CHARLTONS

SOLICITORS

Hong Kong Law **February** 2015

The 10 Most Important Things to Know about China's New Foreign Investment Law

A draft of China's Foreign Investment Law (the **Draft FIL**) published by the Ministry of Commerce (**MOFCOM**) on 19 January 2015 proposes major changes to the regulation of foreign investment in China. The Draft FIL is open for public consultation until 17 February 2015.

Under the Draft FIL, foreign investors will no longer be subject to a separate regulatory regime from Chinese investors. Instead, they will be treated in the same way as Chinese investors with one key exception, they will be subject to restrictions on foreign investment in "restricted" industries, and barred from investment in "prohibited" industries, as set out in a new negative list to be included in the Foreign Investment Law (**FIL**).

Other key changes proposed by the Draft FIL are:

- **In relation to VIEs**
    - the legal validity of Chinese variable interest entity (**VIE**) structures will be recognised;
    - a VIE structure controlled by a foreign investor will have to comply with restrictions on investment in "restricted" and "prohibited" industries;
    - the use of a VIE structure (or similar structures such as shadow shareholdings or trusts) to circumvent foreign investment restrictions will be prohibited;
    - the FIL recognises de facto control so that VIEs under Chinese de facto control (e.g. through dual share structures or rights to nominate a majority of the board) will not be subject to foreign investment restrictions; and
    - an explanatory note invites comments on three possible options for existing VIEs:
        1) VIE structures controlled by Chinese investors would be allowed to continue under the same structure on filing a report confirming Chinese control with MOFCOM;
        2) existing VIE structures under Chinese control would apply to MOFCOM for recognition and would be allowed to continue operations on the grant of recognition of Chinese control; or
        3) existing VIE structures would have to apply to MOFCOM for foreign investment approval. MOFCOM and other relevant bodies would grant approvals on a case-by-case basis.
- A **new negative list** will be adopted under which:
    - industries not included in the negative list will be open to foreign investors; and

    - foreign investors will be barred from investing in "prohibited" industries, but permitted to invest in "restricted industries" subject to obtaining MOFCOM approval and compliance with specified requirements;

- The current system of **case-by-case approvals** of foreign investment will be replaced. Instead:

    - investment in "restricted industries" will require MOFCOM approval; and

    - investment in industries not included in the negative list will not need approval and will be subject to reporting obligations only;

- **New reporting obligations** will apply:

    - foreign investments must be reported within 30 days;

    - a 30-day reporting obligation will replace the MOFCOM approval requirement for many events (e.g. share transfers);

    - annual reports must be submitted by 30 April every year; and

    - FIEs with total assets, sales income or revenues of more than RMB 10 billion per annum or more than 10 subsidiaries must submit quarterly reports within 30 days of quarter end;

- A foreign investor under de facto Chinese control can apply to MOFCOM for treatment as a Chinese investor;

- The FIL will extend the circumstances in which a **national security review** can be conducted to include any foreign investment which damages or may damage China's national security; and

- **Grandfathering Provisions** will allow FIEs in existence on implementation of the FIL to continue but they must ensure their corporate governance body meets the requirements of the Company Law, the Partnership Law or the Law on Individual Proprietorship Enterprises within 3 years.

The following provides a summary of the principal changes proposed by the Draft FIL.

Rationale for the new regime

According to MOFCOM spokesman, Dr. Sun Jiwen, China's existing foreign investment laws, which facilitated foreign investment during the early stages of China's opening up, no longer meet the country's need for deep structural reform and the further opening up of its domestic market. Another problem is that certain provisions of the existing laws overlap with, or contradict, other regulations, such as the Company Law. The new FIL is intended to open the PRC market wider to foreign investment and provide a transparent and predictable legal environment in line with other jurisdictions' regimes governing foreign investment.

The Key Changes

1. New Foreign Investment Law to Replace 3 Existing Laws

The new Foreign Investment Law (**FIL**) will replace the three laws currently governing foreign investment in China: the Law on Chinese-Foreign Equity Joint Ventures, the Law on Foreign Capital Enterprises and the Law on Chinese-Foreign Contractual Joint Ventures, which will be repealed. A key change is that the regulation of foreign investment will cease to be dependent on the form of the investment i.e. whether investments are made by way of wholly-foreign-owned entities, foreign-invested equity joint ventures or contractual joint ventures. These forms of organization will cease to exist and foreign invested entities will have to comply with the same requirements as Chinese entities. In particular, FIEs will need to comply with the corporate governance requirements set out in the Company Law of the People's Republic of China, the Partnership Law of the People's Republic of China or the Law of the People's Republic of China on Individual Proprietorship Enterprises 1999. Grandfathering provisions will apply to existing FIEs (please see section 10 below).

2. Level Playing Field for Foreign and Chinese Entities

A key change under the new regime is that foreign investment will be regulated in the same manner as domestic investment instead of under a separate, more restrictive regime. However, foreign investment will remain subject to restrictions on investment in certain industries which will be set out in a "negative list".

3. Negative List

Foreign investment in China is currently subject to the Foreign Investment Guidance Catalogue (the **Catalogue**) which divides industrial sectors into three categories for the purposes of foreign investment: “encouraged”, “restricted” or “prohibited”. Industries not included in these lists are permitted although, in practice, all foreign investment currently requires prior approval from MOFCOM.

The Draft FIL instead adopts the “negative list” approach which has been used in the Shanghai Free Trade Pilot Zone since 2013. The new negative list for foreign investment retains the concept of “restricted” and “prohibited” industries which exist under the current regime, but will remove the “encouraged” category industries. Foreign investment in industries not included in the negative list will not require approval and will be able to proceed directly to registration with the Administration of Industry and Commerce. Foreign investment in such industries will instead be subject only to reporting obligations as described below which will make the process considerably easier.

Industries categorised as “prohibited” will be closed to foreign investment. Foreign investment in “restricted” sectors will require MOFCOM approval and may also be subject to restrictions which will be set out in the negative list. The types of restriction that may be imposed include a threshold amount which would require prior MOFCOM approval for investments exceeding the threshold. Threshold amounts will be set by the State Council. Other restrictions which may be imposed are: (i) requirements to divest certain types of asset or business lines; (ii) specified ratios of foreign and domestic shareholders; (iii) geographic restrictions; and (iv) requirements for local hires or numbers of employees.

The negative list which will apply under the FIL will be published by the State Council at a later stage (Article 23 Draft FIL) and so it is not yet known how this will look compared to the existing Catalogue.

4. Chinese Reporting Obligations for Foreign Invested Entities

The new regime will abandon the current case-by-case approval system and will instead impose extensive reporting obligations distinct from the approval process. The penalties proposed for contravention of the reporting obligations are severe: companies which breach the obligations will be liable to fines and persons found to be directly responsible may be criminally liable (Articles 147 and 148). Foreign investors and foreign invested entities will be required to submit the following reports:

- ***Report of Initial Investment***

Foreign investors will be required to submit a report containing information on the foreign investor and the investment within 30 days after the date of the investment. If the investment is in a domestic entity, information must also be given in relation to the domestic company. Any change to the matters reported in an initial investment report will require the submission of a revised investment report within 30 days of the change.

- ***Reporting of Certain Events***

Many events which currently require MOFCOM approval (e.g. share transfers and share pledges) will be subject to a 30-day reporting obligation only. However, a change which would have required MOFCOM approval for the initial investment (e.g. if a capital increase causes the capital to exceed a threshold for which MOFCOM approval is required), the foreign investor will need to apply for approval in accordance with the requirements of the negative list.

- ***Periodic Reports***

All FIEs will have to submit an annual report giving information in relation to the investor, the investment and the entity’s operations. Annual reports will be due by 30th April of the following calendar year.

Quarterly reports will have to be submitted by large FIEs, being those with:

- total assets, sales income or revenues of more than RMB 10 billion per annum; or
- more than 10 subsidiaries.

Quarterly reports will have to be submitted within 30 days after the end of the relevant quarter.

The scope of reportable items has been expanded significantly in the Draft FIL. The more comprehensive reporting regime is aimed at encouraging good corporate governance.

5. China's Definition of Foreign Investor

Foreign investors are widely defined in the Draft FIL as:

- individuals who are not Chinese citizens;
- enterprises incorporated under foreign laws;
- organs of foreign governments;
- international institutions; and
- domestic entities controlled by any of the above (Article 11 Draft FIL)

Control for these purposes is defined as:

- 50% equity ownership;
- the right or ability to nominate at least half of the directors;
- holding voting rights enabling the investor to exercise a major influence over shareholders' or directors' decisions; or
- the ability to have a decisive influence over an entity's operations, finances, human resources or technology through contract, trust or other arrangements (Article 18 Draft FIL).

The new definition of "foreign investor" introduces the concept of de facto control for the first time so that a Chinese entity will be subject to the restrictions on foreign investment where foreign persons or entities control the composition of their board or exercise control under contractual arrangements.

Foreign investment is also widely defined to cover most forms of investment activity including:

- setting up a new domestic entity;
- acquiring the shares, equity, property shares or voting rights of an existing domestic entity;
- providing finance to a domestic entity for a period exceeding one year;
- acquiring and exercising concessions to explore or develop natural resources or operate infrastructure;
- acquiring Chinese real estate; and
- acquiring control of a domestic entity either directly or by means of contractual, trust or other arrangements (Article 15 Draft FIL).

6. De Facto Chinese Investors

Where a foreign investor is ultimately controlled by a domestic investor, it will be able to apply to MOFCOM for treatment as a de facto Chinese investor at the time it applies for approval to invest in an industry categorised as "restricted" by the negative list. The Draft FIL does not however specify whether de facto Chinese investors will be treated in exactly the same way as Chinese investors. It is thought that the exception may be intended to give the authorities a basis for distinguishing between VIE structures used to list Chinese companies on foreign equity markets but which remain controlled by Chinese investors (such as Alibaba, Baidu and Tencent) from those VIEs used by foreign investors to circumvent China's foreign investment laws. It is not clear whether a de facto Chinese investor would be allowed to invest in a "prohibited" industry under the negative list.

7. Implications for Variable Interest Entity (VIE) structures

The legality of VIE structures under which foreign investors gain control of domestic entities through contractual arrangements has been something of a grey area. As mentioned above, they are commonly used in the technology and communications industry to get around restrictions on foreign investment. VIE structures are used by many of China's largest offshore-listed companies, particularly those in industrial sectors subject to restrictions on foreign investment. The offshore listing vehicles hold the sensitive licences necessary to conducting business in China through VIEs that are owned by Chinese investors. The listed company then controls the VIE through a series of contracts with the VIE and its domestic shareholders. Many of China's best-known companies use VIE structures, including Alibaba which listed on the New York Stock Exchange in the world's largest ever IPO in September 2014.

When implemented, the FIL will remove the doubt regarding the legality of VIEs. The Draft FIL makes clear that VIE structures will be regulated under the law. In particular, Article 149 of the Draft FIL specifies the potential legal consequences of a VIE structure, or other structures such as shadow shareholdings, trusts, contractual control arrangements and offshore transactions, being used to circumvent the restrictions on foreign investment in prohibited or restricted industries. Those consequences include an order to cease carrying on business; an order to dispose of assets or shares; a fine of up to RMB 1 million or 10% of the amount invested; imprisonment for up to one year for those responsible and confiscation of illegal gains.

In publishing the Draft FIL, MOFCOM has made clear that it is aware that VIE structures are used as a means to get around foreign investment regulations in China and that this will be expressly prohibited in the future. While the Draft FIL recognises the legal status of VIEs, VIEs controlled by a foreign investor will be regarded as a foreign investor and will be subject to the restrictions on foreign investment set out in the negative list.

8. Existing VIE Structures

MOFCOM has proposed three regulatory options for existing VIEs in the explanatory note published with the Draft FIL and has invited public comments on the proposals. The options are:

i) Existing VIE structures controlled by Chinese investors would be allowed to continue under the same structure on filing a report with MOFCOM confirming that they are under Chinese control;

ii) Existing VIE structures with a de facto Chinese controller would be required to apply to MOFCOM for recognition that they are subject to the de facto control of Chinese investors. These companies would be able to continue to operate in their current form if such recognition is granted by MOFCOM; or

iii) Existing VIE structures would be required to apply to MOFCOM for foreign investment approval. MOFCOM and other relevant regulatory bodies would grant approvals on a case-by-case basis.

Implications of the FIL for VIEs

The new law is welcome in that it will provide certainty that VIE structures are recognised as legally valid by the Chinese authorities. On the other hand, companies proposing to use the structure for investments in "restricted" or "prohibited" sectors will have to demonstrate that they are under the de facto control of Chinese investors. If not, they will be treated as foreign-invested entities and will be subject to the FIL's restrictions on investment in "restricted" and "prohibited" industries. For VIEs considering listing, care will need to be taken to ensure that the ability of the Chinese founders to sell shares in offshore companies is made subject to the restrictions on foreign investments.

Commentators have noted that the FIL will favour companies with dual-class share structures which will be able to retain status as Chinese-controlled companies without the company founders having to hold a controlling stake in the companies' equity. Professor Gillis of Peking University's Guanghua School of Management noted that the draft FIL will encourage companies seeking an offshore listing to adopt a dual-class share structure which could benefit the US stock exchanges to the detriment of the Hong Kong Stock Exchange as Hong Kong does not currently allow the listing of companies with dual-share structures.[1] The Hong Kong Stock Exchange (the **Exchange**) published a Concept Paper on Weighted Voting Rights in August 2014 seeking views on whether the Exchange's listing rules should be revised to allow the listing of companies with dual share structures and other weighted voting rights structures. The Exchange has not yet published its conclusions on the issues raised in the Concept Paper. Such structures do not pose an obstacle to listing on either the New York Stock Exchange or Nasdaq, where many Chinese tech companies with dual share structures and other weighted voting rights structures, including Alibaba, Baidu and Weibo, are already listed. Companies such as Tencent, which is listed in Hong Kong and uses a VIE structure but not a dual share structure, run the risk of being treated as foreign-invested enterprises. The FIL does not however address the issue of how existing foreign-controlled VIEs operating in industries specified in the negative list will be treated once the FIL is implemented.

9. China's National Security Review (NSR)

An enhanced national security review procedure is incorporated into the Draft FIL. Under the existing regulations, a national security review is only conducted in respect of transactions resulting in foreign investors acquiring control over Chinese companies active in certain key industrial sectors (e.g. the military sector, infrastructure, agriculture, energy and transport) or which may affect national economic security.

The Draft FIL significantly extends the circumstances in which a national security review could be carried out. In particular, the Draft FIL entitles the government to conduct a national security review of any foreign investment which damages or

1 "Proposed Rules on Variable Interest Entities Deter HK Listing" Sau-Wai Chim, South China Morning Post,2 February 2015.

may damage China's national security (Article 48). It will no longer be a precondition that the foreign investor acquires control of the Chinese entity. Interested parties may also request the NDRC to conduct a review under Article 55 Draft FIL.

Although a national security review is not a prerequisite for foreign investment, foreign investors will be required to explain whether one is necessary when applying for approval to invest in a restricted industry.

It is worth noting that the national security review provisions will be included in Chinese law for the first time. Previously, the framework was established under regulations issued by the State Council. The Draft FIL also includes provision establishing judicial immunity for national security reviews which will not be subject to any administrative review or litigation.

10.Transition and other issues

The Draft FIL contains grandfathering provisions under which FIEs in existence when the FIL comes into force will be allowed to continue to operate within their original scope of business. However approval must be applied for if such an FIE changes its business to include a business sector regulated under the negative list or it increases the amount of its investment above an applicable approval threshold.

FIEs in existence on implementation of the FIL will have three years to ensure that their corporate governance body meets the requirements of the Company Law of the People's Republic of China, the Partnership Law of the People's Republic of China or the Law of the People's Republic of China on Individual Proprietorship Enterprises 1999.

Commenting on the Draft Law

Interested parties can comment on the Draft Law and the explanatory note on or before 17 February 2015 by:

i) Email to investmentlaw@mofcom.gov.cn

ii) Fax to (0086) 010-65198905

iii) Post to the Department of Law and Regulation of the MOFCOM at No.2, Dong Chang An Avenue, Beijing, 100731

CHARLTONS

Best Boutique Firm 2014
Asian Legal Business Awards

This newsletter is for information purposes only.

Its contents do not constitute legal advice and it should not be regarded as a substitute for detailed advice in individual cases.

Transmission of this information is not intended to create and receipt does not constitute a lawyer-client relationship between Charltons and the user or browser.

Charltons is not responsible for any third party content which can be accessed through the website.

If you do not wish to receive this newsletter please let us know by emailing us at unsubscribe@charltonslaw.com

Hong Kong Office
Dominion Centre
12th Floor
43-59 Queen's Road East
Hong Kong
Tel: + (852) 2905 7888
Fax: + (852) 2854 9596

www.charltonslaw.com