China Issues Draft Foreign Investment Law

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China's foreign investment legal regime was first established in the 1980s when the Sino-Foreign Equity Joint Venture Law (1979), Wholly Foreign Owned Enterprise Law (1986), and the Sino-Foreign Cooperative Joint Venture Law (1988) were successively published. The following thirty years witnessed an explosion of laws and regulations governing various aspects of foreign investment activities in China. However, laws and regulations promulgated during this period were mostly aimed at addressing specific types of foreign investment (such as the so called "Circular 10" issued by the Ministry of Commerce governing the merger & acquisition of domestic enterprises by foreign investors) or other specific issues (such as foreign investment in the automobile or other specific industries), and, as a group, lack consistency. Furthermore, after the promulgation and amendments of the PRC Company Law, there are more inconsistencies between the PRC Company Law and the above three laws governing the three types of foreign invested enterprises.

To solve this often complained about issue and also to continue to carry out liberalizing reform of the legal regime governing foreign investment in China, the Ministry of Commerce (MOFCOM) published the draft Foreign Investment Law for public comments on January 19, 2015, with a deadline for comment of February 17, 2015. The proposed version, pending further revisions to be made after the comment period and the legislators' review and approval, suggests a radically different regulatory landscape for future foreign investment in China.

I. Unified Code for Foreign Investment

The proposed Foreign Investment Law will govern all investment activities of foreign investors in China. Foreign investors include not only foreign persons that are domiciled outside China (foreign nationals or entities registered outside China), but also domestic entities that are controlled by such foreign persons. This extended definition covers the following two types of entities that are currently not within the purview

of foreign investment regulations but are commonly used by foreign investors as vehicles to structure certain transactions. One of them is the second-level foreign invested company (i.e., companies invested in by foreign invested enterprises), and the other is the entity controlled by foreign investors via contractual arrangement (also known as a VIE entity).

Investment activities covered under the proposed Foreign Investment Law include (a) establishment of enterprises, (b) acquisition of shares, equity interest, assets, voting rights, or other similar rights and benefits of a domestic enterprise, (c) provision of long-term financing to companies with foreign interests, (d) acquisition of natural resources exploration rights, or right to construct and operate public utilities, (e) acquisition of land use rights or ownership to real property, and (f) control of interest in domestic companies through contracts, trust or other arrangement. Each of these activities is currently subject to separate rules and regulations. For example, the establishment of enterprises are mainly subject to the *Sino-Foreign Equity Joint Venture Law* (EJV Law), *Wholly Foreign Owned Enterprise Law* (WFOE Law), the *Sino-Foreign Cooperative Joint Venture Law* (CJV Law), *Notification on Administration of Settlement of Foreign Exchange in Capital Account of Foreign Invested Enterprises* (Circular 142), and the *Tentative Rules on Domestic Investment by Foreign Invested Enterprises*. The acquisition of shares, equity interests and assets is mainly covered under the *Rules on Acquisition of Domestic Companies by Foreign Investors* (also known as Circular 10), *Several Rules on Change of Equity Ownership in Foreign Invested Enterprises* and the *Administration Rules of Strategic Investment in Listed Companies by Foreign Investors*. The provision of long-term financing to companies is mainly governed by the *EJV Law*, the *WFOE Law* or the *CJV Law*. The acquisition of natural resources exploration rights is mainly covered under the *Several Opinions on Further Encouraging Foreign Investment in Exploration of Mineral Resources*; acquisition of land use right was mainly governed by the *Tentative Rules on Development of Land by Foreign Investors* (which was rescinded in 2008, with no new regulations published to replace it). The acquisition of ownership to real property is mainly covered under *Opinions regarding Regulation of Foreign Investment in Real Estate Industry* and 20 other rules and regulations published by government authorities including Ministry of Commerce, State Administration of Foreign Exchange, State Administration of Taxation and Ministry of Housing and Urban-Rural Development. Contractual control arrangement is discussed under Circular 10.

In proposing the Foreign Investment Law, the Chinese government seems to be following the examples of western countries such as Canada and Australia in having its own comprehensive foreign investment law that governs major aspects of foreign investment in China. However, the current draft only proposes to replace the EJV Law, the CJV Law and the WFOE Law (collectively, the FIE Laws), despite the fact that its coverage, as indicated in its definition to investment activities, is far broader than what used to be covered under those Laws. It still remains uncertain how the proposed Foreign Investment Law will interact with the various other current laws and regulations governing foreign investment activities.

II. National Treatment for Foreign Invested Enterprises

Besides attempting to unify foreign investment regulations, the draft law also provides national treatment to foreign investors except for investment in industries specified under the Foreign Investment Special Administration Catalogue discussed below.

Under the current legal regime, equity joint ventures and, in most cases, wholly foreign-owned enterprises and cooperative joint ventures all take the form of limited liability companies. However, according to the policies issued by the company registration authorities, the organization and management of wholly foreign-owned enterprises are governed by the PRC Company Law while the equity joint ventures and cooperative joint ventures are governed by the EJV Law and CJV Law, respectively. Foreign invested

partnership and foreign invested companies limited by shares are also governed by independent sets of rules instead of the Partnership Law and the Company Law. Hence foreign invested enterprises are subject to different requirements, in terms of minimum registered capital, total investment, corporate management and taxation, depending on the entity form a foreign invested enterprise takes. By replacing the FIE Laws with the Foreign Investment Law, the Chinese government intends to grant foreign invested enterprises national treatment and to embrace them into the current legal system that applies to Chinese companies in general.

We applaud the efforts indeed; after all, not only foreign investors, but also Chinese entrepreneurs and scholars, have been advocating for national treatment to foreign investors for many years. We, however, remain suspicious on how far national treatment can go if we take the entire legal and economic system in China into consideration. For example, foreign exchange under capital account is still under strict control by the government, and the entire foreign exchange control system—including remittance of foreign exchange outside of China, exchange of foreign currency into RMB, and the usage of foreign exchange capital—is, to a large extent, based on the current rules on establishing foreign invested enterprises, contributing and increasing registered capital, borrowing foreign shareholder loan, equity transfer and dissolution, to mention but a few. If national treatment will blur the distinction between foreign invested enterprises and purely Chinese companies, then it will definitely bring a far more extensive challenge to the current foreign exchange administration and control system. Will this mean that foreign exchange control over foreign investment in non-restricted and non-prohibited industries will be lifted? Will this mean Circular 142 (which prohibits FIEs using its capital funds to acquire domestic companies) will be repealed in its entirety? These and many other questions remain unanswered.

III. The Foreign Investment Special Administration Catalogue

The proposed Foreign Investment Law also creates a Foreign Investment Special Administration Catalogue (the Special Catalogue), which will be used to identify industries in which foreign investment is restricted or prohibited, much like the Negative List issued by the Shanghai Free Trade Zone. This function is currently fulfilled by the Foreign Investment Guidance Catalogue (the Guidance), but the Guidance also includes industries in which foreign investment is encouraged. No Special Catalogue has been published yet, but considering that the National Development and Reform Commission and MOFCOM just jointly released a draft version of the updated Guidance for public comments in November 2014, we have reason to believe that the two authorities will consult each other to determine whether the Special Catalogue will replace the Guidance entirely and, if not, see to it that the Special Catalogue be consistent with the "Restricted" and "Prohibited" sections of the Guidance.

IV. Elimination of Examination and Approval of Foreign Investment Projects

Currently, the establishment of all foreign invested enterprises must be examined and approved by MOFCOM or the local Commission of Foreign Trade and Economic Cooperation (collectively, the Approving Authority), and registered with the State Administration for Industry and Commerce or its local branches (collectively, the Registration Authority).

The proposed Foreign Investment Law no longer imposes approval requirements over foreign investment in industries that are not restricted to foreign investors. This is even a bigger step than the current practices in the Shanghai Free Trade Zone, which, though all approval requirements for non-restricted foreign investment have been suspended, still require filing with competent authority and results in an uncertainty over whether the filing is merely for information purposes or is subject to substantive

examination. The proposed Foreign Investment Law takes a clearer position that substantial examination is no longer required.

One laudable improvement is that joint venture agreements and equity (or asset) acquisition agreements no longer require government approval before taking effect. This improvement gives the parties to a transaction more freedom to choose their own transactional structure and more control over the timing of their transaction.

A foreign investor wishing to invest in a restricted industry must apply for a permit. Even in this case, the approval requirement is different from the current system. The proposed Foreign Investment Law places more of an emphasis on information relating to foreign investors and the effect of such investment on the environment, employment, local development, technological innovation and, last but not least, competition and national security. The proposed law specifies that a foreign investor must include in its application for a permit to invest in a restricted industry a statement whether the investment will trigger national security and anti-monopoly reviews.

V. Information Reporting System

In place of the current examination and approval system, the proposed Foreign Investment Law adopts an information reporting system, under which foreign investors and foreign invested enterprises must file for recording with the Approval Authority information relating to their investment. This includes general information about the foreign investor, source of funds, investment method, investment ratio and form, information about the foreign invested enterprises, and updates if the previously filed information has changed. The Approval Authority may disclose information provided by foreign investors and foreign invested enterprises through the information reporting system to the public, except for commercial secrets of foreign investors and foreign invested enterprises, personal data and data the disclosure of which is controlled by some other law.

The changes proposed under the current draft will not only significantly simplify and shorten the period for setting up a foreign invested enterprise, but also give foreign investors and their Chinese partners, if any, more freedom to negotiate and set investment terms.

However, it is not all roses, because:

A. The Information Reporting system is quite onerous. Foreign investors must file not only reports upon making investment and upon any changes to the filed information, but also quarterly reports (in the case of large investment projects) and an annual report.

B. Some information required to be submitted may be commercially sensitive to the foreign investor, such as the party with actual control and the source of investment funds. This is a concern especially because the draft law does not provide for confidential treatment of such information.

C. The proposed Foreign Investment Law does not give a clear answer on whether, in case of foreign investment, the reporting obligations with the Registration Authority will still be required or will be replaced with the Information Report that will be filed with the Approving Authority. If the registration with the Registration Authority is still required, then this is definitely a duplicate effort that will cause troubles to investors and any third parties that want to inspect and review information relating to specific investment project. As indicated in the Notes to the proposed Foreign Investment Law,

which was published together with the proposed draft by MOFCOM (the Notes), the legislators have noticed this potential conflict and will address this issue after taking further consideration.

VI. Future of VIE Structure

The proposed Foreign Investment Law will tighten the administration of contractual arrangement between foreign investors and their domestic VIE entities. Any such contractual arrangement, as long as it results in de facto control over a domestic entity by foreign investors, will be considered as foreign investment and be governed by rules and regulations relating thereto. The definition to "control" under the proposed Foreign Investment Law is quite broad, including (a) direct or indirect ownership of no less than 50% of the shares, equity interest, properties, voting rights or other similar rights of an entity; (b) direct or indirect ownership of less than 50% of the shares, equity interest, properties, voting rights or other similar rights of an entity but with the power (i) to directly or indirectly appoint, or to make its nominees be appointed as, the majority of the members of the board of directors or similar decision-making organ of an entity, and (ii) to exert significant influence over the decisions of the shareholders' meeting, the board of directors or similar decision-making organ of an entity; or (c) having the ability to exert decisive influence over the management, financial mattes, employment or technology of an entity via contracts or trust.

The proposed Foreign Investment Law, however, hesitates on how to deal with VIE structures that have been established before its taking effect, and invites public comments and proposals in this regard. In accordance with the Notes, the legislators will most likely take one of the following approaches:

A. An existing VIE entity can continue its operation as long as it files a statement of de facto control by Chinese investors with the Approving Authority after the Foreign Investment Law takes effect.

B. An existing VIE entity can continue its operation only if it is acknowledged by the Approving Authority to be under de factor control by Chinese investors.

C. An existing VIE entity can continue its operation only if the foreign investors obtain approval from the Approving Authority after the Foreign Investment Law takes effect.

If the finalized Foreign Investment Law adopts either (b) or (c), it will basically strangle all the companies that are currently using VIE structure, which include many famous names such as Sina, Baidu, Alibaba, Youku, eBay China, Amazon CN and Expedia China. Unless the Chinese government is willing to further open China's Internet industry to foreign investors—that is to say, allow wholly foreign-owned Internet companies, which is very unlikely at the present time—this may be catastrophic for China's Internet industry. Considering that Chinese government is always known for its pragmatism, we would rather believe that it will adopts option (a) or some way in between, such as giving the current VIE companies a 3- to 5-year grace period for them to restructure.

VII. Further Observations

The proposed law also brings all foreign investment, regardless of form, under the purview of the national security review system. Previously, MOFCOM issued its *Regulation of the Ministry of Commerce on Implementation of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, which became effective September 1, 2011 and applies to M&A transactions.

There is no doubt that the proposed law will bring significant changes to the current foreign investment legal regime in China. While it lifts many legal obstacles and tedious requirements for foreign investors

making investment in China, it raises many more questions on how the Foreign Investment Law will interact with the other laws and regulations, and in a larger sense, how the foreign investment legal system will interact with the system that applies to purely domestic companies, and with the country's economic system such as foreign exchange control.

The proposed Foreign Investment Law is an ambitious undertaking. In attempting to unify China's law governing foreign investment and offering national treatment to foreign investors, it would rescind the FIE Laws and, more importantly, do away with the examination and approval process, except in the case of investment in restricted industries. It would give foreign investors the long-awaited flexibility, but at the expense of supervisory power of the Approving Authority. Carrying out the changes (quite radical from China's perspective) suggested in the proposed law to the full extent might mean trimming a lot fat off the bloated bureaucracy of the current system, to which some agencies might object. We suspect that MOFCOM will need a fair amount of time to consult with all the agencies affected in order to come to a consensus before finalizing the Foreign Investment Law.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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