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## China's Draft Unified Foreign Investment Law

JANUARY 27, 2015

China's Ministry of Commerce (MOFCOM) on January 19 issued the draft unified Foreign Investment Law for public comment (Draft Foreign Investment Law) to unify legislation on foreign-invested enterprise (FIEs).<sup>1</sup> A lengthy inter-ministerial consultation process will ensue, followed by State Council approval and enactment by the Standing Committee of the National People's Congress. After the Draft Foreign Investment Law takes effect, the Law on Chinese-Foreign Equity Joint Ventures, the Law on Wholly Foreign-Owned Enterprises and the Law on Chinese-Foreign Contractual Joint Ventures (the Three FIE Laws), which were enacted early in China's economic reform period more than 25 years ago, will be abolished. The new Foreign Investment Law will ease some restrictions on foreign investors, granting them more access to the Chinese market and creating a more level playing field for overseas companies.

The Draft Foreign Investment Law is not intended to be a mere revision of the Three FIE Laws, but rather is a reform and standardization of the old foreign investment regime, which consisted of scattered and sometimes inconsistent national and local laws and regulations. The constraints and distinctions between cooperative joint venture, equity joint venture and wholly foreign-owned enterprise will disappear. In general, a 50% threshold (based on equity ownership, voting rights, board control or other forms of control) in place of the existing 25% threshold will determine whether a company is an FIE. The bottlenecks to be eased include: (i) over-regulation: under the current Three FIE Laws, all FIEs, regardless of scale and industry, are required to obtain government pre-approval for establishment, charter documents, governance structures, changes to capitalization and dissolution. Over-regulation increases supervision and compliance costs, hinders market access, and discourages foreign investment; (ii) inconsistency: according to MOFCOM spokesperson Sun Jiwen, some provisions of the Three FIE Laws are duplicative or even in conflict with the Company Law and other relevant laws (including the Partnership Law, Sole Proprietorship Enterprise Law and Securities Law); and (iii) complicated and uncoordinated administrative regulations and rules. For example, the Regulations on Acquisitions of Domestic Enterprises by Foreign Investors, Notice on Launching the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, Provisions on Changes to Shareholdings of Investors in FIEs, Interim Provisions on Domestic Investment by FIEs, and Regulations on Strategic Investment by FIEs in Listed Companies were promulgated by different administrative authorities at different times in a less-than-fully-coordinated manner.<sup>2</sup>

Mindful of such criticism, the Draft Foreign Investment Law is designed to create a unified foreign investment legal regime<sup>3</sup> that deepens institutional reform, further opens China to and advances foreign investment, and improves the regulation of foreign investment management. The Draft Foreign Investment Law features the following in particular:

- Deepening institutional reform: the Draft Foreign Investment Law transforms the current foreign investment regulation system so that foreign companies will receive pre-entry national treatment,<sup>4</sup> and the case-by-case approval system set forth under the Three FIE Laws will be replaced by a "negative list"<sup>5</sup> like that which has been issued in the Shanghai Pilot Free Trade Zone and more ambitious ones being negotiated in bilateral investment treaties with the United States and the European Union." FIE contracts and articles of association will no longer be subject to administrative review, but national security and anti-monopoly statements will be required to be submitted for review as part of the application form.<sup>6</sup> This will allow investors greater freedom to organize and operate their businesses. Foreign investment in industry sectors not on the "negative list" will no longer have to apply for approval,<sup>7</sup> but all foreign investors are obligated to "report" their investments to the government for statistical purposes.<sup>8</sup> Most foreign investment will no longer be subject to review and approval.
- Further opening-up to foreign investments: under the system of pre-entry national treatment and "negative list," prohibited and restricted categories for foreign investment will be specifically listed in a catalogue, and remaining industries will be fully open to foreign investment.<sup>9</sup> Foreign investors and their investments will receive treatment that is no less favorable than that accorded Chinese investors and their investments.<sup>10</sup> The encouraged category will be abolished.
- Promoting foreign investment: the Draft Foreign Investment Law sets out policy measures for promoting international investment, reinforces the protection of foreign investors and their investments, and strengthens the foreign investment complaint settlement mechanism.<sup>11</sup>
- Regulating foreign investment management: the Draft Foreign Investment Law relaxes foreign investment access and lets the market play a decisive role in resource allocation. At the same time, it further improves the foreign investment access management system, national security review system, and foreign investment promotion and protection system. It also subjects foreign investors and foreign businesses' investment and operating activities to supervision, and intensifies interim and ex post regulation.
- Adopting a VIE (variable interest entity) structure: Apart from the "negative list" regime, the Draft Foreign Investment Law adopts the "actual control" concept with its large potential impact on round-trip investments and the so-called VIE structure which is widely used by overseas "Chinese Concept" listed companies to raise capital on overseas markets and otherwise circumvent restrictions on foreign investment.<sup>12</sup>

Under the Draft Foreign Investment Law, whether a company is foreign-invested will be determined by the nationality of the ultimate controller(s) rather than that of the direct shareholder.<sup>13</sup> The definition of foreign investor is based on the registration jurisdiction together with "who is in

control." Article 18 of the Draft defines "control" to include more than 50% of shares, voting power, seats on the board of directors or other governing body, and significant influence over decision-making power, as well as decisive influence through contract or trust arrangements.

If the ultimate controller(s) is Chinese, the company will be treated as domestic.<sup>14</sup> This is intended to hold "fake foreign investment" or "round-trip investment" in check while still providing access to overseas capital markets. In the past, Chinese investors would commonly invest in China through foreign companies registered offshore, such as in the Caymans or British Virgin Islands. Such "fake foreign investment" enjoyed preferential treatment specifically granted to foreign investors. If the Draft Foreign Investment Law takes effect in its current form, such round-trip investment will likely be treated as domestic investment, as opposed to foreign investment. While preferences for overseas investment have diminished over time, the new structure will enable access to some treaty-based tax preferences without disqualification from certain industries for being foreign-invested.

Chinese companies that are in fact controlled by foreigners-through VIEs, in which a foreigner controls a domestic company via contractual or trust arrangements-are likely to be treated as FIEs and hence subject to review if the industry comes within the "negative list." Foreign ownership is currently restricted or prohibited in key areas of the Chinese economy, including the finance, cultural, education and Internet industries. Under the proposed change, enterprises incorporated on the Chinese mainland will still be considered FIEs if they are controlled by overseas investors.

MOFCOM has yet to give a definitive answer regarding existing VIE investments if such investment falls within the restricted or prohibited categories. MOFCOM has listed three possible solutions in the Explanation for Draft Foreign Investment Law:

1. Where a company using a VIE structure declares to MOFCOM that it is under the control of Chinese investor(s), the VIE structure may be retained and the relevant entity may continue its business operations;
2. A company using a VIE structure is required to apply to MOFCOM for certification of being under the control of Chinese investor(s); if the FIE is certified by MOFCOM as being under the control of Chinese investor(s), the VIE structure may be retained and the relevant entity may continue its business operations; or
3. A company using a VIE structure is required to apply to MOFCOM for market access; the MOFCOM will, together with relevant government departments, make comprehensive consideration of such factors as the actual controlling party of the FIE before making a decision.

The VIE structure is particularly widely used in the TMT industries: technology, media and telecommunications. Whether this will inhibit the authorities from revoking or not renewing the business licenses of VIEs that are actually under ultimate foreign investor control is unclear, but it seems likely that such companies will be forced to transition to domestic control if the industry is on the negative list.

- Increasing transparency: the Draft Foreign Investment Law includes 27 articles on state security review.<sup>15</sup> This is an advance in transparency compared to the existing body of

national security regulations. Under the Draft, foreign investors will have to gain security clearance from the Foreign Investment National Security Review Joint Ministerial Conference<sup>16</sup> for investments that are considered potentially harmful to China's national security. Unlike in the United States, foreign investment subject to such review will extend beyond mergers and acquisitions to include greenfield investment, medium- to long-term financing, concessions to explore or exploit natural resources or infrastructure operations, acquisitions of real property rights, and control of businesses in China or holding the interests of businesses in China via contractual or trust arrangements. The Draft lists investments in a broad range of sectors, such as defense, energy, grain and other key resources, core infrastructure and key technology, and information networks as potential sectors for review.<sup>17</sup> Foreign investors whose applications have been rejected will not have a right of appeal. The extent to which the government may use the national security review system as a tool to restrict foreign investment, as it has been criticized for doing under the Anti-Monopoly Law, is unclear but the potential is clearly there, especially as requests for review may emanate from society and competitors, among others. One item of progress under the Draft Foreign Investment Law is subjecting the national security review to a clear timeframe: a 30-day phase one followed by a 60-day phase two if needed.

The unified Foreign Investment Law, when it takes effect, will fundamentally reform the current foreign investment legal system. Its implementation will depend on detailed supporting regulations and rules, including guidance on national security review, the creation of an information reporting system and progress in negotiating a "negative list."

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<sup>1</sup>See "MOFCOM Spokesman Sun Jiwen issued a statement on the solicitation of public comment on the Foreign Investment Law of the People's Republic of China (Draft for Comment)," MOFCOM (Jan. 19, 2015), Draft for Comment and its explanation *available for download at* [www.mofcom.gov.cn/article/ae/ag/201501/20150100871007.shtml](http://www.mofcom.gov.cn/article/ae/ag/201501/20150100871007.shtml).

<sup>2</sup> A keyword search using "foreign investment" in certain legal research software reportedly generated more than 42,000 hits. See Ren Qing, "China re-structures legal system for foreign investment," Caixin (Jan. 19, 2015).

<sup>3</sup> Article 5.

<sup>4</sup> Article 6.

<sup>5</sup> Articles 6, 20-26.

<sup>6</sup> Article 30.

<sup>7</sup> Article 6.

<sup>8</sup> Article 78.

<sup>9</sup> Articles 6, 22.

<sup>10</sup> Article 6.

<sup>11</sup> Article 1.

<sup>12</sup> Reuters has reported that 95 of the 200 plus "Chinese Concept" companies listed on NYSE and Nasdaq use a VIE structure. According to Tencent Technology, during the past 20 years, 44 of the top 50 largest family enterprises listed in Hong Kong are registered in the Caymans. See Ma Jianzhong, "Draft Foreign Investment Law was issued, VIE enjoys national treatment?" Nandu.com (Jan. 21, 2015).

<sup>13</sup> Articles 15, 18.

<sup>14</sup> Article 12.

<sup>15</sup> Articles 48-74.

<sup>16</sup> The Joint Ministerial Conference is convened by the National Development and Reform Commission and Ministry of Commerce, with of other relevant government bodies as members.

<sup>17</sup> Article 57.

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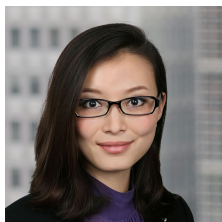


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