

China's Draft Foreign Investment Law Could Be a Game Changer?

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China's Ministry of Commerce (**MOFCOM**) has issued a draft *Foreign Investment Law* for public comment.

The draft law (the **Draft**) will almost certainly not become law until 2018 at the earliest and changes are likely before it does. However, the Draft signals a major and interesting development in China's legal regime for foreign investments.

If enacted, the Draft would go some way towards making investment in China more straightforward for foreign parties. At the same time, it includes elements that would increase uncertainty and costs for investors looking to enter the China market.

In this note, we consider the five most significant elements of the Draft.

1. **Unifies foreign investment rules:** The Draft consolidates and unifies the raft of laws and regulations that currently governs foreign investment in China. It also brings the foreign investment regime into line with China's *Company Law*.
2. **Removes the approval procedure for most new foreign investment projects:** If the Draft is enacted, most foreign investment projects will no longer be subject to approval. Generally, only projects in restricted sectors, which will be set out in a *Negative List*, and projects that exceed a certain investment threshold will require the investor(s) to obtain a *Market Entry Permit*.
3. **Tackles the VIE structure:** In providing that a *foreign invested enterprise* will include a Chinese company *controlled* by a foreign party – even if it is directly Chinese-owned – the Draft will be the first legislation to address the *variable interest entity* (VIE) structure. A VIE structure usually involves a set of contractual arrangements that gives a foreign investor effective control over a Chinese company that is held by Chinese shareholders. It has long been used in sectors where foreign investment is prohibited or restricted and has historically been tacitly tolerated by Chinese authorities.
4. **Broadens the ambit of China's National Security Review:** The Draft states simply that a national security review may be required if the "proposed investment would or could give rise to national security concerns". This is much broader than the existing rules, which specify the circumstances where a national security review is required.
5. **Imposes reporting requirements:** While in most cases, the Draft would make market entry more straightforward, it would impose more stringent post-establishment reporting requirements.

We examine below the potential impact on existing and future foreign investment projects of these five key points.

Unified law

Very broadly, the current laws governing foreign investment in China are set out in three main laws (one for each of the main available corporate vehicles: the wholly foreign-owned enterprise, the equity joint venture company and the cooperative joint venture company), a set of implementing rules for each of those laws and various other laws, rules

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and regulations.

One existing oddity of Chinese law would be removed if the Draft is enacted; under current rules governing Sino-foreign joint venture companies, the board of directors is the joint venture company's ultimate governing body. This is different from the rules for wholly foreign-owned enterprises and domestic (Chinese-owned) capital companies and is contrary to the *PRC Company Law*, all of which require the shareholders' meeting to be a company's governing authority. Under the Draft, the governing authority of all companies in China would be the shareholders' meeting.

For new foreign investors, this change should make joint venture negotiations slightly easier. Under the current regime, the composition of a board of directors effectively determines which joint venture party controls the company so the question of how many directors each party may appoint is almost invariably a sticking point in negotiations.

This change will likely mean that existing Sino-foreign joint venture companies will need to amend their corporate documents to render their boards subordinate to their shareholders. (The Draft currently allows a three year grace period for companies to comply with its provisions.)

The Draft makes no mention of *total investment amounts* or *debt : equity ratios*. Under current laws, a foreign invested enterprise may borrow no more than the difference between its registered capital and its total investment amount – both of which figures are subject to approval. This is not the case for domestic capital companies. Removing the strict *debt : equity* limitations would allow for larger investments by foreign parties and this will no doubt be a matter on which comment will be made during the Draft's consultation process.

New establishment procedures: the Market Entry Permit

Under current rules, other than in the Shanghai (Pilot) Free Trade Zone, the establishment of all foreign invested entities in China is subject to the approval of MOFCOM and/or, in some industries, the relevant industry regulator. In contrast, the establishment of a domestic capital company is usually subject only to approval where it will operate in a regulated industry; there is no general approval requirement. Approval procedures mean that company establishment takes time, is relatively expensive and involves a degree of uncertainty (because any approval is, by nature, discretionary).

The Draft would make approval requirements the exception rather than the rule. Foreign investment projects would not require approval unless they fall into industry sectors categorised as "restricted" in a (to be issued) *Negative List* or exceed a certain investment threshold. Sectors that remain closed to foreign investment will be categorised as "prohibited" in the Negative List. Investment in restricted sectors will be subject to a *Market Entry Permit*.

This follows the approach taken in the Shanghai (Pilot) Free Trade Zone (and, soon, in recently announced similar zones in Tianjin, Guangdong and Fujian) and the *Negative List* will replace the *Guidance Catalogue for Foreign Investment Industries*, which currently categorises foreign investment into *prohibited*, *restricted* and *encouraged* classes, with non-listed sectors falling within a default *permitted* class. Industry regulators' approval will still be required in more regulated sectors.

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The Draft allows for MOFCOM to make Market Entry Permits subject to conditions such as a requirement to spin-off certain assets or businesses, shareholding restrictions, limited operating terms, restrictions on investment regions and proportions of local employees. The current regime does not allow for conditional approvals.

The concept of “control” and the VIE structure

The Draft provides that:

1. a *foreign investor* includes non-Chinese nationals, entities incorporated outside China, foreign governments and their agencies, and international institutions;
2. a *Chinese investor* includes Chinese nationals, the Chinese government and its agencies and enterprises controlled by such parties; and
3. a *foreign invested enterprise* includes Chinese enterprises that are *controlled by* a foreign investor.

Under VIE structures, foreign investors control Chinese enterprises by way of contractual arrangements. These sorts of arrangements have allowed foreign parties to indirectly invest in Chinese enterprises that operate in industries in which foreign investment is precluded or restricted, such as telecommunications, technology and media. They work because the entity is owned by Chinese shareholders and, under the current rules, the “nationality” of the shareholders defines whether a company is a foreign-invested or a domestic entity. The Draft would allow the authorities to “look through” that direct ownership to examine which party truly controls the enterprise. If that controller is a foreign party, the Chinese enterprise will be deemed a foreign invested enterprise and subject to the foreign investment regime.

The Chinese government has long been aware of the VIE structure and has historically tacitly tolerated what is effectively a circumvention of Chinese law. It is also very aware of the substantial potential impact of it “shutting down” all existing VIE arrangements given the large numbers that are in existence; the size of many of the investments involved and the skills and technology they bring into the country. The Draft does not specify how existing VIEs will be dealt with but MOFCOM has issued three suggestions for public comment. Those suggest that they may be permitted to remain in place if they are controlled by Chinese investors (subject to a requirement to report to MOFCOM or obtain its approval) or be required to apply for foreign investment approval, which approval would be subject to MOFCOM and any relevant regulator’s discretion.

The impact of these provisions could be substantial, though it will depend on which industries appear in the Negative List and whether there is any relaxation in the restrictions on foreign investment in industries where VIE structures are most used, by the time the Draft becomes law.

National Security Reviews – wider scope means less certainty for new investors

The Draft provides that any foreign investment that gives rise to or could give rise to national security concerns will be subject to a national security review.

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This is significantly broader than the scope of China's existing rules in this area. Those provide that a review is required only where the investment is in certain sensitive sectors or locations and involves certain types of transactions.

The Draft expressly provides that the results of a review would not be subject to any administrative or judicial review.

This new broader ambit would add a new element of uncertainty into new investment projects as investors would not know for sure whether or not the additional time and cost of a national security review process will need to be factored into their establishment process. It also gives rise to concerns that the discretion to require a national security review will be exercised for purely political reasons.

Onerous reporting requirements

The Draft imposes substantial reporting requirements on foreign invested entities/their investors. These include a report upon establishment, reporting of any changes to the project and annual or (if certain thresholds are met) quarterly reporting.

These reporting requirements would have a time and cost impact on foreign-invested enterprises and are more onerous than those imposed on Chinese domestic companies. The information to be reported includes some commercially sensitive details, such as the actual controller of the company, sources of capital and areas and regions for investment. That, combined with the Draft's provision that MOFCOM will post the information on a foreign investor database which will be open to public enquiries (except for personal information and trade secrets) will concern some foreign investors.

Concluding comments

If enacted, the Draft will certainly be a game changer. It will be the first wholesale revamp of China's foreign investment regime in decades.

China is clearly aware that its existing approval-based system needs to be reformed and the Draft suggests positive steps in that direction. Replacing a raft of laws and regulations with a single (or at least a single main) foreign investment law will make the rules for foreign investment clearer and more straightforward. Addressing the VIE structure in legislation should, at least, clarify the legal position of those structures, which have traditionally fallen into something of a grey area.

Foreign investors will see the proposed changes to the national security review regime and substantial reporting requirements in a less positive light. However, the current consultation process should give rise to comments about these and other issues, and those comments may, to some extent, be addressed in future drafts before the Draft is finalized and becomes law.