

Client Alert

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China's Draft Foreign Investment Law Still under Review, but "Negative List" System Comes into Effect Nationwide October 1

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A February 2015 Morrison & Foerster client alert reported on the issuance of a new draft Foreign Investment Law ("FIL") that, if promulgated, would institute far-reaching changes to the Chinese government's oversight of foreign investment. Twenty months on, the FIL has yet to be promulgated. Nonetheless, two key changes anticipated by the draft FIL – the introduction of a new "negative list" in place of the foreign investment catalogue and a shift away from mandatory government approval to a filing system for most types of investment – come into effect October 1, 2016, as a result of amendments to key existing foreign-investment legislation passed by the Standing Committee of the National People's Congress ("NPC") on September 3, 2016. Affected laws include the core laws governing establishment of wholly foreign-owned enterprises and both Sino-foreign equity and Sino-foreign cooperative joint ventures (often collectively referred to as "foreign investment enterprises" or "FIEs.")

In anticipation of these changes, the Ministry of Commerce ("MOFCOM") has circulated for public comment new draft measures governing MOFCOM filings in regard to FIEs, which we expect will be finalized soon so they can also come into effect October 1.

KEY TAKEAWAYS

- Effective October 1, many foreign investment projects will no longer be subject to a government approval (审批) procedure but instead will require only a filing (备案). Only projects in sectors specified in a so-called "negative list" will be subject to government approval.
- This change adopts an approach to foreign investment already piloted locally in a number of free trade zones starting in 2013, including initially the Shanghai Free Trade Zone and then free trade zones in Guangdong, Tianjin and Fujian.
- The national negative list that will underpin this change has not yet been finalized. The State Council will need to approve a national negative list before October 1 in order for the NPC amendments to be implemented. The negative list may resemble to some extent the negative lists currently in effect in the various free trade zones.
- The NPC amendments will have a significant impact on MOFCOM procedures, so it is not surprising to see MOFCOM's issuance of draft filing measures. Many other national and local laws and regulations, and many administrative procedures, will need to be revamped to take account of the NPC amendments, involving coordination between MOFCOM and other government authorities, such as the National Development and Reform Commission, the State Administration for Industry and Commerce ("SAIC") and the State Administration of Foreign Exchange, at both the central government and local level. The next several weeks are likely to see a flurry of work by these authorities. At the same time, we anticipate that it

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may not be feasible for the NPC amendments to be fully implemented as of October 1 and may instead be implemented gradually over a period of months after that date.

A special concern relates to the interplay between MOFCOM and SAIC procedures after October 1, 2016. For most FIEs, completion of MOFCOM formalities is no longer a condition for registration with SAIC. This change potentially places an additional burden on the SAIC. Will the SAIC have authority to interpret the “negative list” and to deny registration of an FIE and require the FIE to obtain MOFCOM’s pre-registration approval? What if SAIC and MOFCOM officials have different views on whether an FIE falls into the scope of the “negative list?” These issues will need to be addressed.

- MOFCOM’s draft filing measures contemplate adoption of a requirement also found in the draft FIL to disclose the “actual controlling person(s)” of an FIE. The term seems to have a broad scope and includes not only a person who holds 50% or more of the ownership interests but also a person who has “a material influence” on operational decisions of the enterprise. This change represents an important evolution in the approach of Chinese foreign-investment rules, looking beyond the place of incorporation of the immediate investor. Implementation of the requirement will be challenging in many cases, such as where information about actual controlling persons is confidential or where the actual controlling person is a PRC person. Various legal and practical questions will need to be clarified by MOFCOM.
- MOFCOM’s draft filing measures contemplate a relatively streamlined filing process applicable to FIEs in sectors not included on the negative list, devolving to FIEs for the first time significant autonomy in relation to corporate structure and governance.
- MOFCOM’s draft filing measures contemplate that existing FIEs do not need to make immediate changes in order to conform to the NPC amendments. Existing approval certificates will remain valid and only when an FIE makes a corporate change that needs to be filed with MOFCOM (such as, for example, amending its business scope) must its approval certificate be surrendered to MOFCOM and a “filing receipt” issued under the new filing system provided in its place.
- An ongoing uncertainty is in regard to when / whether the draft FIL will be promulgated. The draft FIL contemplates scrapping altogether the foreign-investment legislation that the NPC has just amended. Some commentators suggest that the NPC’s amendment of these laws signals a likely delay in implementing the much more extensive changes contemplated in the draft FIL. Others see the amendments as part of a staged implementation of the draft FIL, with promulgation of the FIL to follow. Time will tell.

THE DETAILS

1. NPC Decision

The *Decision of the Standing Committee of the NPC on Amendment of Four Laws Including the Law of the People’s Republic of China on Wholly Foreign-Owned Enterprises* (全国人民代表大会常务委员会关于修改《中华人民共和国外资企业法》等四部法律的决定, the “NPC Decision”), which was passed on September 3, 2016, amends the following legislation:

- Law on Wholly Foreign-Owned Enterprises;
- Law on Sino-Foreign Equity Joint Ventures;
- Law on Sino-Foreign Cooperative Joint Ventures; and
- Law on Protection of Investments by Taiwanese Compatriots.

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The amendments, which come into effect on October 1, 2016, eliminate the requirement to obtain government approval (审批) for the establishment of any FIE and provide instead for a filing (备案) process relevant to most FIEs. Only if the business scope of an FIE is within an industry listed on a “negative list” for inbound foreign investment is government approval as such required.

The “negative list” approach to the regulation of inbound foreign investment is a key feature of the draft FIL and was provisionally implemented in 2013 on a pilot basis in the Shanghai Free Trade Zone as well as in free trade zones in Guangdong, Tianjin and Fujian.

The negative list has not yet been issued, and it is anticipated that the State Council will approve issuance of the negative list in the coming weeks. The negative list may resemble to some extent the negative lists currently in effect in the various free trade zones.

2. MOFCOM Draft Filing Measures

On the same date the NPC Decision was passed, MOFCOM published the draft *Interim Administrative Measures for Filing of Establishment and Changes of Foreign-Invested Enterprises* (外商投资企业设立及变更备案管理暂行办法(征求意见稿), the “**Filing Measures**”) for public comments. The deadline for comments is September 22, 2016, and the draft Filing Measures would need to be finalized for promulgation by October 1, 2016.

The draft Filing Measures provide details in relation to the filing process to govern both the establishment of FIEs no longer requiring government approval and corporate changes in respect of those FIEs. Notable features of the draft Filing Measures include as follows:

- *Filing Authority.* The draft Filing Measures contemplate that MOFCOM and its counterparts at the provincial level will be designated as the competent filing authority. For the moment at least, it does not seem as if local branches of MOFCOM below the provincial level will have authority to accept FIE filings, possibly with a view to enhancing consistency in the implementation of the draft Filing Measures.
- *Post-Filing.* Current law makes the effectiveness of joint venture contracts and other constituent documents for the establishment of FIEs conditional upon MOFCOM approval, and such approval must be obtained before an FIE is established and before various important corporate changes take effect. The draft Filing Measures contemplate that filings by FIEs whose business scopes fall outside of the “negative list” can be made after the fact. A filing can be made as late as 30 days after issuance of the business license when an FIE is established. For a corporate change, the filing deadline is 30 days after the change “comes into effect,” which the draft Filing Measures define as when the highest authority of the FIE (a reference to what would usually be its board of directors) makes its decision about the change. The draft Filing Measures contemplate devolution to FIEs for the first time of significant autonomy in relation to corporate structure and governance.
- *Streamlined Filing.* The filing will be done through a consolidated online information system for administration of foreign investment. As compared with the current approval system, the documents required to be included as part of the new filing system are quite limited. MOFCOM does not require documents such as joint venture contracts, articles of association and feasibility study reports to be filed. Moreover, it is required that the filing process be completed within three business days.

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- *Proof of Online Filing.* The proof of online filing will be a “Filing Receipt,” instead of “Certificate of Approval.” An existing FIE whose business scope falls outside of the “negative list” is not required to take immediate steps to conform to the new filing system as of October 1, 2016. However, if it makes corporate changes in the future (such as changes to its basic information or those of its investor(s) or material changes such as equity transfer, merger or termination) these will need to be addressed via an online filing, and at that time the FIE’s original Certificate of Approval will be surrendered with a “Filing Receipt” issued in its place.
- *Disclosure of Actual Controlling Person(s).* The draft Filing Measures require disclosure of “Actual Controlling Person(s)” by FIEs but provide no formal definition. However, Appendix I of the draft Filing Measures does enumerate the following methods for acquiring “actual control” of an FIE:
 - independently or jointly with affiliate investors, directly or indirectly owning 50% or more of the shares, equity, share of property, voting rights or other similar interests of the FIE;
 - owning less than 50% of the foregoing interests but having a voting that may have a material influence on decisions made by the FIE; or
 - other methods that may have a material influence on operational decisions or on human resources, financial or technical matters.

This broad disclosure requirement will cause substantial regulatory and practical issues in its implementation, including in relation to whether and how an FIE will be required to verify and report changes to direct and indirect shareholdings and how an enterprise with an offshore holding structure but with a PRC person as the controlling person will be viewed.

- *Supervision and Inspection.* At the same time as the draft Filing Measures make ongoing compliance less onerous, they also enhance the supervisory powers of the filing authority in order to deal with FIEs that do not strictly follow the filing requirements. These include the right to conduct spot-checks and also initiate inspections in response to whistleblower reports or at the suggestion of other government departments.
- *Penalties.* Under the draft Filing Measures, the most severe penalty for different types of violations (including conducting business activities restricted or prohibited for foreign investment under the “negative list”) is RMB 30,000. This is a much lighter penalty than those contemplated under the draft FIL, which include confiscation of illegal income and fines of up to RMB 1,000,000 (or 10% of the illegal investment). The draft Filing Measures also contemplate that MOFCOM will establish a blacklist system in order to publicize noncompliant conduct by FIEs or foreign investors.

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