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Proposed Major Changes to PRC Laws on Foreign Investment

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Substantial revisions to the body of PRC laws governing foreign investment in China are currently underway at the State Ministry of Commerce (“**MOFCOM**”). On January 19, 2015, MOFCOM circulated its newly revised *Foreign Investment Law of the People's Republic of China*¹ (*Draft for Public Comments*) (“**Draft**” or “**Foreign Investment Law**”) with the intention to promulgate this law in the next year. In keeping with the PRC government’s recent efforts to simplify and normalize foreign investment to keep pace with the developing sophistication of the Chinese market, this new law will dramatically change the legal landscape of foreign investment in the PRC.

¹ <中华人民共和国外国投资法（草案征求意见稿）>

The following is a quick overview of the key changes in the law affecting revisions on entity types, restrictions on business activities, compliance measures, and regulations on alternative entity structures, etc. Most notable is the quasi-normalization of foreign invested entity structures with domestic enterprises through the abandonment of the various foreign enterprise structures in favor of a single model called a Foreign Invested Enterprise (“**FIE**”). All previously incorporated foreign invested enterprises in China will be affected by this change, requiring such enterprises to re-incorporate under the same incorporation scheme applied to domestic companies, at which point both domestic and foreign invested enterprises will be normalized, meaning that they will all be governed by the same body of PRC laws regulating businesses incorporated in China. However, this so-called “**National Treatment**” only brings about a quasi-normalization since, as you will see below, foreign investors will still be subjected to extraordinary review and approval by PRC authorities. And foreign investors who do not undergo the extraordinary review will be exposed to more severe penalties under this new law.

A. Definition of Foreign Investment

Although the new law portends to normalize foreign invested enterprises with the same entity types already enjoyed by domestic investors, the presence of a foreign element persists as a distinguishing factor for these quasi-normalized entities under the Foreign Investment Law. Several key definitions are outlined in the Foreign Investment Law to give guidance on who will be regulated by this new law.

- (a) Foreign Investor (“**FI**”) – all FIs are subject to the Foreign Investment Law
- i. Foreign Natural Person. A non-Chinese citizen, including foreigners and stateless persons; a Chinese who has acquired a foreign nationality.
 - ii. Foreign Company. A company which is established according to laws in foreign countries or areas
 - iii. Foreign Government. The government of a foreign country or area, including departments or authorities acting on behalf of that foreign government.
 - iv. International Organization.
 - v. Foreign Domestic Enterprise. A domestic company, which is actually controlled by any of the entities above.
- (b) Foreign Invested Enterprise (“**FIE**”) – all FIs are subject to the Foreign Investment Law

An enterprise which is owned, whether wholly or partly, by any FIs as defined above, including limited liability companies, joint stock companies, partnerships, and sole proprietorships (“**SP**”). Any previously established FIEs must change their legal form and governance structures to conform with the provisions of the Foreign Investment Law within three (3) years from the date this new law is

made effective.

(c) Foreign Investment (“**Foreign Investment**”)

The Foreign Investment Law also expands the scope of investment types, which shall be deemed as foreign investment to be regulated under this new law. So far, this expanded scope will include incorporations, mergers and acquisitions, long-term financing, acquisition of franchise rights and rights over property, controlling or holding interests in domestic enterprises by agreements or trusts, and overseas transactions which cause the actual controlling rights of a domestic enterprise to be transferred to any FIs.

B. Effect on current FIEs and Other Relevant Laws and Regulations

The Foreign Investment Law will reshape the landscape for all FIEs in China from an entity structure perspective, and, at least in theory, puts FIEs on the same playing field as domestic entities in terms of structure and applicable laws. By superseding the Sino-Foreign Equity Joint Venture Enterprise Law², the Wholly Foreign-Owned Enterprise Law³, and the Sino-Foreign Cooperative Joint Venture Enterprise Law⁴, the Foreign Investment Law ultimately eliminates all existing forms of FIEs in China today. In that sense, at least to the extent that the Foreign Investment Law does not state otherwise in its present form, FIEs will be governed the PRC Company Law⁵, the PRC Partnership Law⁶, the PRC Security Law⁷, and other current corporate laws, and existing and future FIEs will structurally resemble domestic enterprises such as a limited liability companies, joint stock companies, partnerships, and SPs.

We expect that further revisions of the Foreign Investment Law will address other aspects of PRC law which affect FIEs, such as the Provisions on Foreign Investors' Merger with and Acquisition of Domestic Enterprises⁸ (“**Merger Rules**”) and the laws that govern foreign exchange. We will have to wait for further drafts of the Foreign Investment Law to be circulated to get a better picture of how contract mechanisms in the corporate documents of FIEs will need to be drafted under this new law.

C. Negative List and National Treatment

In the spirit of the Shanghai Pilot Free Trade Zone established in 2014, MOFCOM intends to scrap the complicated Industry Catalogue for the Guidance of Foreign Investments (“**Investment Catalogue**”) in favor of a single negative list which outlines business activities or levels of investment for which FIs must be approved for Foreign Investment (“**Negative List**”). The presumption is that FIs are prohibited from engaging in these areas until they receive clearance by MOFCOM for entry in to

² <中华人民共和国中外合资经营企业法>

³ <中华人民共和国外资企业法>

⁴ <中外合作经营企业法>

⁵ <中华人民共和国公司法>

⁶ <中华人民共和国合伙企业法>

⁷ <中华人民共和国证券法>

⁸ <关于外国投资者并购境内企业的规定>

that business sector (“**Entry Clearance**”). However, as currently drafted, it appears that MOFCOM intends to grant greater latitude to FIEs controlled by Chinese investors to engage in these areas much more freely than if the FIE is controlled by an FI. Foreign investment which does not fall within the Negative List, which will be the overwhelming majority of foreign investment activities in China as stated in the Draft, will receive the so-called national treatment, notwithstanding that FIEs will still be subjected to the extraordinary treatment outlined in Section E below.

Naturally, previous requirements for applicable licensure and other permits will still be in effect for the establishment of entities in China, along with the potential need to undergo applicable anti-monopoly and national security reviews in some cases.

D. National Security Review and New Administrative Dispute Mechanism

The National Security Review, which has been informally required by certain foreign investments into China already, will finally be formalized in the Foreign Investment Law. This draft has not given very detailed guidelines on when such a review will actually be required (e.g., which business sectors, etc.), but it does state that the review, if necessary, would take 30-60 days, and that the decision of the review committee will be final, with no right to judicial or administrative review once the decision has been made. It also states that where an FIE seeking Entry Clearance to certain business sectors in China may touch on national security issues, the national security review will be reviewed first before the Entry Clearance review will be undertaken.

Meanwhile, the draft Foreign Investment Law has outlined a new framework for FIs and FIEs to bring disputes and complaints against PRC administrative bodies in a separate forum for other types of regulatory issues encountered in the PRC. Details on this new forum are still pending.

E. Comprehensive Information Reporting Mechanism

As described above, FIs and Foreign Investment as conducted by such FIs will still be subjected to extraordinary treatment under the Foreign Investment Law. In particular, the new law outlines some information reporting guidelines for FIs and FIEs which appear to be a carry-over from the current legal regime on foreign investment.

Report	Timeframe	Content of Report	Scope
Investment implementation Report	Before or within thirty (30) days after the completion of investment	Basic information of the FI, this investment and the FIE (if any)	All Foreign Investment projects

Report for Entry Clearance Approval	Within thirty (30) days after approval	The foregoing information and the information about Entry Clearance Approval	Foreign Investment projects which fall within the Negative List
Investment Amendment Report	Within thirty (30) days after amendment	<ul style="list-style-type: none"> ● The new information about the Foreign Investment, the FI, and the FIE; and the cancellation of the FIE; ● If Entry Clearance Approval is required due to such amendment, the FI or/and FIE shall apply for Entry Clearance Approval. 	All Foreign Investment projects
Annual Report	Prior to April 30 every year	<ul style="list-style-type: none"> ● Basic information of the FI, this investment and the FIE to be established or changed (if any); ● the FIE's operation condition and financial information in the last year; ● the related-party transactions with shareholders of the FIE, the major lawsuits inside or outside China (if any); ● administrative/criminal penalties etc.(if any) 	All Foreign Investment projects
Quarterly Report	Within thirty (30) days after every season	The FIE's quarterly operation condition and financial information	<p>Key FIEs which meet one of the following categories:</p> <ul style="list-style-type: none"> ● The total asset / turnover/ operation revenue of the FIE controlled by the FI exceeds RMB

			10,000,000,000; or ● The number of subsidiaries of the FIE controlled by the FI exceeds ten (10).
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F. Closer Regulations on Variable Interest Structures (“VIE”)

One of the traditional corporate structures employed by foreign investors to engage in restricted and prohibited business sectors under the soon to be abandoned Investment Catalogue , the VIE, will be formally addressed in the new Foreign Investment Law. Chinese regulators have known about, and puzzled over how to regulate this indirect control structure without also interfering with well-established PRC enterprises already employing the long tolerated structure. MOFCOM still appears to be uncertain about how they will reign in the VIE structure at this point because, while the draft indicates that it will be addressed as a type of FIE, and that existing and future VIEs will be affected, they stop short of explaining whether any such structure will actually be prohibited if the VIE touches on business sectors contained in the Negative List. Oddly, they have given clear guidelines on how to proceed if the VIE is ultimately controlled by a Chinese investor. However, that type of arrangement seems rather odd since the purpose of the VIE, which is a risky structure for the indirect controller, is to permit foreign investors to engage in restricted areas in which domestic investors have been traditionally free to engage.

G. Increased Penalties

Foreign investors should be aware that the Foreign Investment Law outlines enhanced penalties for parties that attempt to evade the provisions of this new law. If it is determined that an FIE is conducting business as an FIE without full compliance with the Foreign Investment Law, the FIE could be subject to fines, penalties according to investment amount, confiscation of goods and illegal gains, the forced sale of related equity interests, orders to cease the investment, and cancelation of the prior approval for market access etc. Compared to penalties which would have been applied to FIE-related non-compliance under the laws which will be supplanted, the Foreign Investment Law stipulates much higher fines in this draft, which is up to RMB1,000,000 or 10% of illegal investment of the FI in the previous year.

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End Notes:

* The laws and regulations as contained on the government websites provided in our links above are the official versions, published in Chinese language. In case you are interested in receiving an English translation of said laws/regulations, please inform us accordingly. We will be able to provide you with an unofficial translation of said laws/regulations for your information within a few days.

* 我们提供的政府网站链接为相关法律法规的中文正式版本。如您需要相关法律/法规英文译本，请告知我们。我们可以在几天内为您提供相关法律/法规非正式译本供您参考。

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