

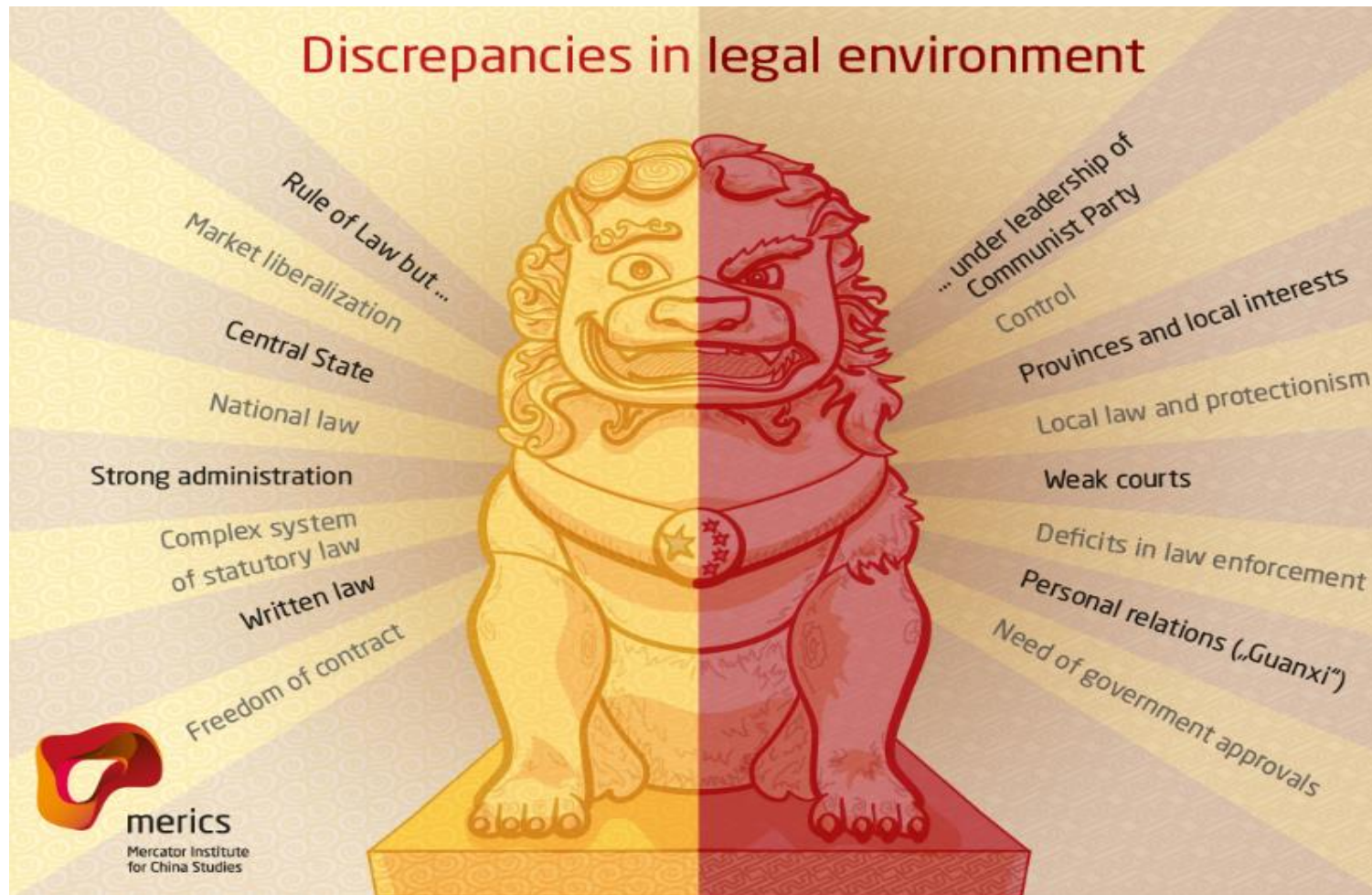
## Trends in foreign investment legislation: Unsteady balance between control and liberalisation

Draft Foreign Investment Law contains progress and disadvantages. Planned extension of national security review raises concerns. Local preferential promises to be checked carefully.

By Joachim Glatter

### MAIN FINDINGS AND CONCLUSIONS

- Basic Decisions taken by the Central Committee of the Chinese Communist Party at its Plenary Sessions in 2013 and 2014 emphasise the necessity of strengthening market forces and the importance of improving China's legal system, as well as reliance on and compliance with law.
- Anti-bribery and anti-monopoly legislation results in **compliance challenges** for foreign companies (e.g. regarding price cartels, payments to business partners) and the need to **adapt business conduct**.
- In the foreign investment sector recent legislation suggests that **keeping and even strengthening control** over foreign investment remains a key concern of the government. Liberalisations occur but are limited to specific aspects.
- The latest Foreign Investment Guidance Catalogue has improved **market access** for foreign investors only in some industries. Restrictions continue to apply in a number of sectors.
- If the **draft** of a **Foreign Investment Law** published in January 2015 becomes law, it would **consolidate** the existing laws on joint ventures and wholly foreign-owned enterprises. It would streamline and liberalise the establishment of foreign invested enterprises ("**FIE**") as simple registration is all that would be required; government approval would generally no longer be necessary. **Control**, nevertheless, will remain substantial unless the planned Negative List of industries in which approval of FIEs is still required is much shorter and less restrictive than the Foreign Investment Guidance Catalogue, and unless national security reviews are only carried out in exceptional cases and do not discriminate against foreign investors.
- **Benefits offered by local governments** have come under scrutiny from the national authorities. Whereas preferential treatments promised in the past may continue to be unchallenged, foreign investors should be very cautious to rely on local promises for future projects.
- Liberalisations can be observed in specific areas: recent foreign exchange control and loan regulations open new opportunities for **more flexible use of FIEs' registered capital injected in the form of foreign exchange**, as well as for **intercompany loans**.



## 1 Political background: political emphasis on rule of law results in increased compliance challenges

To many foreign observers, companies and lawyers, China's legal environment is characterised by numerous contradictions and discrepancies, a lack of transparency and insufficient enforcement of the law.

It is, therefore, not surprising that for European companies, according to the 2015 Business Confidence Survey of the European Chamber in China<sup>1</sup>, the “*rule of law, and transparent policy-making and implementation, remains the most significant driver for China's economic performance in the coming years*”<sup>2</sup>.

Compliance with law has also become a major theme for the current Chinese leadership and part of its overall political and economic strategic agenda. This agenda has been outlined in particular in the final Decisions released upon conclusion of the Plenary Sessions of the Central Committee of the Chinese Communist Party held in 2013<sup>3</sup> and 2014 (“**2014 Decision**”)<sup>4</sup>. Specifically, the *2014 Decision* highlights China's understanding of the rule of law: China shall be governed by

a “Socialist rule of law with Chinese characteristics” under the leadership of the Communist Party, and “Party leadership and Socialist rule of law are identical”.

Ultimately, therefore, there is Party control over the law. Within this understanding and limitation, however, ruling China according to law (“rule **by** law”) is more critical for the Party and its credibility than ever before.

In the economic sector the emphasis on compliance with law needs to be read in conjunction with China's core goal of strengthening the role of market forces and reducing administrative influence in the running of the economy. An intensified effort to address instances of non-compliance can be observed in recent years.

In particular, government agencies have taken measures to enforce the *Anti-Monopoly Law*:<sup>5</sup> in addition to intensified merger controls, they have for example investigated and punished companies engaged in price fixing or restrictions of products' resale prices. Even though actions have also been taken against Chinese companies, there are concerns of discriminatory treatment of foreign companies/investors.

As another example, at the end of August 2015 the anti-corruption campaign led to a further tightening of the *Criminal Law*:<sup>6</sup> Amongst other modifications, for example, Article 390 of the Criminal Law was revised so that in situations in which persons close to present or former government officials are given bribes, both the briber and the recipient would be punishable rather than just the recipient, as was previously the case.

To reduce their risks, foreign companies/investors need to carefully analyse their way of doing business (e.g. regarding determination of prices and resale prices), the business conduct of their employees (e.g. regarding payments and gifts), as well as their contracts. Otherwise they may be vulnerable to actions taken by competitors or government agencies. Foreign investors should also closely monitor developments and changes to new foreign investment-related laws and regulations which are currently on the government agenda.

## 2 Foreign investment legislation

A comparison between the current foreign investment regime and reform measures taken or

planned for suggests that some liberalisation is intended but that control remains essential to the government.

## 2.1 Current status: control by investment guidance and government approval

The features of the present Chinese foreign investment environment are characterised in table 1.<sup>7</sup>

## 2.2 Developments and future changes: selected liberalisation but no waiver of control

How the current foreign investment regime, established for decades, will likely change can partially be seen in pilot programmes run in the Free Trade Zones established since 2013 in Shanghai, Tianjin, Guangdong and Fujian. On a national level, further trends and developments can be deduced from:

- the last revisions recently made in the 2015 Catalogue;
- the draft of a Foreign Investment Law (“FIL”) which was published on the Ministry of Commerce website for public comment on 19 January 2015 but has not yet been promulgated.

Table 1: *The features of the present Chinese foreign investment environment*

<b>Market access</b>	<p>Regulated by a Foreign Investment Guidance Catalogue (“<b>Catalogue</b>”) and (in some industries) by special industry regulations which determine the industrial sectors in which:</p> <ul style="list-style-type: none"> <li>• foreign investment is encouraged, restricted, prohibited or (if not explicitly regulated) permitted;</li> <li>• a Chinese minority/majority partner is required and, therefore, a joint venture company must be established rather than a wholly foreign-owned enterprise;</li> <li>• a certain minimum registered capital must be contributed;</li> <li>• the foreign/Chinese partner(s) must fulfil certain qualifications (e.g. regarding financial standing and industrial experience).</li> </ul> <p>Latest update of the <i>Catalogue</i> on 10 April, 2015 (“<b>2015 Catalogue</b>”) (replacing version issued in 2011 (“<b>2011 Catalogue</b>”).</p>
<b>Split into several foreign investment laws</b>	Regulation of each FIE corporate form (e.g. equity or contractual joint venture or wholly foreign-owned enterprise) in separate laws.
<b>Government control</b>	Establishment/major changes and restructuring measures regarding each and every FIE subject to governmental approval.
<b>Merger control</b>	According to <i>Anti-Monopoly Law</i> , this is needed with respect to certain M&A transactions and joint venture projects if certain turnover thresholds are surpassed.

## **Trends in the 2015 Foreign Investment Guidance Catalogue**

The *2015 Catalogue* has reduced the number of industries in which foreign investment is subject to limitations but has kept restrictions in important sectors. (See *table 2*).

### **Quantitative reduction of foreign investment restrictions**

Further, some industries were also added to the “encouraged” category.

Industries which benefit from liberalisation include, for example, e-commerce, real estate, some machine building areas and aviation equipment.

*Table 2: Comparison Foreign Investment Guidance Catalogue*

Issue	2011 Catalogue	2015 Catalogue
Number of industries in which foreign investment is “restricted”	79	38
Number of industries in which foreign investment is “prohibited”	38	36
Number of industries requiring Chinese partner	43	15
Number of industries requiring Chinese partner and Chinese majority	44	35

### **Persisting restrictions**

Restrictions continue to apply in important industries such as telecoms, life insurance, railway passenger transport, aviation, and the cultural sector (e.g. radio, television, cinema). Foreign investment in some industries was even “downgraded”, such as the manufacture of complete automobiles (previously “permitted”, now “restricted”, even though this only reflects reality and other pre-existing policies).

### ***Draft Foreign Investment Law: replacement of approval system clouded by national security review risks***

### **Consolidation of FIE laws**

The existing separate laws for the various foreign investment vehicles shall be consolidated into one law, i.e. the FIL. In the event that a matter is not regulated by the FIL, the

general Company Law (or other generally applicable regulations on the particular matter) shall apply.

### **New and broader definition of “foreign investment”**

The draft FIL contains a very broad definition of “foreign investment”. Under it, “foreign investment” would not only cover greenfield establishment of companies, but also M&A transactions and other commercial activities of foreign companies such as the acquisition of real estate, the provision of financing for more than one year, concessions for exploration and exploitation of natural resources, and concessions for the construction and operation of infrastructure.

Additionally, control of a domestic enterprise by way of contract, trust or other means (so-called VIE – variable interest entities – structures) is considered a foreign investment. By using VIE structures, foreign investors have tried to circumvent restrictions on foreign investment in certain industries (such as the telecoms industry). Closer scrutiny of such structures after the FIL comes into effect might challenge their legality and it remains to be seen whether they will be permitted to remain intact.

## Introduction of Negative List: registration replacing approval

As already practised in the current Free Trade Zones, the FIL will introduce a so-called Negative List. The Negative List will (like the *Catalogue*) list those industrial sectors in which foreign investment is prohibited or restricted (including limitation to joint venture and other requirements). However, it will have an important additional function: the establishment and modification of foreign investment projects in industrial sectors not contained in the list will only require a registration (record filing). They will, therefore, enjoy the same treatment as domestic companies (national treatment principle). Government approval (so-called “foreign investment access permission”) will only be required for FIEs in sectors listed in the Negative List.

The Negative List will be revised on a regular basis. It can be expected that upon the introduction of a nationwide Negative List, the Foreign Investment Guidance Catalogue will simultaneously be repealed.

At first sight this seems to be good news because it suggests simplification of the establishment and operation of FIEs. However, whether control and

administrative hurdles are really relaxed will depend on how the Chinese authorities implement a number of other factors such as merger control under the *Anti-Monopoly Law*, as well as reporting requirements and national security reviews described below.

## Comprehensive reporting

Even though in most cases the establishment of an FIE will not require government approval, a number of reports will have to be submitted. This includes reports on the establishment of and major changes to the FIE, as well as annual and, under certain circumstances, quarterly reports. Additionally, at present FIEs are subject to annual review/information disclosure requirements. However, the information required according to the draft FIL goes beyond present requirements in some respects. In particular, information required regarding the structure and control of the foreign investor including changes thereunto, is extensive and until recently was only asked for in special cases. If kept in the final version of the FIL, these requirements could potentially be misused to acquire information which investors would normally keep confidential.

## National Security Review

The draft FIL substantially broadens the ability of the government to carry out a national security review (“NSR”) with regard to foreign investment projects. There are concerns that the authorities could use NSRs as control measure preventing any foreign investment not considered appropriate for almost any reason. Depending on the practical implementation by the authorities, the advantage of no longer needing government approval could be outweighed by the risk of discriminatory NSR treatment.

The NSR system under the draft FIL needs to be seen in the context of the recently promulgated and much criticised *National Security Law*,<sup>9</sup> which deploys an extremely broad concept of “national security”: it shall not only protect against threats to core areas of national security such as sovereignty and territorial integrity, but also against threats to sustainable economic and social development. It also provides for an NSR system regarding foreign investment<sup>10</sup>.

Past legislation<sup>11</sup> essentially limited potential NSRs to M&A transactions through which foreign investors acquired stakes in or control of Chinese

enterprises in certain sensitive sectors (e.g. military, agriculture, energy and resources, infrastructure, transportation services, key technologies, major equipment manufacturing). Recent regulations applicable in Free Trade Zones have already expanded the scope of foreign investment-related NSRs to include greenfield and VIE projects.<sup>12</sup> The draft FIL would even go further: the wording permits NSRs for **any** type of the broadened scope of “foreign investment” transactions. The outcome of NSRs can be unpredictable because some criteria used in NSRs are vague (e.g. examination of the “impact on the stable operation of the economy”). In addition, according to the draft FIL, no NSR decision can be challenged by court or administrative proceedings.

Adding a further level of control, it needs to be noted that a national security review would not exclude a separate merger control procedure if an M&A deal or certain joint venture transactions triggered the turnover thresholds set forth in the *Anti-Monopoly Law*.

### Transitional issues

The draft FIL grants to existing FIEs a three-year transition period to adapt their legal form and governance to the new circumstances (e.g. to the *Company Law* in particular). The current FIE laws

shall remain valid until the end of this three-year period.

One interesting question will be how existing projects which newly qualify as foreign investments (e.g. financing, concessions, real estate, M&A) will be treated.

### 3 The best location: reliance on local promises doubtful

The recent, partly failed, attempt by the State Council to order a clean-up of the legally dubious local practice of granting foreign investors special benefits highlights the discrepancy between national and local interests and even resistance by local authorities against unfavourable national regulations.

In the past, competition between regions and municipalities frequently resulted in arrangements (often called “**investment agreements**”) between foreign investors and local governments or investment park authorities in which foreign investors were promised a number of benefits: reduction or partial return of grant fees for land use rights, return of the local part of various taxes, subsidies for payments for certain utilities, etc. Even though this is almost standard practice throughout China, it

has always been doubtful whether this practice was legal or a circumvention of the law.

True to its goal of enhanced compliance with the law, the State Council, in a Circular issued on 27 November 2014,<sup>13</sup> virtually prohibited this practice and ordered a clean-up. However, this strict prohibition met strong resistance from local governments and investors, in particular because no grandfathering of benefits agreed in the past had been provided for. In a remarkable withdrawal of its strict line the State Council, on 10 May 2015, issued a further Circular<sup>14</sup> stating that:

- preferential treatments granted by contract shall remain in effect and shall not be reclaimed, which practically legalises investment agreements concluded in the past;
- preferential policies already made public by local governments will remain effective during the term for which they were granted, or, if no fixed term is determined, for a transitional period;
- new local incentives require government approval (in particular State Council approval if the benefits impact tax or non-tax revenues).

The original clean-up effort has been suspended until further notice. However, **foreign investors** must be aware that **in future promises by local governments to grant tax, land use fee and other benefits without a well-defined statutory basis can easily become worthless.**

#### 4 Foreign Exchange liberalisation

A Circular issued by the State Administration of Foreign Exchange (“**SAFE**”) which took effect on 1 June 2015<sup>15</sup> (“**Circular 19**”) now permits FIEs to convert capital contributions made in foreign exchange into Renminbi at any time they deem appropriate (at will).

When establishing an FIE, in most cases the foreign investor makes a capital contribution in cash denominated in foreign exchange such as euros or US dollars. Such foreign exchange contributions are paid into the so-called capital account of the FIE. In the past, the FIE could only convert the foreign exchange on the capital account into RMB at such time as it actually needed to settle an RMB payment obligation (for example when the FIE had to pay the purchase price to a domestic seller). In addition, the FIE (unless it was a Holding Company) was not permitted to use its

foreign exchange capital to make equity investments in third companies.<sup>16</sup>

By contrast, Circular 19 now provides for substantial changes which had been tested from 2014 in the Shanghai Free Trade Zone<sup>17</sup> and other pilot areas:<sup>18</sup>

#### Conversion at any time

An FIE may now convert capital contributions made in foreign exchange on its capital account at any time it deems appropriate (at will). An FIE can, therefore, exchange foreign currency on its capital account at a time when the exchange rate is favourable and it can therefore better control currency exchange risks. The actual use of the RMB can take place at a later date than the conversion itself. The bank instructed to pay out the converted RMB (e.g. to settle a purchase price payable by the FIE) still needs to review whether the payment complies with the permitted purposes for using converted RMB (see below).

#### Use for equity investments

Furthermore, FIEs that are not Holding Companies may now use RMB converted from foreign exchange on their capital accounts to make equity investments in China.

#### Prohibited uses

Nevertheless, the converted RMB must not be used for a number of purposes such as payments beyond the business scope of the FIE, purchase of securities, granting entrusted loans or (unless the FIE is a real estate development company) purchase of real estate which is not used by the FIE itself. Against this background, it remains to be seen whether converted RMB may also be used by FIEs for investment into companies with a business scope different to the business scope of the investing FIE (for example investment by a machine building FIE into one producing chemicals).

#### 5 Intercompany loans now permissible

In regulations issued on 6 August 2015,<sup>19</sup> the Supreme People’s Court has now lifted the prohibition of intercompany loans.

As a long standing principle, under Chinese law<sup>20</sup> direct borrowing and lending between Chinese companies was prohibited. Respective loans were considered legally void. To bypass this problem, so-called “entrusted loan” structures were used: Company A would entrust funds to a domestic bank which lent these funds to Company B and charged a fee for its services.



However, with few exceptions and unless the lending company regularly carries out loan business (which only financial institutions are allowed to do) intercompany loans are now held valid by the Supreme People's Court.

Assuming that administrative organs controlling the finance and banking sector will not object the liberal attitude of the Supreme People's Court, FIEs can take advantage of this liberalisation because they will, for example, be able to borrow from Chinese companies without involving an intermediate bank and incurring the respective costs. Of particular relevance for foreign investors who have established several FIEs in China, loans amongst these subsidiaries may become an interesting additional financing tool. However, the prohibition of FIEs using funds borrowed from abroad to lend to domestic borrowers will likely continue to apply in the future.

## 6 The way forward: raise your concerns

In summary, some progress and liberalisation can be seen in relation to some specific operational aspects of FIEs in China. However, laws like the *National Security Law* and the draft *Foreign Investment Law* suggest that maintaining and even

strengthening control over foreign investment continues to be one of the government's key concerns, despite the fact that this is contradictory to the important goal of strengthening market forces. It is therefore important that foreign companies continue to request that Chinese authorities improve market access and provide a less tightly controlled foreign investment environment. This can be done through various channels: government delegations, national and international chambers of commerce in China, industry associations and individual relations to Chinese government organisations at local and national level. Particularly important matters include the need for a reduction of those industries in which foreign investment is restricted in a future national Negative List and strict limitation of cases in which national security reviews of foreign investment projects shall be permitted.

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<sup>1</sup> European Business in China – Business Confidence Survey, [http://www.europeanchamber.com.cn/en/publications-archive/334/Business\\_Confidence\\_Survey\\_2015](http://www.europeanchamber.com.cn/en/publications-archive/334/Business_Confidence_Survey_2015)

<sup>2</sup> Ibid., p. 39

<sup>3</sup> *Decision on Several Major Issues Concerning Comprehensively Deepening Reforms*, passed on 12 November 2013 at the 3rd Plenary Session of the 18th Central Committee of the Chinese Communist Party, text in Chinese and English at <<https://chinacopy-rightandmedia.wordpress.com/2013/11/15/ccp-central-committee-resolution-concerning-some-major-issues-in-comprehensively-deepening-reform/>>

<sup>4</sup> *Decision on Several Important Issues regarding the Comprehensive Promotion of Ruling the State according to the Law*, passed on 23 October 2014 at the 4th Plenary Session of the 18th Central Committee of the Chinese Communist Party, text in Chinese and English at <<https://chinacopyrightandmedia.wordpress.com/2014/10/28/ccp-central-committee-decision-concerning-some-major-questions-in-comprehensively-moving-governing-the-country-according-to-the-law-forward/>>

For an overview of this Decision see, for example, Kjeld Erik Brodsgaard and Nils Grünberg, *The Fourth Plenum of the CPC Makes an Important Decision on Law Reform in China*, *The Copenhagen Journal of Asian Studies* 32(2), 2014, p. 122 - 130

<sup>5</sup> Promulgated 30 August 2007 and effective 1 August 2008, Zhu Xi Ling [2011] No. 68

<sup>6</sup> *Amendment 9 to the Criminal Law of the People's Republic of China*, promulgated on 29 August 2015 and coming into effect on 1 November 2015, Zhu Xi Ling [2015] No. 30

<sup>7</sup> Chinese:

[http://www.fdi.gov.cn/1800000121\\_23\\_72150\\_0\\_7.html](http://www.fdi.gov.cn/1800000121_23_72150_0_7.html)  
English:

[http://www.fdi.gov.cn/1800000121\\_39\\_4830\\_0\\_7.html](http://www.fdi.gov.cn/1800000121_39_4830_0_7.html)

<sup>8</sup> <http://www.mofcom.gov.cn/article/ae/ag/201501/20150100871007.shtml>

<sup>9</sup> *National Security Law* passed on 1 July 2015

<sup>10</sup> National security is also emphasized in other recent draft laws such as the drafts of a *Cyber Security Law* ([http://www.npc.gov.cn/npc/xinwen/lfgz/flca/2015-07/06/content\\_1940614.htm](http://www.npc.gov.cn/npc/xinwen/lfgz/flca/2015-07/06/content_1940614.htm)) and of a *Counter-Terrorism Law* ([http://www.npc.gov.cn/npc/xinwen/lfgz/flca/2014-11/03/content\\_1885027.htm](http://www.npc.gov.cn/npc/xinwen/lfgz/flca/2014-11/03/content_1885027.htm))

<sup>11</sup> See for example the *Circular of the General Office of the State Council on Establishing the Security Review System for Merger and Acquisition of Domestic Enterprises by Foreign Investors*, promulgated 3 February 2011 and effective 4 March 2011, Guo Ban Fa [2014] No. 6, the *Provisions of the Ministry of Commerce on the Implementation of the Security Review System for Merger and Acquisition of Domestic Enterprises by Foreign Investors*, promulgated 25 August 2011 and effective 1 September 2011, Shang Wu Bu Gong Gao [2011] No. 53 as well as Article 31 of the *PRC Anti-Monopoly Law*, and the earlier *Provisions for the Acquisition of Domestic Enterprises by Foreign Investors*, first promulgated in 2006 and revised on 22 June 2009, Shang Wu Bu Ling [2009] No.6

<sup>12</sup> *Circular of the General Office of the State Council on Issuing the Tentative Measures for the National Security Review of Foreign Investment in Pilot Free Trade Zones*, promulgated 8 April 2015 and effective 8 May 2015, Guo Ban Fa [2015] No.24

<sup>13</sup> *Circular of the State Council on Cleaning Up and Standardizing Preferential Policies on Tax and Other Aspects*, Guo Fa [2014] No. 62

<sup>14</sup> *Circular of the State Council on Matters Relating to Preferential Policies for Tax and Other Aspects*, Guo Fa [2015] No. 25

<sup>15</sup> *Circular on Reforming the Management Approach regarding the Settlement of Foreign Exchange Capital of Foreign Invested Enterprises*, promulgated 30 March 2015 and effective 1 June 2015, Hui Fa [2015] No. 19

<sup>16</sup> *Circular on Operational Issues in relation to Improving the Administration of the Payment and Conversion of Foreign Exchange Capital of Foreign Invested Enterprises issued by the State Administration of Foreign Exchange*, Hui Zong Fa [2008] No. 142

<sup>17</sup> *Implementing Rules on Foreign Exchange Administration to Support the Establishment of the China (Shanghai) Pilot Free Trade Zone*, promulgated and effective 28 February 2014 Shanghai Hui Fa [2014] No. 26

<sup>18</sup> *Circular of the State Administration of Foreign Exchange on Relevant Issues Concerning Implementation of the Pilot Reform on an Administrative Approach for the Settlement of Foreign Exchange Capital Funds of Foreign-invested Enterprises in Certain Areas*, promulgated 15 July 2014 and effective 4 August 2014, Hui Fa [2014] No. 36

<sup>19</sup> *Regulations on Application of Laws to Certain Issues in Hearing of Private Lending Cases*, Fa Shi [2015] No. 18, effective 1 September 2015

<sup>20</sup> See for example Article 61 of the *General Rules for Loans*, Zhongguo Renmin Yinhang Ling [1996] No. 12, promulgated by the People's Bank of China on 28 June 1996 and effective on 1 August 1996