China to Overhaul its Foreign Investment Regulatory Regime

On January 19, 2015, the Ministry of Commerce (MOFCOM) of China released for public comments a draft version of a new law governing foreign investments into China. If passed, this new law will supersede the current structure for the regulation of foreign investments in China and mark a major step in China's efforts to take a more rationalized approach in regulating foreign investments. The closing date for public comments was February 17, 2015.

Replacing the Existing Foreign Investment Laws

The existing foreign investment laws that apply to foreign invested enterprises (FIEs) will be repealed and replaced with this unified law. Transition issues for the vast number of FIEs in China will be closely watched by foreign investors, and the draft has built in provisions to grandfather certain aspects of the current business and operations of existing FIEs. The draft also requires existing FIEs to comply with the Company Law of China (within a defined transition period). This suggests that in the future FIEs will be subject to the same set of rules under China's corporate law which used to apply primarily to domestic companies.

Negative List

In respect of market entry foreign investments,[1] foreign investors will enjoy "national treatment" except for certain industrial sectors that will be subject to a "negative list." This list may be the successor of the foreign investment catalogue that the Chinese government used to publish and update from time to time, and will retain the concepts that exist under the existing regime of industrial sectors in which foreign investment is "restricted" or "prohibited." The key change, however, is that foreign investments in sectors that are not identified in the negative list as "restricted" or "prohibited" will be able to proceed to corporate registration the same way as domestic investors. They will no longer be subject to the existing regime which requires approval by MOFCOM (and potentially other governmental authorities) for each single foreign investment. The draft does not contain a draft of the negative list, which will be promulgated and released by the State Council.

Foreign Investors and the Concept of "Control"

While the existing regime generally determines whether an investor is foreign based on nationality or place of incorporation, the draft introduces the concept of "control" to rationalize the regulatory regime in this regard. "Control" is broadly defined in the draft to include over 50 percent of equity ownership, as well as governance, contractual or other types of rights that provide the ability to exert influence or direct decisions. Hence a domestic entity controlled by a foreign investor will be regarded as a foreign investor, and its investment will be subject to the negative list accordingly.[2] Investors should also be on alert when attempting to obtain "control" (whether by way of acquisition of equity, assets or contractual arrangements) over offshore holding vehicles of Chinese businesses that are on the negative list since such transactions may be regarded as foreign investments.

[1] "Foreign investment" is broadly defined to include not only equity investments or acquisitions, but also acquisitions of contractual control, real properties or concession rights. It also captures providing financing with a term of over one year.
[2] Note: Under the current regime, FIEs (which by definition are incorporated in China) can effectively be treated as domestic investors under certain conditions.

Domestic Investors and Variable Interest Entity (VIE)

The flip side of the concept of "control" is the domestic investors that conduct "round trip" investments (i.e., investing in offshore entities that will invest back in China). The draft provides that if a foreign investor is actually controlled by a "domestic investor" (i.e., a Chinese citizen, a branch of the Chinese government or any entity controlled by either of those), such foreign investor will be regarded as a *de facto* domestic investor after being examined by MOFCOM. The draft also provides heavy penalties on contractual arrangements circumventing foreign investment restrictions.

As a result of such sweeping changes, investors may wonder (i) whether the controversial "variable interest entity" (VIE) structure will still be necessary in the future for investors that can satisfy MOFCOM's requirements and thus obtain market access as domestic investors, and (ii) how to treat the vast number of VIEs already in the market. For question (i), the draft leaves the door open for Chinese companies to raise financing internationally (e.g., conducting IPOs in the US and Hong Kong markets) through offshore vehicles if MOFCOM can be satisfied that such vehicles are controlled by domestic investors. For question (ii), the explanatory note accompanying the draft proposed three different alternatives (giving MOFCOM different levels of discretion) for MOFCOM to conduct an examination to determine whether the structure should be characterized as foreign or domestic. It remains to be seen what approach will be adopted in the promulgated new law.

National Security Review

The draft overhauls the current national security review regime (embodied in certain lower-level regulations issued by the General Office of the State Council) by (i) expanding the scope of matters subject to review from investments in certain enumerated businesses/sectors to any foreign investment which damages or may damage the national security of China, and (ii) establishing judicial immunity for national security review cases, meaning that decisions in national security reviews will not be subject to any administrative review or administrative litigation proceedings. The draft also provides a framework for the review process.

Reporting Regime

In conjunction with the Chinese government's efforts to ease upfront approval requirements for each single foreign investment, the draft provides comprehensive reporting requirements for foreign investors, including (i) initial reporting upon the consummation of the foreign investment, (ii) subsequent reporting after the occurrence of certain changes, and (iii) periodic reporting for foreign investors whose operations in China exceed defined thresholds. It is also worth noting that the scope of matters to be reported is very extensive.

The draft also provides certain guidelines and policy framework for statistics collection and compilation, publication and protection of information as well as coordination among foreign investors and governmental authorities for foreign investments. The draft law, if passed and promulgated in its current form, will have far-reaching impact on the entire foreign investment regulatory regime in China.