Client Alert

February 12, 2015

China's Draft Foreign Investment Law: A Paradigm Shift in Regulation of Foreign Investment

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On January 19, 2015, China's Ministry of Commerce ("MOFCOM") released for public comment a draft Foreign Investment Law (中华人民共和国外国投资法 （草案征求意见稿）; "FIL") along with an accompanying explanatory note (说明; "Note"). The deadline for comments is February 17, 2015.

The draft FIL contemplates a paradigm shift in China's approach to the regulation of inbound foreign investment. It contemplates the elimination of the current foreign investment approval regime and, with it, the equity joint venture, the cooperative joint venture, and the wholly foreign-owned enterprise, historically the three main corporate vehicles for foreign investment transactions. In place of the current approval regime, the draft FIL contemplates a more limited regulatory approval requirement applicable only to projects of a size and in sectors stipulated in a so-called "negative list, " adopting an approach mirroring that which was first implemented in 2013 on a pilot basis in the Shanghai Free Trade Zone (see our prior client alert on the Shanghai Free Trade Zone). Assuming the law in its final form reflects this same approach, the FIL should streamline regulatory formalities applicable to foreign investment transactions and, depending on what the "negative list" ultimately includes, result in further opening of the Chinese market to foreign investment.

That said, the draft FIL also presents potential challenges for foreign investors:

- *Transition Issues.* Other than a single provision in the draft and an accompanying general statement in the Note that indicate a three-year transition period following the FIL's promulgation for existing foreign-invested entities ("FIEs") to "change their organizational form and structure" in accordance with current statutes such as the PRC Company Law and Partnership Enterprise Law, the draft FIL is silent on the specifics of how such transitions are to be effected and the review and approval process that will apply to such transitions.

- *New Reporting System.* In place of the current approval regime, the draft FIL proposes a comprehensive reporting system that would require extensive information on cross-border investment to be submitted to MOFCOM.

- *National Security Review.* The FIL would codify a unified national security review ("**NSR**") system governing foreign investments, which would replace and significantly broaden the scope of the NSR system first introduced through 2011 administrative regulations.

- *Governing Law.* The draft statue would also require that foreign investment contracts to be performed in China be governed by Chinese law. If adopted as proposed, this provision would draw a wide range of financing and acquisitions agreements under the ambit of Chinese law.

In this initial Alert on the FIL, we consider the FIL's place in the longer-term development of Chinese foreign investment rules, discuss briefly the FIL provisions governing NSR, VIEs, and foreign investment reporting obligations, and offer some suggestions on areas to watch as the current draft FIL progresses through China's legislative process.

BACKGROUND

Although the draft FIL represents a paradigm shift in how China regulates foreign investment, it is in line with the general trend of legislative reform in China, at least since the country's accession to the World Trade Organization ("**WTO**") in 2001. Following WTO accession, China has gradually moved toward "national treatment" for foreign investors, as WTO requires (meaning that foreign-invested businesses are increasingly treated on the same footing as domestically-invested businesses), while, at the same time, developing means of keeping the gate shut to foreign investors when it has been deemed necessary to do so. To date, such gatekeeping tools have included China's Anti-Monopoly Law and its regulations governing NSR. Thus, it is not surprising that the draft FIL opens the door wider to foreign investment, while concurrently broadening the scope of NSR to enable the government to review and prevent or limit what it considers to be impermissible or sensitive investments.

NATIONAL SECURITY REVIEW

If promulgated, the draft FIL would, for the first time, entrench an NSR process governing foreign investment into national law, formally promulgated by China's legislature. It would also significantly broaden the scope of NSR.

Under administrative regulations issued by the State Council in 2011, NSR of a proposed foreign investment transaction is required under relatively limited circumstances, such as in connection with a foreign investment into a domestically-owned enterprise connected with the military or national defense and in connection with the foreign acquisition from a PRC investor of a controlling interest in an enterprise in one of a number of key industry sectors.

The FIL significantly expands the scope of NSR to cover any proposed foreign investment that "endangers or may endanger" national security. This widens the type of transaction covered to include green field foreign investment projects, investments in existing businesses even if a change of control is not involved, and acquisitions by one foreign investor from another of an interest in an enterprise in China. It also, potentially, significantly broadens the range of industries subject to NSR, although we note that, in applying the current NSR regulations, MOFCOM has occasionally applied a broad interpretation of the term "key industries" to include certain technology-related market sectors with no ostensible national security significance, in order to scrutinize a proposed transaction deemed to be "high-profile" due to involvement of a major foreign multinational or a sensitive domestic industry sector.

The FIL also stipulates that an NSR decision may not be challenged via either administrative or judicial review.

These changes — which many commentators see as reflecting a decision by the Chinese government to follow the U.S. approach to NSR, embodied in the Exon-Florio Amendment — will strengthen Beijing's ability to use the NSR process to block foreign investments it deems unacceptable for policy or other reasons, a power it may use more often in the future in different sectors — including in the IT sector, which has become a significant focus of national security concerns for China in the post-Snowden era.

VIE

Perhaps the most interesting aspect of the draft FIL is its impact on the "variable interest entity" or "VIE" structure (see our prior client alert on VIE issues). As many of our readers know, the VIE structure has been used extensively to facilitate offshore financing of Chinese businesses in the TMT and other industries, thereby enabling foreign strategic investors to enter these sectors despite foreign equity ownership restrictions or *de facto* prohibitions under PRC regulations. This has been feasible because existing foreign investment regulations consider only the jurisdiction of incorporation (or nationality) of the direct shareholder of the "captive" domestic entity that serves as the VIE and disregard arrangements that allow *de facto* control of such businesses through the contractual arrangements utilized in a VIE structure.

The specifics of the FIL's application to VIE structures have yet to be announced, but, based on the FIL's broad focus on "control" of a domestic enterprise as well as its inclusion of "arrangements that effect control of a domestic enterprise through contracts, trusts and other means" within the definition of foreign investments, it is clear that the FIL will directly regulate VIEs. In a comment in the Note on existing contractual control structures that is clearly directed at VIE structures, MOFCOM suggests both registration and approval as potential options for the regulation of VIE structures, depending on whether they are Chinese or foreign-controlled, but reserves judgment pending the collection of public views and further research. The treatment of existing VIEs, and the feasibility of structuring investments as VIEs going forward will be key areas to watch as the FIL is promulgated and implemented.

The control-related provisions of the FIL will prevent use of VIE structures to achieve foreign control of businesses that the to-be-promulgated "negative list" stipulates are not eligible for foreign control. The draft FIL contemplates that such list will be formulated by MOFCOM and "other authorities concerned." Foreign investors seeking to gain access to the world's largest mobile internet market, for example, may, thus, encounter greater challenges in structuring their holdings without the VIE as an available option. Taking account of the recent liberalization of the treatment of e-commerce under the Shanghai Free Trade Zone's own "negative list," some observers, however, are optimistic that the "negative list" under the FIL will incorporate a loosening of foreign investment restrictions in other sectors.

For the same reason, the draft FIL may make it difficult for foreign entrepreneurs to establish and control their own TMT enterprises. In addition, in its current form, the draft FIL will make it difficult for foreign financial investors, including private equity and venture capital firms, to obtain a controlling interest of a Chinese enterprise in a foreign restricted industry.

At the same time, the FIL may be welcomed by foreign investors who are content to take a minority, non-control-based interest in a Chinese-controlled foreign restricted industry. These investors will likely no longer need to hold their interests through a VIE structure, which is suboptimal, due to lingering questions about the enforceability of its contractual control arrangements and due to its tax inefficiencies.

One area that will likely be the subject of further discussion is the relatively nuanced determination of whether someone is a "Chinese" investor. For example, it appears that Chinese-born founders that have subsequently obtained foreign citizenship are treated as foreign investors under the draft FIL. Additional rules are contemplated for residents of Taiwan, Hong Kong, Macau and other "overseas Chinese" investors, as well as foreign investors who obtain permanent residency in mainland China.

Another important issue that will hopefully be clarified is at what point a PRC enterprise becomes "controlled" by a foreign investor. The draft FIL does not contain a "safe harbor" in determining what minimum percentage ownership interest that constitutes "control" but does include within its definition of "control" broad concepts such as voting power that is sufficient to have "significant impact" on decisions and possession of "decisive influence" on such matters as an investee's management, finance, human resources or technology through contractual, trust or other means. We anticipate that these issues will be raised during the public comment process, and we will discuss them further in future client alerts.

OTHER PROVISIONS OF FIL

The FIL fundamentally reforms the current PRC foreign investment regulatory regime. Among the more significant changes are:

- Replacement of the general requirement that all foreign investment transactions be approved by MOFCOM with the more limited requirement that investments in specific, sensitive sectors that are designated in the "negative list" are subject to approval. How broad this "negative list" will be remains unclear. Taking account of the recent liberalization of a number of sectors under the Shanghai Free Trade Zone's own "negative list," some observers are hopeful that the "negative list" under the FIL will incorporate a loosening of foreign investment restrictions as well, although this issue will, doubtless, be subject to significant discussions among relevant government authorities.

- Change from a focus on jurisdiction of incorporation of immediate shareholder to a focus on who controls the shareholder. Under the FIL, an investment in China by a foreign company controlled by Chinese nationals can still be deemed to be a domestic investment. In contrast, an offshore transaction that results in control by foreign nationals of a domestic enterprise will be deemed to be a foreign investment.

- Elimination of the requirement that the investment documents, including target companies' articles of association and joint venture contract, be approved by MOFCOM.

- Introduction of relatively detailed reporting requirements when a foreign investment transaction is first undertaken and when a stipulated change with regard to the investment occurs. Foreign invested enterprises with total assets, revenues or operating income exceeding RMB 10 billion or with more than 10 subsidiaries are subject to quarterly reporting. Relatively extensive information is required to be filed, including information about source(s) of funds and the identity of *de facto* controlling shareholder(s).

THINGS TO WATCH FOR

MOFCOM's release of the draft FIL is the first step in the legislative process. When the law will be promulgated remains unpredictable, as is the extent of amendments that will be made in the meantime.

Under China's Legislation Law (立法法), the State Council, and not MOFCOM or another department under it, has the right to submit a draft law to the National People's Congress ("**NPC**"), China's legislature, or its Standing Committee for promulgation. We anticipate that the State Council will solicit input from a number of key Chinese government agencies and reflect their amendments in the draft FIL before passing it to the NPC. The law will then be subject to a minimum of three readings by the NPC or its Standing Committee before it is formally promulgated. Commentators differ as to how long the promulgation process is likely to take in the case of the FIL, but we expect the FIL will not be promulgated until 2016, at the earliest.

In light of the changes to the regulatory landscape contemplated by the draft FIL, the scope of the "negative list" will greatly affect foreign investors' China investment strategies and structures going forward. We expect that the issue of what industry sectors are included in that list and what investment caps and other restrictions apply to industry sectors that are on the list will be hotly debated in official circles as the draft FIL progresses through the legislative process. The negative lists issued and to be issued for the Shanghai and other free trade zones may serve as useful references in predicting the future "negative list" under the FIL.

Grandfathering protection is one of the key issues to watch for as it will affect many existing companies adopting a VIE. Further, information reporting is a brand new system that the FIL attempts to introduce. This system may partially respond to the recent concerns that the Chinese leadership has expressed about information security. If this system is adopted, foreign invested entities, even if operating in an area outside those in the negative list, are likely to be subject to strict disclosure obligations and government scrutiny.

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