Opening up the Chinese markets for foreign investors

The Foreign Investment Law (Draft for Comments)

On 19 January 2015, China’s Ministry of Commerce published the long-awaited Foreign Investment Law (Draft for Comments) for general public consultation. After completion of the consultation procedure, the law will be finalized and it is expected to come into force as soon as 2016. The Foreign Investment Law will result in sweeping reforms of the rules that apply to investments in China by foreign companies and individuals. The new law will fundamentally change the investment landscape of China, substantially increasing the investment opportunities for foreign investors.

1. Redefinition of fundamental concepts related to foreign investment

1.1 Definition of foreign and Chinese investors

Article 11 of the Foreign Investment Law (Draft for Comments) states that the term “foreign investors” in this law refers to the following subjects who make investments in the People’s Republic of China (PCR): (1) individuals who do not have Chinese nationality; (2) enterprises incorporated under the laws of other countries or regions; (3) governments of other countries or regions, or their subordinate departments or authorities; (4) international organizations; and (5) domestic enterprises controlled by the aforesaid subjects, which shall be deemed as foreign investors. Article 12 provides that the term “Chinese investors” in this law refers to the following subjects: (1) individuals who have Chinese nationality; (2) the Chinese Government and its subordinate departments or authorities; and (3) domestic enterprises controlled by the aforesaid two subjects.

Article 14 provides that the term “foreign investment enterprises”
in this law refers to enterprises that are wholly or partially invested in by foreign investors and incorporated in the PRC under its laws.

Based on these provisions, when defining these two types of investors, the Foreign Investment Law (Draft for Comments) not only adopts the “place of incorporation” standard, but also the “actual control” standard. Therefore, the key means of determining whether an investor is a foreign or Chinese investor is to ascertain the identity of the investor’s actual controlling person. Therefore, in the future, if PRC domestic enterprises are controlled by foreign investors, they will be deemed as foreign and be subject to the relevant regulations on foreign investment.

1.2 Who is the ‘Actual Controlling Person’ and what is ‘control’?

Article 19 of the Foreign Investment Law (Draft for Comments) provides that the term “Actual Controlling Person” in this law refers to individual(s) or enterprise(s) that directly or indirectly control foreign investors or foreign investment enterprises.

Article 18 provides that the term “control” in this law, as for an enterprise, refers to a circumstance that meets one of the following requirements: (1) directly or indirectly holding 50% or more of the shares, equity interest, assets, voting rights or other similar rights of the enterprise; (2) directly or indirectly holding less than 50% of the shares, equity interest, assets, voting rights or other similar rights of the enterprise, but (i) having the right to appoint, directly or indirectly half or more of the members of the board or similar decision-making bodies, or (ii) having the power to procure the appointment, directly or indirectly, of nominated persons to make up half or more of the members of the board or similar decision-making bodies, or (iii) having sufficient voting rights to exert significant influence on the resolutions of the shareholders’ meeting, general meeting or board of directors or other decision-making bodies; or (3) exerting determinative influence over the operations, finance, human resources, technology or related areas of the enterprise, whether by contracts, trust arrangements or otherwise.

These provisions reference provisions on the right of control of enterprises in fundamental laws such as the Company Law and the Securities Law. It is easy to understand the circumstances as provided in paragraph (1) and subparagraphs (i) and (ii) of paragraph (2) of Article 18. Regarding the circumstance as provided in subparagraph (iii) of paragraph (2), there are no specific provisions on significant influence for the time being or, in practice, whether “veto power” or a “shareholder who holds more than one-third of the shareholding” can be interpreted as such significant influence and, if so, whether it is relatively easy to control the enterprise jointly. These questions require further clarification. Regarding the circumstance as provided in paragraph (3), there are no specific provisions on “determinative influence” for the time being. However, we understand that variable interest entities (VIE) shall fall within this circumstance.

Moreover, we note that, if foreign and Chinese investors jointly control the enterprise, or if neither foreign or Chinese investors control the enterprise, then the actual controlling person standard inevitably leads to questions regarding: (1) the nature of the enterprise; (2) whether investments in the enterprise are foreign or Chinese investments; and (3) whether foreign enterprises that cannot be proved to be controlled by Chinese persons shall be deemed as foreign investors without exception. These questions deserve further attention.

1.3 Definition of foreign investment

Article 15 of the Foreign Investment Law (Draft for Comments) further expands the definition of foreign investment, which includes not only greenfield investment (i.e., establishment of a new enterprise) and mergers and acquisitions (including equity acquisition and asset acquisition), but also medium-and long-term financing (with a term of more than one year), obtaining licenses to explore natural resources or build and operate infrastructure (such as joint offshore oil exploration, Build-Operate-Transfer (BOT) and others), acquisition of houses, land and other real property, contractual control (such as VIE arrangement) and other forms. For real property investment, Article 16 of the Foreign Investment Law (Draft for Comments) requires foreign investors to perform a national security review and comply with information reporting obligations.
Based on these provisions, the foreign investment law will apply to all kinds of foreign investment in the future and change the current conditions under which “different forms of foreign investments are regulated by different laws and provisions;” for example, greenfield investment is regulated by the Three FIE Laws, but mergers and acquisitions involving foreign investment are regulated by Circular 10 of MOFCOM (i.e., Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors). It is expected that, once the foreign investment law comes into effect, the Three FIE Laws, Circular 10 and other regulations on foreign investment will be repealed simultaneously.

2. Reconstruction of the entry clearance regime

2.1 Overall introduction

Under the current foreign investment regime, foreign investment enterprises must acquire preapproval or, in certain free trade zones, perform filing procedures with the relevant department of commerce from its establishment on through any changes it might undergo until its dissolution or liquidation, regardless of industry or size. This not only affects the efficiency of a foreign investment enterprise’s operation, but also occupies government resources. In order to streamline administration, institute decentralization and simplify the administrative approval process as required by the Chinese Government, the Foreign Investment Law (Draft for Comments) would repeal the approval or filing regime established by the Three FIE Laws and design an entry clearance regime for foreign investment administration that is compatible with the management model, the “pre-entry national treatment” requirements and the “special administrative measure catalog.”

Articles 20 to 26 of the Foreign Investment Law (Draft for Comments) generally provide for entry clearance, and the special administrative measure catalog comprises the “prohibited catalog” and “restricted catalog.” In general, foreign investors and domestic enterprises in which shares or interest are directly or indirectly held by foreign investors cannot invest in areas specified by the prohibited catalog. Investments listed in the restricted catalog require applications for entry clearance, while investments that are not specified in the restricted catalog do not require applications for entry clearance.

The content of the special administrative measure catalog is a matter of concern for all businesses and relevant parties. As far as we understand, there are two schools of prevailing opinions at the moment: one is that the content of the catalog will mainly refer to the “negative list” implemented in the Shanghai Pilot Free Trade Zone; and the other is that reference will be mainly made to the current industry catalog for the guidance of foreign investments, especially the industry catalog for the guidance of foreign investments (Draft for Comments) published in the second half of 2014. In contrast to the “negative list,” the special administrative measure catalog will also specify the types of special administrative measures. However, it remains to be further clarified by the legislative authorities on exactly which opinion will be adopted.

2.2 Authority for entry clearance

Article 26 of the Foreign Investment Law (Draft for Comments) provides that the restricted catalog contains two circumstances: (1) investments that exceed certain investment amount thresholds set by the State Council; and (2) areas where foreign investment is restricted. Article 27 further states that, for investments exceeding thresholds in the aforesaid paragraph (1), an application for entry clearance must be made to the competent foreign investment department of the State Council (i.e., MOFCOM). However, for investments in restricted areas, an application for entry clearance must be made to MOFCOM or the competent department of commerce at the provincial level (for instance, the Shanghai Municipal Commission of Commerce). When calculating

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1 See the Interpretation Regarding Foreign Investment Law of the People’s Republic of China (Draft for Comments) (19 January 2015).
the investment amount, Articles 28 and 29 further specify that, if a foreign investor makes several investments in the same investment project within two years, the investment amount will be the cumulative investment amount and, if a foreign investor provides financing with a term of more than one year to a domestic enterprise, the amount of the financing shall be calculated as the investment amount.

As such, the future competent authority that grants entry clearance will be MOFCOM or the department of commerce at the provincial level (the “approval authority”); as a result, we believe commissions of commerce at the prefecture level and district or county level that currently do significant foreign investment approval work may not engage in industry entry clearance work, but rather focus on doing more post-mortem supervision work on foreign investment enterprises instead, which again requires further clarifications from the authorities.

2.3 Entry clearance process

Articles 30 to 35 of the Foreign Investment Law (Draft for Comments) provide for the entry clearance process, such as application materials, review factors, interconnections with the national security review and review period, on which attention is needed. If the investment areas require relevant industrial permission (for instance, the License for Practice of Medical Institutions), then prepositive industrial permission shall be obtained before applying for entry clearance. In the entry clearance process, if the approval department notes relevant investment matters that jeopardize or may jeopardize national security, then the entry clearance review process shall be suspended, and the department shall notify the applicant to apply for the national security review in writing. The review period is normally 30 working days (from the date when the Approval authority officially accepts the application) and, for complicated applications, the review period can be extended by another 30 working days.

Overall, the Foreign Investment Law (Draft for Comments) specifies the entry clearance review period, which makes the entry clearance period expectable from the perspective of foreign investors, but prepositive industrial permission and potential national security problems may materially affect the amount of time required for foreign investment entry. In order to decrease such uncertainty, Article 47 allows foreign investors to consult the approval authority on the entry clearance scope and process in advance, and the approval authority shall respond within 10 working days. Meanwhile, Article 52 also provides the appointment and negotiation mechanism for the national security review; that is, foreign investors can request negotiation on procedural issues before applying for the national security review.

2.4 Review decision on entry clearance

According to Article 36 of the Foreign Investment Law (Draft for Comments), for entry clearance, the potential review decision options will include “conditional approval,” in addition to the current two decision options (approval and non-approval). Article 37 provides that the additional conditions consist of: asset or business stripping, restrictions on shareholding, requirements on operation period, restrictions on investment area, requirements on local employment ratio or figures, etc. One or more of these conditions can be attached to the final decision. This means the foreign investment review decision is not just a “yes” or “no” answer, and that such conditional approval can provide both foreign investors and approval departments with more room for negotiation and bargaining, so as to balance the need to attract investment and the need to protect the domestic economic order.
3. Improvement of the national security review regime

3.1 Overall introduction

According to the relevant existing regulations promulgated by the State Council, foreign investment will be subject to a national security review in the following situations: (1) the foreign investors merge and acquire a domestic enterprise and obtain the right to control the domestic enterprise; and (2) the domestic enterprise is a military industrial or a military industrial support enterprise, or an enterprise that is close to key and sensitive military facilities, other entities relating to national defense and security, enterprises related to national defense and security, enterprises related to national security in fields involving important agricultural products, important energy and other resources, key infrastructure, important transportation services, key technologies and major equipment manufacturing. In general, the existing security review is limited to mergers and acquisitions by foreign investors for the right of control and is only conducted for specific areas.

The 27 articles in Chapter Four of The Foreign Investment Law (Draft for Comments) provide comprehensive information on the foreign investment security review regime, which also solves the issues arising from the existing security review regime’s low status in the legal hierarchy. The draft expands the scope of the security review to “any foreign investment that jeopardizes or may jeopardize national security.” Foreign investors need to apply for the security review as long as the relevant foreign investment (in or out of the restricted catalog) jeopardizes or may jeopardize national security, and the competent department can also initiate the security review based on its own authority. As the relevant departments have not published applicable standards for determining what jeopardizes or may jeopardize national security, the expansion of the security review’s scope may also lead to concern from legal professionals on the lack of transparency and certainty regarding the future security review process. According to Article 68 of the Foreign Investment Law (Draft for Comments), once the foreign investment law is officially promulgated, or afterwards, MOFCOM will promulgate guidelines related to the security review in order to strengthen its certainty and transparency.

3.2 Other detailed provisions related to the security review

- **Review authority:** the joint ministerial panel for national security review, which comprises the National Development and Reform Commission and MOFCOM as convening departments, will conduct the joint review, together with other relevant departments and commissions.
- **Method of initiation:** foreign investors may proactively apply for the security review before MOFCOM or the joint ministerial Panel initiates the security review based on its authority. Moreover, competitors, industrial associations and others can advise the joint ministerial Panel to initiate the security review, and the joint ministerial Panel can initiate the security review after accepting their advice.
- **Review procedure:** foreign investors can, before applying for the review, discuss any procedural issues with MOFCOM. After an application is made, MOFCOM will notify the applicant whether the security review is required within 15 working days from the date it receives all materials. Foreign investors cannot withdraw their applications for the security review without MOFCOM’s consent. After the security review procedure is officially initiated, it comprises the general review (30 working days) and special review stages (60 working days).
- **Types of security review decisions:** this includes approval, conditional approval and non-approval. The applicant cannot appeal for an administrative review or administrative proceedings against the security review decision.
4. Information reporting system for foreign investment implementation

Chapter Five of The Foreign Investment Law (Draft for Comments) outlines in detail the information reporting system. Foreign investors and foreign investment enterprises are specifically subject to information reporting. The information reports comprise the following four types:

- **Report on foreign investment matters:** This information report shall be submitted within 30 days following the implementation of foreign investment. The report content outlines the foreign investors (including the actual controlling person), foreign investment (including the source of investment), basic information on the foreign investment enterprises and the entry clearance situation (if required).

- **Report on change of foreign investment matters:** This report shall be submitted within 30 days from the date the relevant change is made.

- **Periodical reports:** This information includes: (1) an annual report for the previous year that shall be submitted before April 30th of the reporting year; (2) the quarterly reports of key foreign investment enterprises with total assets, sales or revenues over RMB10 billion (USD1.6 billion) or having more than 10 subsidiaries; these reports shall include the quarterly business situation and finance and accounting information and be submitted within 30 days from the end of each quarter, and (3) a consolidated report, in which foreign investors shall consolidate relevant information about any domestic enterprises directly or indirectly controlled by such investors.

- **Investment portfolio report:** A foreign investor shall perform reporting obligations when it purchases 10% of the shares of a listed domestic company, or a portion comprising less than 10% of such shares that nevertheless leads to a change in the right to control the listed company. If the foreign investor purchases less than 10% of the shares of a listed domestic company with no change in the right to control the company, then this shall be mentioned in the annual report.

Compared with the current approval system, post-mortem reporting will reduce the burden on foreign investors to a significant extent, but we note that the scope of information reporting, such as information about the actual controlling person, source of investment and other information, is quite extensive. Considering the investment structures of some large corporate groups are quite complicated, the reporting obligations of these foreign investors may be more cumbersome. Moreover, there is an overlap in the information reporting requirement under the foreign investment law and the current registration and reporting required by the Administration for Industry and Commerce, and the question of how these two systems will coordinate with each other to reduce the actual information reporting burden on foreign investors deserves further attention.

5. New arrangement concerning contractual control (VIE)

The VIE structure was first adopted in the Sina.com mode. Nowadays, most Chinese internet, e-commerce and education companies listed overseas consolidate the financial statements of their offshore listed companies and onshore actual operating companies through the VIE arrangement. The common ground of these companies’ businesses is that they fall within restricted foreign investment in China or investment items with strict foreign equity ratio restrictions. In practice, some foreign investors “adopt” the VIE structure to invest in areas where foreign investment is restricted.
Article 15 of the Foreign Investment Law (Draft for Comments) specifies contractual control as a form of foreign investment, and also specifies that foreign investors who use contractual control to circumvent restrictions shall be subject to the relevant legal liabilities. The law will exert a profound influence over the VIE structure, mainly in the following aspects:

5.1 New VIE structure after the foreign investment law comes into effect

Since the VIE structure is a form of foreign investment, foreign investors need to apply for entry clearance if their investments through the VIE structure fall within the restricted catalog. Similarly, foreign investors cannot make investments that fall within the prohibited catalog. For investments not covered by the restricted catalog, both Chinese and foreign investors can make investments through the VIE structure with no requirements for approval due to the national treatment.

Regarding the fate of the VIE structure, one opinion is that, after the foreign investment law comes into effect, it will be eliminated, but we advise not to jump to conclusions. Instead of prohibiting the contractual control, the foreign investment law provides for contractual control as a form of foreign investment, and also grants official legitimacy to this method. As a result, whether the VIE structure is necessary depends on the choices made by other market participants, such as repositioning the VIE structure by overseas stock exchanges, auditors and others, reviewing the problems and risk associated with the VIE structure itself when compared with shareholding control, and so on.

5.2 Existing VIE structures before the foreign investment law comes into effect

Regarding these VIE structures, MOFCOM has three opinions for the time being: (1) reporting option- a foreign investment enterprise implementing contractual control, which reports to MOFCOM that it is actually controlled by Chinese investors, may continue to use the contractual control structure for operation; (2) recognition application option- a foreign investment enterprise implementing contractual control must request MOFCOM to recognize it as actually being controlled by Chinese investors and, after MOFCOM does so, the enterprise may continue to use the contractual control structure; and (3) entry clearance application option- a foreign investment enterprise implementing contractual control shall apply to MOFCOM for entry clearance and, then, MOFCOM (working together with other departments) will determine whether to grant entry clearance based on a variety of factors, including the actual controlling person of such enterprise. MOFCOM is currently seeking feedback from the general public on these three options, and will provide further advice based on the comments it receives.²

We believe the existing VIE structures need to be treated differently depending on the actual controlling person. Regarding the VIE structure in which the actual controlling person is a Chinese investor, we can see that most companies that currently adopt this structure are internet and e-commerce companies, whose business falls within restricted foreign investment or investment items with specific restrictions on foreign equity ratios (for example, foreign equity ratios in operating value-added telecommunication services cannot be more than 50%). Currently, on one hand, China deregulates areas with entry restrictions; for instance, the Shanghai Pilot Free Trade Zone has promulgated new regulations that allow foreign equity ratios in companies engaging in operating e-commerce in the zone to reach 100%. On the other hand, since the Foreign Investment Law (Draft for Comments) adopts the actual controlling person standard, even if these industries fall within restricted areas, the Chinese investors may apply to be deemed as domestic investments, so as to avoid general foreign investment entry clearance. Moreover, these VIE companies may be industry leaders with significant resources at their disposal that allow them to exert correspondingly significant influence. From the regulatory perspective of MOFCOM, it is more likely that existing VIEs will continue operating under their current structure, and not adopt the equity control structure.

² For example, the Sino-foreign Equity Joint Venture Enterprise Law, the Sino-foreign Cooperative Joint Venture Enterprise Law and the Wholly Foreign-invested Enterprise Law
However, regarding VIEs in which the actual controlling person is a foreign investor, the prospects for continued treatment as VIEs are not very optimistic. Such VIEs may require negotiations with the relevant governmental authorities on a case-by-case basis; therefore, many uncertainties remain.

6. Legal liabilities and the consequences for non-compliance

Chapter 10 of the Foreign Investment Law (Draft for Comments) specially provides for legal liabilities and not only specifies administrative or criminal liabilities for violations such as investment in prohibited areas and investment in restricted areas without permission or non-compliance with conditions of permission, information reporting obligations and national security review provisions and others, but also specifies legal liabilities for first-time offenders. Circumvention may include shadow shareholding, trust arrangements, multiple investments, contracting, contractual control and offshore transactions. If foreign investors employ these practices and commit violations such as investment in prohibited areas, investment without entry clearance, noncompliance with information reporting obligations, etc., they will be subject to penalties applicable to these violations. Apart from Chapter 10, the Foreign Investment Law (Draft for Comments) also outlines other legal liabilities; for instance, Article 72 outlines the legal liabilities for not applying for the security review before investment implementation.

7. Arrangement for existing enterprises during the transition period

The Foreign Investment Law (Draft for Comments) requires existing enterprises to reform relevant organizational bodies according to requirements of the Company Law, the Partnership Law and the Individual Proprietor Enterprise Law, so they shall complete changes in corporate organizational form or body according to the aforesaid laws within three years following the promulgation of the foreign investment law. For example, some existing foreign investment enterprises have not appointed their supervisors or the board of supervisors and shall do so during the three-year transition period following the promulgation of the foreign investment law, in order to comply with the Company Law’s requirements. In addition, there are Sino-Foreign cooperative joint ventures that do not have legal personalities in practice, and they may need to be reformed into companies with legal personalities.
Conclusion

It is easy to see that, once the foreign investment law comes into effect, it will have a fundamental and radical effect on China’s current foreign investment legal regime. But the foreign investment law itself is just the beginning; it will rely on the formulation of relevant implementation rules and complementary guidelines, such as the restricted list, the security review guidance, the entry clearance guidelines and information reporting rules, and drafting and improvement of these complementary guidelines will take time. Meanwhile, regarding the legislative process, the current Foreign Investment Law (Draft for Comments) is at the stage of “seeking public commentary.” The deadline for “seeking public commentary” was 18 February 2015. MOFCOM will finalize the formal Foreign Investment Law (Draft for Comments) on the basis of the feedback received from the public, submit the formal draft to the standing meeting of the State Council for deliberation and, finally, circulate an updated draft for the Standing Committee of the National People’s Congress to review; this process will also take time. When the Foreign Investment Law will be promulgated is another matter of concern for all businesses and relevant entities. The Government encourages and calls for establishing a “new open economy” and, in line with the negotiation of Sino-US and Sino-EU bilateral investment agreements, the legislative process of the new Foreign Investment Law may be accelerated. That being said, in view of these factors, the Foreign Investment Law is not likely to be announced in 2015, and will probably be promulgated in 2016.

If you have any questions on the Foreign Investment Law (Draft for Comments), please feel free to contact the following partners of Chen and Co. Law Firm (a member firm of Ernst & Young Global Limited):

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