve common development."[45]

To that end, China has set up a free trade zone in Hainan, which has become an investment magnet with "zero-tariffs, low tax rates, a simplified tax system, and an enhanced legal system."[46] China has also unveiled its Guangdong-Hong Kong-Macao Greater Bay Area plan to build a center for advanced manufacturing and innovation. The recently announced Pudong New Area in Shanghai is expected to house an international financial asset transaction platform, equipped in three to five years to manage cross-border capital flow of one trillion yuan (more than US$150 billion).[47] Given these developments, the major question for investors may be more of ***how*** to invest ***strategically***, rather than ***whether*** to invest at all.

III. Major Players Continue to Invest in China, with Enhanced Caution Toward Compliance and Risk-Management

Many institutional investors share the impression that China's regulatory actions have not been unusual as compared to actions in other countries. Multiple data sources show that in Q3 2021 global investors put substantial money into Chinese start-ups, bringing the 2021 YTD totals to higher levels than in all of 2020.[48] The total investment in Chinese start-ups for the first three quarters of 2021 rose 75%

from a year earlier, and has stayed on track to reach the peak set in 2017.[49] Many major Wall Street players, such as BlackRock, J.P. Morgan, and Goldman Sachs, have expressed optimism in continuing to invest in China. BlackRock even urged investors to double or triple their exposure in China.[50]

Institutional investor confidence has kept growing into 2022. They believe that new financing, easier monetary policy, and increased earnings are likely to make China an attractive investment destination.[51] Some investors also call for attention to the expansion in the size of China's consumer class, as well as a more inclusive and sustainable growth.[52] As China opens up its financial markets, institutional investors have committed more resources to their Chinese investments. For instance, Goldman Sachs took 100% ownership of its Chinese securities joint venture, set up a majority-owned wealth management venture with a major Chinese bank, and announced that it would grow all of its four global business lines in China.[53]

That said, higher regulatory risks and heightened requirements for compliance are in place, which will mean higher compliance costs. This will require more sophisticated understanding and investor planning. To invest smartly in China, investors need to appreciate the new regulations and their underlying policy goals. For example, although it is unclear to what extent the DSL and PIPL will apply retrospectively, tech companies and their investors must follow regulatory updates for data security and cross-border data transfers. Violation of the new statutes can result in significant civil fines, revocation of business licenses, and even criminal liability. To ensure DSL and PIPL compliance, companies doing business in China should consider the following measures:

- **Properly preserve data**: Data preservation is regulated by multiple laws and regulations in several jurisdictions. In anticipation of a dispute or investigation, companies should consider establishing or updating their document retention and destruction policies, suspend ordinary document retention policies, and preserve relevant data.

- **Categorize data pursuant to relevant regulatory regime**: Companies need to keep in mind that data other than personal information is subject to both national and local regulation, including administrative regulations and industry-specific regulations. Under the new data protection regime, it is essential for companies to categorize their data and adopt corresponding security measures.

- **Establish a compliance program to protect personal information**: PIPL imposes obligations on processors of important personal information to set up compliance systems to protect that information, to regularly publish social responsibility reports regarding these information protection measures, and the like. A company whose business falls in this category needs to identify lawful bases for collection and use of all personal information, evaluate whether the company needs to appoint a dedicated representative or an office in charge of personal information protection, have in place a security breach response and notification mechanism, and provide individuals with sufficient privacy notices.

- **Promptly assess the risk of cross-border data transfers with outside counsel**: Before companies transmit any information overseas as part of complying with U.S. and other foreign regulators' information requests or to fulfill their discovery obligations in U.S. litigation, they need to consult with their outside counsel to assess data compliance risks.

- **Evaluate the class action risks**: U.S.-listed Chinese companies have been and are likely to be under closer regulatory scrutiny in both China and the U.S. A breach may not only invite government investigation but also lead to expensive private litigation. Investors need to examine the company's risk exposure and practices and procedures for compliance with the relevant regulatory regime.

- **Pay close attention to policies and consider all options**: Because the regulators are still finalizing the rules, companies and investors need to closely follow the policy-making process. Companies and investors need to explore different markets and options to ensure risk diversification.

Despite its regulatory tightening, China continues to present meaningful opportunities for global investors. The key to success in China is possessing a full understanding of the risks under the new regulatory environment and an ability to manage these risks.

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Xiaoliu@quinnemanuel.com Haiyantang@quinnemanuel.com

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