China's MOFCOM Drafts a new Foreign Investment Law

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China's proposed law to integrate and replace the Law of the PRC on Chinese-Foreign Equity Joint Ventures, Wholly Foreign-owned Enterprise Law and Law of The People's Republic of China on Sino-foreign Cooperative Enterprises may bring significant changes over foreign investments in China.

Jean Kester, Partner, LehmanBrown International Accountants, January 2015

Introduction

On January 19, 2015, China's Ministry of Commerce (commonly known as "MOFCOM") published a draft version of a proposed Foreign Investment Law[1] (the "draft Law") with an "explanatory note". This law will replace and integrate the three existing laws over foreign investments; the Law of the PRC on Chinese-Foreign Equity Joint Ventures, the Wholly Foreign-owned Enterprise Law and the Law of The People's Republic of China on Sino-foreign Cooperative Enterprises. The Foreign Investment Law was "formulated with a view to opening wider to the outside, promoting and regulating foreign investment, protecting the legitimate rights and interests of foreign investors, safeguarding national security and public interests, and facilitating the healthy development of the socialist market economy." (Article 1 of the draft Law).

MOFCOM has requested comments from the public on the draft Law by February 17, 2015.

Some of the more significant concepts in the draft Law include the following

Actual Control

The proposed law has adopted the concept of actual control in the foreign investment area. The draft Law notes that a company established in China but controlled by foreign investors shall be deemed a foreign investor and foreign entities controlled by Chinese investors can, in some circumstances, be deemed Chinese domestic investors. The draft Law notes that, previously, to avoid limitations on foreign investment in certain industries, some foreign investors cooperated with Chinese companies or individuals to establish a company and executed certain agreements with those Chinese cooperators to actually control the company. (See VIE discussion below)

According to Article 18 of the draft Law,' "control" refers to the circumstance that any of the following conditions is met with respect to an enterprise:

1. holding, directly or indirectly, not less than 50% of shares, equities, share of properties, voting rights or other similar rights of the enterprise;
2. holding, directly or indirectly, less than 50% of shares, equities, share of properties, voting rights or other similar rights of the enterprise, but falling under any of the following circumstances:
    (1) having the right to directly or indirectly appoint not less than half of the members of the board of directors or other similar decision-making body of the enterprise;
    (2) having the ability to ensure that its nominees occupy not less than half of seats in the board of directors or other similar decision-making body of the enterprise; or
    (3) holding voting rights sufficient to impose significant impacts on any resolution of the board of shareholders, at the general meeting of shareholders, or of the board of directors or other decision-making body of the enterprise.
3. Imposing decisive impacts on the operation, finance, personnel or technology of the enterprise by contract, trust or other means.' (Article 18)

What the draft Law means for variable interest entities (VIEs), both existing and future is a current subject of rigorous debate. The VIE structure was designed to allow foreign investors access to restricted or prohibited industry sectors in China, such as internet or e-commerce, and is also used by Chinese domestic entities for offshore listings to gain access to international capital markets. The VIE structure is characterized by foreign investors working with Chinese nationals to form a foreign controlled enterprise which gains control over the ownership and management of a domestic licensed company that holds the necessary license(s) to operate in a sector restricted to foreign investment in China. The parties enter into various service agreements and through those agreements between the foreign entities and the domestic licensed company, the foreign investors control the domestic entity and are able to participate in the economic gains and losses of the domestic entity. This structure has been widely used by foreign investors in China for almost 15 years. The draft Law appears to state that domestic VIEs which are controlled by foreign entities are in effect, foreign entities, and therefore potentially subject to regulations over foreign entities rather than domestic entities..

Negative List Management

Most foreign investments will not need pre-approval as was previously required. It means that the Chinese market could be more open and more efficient in some sectors to set up foreign invested companies. However, the draft Law sets out a Negative List, or Catalogue of Prohibitions. Under Article 25, "Foreign investors are not allowed to invest in any sector set out in the Catalogue of Prohibitions." Further, a Catalogue of Restrictions will note those sectors with restrictions imposed on foreign investors. The use of Negative lists, represent a method of management or administration of foreign investments. Sectors not listed on the prohibited list or restricted list are open to foreign investment. This method of administration is currently being used in the Shanghai Free Trade Zone (the Zone) by the Shanghai Municipal People's Government which, in 2013 released a set of special administrative regulations (known as the Negative List) concerning the access of foreign investment to entities established in the Zone.

How domestic VIEs, potentially deemed to be foreign enterprises under the draft law, and currently operating in Negative List sectors will be treated is unclear. Under Article 25, noted above, no foreign investors are allowed to invest in prohibited sectors.

National Security Reviews

The draft Law also establishes a united foreign investment national security review system which will conduct examinations on the foreign investments that "endangers or may endanger the national security." (Article 48)

Information Reporting System

The draft Law establishes a foreign investment information reporting system. The new rules include submission of a Foreign Investment Report (such as when setting up a company), a Report of any Changes of Foreign Investment Report (any adjustments of investment) and an Annual Report. Generally, reporting obligations arise when a foreign investor purchases not less than 10% of the stock of a domestic entity, or less than 10% but the purchase results in a change of control of the domestic entity.

Complaint Coordination

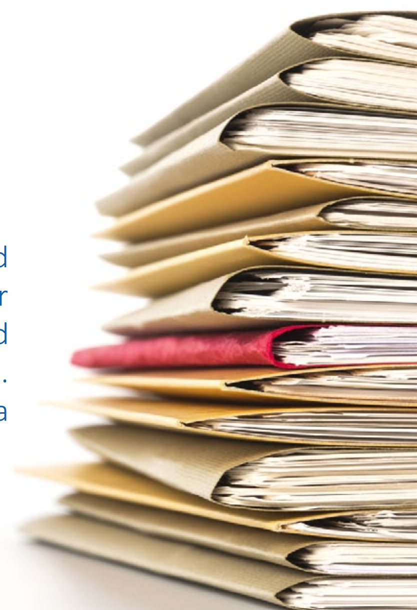
Under the draft Law, China will establish a Foreign Investment Complaint Coordination System, which will be in charge of the coordination and disposal of investment disputes between foreign investors, foreign invested companies and governmental departments.

Supervision and Inspection

The draft Law establishes a mechanism for the supervision and inspection of foreign investors and foreign invested enterprises from industrial and commercial, taxation, foreign exchange, auditing and other administrative departments. The government's eye on foreign investments and foreign investment management has shifted from the approval prior to a foreign invested company being established to the supervision and inspection after it is set up.

Summary

The draft Law has been published to the public for "comments from all sectors of the society"[2] by February 17, 2015. With the concepts of Actual Control and Negative List Management in the Foreign Investment legislation, as well as supervision and inspection, regulatory reporting and potential national security reviews, the draft law could bring sweeping changes to foreign investments in China and the foreign investment regulations. How these changes will affect entities currently operating in China, particularly foreign controlled VIEs, is not entirely clear and is the subject of much attention and debate by lawyers, analysts, accountants and industry experts.



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