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Hong Kong Law **December** 2014

China Consults on 2014 Draft of Foreign Investment Catalogue

On 4th November 2014, China's National Development and Reform Commission (**NDRC**) released a revised draft of the Catalogue for Guidance on Foreign Investment in Industries (**Catalogue**), in conjunction with the Ministry of Commerce. The proposed revisions to the Catalogue would significantly expand the sectors in which foreign investment is allowed. The stated intention of the revisions is to facilitate China's transition to a more globalised economy and expedite the liberalisation process through the injection of foreign capital and technology.

The consultation period for the proposed revisions ended on 3rd December 2014.

The Catalogue

First published in 1995, the Catalogue provides a roadmap for foreign investors investing in China and, at the same time, provides a means for the Chinese government to direct the flow of foreign investment. The Catalogue is revised every 3 years and was last revised in 2011.

The Catalogue categorises foreign investment projects into four categories: "encouraged", "permitted", "restricted" and "prohibited". China's regulatory regime and policies governing foreign investment are written in terms of these categories. "Encouraged" industries may enjoy policy incentives in terms of tax, land, etc., while those falling within the "restricted" or "prohibited" categories, can face investment restrictions such as a cap on foreign shareholdings, a requirement for a Chinese controlling partner, a requirement for approval at the central government level and unfavourable tax regimes, etc.

Background to Amendment

The further liberalisation and streamlining of foreign investment approval procedures have been in the limelight since the 2013 Sino-US Bilateral Investment Treaty (**BIT**) discussion. In response, China launched the Shanghai Pilot Free Trade Zone (**FTZ**) in 2013 and adopted a Negative List approach to foreign investment for the FTZ. Essentially, for any industry or activity which is not explicitly restricted or prohibited by its inclusion in the Negative List, foreign investors are treated in the same way as Chinese investors. The introduction of the Negative List was however met with disappointment since it was scarcely more liberal than the Catalogue governing foreign investment in the rest of China.

In June 2014, the FTZ Negative List was updated to cut the number of sectors subject to restrictions on foreign investment in the FTZ to 139 (down from 190). The 2014 draft Catalogue has followed the approach adopted by the FTZ Negative List and many of the proposed changes mirror the approach in the updated Negative List. However, the Draft Catalogue has gone further and proposes to open up 27 more sectors to foreign investment, such as liquor, which is currently restricted under the FTZ Negative List.

Considerable Revision

The 2014 Catalogue revision proposes the greatest degree of change of any revision to date. Under the proposed amendments:

- the number of restricted sectors will be reduced by more than half, from 79 to 35;

- only 11 industries will be restricted to joint ventures and partnerships, compared to 43 in the earlier version; and
- the number of industries for which a Chinese majority shareholder is required will be cut from 44 to 22.

The proposed changes fall into two main categories:

i) reducing the number of industries in the restricted category which will remove caps on the amount of permitted foreign investment in these sectors. Instead, total foreign investment of between US$50 million and US$300 million will be allowed in these industries subject to filing with the NDRC and approval of MOFCOM at the local level; and

ii) including more industries in the encouraged category making them eligible for government incentive policies.

Overview of Changes

1. Life Science and Healthcare

Encouraging relaxations are proposed which would leave in the "restricted" category only those pharmaceutical products suffering from over-capacity (e.g. multi-vitamins). Medical institutions would again be included in the "restricted" category after being removed from it under the last 2011 revision. In practice, setting up a wholly foreign owned enterprise in the medical institution sector remained fraught with difficulties notwithstanding removal from the restricted category. Inclusion in the restricted category again would mean that setting up a hospital in China would require a foreign investor to enter into a joint venture with a Chinese partner.

2. Real Estate and Infrastructure

Real estate projects would be included in the "permitted" category and no longer subject to foreign investment restrictions. The current restrictions on land development, office construction and luxury hotel construction would also be removed under the proposed revisions. The construction and operation of subways and railways would be "encouraged" and freed from the need to have a Chinese majority shareholder.

3. Telecommunications

In line with the country's policy of encouraging IT development, internet technology development and application would be categorised as an "encouraged" industry for the first time. Some fields which would remain "restricted" would see an easing of restrictions. For example, the cap on foreign investment in e-commerce would be raised to 50%. Services relating to internet publishing are however "prohibited" in line with government policy.

4. Manufacturing

This is the key sector which would benefit from the removal of restrictions on foreign investment under the proposals. Many industries including steel, paper, coal chemical equipment and ethylene would be re-opened to foreign investment by inclusion in the "encouraged" list. Other industries from which investment restrictions would be removed include beverages, communications and electronic devices, chemical fibres, etc.

5. Mining

The revised draft proposes lifting many of the foreign investment restrictions in the mining industry. The requirement for a Chinese majority shareholder would however remain for rare types of coal, granite and lithium, as well as precious metals. Foreign investment in the rolling and smelting of non-ferrous metals would be permitted under the revised Catalogue.

6. Services

Despite the statement on the NDRC's website that the opening of the manufacturing and service sectors to foreign investment is the focus of the 2014 Catalogue revisions, the approach to liberalisation of the service sector has been more cautious than for the manufacturing sector.

Foreign investment in accounting and auditing would be allowed to be made via a wholly owned foreign enterprise (WOFE) and would no longer need to be made via a joint venture or partnership with a Chinese entity. On the other hand, certain fields would face tighter control if the draft is adopted. For example, legal advisory services have been in the "restricted" category for a number of years, but Chinese legal affairs consulting would be prohibited under the 2014 revision. The restriction on non-Chinese legal advice would however be lifted. Auctioning of Chinese cultural relics too would see a move from "restricted" to "prohibited".

7. Finance

The revised draft Catalogue would introduce considerable liberalisation to the finance industry including:

- Foreign investment in Chinese commercial banks would be permitted subject to:
    - a 20% cap on the holding by a single foreign entity and its controlled entities;
    - a 25% cap on the number of shares that can be owned by foreign financial institutions in total; and
    - in the case of rural commercial banks, a restriction allowing investment by foreign banks only (i.e. other types of foreign companies are prohibited from investing);
- Foreign investment restrictions would be removed for finance companies, currency brokerages, trust companies and insurance companies; and
- The limit on foreign ownership in certain securities companies would be raised to 49% (from one third). The easing of the restriction would apply to securities companies engaged in: (i) underwriting and sponsoring RMB-denominated ordinary shares, foreign shares, government and corporate bonds; and (ii) brokerage of foreign shares and government and corporate bonds.

8. Automobiles and Education

Automobile manufacture was once an "encouraged" industry (in 2007), but was later downgraded to "permitted". The latest draft puts automobile manufacture in the "restricted" category in line with the government's policy of supporting local automobile brands. Under the proposed Catalogue amendments, foreign ownership in the automobile manufacturing industry would be capped at 50% and a single foreign investor would not be able to invest in more than two joint ventures in the sector.

As for education, the Chinese government keeps a tight rein on the sector and many areas would remain "restricted" and "prohibited". Under the revised Catalogue, child day-care and higher education would be added to the "restricted" category making them subject to the requirement for a Chinese joint venture party. Secondary education is already "restricted" while "compulsory" education would remain "prohibited".

Overall, more than 40 industries previously categorised as "restricted" would be removed from the Catalogue. The list of "encouraged" industries would be expanded to 349.

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