

Draft Foreign Investment Law of the PRC

A major change in the regulation of foreign investment in China is underway. On 19 January 2015, the Ministry of Commerce (MOFCOM) of the People's Republic of China (China) issued a draft Foreign Investment Law (Draft) for public consultation. The content of the Draft marks a significant move of MOFCOM to relax its regulation on foreign investment and streamline the current fragmented regulatory framework. If the Draft is passed, it will replace the existing set of laws and regulations that govern the formation and operation of foreign-invested enterprises (which includes foreign-invested equity and cooperative joint ventures as well as wholly foreign-owned enterprises) in China (FIE Laws), some of which have been in place for almost 30 years.

This briefing looks at the background of the Draft and discusses the groundbreaking changes that it introduces to the regulatory framework on foreign investment.

Highlights of the Draft

The Draft introduces significant reform to the FIE Laws. Some major prospective changes are set out below:

1. Adoption of "negative list" reduces approvals

The Draft adopts the "negative list" approach currently implemented in Shanghai Free Trade Zone and subsequently expanded to other free trade zones.

Foreign investments into China are currently approved on a case by case basis.¹ In practice, greenfield foreign investment project or foreign acquisition of domestic companies could take up to three months or even more to complete the required governmental approval and filing procedures.

If the "negative list" approach is enacted as law, foreign investment projects in the "permitted" or "encouraged" sectors would be reduced to a mere filing procedure. However, foreign investment in the "restricted" sectors would still require a "market entry permit".

¹ The current foreign investment policies in China categorize the industries as "encouraged", "permitted", "restricted" and "prohibited" for foreign investment. Those foreign investment projects falling within the "encouraged" or "permitted" industries are subject to a less stringent scrutiny by the Chinese authorities, compared to the "restricted" sector. Further, a comparatively small size of foreign investment (US\$100 million) in a "restricted" sector would be escalated to the central level authorities for review, while any investment of less than US\$1 billion in an "encouraged" or "permitted" sector has been delegated to the local authorities.

The Draft clarifies the procedures and timeline for applying for the "market entry permit". These include the introduction of public hearings, whereby foreign investors would be given the opportunity to explain themselves before the authorities, and that decisions will be published. Furthermore, foreign investor will have access to an official channel where they could submit queries, for which the relevant authorities would be committed to respond within 10 business days.

The Draft contains certain measures to deter circumvention of the requirement for a "market entry permit". Currently, it is common practice for foreign investors to inject capital into a target project on a staggered basis so that each instalment of the investment falls below the threshold which would otherwise trigger approval by a higher level regulatory authority. To combat this practice, the Draft states that if any instalment of the investment, when aggregated with the investment amounts previously made in the preceding 2 years, exceeds a certain threshold, the foreign investor would need to apply for a "market entry permit" in respect of this investment project, even if one was not required for the previous instalments of investment.

2. Identity of foreign investor

Foreign investors are defined under the existing FIE Laws to be those incorporated outside China irrespective of their source of capital or who their ultimate controller is. The Draft, for the first time, takes a "substance over form" approach by stipulating that only a domestic enterprise established in China but "controlled" by a foreign investor will be deemed to be a foreign-invested enterprise (**FIE**). "**Control**" is broadly defined in the Draft to mean:

- the ownership of not less than 50% of the voting rights
- the right to appoint (or the ability to secure) a majority of the board of directors
- the ability to otherwise materially influence the decisions of the board or shareholders' meeting of a company, or
- the ability to exercise decisive influence over a company by way of contractual or trust arrangements.

If this "substance over form" approach is preserved in the Draft and it is eventually passed by the NPC into law, FIEs' operations and investment in China would be dramatically affected. For instance, acquisition or incorporation of subsidiaries by FIEs in China will be regulated as a foreign investment activity, which, currently is treated as a domestic enterprise's investment (except in the case of an FIE being a foreign invested holding company) though subject to the restrictions on industry sectors in which foreign investment could be made. In addition, investments into China by an offshore entity effectively "controlled" by Chinese investors could be regarded as domestic investments and therefore allowed in certain restricted industry sectors.

The Draft also intends to apply beyond China's borders to offshore transactions where foreign investors gain "control" over PRC domestic businesses.

3. Impact on VIE structure

The so-called VIE structure is very widely used in the PRC, particularly in "restricted" sectors such as Internet and e-commerce, to enable foreign investors or Chinese shareholders investing through offshore entities to have effective control over a domestic company (typically holding the necessary licences for operating in a regulated industry) through a series of contractual arrangements. The VIE structure involves the Chinese shareholders of the domestic company acting as nominee shareholders, with a series of contractual arrangements to allow an offshore holding company and its directly owned subsidiary to have effective control over the domestic company. The VIE structure has been tacitly tolerated by the Chinese government since its emergence in the early 2000s and has been widely adopted by companies seeking offshore financings or listing.

This status quo may be under threat if the Consultation Draft is passed into law.

Specifically, the Consultation Draft provides that a domestic enterprise established in the PRC that is "controlled" by a foreign investor will be deemed to be a foreign invested enterprise, even if the domestic enterprise is directly owned by Chinese shareholders. If the domestic enterprise within a VIE structure is operating in a restricted or prohibited sector (to be

set out in the "negative list"), and the ultimate "controller" is a foreign investor, this means that it will be in breach of the foreign investment restrictions and/or would need to obtain additional approvals.

Possibly due to the sensitivity related to the VIE structure, the Draft intentionally refrains from stating how businesses controlled through the VIE structure will be regulated, but makes reference to a separate explanatory note (**Explanatory Note**) that accompanies the Draft. This Explanatory Note indicates that MOFCOM is contemplating three possible approaches with respect to domestic companies under existing VIE structures which are in the restricted or prohibited sectors:

- a company under a VIE structure may report to MOFCOM that it is controlled by Chinese investors, with the result that the VIE structure can remain in place;
- a company under a VIE structure may apply to MOFCOM for certification that the company is controlled by Chinese investors, and upon such verification, the VIE structure can remain in place, or
- a company under a VIE structure may apply to MOFCOM for foreign investment approval, and MOFCOM would assess the situation (taking into account the actual controlling parties) together with other relevant regulators and make a decision.

The Explanatory Note indicates that the existing VIE structures may not be automatically grandfathered when the Consultation Draft is passed into law. Instead, it appears that MOFCOM is proposing to review existing VIE structures and "validate" as appropriate. However, some comfort can be taken as the Explanatory Note suggests that MOFCOM will not act rashly to shut down existing VIE structures which do not comply with foreign investment restrictions. Much will also depend on what sectors will be covered by the "negative list" which has yet to be published.

4. Corporate governance structure

Currently, an existing foreign-invested equity or cooperative joint venture is governed by its board of directors as the company's highest decision-making body, while a wholly foreign-owned enterprise is governed by its shareholders' meeting. The Draft clearly mandates all existing FIEs to conform their respective governance structure in accordance with that under the *Company Law of the PRC* (which specifies that the shareholders' meeting is the highest decision-making body of a company) within three (3) years of the effectiveness of the Foreign Investment Law. Therefore, if the Draft is enacted as law, many foreign-invested enterprises would have to amend their constitutional documents to comply with the new regulatory requirements. Parties to a foreign-invested joint venture may take this opportunity to renegotiate existing governance arrangements. For example, under the current FIE Laws, certain matters must be approved unanimously by all the directors of a joint venture. Under the *Company Law*, such matters only require the approval of 2/3 of the shareholders.

5. National security review

China already has a set of administrative rules relating to the national security review ("**National Security Review Rules**") as introduced by MOFCOM as from 2011. The Draft seems to indicate that the Chinese government is generally relaxing approvals for "encouraged" or "permitted" foreign investments, but is stepping up scrutiny and regulation in more strategic areas such as national security.

Among other changes, the most significant one introduced by the Draft is that it expressly states that national security review decisions will not be subject to any administrative or judicial review.

Some other notable changes are set out below:

- the Draft no longer describes what industries would trigger national security review. Instead, it only provides, in vague and circular terms, that a national security review may apply if "the proposed foreign investments would have or possibly have national security concerns";
- the Chinese authorities may clear or block or conditionally clear a proposed foreign investment or acquisition under the Draft, while the conditional clearance is not an option under the existing National Security Review Rules; and

- the Draft contemplates an escalation mechanism whereby any decision to block a proposed foreign acquisition or investment has to be escalated to the State Council.

6. Information gathering and reporting scheme

While the Draft relaxes the pre-approval procedures and requirements for establishing a foreign investment project, it strengthens the regulation of the project after the investment is made. Specifically, if any changes are made to the project, the foreign investor or the FIE must file such changes on a timely basis. FIEs are also required to submit annual reports, and for larger FIEs with total assets, sales revenue or operational income exceeding RMB 10 billion or having more than 10 subsidiaries, quarterly reports are required.

In addition, the Draft proposes the establishment of a publicly accessible database that provides information on the creditworthiness of foreign investors. The Draft, however, fails to specify what specific information will be disclosed or stored on the database.

How far is this Draft from being enacted?

The National People's Congress (NPC), being the Chinese legislator, issued its legislative plan in December 2013 to prioritize its work tasks of the next five years in three different groups. Specifically, bills that must be passed into law by 2018 are categorized in the first class; bills that need further research but may be submitted to NPC for enactment into laws are categorized in the second class; while those bills which are premature and require even more research are categorized in the third class. The amendments to the FIE Laws were categorized in 2013 under the second class, which means that they were not planned to require top priority attention.

Subsequently, NPC authorized the State Council (which is China's highest executive body) to coordinate the legislative efforts. In the 2014 Legislation Work Plan of the State Council issued in February 2014, the "amendment of the FIE Laws" was only stated to require further research.

This would suggest that it may still take a long time before the Foreign Investment Law is finally promulgated. Until then, the Draft could be substantially amended as other relevant regulators such as the National Development and Reform Commission and the State Administration of Industry and Commerce may intervene in the drafting. It is expected that NPC would provide a clearer legislative timeline when it reconvenes its annual general meeting in March 2015.

Conclusion

The Draft reflects China's desire to reduce beauracritic approval requirements for foreign investments in the "permitted" and "encouraged" sectors, and at the same time focus MOFCOM's scrutiny on foreign investment in "restricted" sectors and re-emphasize MOFCOM's role as a gate keeper on foreign investment related issues. This is indeed a welcome development. Yet, the Draft still leaves many questions unanswered. One major question relates to the acquisition of a domestic business by foreign investors. While such transactions are currently governed by a separate set of regulations issued by MOFCOM, commonly referred to as the "M&A Rules", the Draft does not address how the M&A Rules would be reconciled with the Foreign Investment Law.

The legislative process for the Foreign Investment Law would take some time to complete. It remains to be seen how much of the Draft would eventually be preserved or changed before it is submitted to the NPC for final reading.

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