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Radical Changes for Foreign Investment in China are on Their Way

Replacement of the Three Primary Foreign Investment Laws

On January 19, 2015, the PRC Ministry of Commerce ("MOFCOM") released a draft Foreign Investment Law (the "Draft FIL") for public comments. If adopted, the Foreign Investment Law will replace the three primary laws that currently apply to foreign-invested enterprises (the "FIEs") since 1979, i.e., the Wholly Foreign-owned Enterprise Law, the Sino-foreign Equity Joint Venture Enterprise Law and Sino-foreign Cooperative Joint Venture Enterprise Law (collectively, the "Existing FIE Laws") and will dramatically and fundamentally change the regulatory regime for foreign investment in China. The key highlights of the Draft FIL are summarized below.

End of the Era of Approval – Negative List and Market Entry Permit

Under the current foreign investment legal regime, every foreign investment activity is subject to approval by the Chinese government, the Ministry of Commerce ("MOFCOM"), regardless of industry or invested amount, including approval of incorporation, corporate charter documents, joint venture contracts and any material changes thereto, such as shareholding, investment amount, business scope, acquisition or liquidation.

The Draft FIL, adopting global practice, grants foreign investment national treatment subject only to "market entry" restrictions on foreign investment, as will be set forth in a to-be-formed Special Administrative Measure Catalogue. This so-called "Negative List" is supposed to exhaust all the prohibitions and restrictions on foreign investment. Any foreign investment that does not appear on the Negative List will be treated equally with a purely domestic investment and will no longer require MOFCOM approval. This change would include not only the forming of a new legal entity but also any change to such investment, such as mergers and acquisitions.

Any foreign investment that falls within the Negative List must obtain a "market entry permit" from MOFCOM before the investment can be made. A market entry permit will differ from the current "prior approval" system, focusing on the qualifications of the investor rather than the specific investment, i.e., unlike the existing regime, there will be no review and approval of contracts, incorporation documents, etc. Once a foreign investor receives the market entry permit, it may proceed with the normal corporate procedures required for a Chinese company without further approval. MOFCOM may impose conditions on a market entry permit, such as restrictions on territory, shareholding percentage, and number of employees. In such cases, the foreign invested enterprise ("FIE") will be required to submit an annual report to MOFCOM reporting the compliance with such conditions.

The Negative List will be published by the State Council of China and is likely to be based on the negative list that has been used in the China (Shanghai) Pilot Free Trade Zone ("Shanghai PFTZ").

Voluntary Reporting of Foreign Investment

The Draft FIL proposes to abolish the pre-approval requirements for most of foreign investment; however the PRC government nonetheless wishes to monitor foreign investment flows. As a result, the Draft FIL requires a foreign investor or, if a legal entity has been formed in China, the FIE to voluntarily report to MOFCOM through an online system. Such reports include (i) a specific investment report, i.e., reporting a particular investment upon completion, (ii) a change of investment report, i.e., reporting any adjustment to a specific investment after completion of such change, and (iii) an annual report and quarterly report (in the case of a key foreign investor) in respect to the operation conditions of an FIE. According to the Draft FIL, an FIE appears to be required to disclose a large amount of information in an annual/quarterly report, including operational information, financial information, import and export, investment, judicial proceeding, and government investigations, if any.

"Actual Control" Principle; Unknown Future for the VIE Structure

Variable Interest Entity ("VIE") structures have been under the spotlight since the second publication of the Draft FIL. The so-called VIE structure is also known as a "contractual control scheme" and is frequently used in the overseas listing of Chinese companies, including Sina and Alibaba. However, the structure has also been used by foreign investors to bypass certain foreign investment restrictions through the establishment of a wholly foreign-owned enterprise ("WFOE") in China that controls a Chinese entity that is able to operate the business through contractual arrangements. The current law is silent on the legality of the VIE structure, thus placing the VIE structure in a grey area.

The Draft FIL defines "foreign investment" from the perspective of "actual controller" for the first time. "Control" under the Draft FIL means (i) 50% or above of the equity share or the ability to influence the major decision of a company, as well as (ii) the ability of imposing decisive impact on the operation, finance and human resource of an enterprise in the form of contract or trust. To that end, an entity incorporated in a foreign jurisdiction that is controlled by a Chinese citizen will be deemed to be a Chinese investor under the Draft FIL. In contrast, a pure Chinese company controlled by a foreign investor via a VIE structure will be treated as foreign investment.

The Draft FIL does not address the validity of the existing VIE structures, which raises in particular questions for those that violate the current foreign investment restrictions and might not be granted "market entry permits". We do not anticipate that the final version of the Foreign Investment Law will require a de-listing or the equity transfer of the companies in a VIE structure considering there have been nearly 100 companies listed in the US stock market and thousands of high-tech companies that have adopted such structures. Moreover, for any new VIEs in the future, it is unclear whether the Chinese government will simply shut the doors to foreign investment in those restricted industries that highly rely on venture capital, such as Internet industry.

National Security Review

The Draft FIL expends the applicable scope of national security review from the foreign investors' acquisition of domestic enterprises in the areas of military, agriculture, energy and resources, infrastructure, transportation services, key technologies, and major equipment manufacturing into all the foreign investments that threaten or may threaten national security. The national security review may either be voluntarily applied for by the foreign investor or be initiated by the State Counsel. While requiring a foreign investor to decide whether to make a national security review, the draft fails to provide any guidance as to the circumstances where national security review will be required. It is expected that the government will release implementing rules to allow foreign investors to make assessment.

Conclusion

The Draft FIL constitutes a significant revolution in the regulatory regime for foreign investment in China, though many provisions remain to be clarified or detailed in the finalized Foreign Investment Law, which will be circulated once the authorities have collected opinions of the public on the Draft FIL.

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