

Draft Foreign Investment Law: China's Reform on Regime of Foreign Investment

The PRC Ministry of Commerce ("MOFCOM") released recently a draft of the Foreign Investment Law ("Draft") for public comments. The Draft is aiming to encourage and liberalize the foreign investment into China, and it is also designed to replace the current legal framework of foreign-invested enterprises ("FIEs") in China applied since 1979, which includes the Sino-Foreign Equity Joint Venture Law, the Sino-foreign Cooperative Joint Venture Law, and the Law on Wholly Foreign Owned Enterprises, as well as the corresponding administrative rules and regulations in relation to the FIEs (collectively, "FIE Laws") by a uniformed law.

1. Key features of the draft

1.1 A "substance over form" principle

The Draft adopts a quite broad definition of foreign investor and foreign investment based on the substance over form principle.

- Foreign Investor

Under the Draft, a domestic company controlled by foreigner(s), foreign entity, foreign governmental institution(s) and international organizations will be deemed as foreign investors. The concept of "control" is first introduced to regulating the foreign investment, which include (i) holding, directly or indirectly, more than 50% of shares, equity interest, share of property, voting power or other similar equity in the enterprise; (ii) being titled to, directly or indirectly, appoint more than half of the members of the decision-making body of an entity or holding sufficient voting power to have significant impact on the resolutions made by the decision-making body; and (iii) being able to have significant impact on the operation, finance, human resource or technologies by contractual control or trust arrangement.

The broader definition of foreign investor may question the feasibility of variable interest entity structure ("VIE"), which was first used by Sina.com and is now widely used by the foreign investors in those industries not allowing wholly owned by foreign funds, i.e. value-added telecommunication, education, etc..

- Foreign Investment

For the definition of foreign investment, the Draft not only covers green field investment and acquisition, but also iterates that the following activities directly or indirectly conducted by foreign investors shall be regulated as foreign investment:

- providing financing with a term of one year or more to their subsidiaries in China;

- obtaining a concession to exploit and develop natural resources in China or to build and operate an infrastructure project in China;
- obtaining real property rights in China; and
- controlling, or holding interests in, a domestic enterprise via contractual or trust arrangements or other means.

The Draft significantly expands the coverage to activities that were previously not subject to foreign investment review or reporting. Whether it could actually decrease the market entry barriers would be subject to the scope of the Negative List (as defined below) and the implementation of the Draft.

1.2 The Negative List approach

In order to be more efficient in foreign investment administration, the Draft will adopt the negative list approach in respect of foreign investment approval similar to the model applied in the China (Shanghai) Pilot Free Trade Zone, which sets out restricted industry sectors to foreign investment and approval thresholds for foreign investment amount ("Negative List"). Foreign investment approval is only limited to the investment explicitly indicated in the Negative List to be released by the State Council, which would lower time cost of those foreign investment projects not restricted by the Negative List.

1.3 The information reporting system

According to the Draft, Foreign Investors and their subsidiaries in China are obliged to fulfil a number of reporting responsibilities via an online system to be set up by MOFCOM, normally including an initial information report, a change report and an annual report. For a foreign investor with total assets, sales income or revenues exceeding RMB 10 billion per annum in China, or having more than 10 subsidiaries in China, an additional quarterly report is also required.

1.4 National security review

The Draft expands the current scope of matters that are subject to national security review. Any foreign investment that endangers or may potentially endanger national security is subject to a unified national security review regime to be implemented by a joint committee, regardless whether any acquisition of controlling stake of domestic enterprises or any particular industry is involved. Such a broad coverage raises much uncertainty to foreign investment, and hopefully the guidelines on national security review to be promulgated separately in the future will provide some detailed clarifications.

Meanwhile, it is worth to mention that the national security review decision shall be final and immune to administrative reconsideration and administrative litigation.

2. Impact on foreign investment

2.1 Impact on existing FIEs

Under the Draft, the corporate governance of foreign invested entities should follow the same requirements as domestic enterprises under the PRC Company Law, the PRC Partnership Law and the PRC Individual Proprietorship Enterprises Law, etc. The existing FIEs will have a three-year transitional period to conform to the aforementioned laws, i.e. the EJV and CJV shall change its highest decision-making body from the board of directors to the shareholders' meeting; the profit distribution ratio of the EJV could be agreed by the shareholders in the articles of association; sale of equity shall only require consent from more than half of the non-selling shareholders, etc.

2.2 Impact on VIE structure

At present, the VIE structure is often used by foreign investors to invest in Chinese enterprises that are restricted to foreign investment. For those sectors permitted for foreign investment but not allowed wholly owned by foreign funds, joint venture structure could be used and the VIE structure could be removed. For the prohibited sectors, VIE structure would not remain in the "grey area", but would either be regularized or outlawed subject to the Negative List and the released provisions governing existing VIE structures.

3. Outlook of the PRC foreign investment framework

The Draft is widely considered a positive sign of Chinese government's determination to build up a more transparent legal framework for foreign investors. In order to achieve the goal, it may take a certain period of time for the lawmakers to have an overview of the existing foreign investment regime and present a more consistent and unified foreign investment legal framework. The Draft is not listed in the meeting schedule of the third session of 12th National People's Congress to be held from March 5th, 2015, which hints that additional rounds of legislative review and revision would be taken in this year.

Close attention shall be paid by the existing and potential investors to the development of this new law as it will undoubtedly and significantly affect structuring and timing of foreign investments in China.

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