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China's New Proposed Foreign Investment Law—What to Expect

On January 19, 2015, the Ministry of Commerce of China (“**MOFCOM**”) released a draft PRC Foreign Investment Law (the “**FIL**”) for public comment. Once adopted, the FIL would abolish the Law on Sino-Foreign Equity Joint Ventures (“**EJV Law**”), the Law on Sino-Foreign Cooperative Joint Ventures (“**CJV Law**”) and the Law on Wholly Foreign Owned Enterprises (“**WFOE Law**”), which form the current framework for foreign investment into China. According to the MOFCOM release accompanying the draft law, the aim of this overhaul of the current framework and promulgation of the FIL is to provide more clarity and transparency into China's foreign investment regulatory regime.

The regulatory framework being proposed under the FIL will be very different from the current Chinese foreign investment regulatory regime. As such, it remains to be seen how the FIL will interplay with other existing Chinese regulations, and the ultimate effect on foreign investment into China.

Expanded Regulatory Regime on Foreign Investment

The draft FIL as currently proposed seeks to cover a wider range of foreign investments by foreign investors than under the existing framework. The definition of a “foreign investor” has been expanded, and certain types of transactions that currently do not fall under the definition of a “foreign investment into China” may be captured under the FIL if implemented as currently drafted. And, if a transaction falls under the FIL as an investment by a foreign investor, such transaction could be subject to approval by the authority in charge of foreign investment (the “**Foreign Investment Authority**”).

Under the FIL, the definition of a “foreign investor” will focus on the person or entity with ultimate “control” over the company making the investment. The FIL will consider any person with foreign citizenship, any entity incorporated under the laws of any country other than China and any foreign government agencies or organizations to be “foreign investors.” As a result, investments carried out by a Chinese entity ultimately “controlled” by a foreign person may be deemed a “foreign investor” while a foreign incorporated enterprise might be treated as a Chinese investor if it is deemed to be ultimately “controlled” by Chinese entities. This is different from the current regulatory regime where the key factor for determining “foreign investment” is the direct investor's nationality.



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Furthermore, direct or indirect investments in China by a “foreign investor” in any of the following forms will be considered a foreign investment under the FIL: (1) establishment of a greenfield project; (2) an acquisition of equity, voting rights or other equivalent rights in a Chinese entity; or (3) acquisition of control in a Chinese entity by contract, trust or financing, for over one year. Direct or indirect acquisition by “foreign investors” of concessions for natural resources, infrastructure development or real estate will also be subject to the FIL.

Finally, the FIL will consider any offshore transactions that result in the transfer of a Chinese entity’s actual control to a foreign investor as a type of foreign investment activity governed by the FIL.

Given the foregoing, the FIL will consolidate foreign investment related regulations and close existing loopholes for indirect foreign investments into areas where foreign ownership has not been historically encouraged.

Changes to the Regulatory Approval Regime

The FIL seeks to streamline and simplify the regulatory approval regime for foreign investments. Previously foreign investors needed to look at the Foreign Investment Catalogue to determine whether foreign investment in an industry is prohibited, restricted, encouraged or permitted and then structure their investment accordingly. Such foreign investments would then be subject to regulatory approval by the National Development and Reform Commission and Ministry of Commerce, and in certain instances, the relevant industry agency. Under the FIL, State Council will promulgate a *Catalogue of Special Administrative Measures* to be promulgated by the State Council (the “**Negative List**”) which will set out the industries into which a foreign investor will be “prohibited” from making investments. The Negative List will also contain a “restricted” industry list, investments into which will require governmental approval. All other industries should be open to foreign investment.

Despite the streamlining of the previous framework under the Foreign Investment Catalogue, the FIL potentially complicates the national security review process. As currently drafted, this review process appears to be much broader than the existing national security review process administered and implemented by MOFCOM under the *Notice on the Establishment of Security Review of Foreign Mergers and Acquisitions of Domestic Enterprises* (2011).

The current rules on national security review are implemented through rules at the ministerial level and are applicable to proposed acquisitions in which a foreign investor gains control of a Chinese entity or its assets in the defense sector, or other acquisitions in certain industries that may implicate national security concerns, such as agriculture, energy, transportation, technology, and certain types of equipment manufacturing. The FIL broadens the current scope of national security review by stating that any foreign investment (including both acquisitions and greenfield investments) that damage or may potentially damage national security will be subject to review.

Further, under the current rules, the review panel has the discretion to veto any transaction and it is not clear whether its decisions can be appealed. In contrast, the FIL provides that decisions to veto a transaction during the extended 60-day specific review period must be made through the State Council. It is further expressly stated in the FIL that the decision issued by the panel or the State Council is not subject to administrative review or judicial review.

Finally, the FIL specifically states that along with a suspension or mandatory disposal of a transaction, the consequences for failing to submit an eligible transaction for national security review shall now include divestiture “without compensation.” It is also worth noting that once commenced, the applicant cannot withdraw from the review process without the Foreign Investment Authority’s consent and all decisions issued by the review panel will be considered final.

While the stated intent of the FIL is to integrate regulatory approvals for foreign investments into China, there remain questions on how the FIL will interact with existing PRC industry-related and other regulations. The FIL clearly states that it will replace the laws for the establishment and governance of Sino-foreign joint ventures and wholly foreign-owned enterprises. But it does not address other PRC regulations and restrictions under existing PRC laws that will impact a foreign investment into China. Examples of such existing regulations include rules relating to mergers and acquisitions, loans provided by foreign investors, acquisition of concessions for the exploration and development of natural resources, and concessions for the construction and operation of infrastructure in China.

Corporate Governance and Reporting Requirements

Once the FIL is adopted, foreign invested companies will no longer be subject to the existing laws relating to Sino-foreign joint ventures and wholly foreign owned enterprises (i.e. the EJV Law, CJV Law and WFOE Law). It follows that these foreign invested companies will be subject to the same treatment as local enterprises with respect to corporate governance matters. As a result, certain corporate governance structures/approval requirements that are unique to foreign invested companies under the current regime may no longer be available. The FIL provides for a three-year transitional period for all the current CJVs, EJVs and WFOEs to comply with the PRC Company Law.

At the same time, the FIL proposes to impose regular reporting requirements for all foreign investments and all such disclosures will be accessible by the public through public inquiries with the exception of trade secrets and personal information. This will be very different from the current regime under which minimal information is required to be provided by foreign invested enterprises each year.

Conclusion—Beyond the Draft FIL

In China, publishing a draft of a new law for public comments is usually the first step in the legislation process. There is no definitive timeline on when the FIL will be formally promulgated. According to Gao Hucheng, Minister of Commerce at a press conference held on March 7, 2015, the draft FIL received warm responses from inside and outside China, and MOFCOM will further improve the draft by incorporating comments it receives to kick-start the legislative process “as soon as possible.”

Meanwhile, more details are needed to further clarify the ambiguities that are present in the current draft, such as the following:

- *Status of Ancillary Rules Governing Foreign Investments.* As discussed above, certain special features of foreign invested companies under the current regulatory framework such as total investment amounts, debt to equity ratio requirements and foreign exchange control on capital accounts are based on various ancillary rules (rather than EJV law, CJV law and WFOE law) developed over a long period of time. Although one of the main purposes of the FIL is to consolidate the foreign investment regulations in order to replace these laws, the current draft is still silent on how these ancillary rules will be reconciled with the new FIL-based regulatory system or

whether these ancillary rules will be abolished once the FIL is implemented. It is important to note that various authorities are already reforming the ancillary rules on a piecemeal basis. For example, the State Administration for Foreign Exchange recently in February 2015 delegated its authority to approve and register any foreign exchange inflow under any foreign direct investments (which is a condition precedent for foreign-invested companies to open bank accounts) to banks. This reform will simplify approval procedures for establishing a foreign-invested enterprise in China. However, it is not clear how these changes will interact with the draft FIL.

- *Interaction with the M&A Rules.* Among the various ancillary rules, the *Rules on Acquisition and Merger of Domestic Enterprises by Foreign Investors* (the “M&A Rules”) is an area of particular concern. The M&A Rules is the current framework setting out the rules and procedures to be followed for foreign acquisitions of Chinese companies either by way of equity or asset acquisition. Since the FIL does not require approval from Foreign Investment Authority for foreign acquisitions of domestic companies (unless the acquisition exceeds a certain threshold or is covered by the Negative List), it is unclear whether the current restrictions and approvals under the M&A Rules will continue to apply. It is also unclear whether the FIL will abolish the restrictions on round-trip investment under the M&A rules.
- *Reopening Negotiation with Chinese Partners.* From a corporate governance perspective, after approximately 30 years of application and enforcement, existing FIEs have adopted a stable governance structure within the confines of the CJV law, EJV law and WFOE law. Governance structures formulated in accordance with these laws can be very different from the governance structure formulated under the PRC Company Law. However, if the FIL will be promulgated in its current fashion, existing FIEs must modify their existing structure to comply with the PRC Company Law within three years after the promulgation of the FIL. This may force the Chinese and foreign investors to revisit some sensitive issues when modifying the existing structure of their company. An example of some of the issues that the shareholders may face includes the potential shift of the ultimate governing authority from the board of directors (under the current regime for sino-foreign JVs) to the shareholders (under the FIL). Other issues may include how to restructure a JV partner’s right of first refusal and consent rights to any transfer of equity by the other JV partner. This three year deadline, along with the uncertainty associated with such changes in the governance structures of these companies may be unsettling for foreign investors during the transition period.

- *Onerous Reporting Requirements.* The FIL purports to impose burdensome reporting obligations on foreign investors and their invested companies in China. Noncompliance with these reporting requirements could result in criminal liability for the responsible personnel. As a result, these provisions would likely increase the compliance burden of the FIEs and appears to run counter to the stated goal of streamlining processes for foreign investments in China.
- *Implication on Existing VIEs.* The FIL, if passed in its current form, would apply to companies using the variable interest entities (VIE) structures, which involve foreign control by way of contractual arrangements. The VIE structures are often used by foreign investors to invest or operate in areas subject to foreign investment restrictions. The FIL is silent on how existing VIEs will be treated. Instead, MOFCOM proposed several options for the regulation of VIEs, although it is still unclear whether any grace period will be granted to existing VIE investments in order for such VIE investments to comply with the FIL. It is also unclear what will happen to existing foreign investments (via the VIE structure) in sectors that would be listed as “restricted” or “prohibited” in the Negative List. It remains to be seen whether these entities will be “grandfathered” or will be ordered to exit the sectors where they currently operate.

Despite all the uncertainties discussed above, the draft FIL represents steps that the Chinese government is taking to reform its existing foreign investment regulatory framework. The FIL, once promulgated, will have profound impact on foreign investments in China. As details are considered and re-worked, multinationals will need to continue to monitor the FIL not only for new investments into China but also its existing investments in China.

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