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China Releases Draft Foreign Investment Law

On January 19, 2015, China's Ministry of Commerce ("MOFCOM") released a new draft foreign investment law for public comment. The draft law would replace the network of current laws governing foreign investors and foreign-invested enterprises ("FIEs") and provide new regulations governing all material aspects of foreign investment into China, including entry by FIEs and investment approval and reporting obligations. Although MOFCOM intends the draft law to attract greater foreign investment to China, the practical impact of the draft law remains uncertain, especially in relation to foreign investment in politically-sensitive industry sectors. On its face, and consistent with MOFCOM's comments, the draft law purports to expand opportunities for foreign investment in China and reduces regulatory burdens. However, many of the benefits will not apply to investments in a set of to-be-named sensitive sectors, and China will maintain a rigorous, and likely opaque, national security review process. We have summarized below the major details of the draft law, and certain key take-aways for your reference.

The "negative list" approach and national treatment

Currently, all foreign investments must secure prior regulatory approval on a case-by-case. The draft law will replace the prior approval requirements with a post-investment reporting obligation – for certain sectors only. MOFCOM will implement a "negative list" approach like the one currently used in the Shanghai Pilot Free Trade Zone. Under the new process, foreign investors would be permitted to invest in any sector that does not appear on the negative list without first applying to MOFCOM for approval. Eliminating the approval process should facilitate more efficient market entry for prospective foreign investors in such open sectors. Although the draft law does not specify which sectors will be included on the negative list, it will presumably include several politically and economically-sensitive sectors. MOFCOM has commented that it anticipates most foreign investment will not require prior approval. Prospective investors in negative list sectors must seek prior MOFCOM's approval, and the draft law outlines the potential application process for such investments.

The draft law does provide for national treatment for foreign investors in sectors that are not on the negative list. Under this provision, foreign investors *"will receive . . . treatment not inferior to that for Chinese investors or investment."* Foreign investors in negative list sectors will be subject to additional restrictions beyond the prior approval process. It should be noted, however, that the draft law would obligate all FIEs in both open and negative list sectors to submit reports with business-related information. Reports must be submitted annually or quarterly, depending on the size of the investment.

Defining FIEs

Chinese law currently classifies FIEs as either cooperative or equity joint ventures, or wholly-owned foreign enterprises. The draft law eliminates these categories and defines FIE as *"enterprises wholly or*

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partly invested by foreign investors and incorporated within the territory of China in accordance with Chinese laws." This change is designed to streamline the regulatory environment by simplifying the multiple existing statuses and rules applicable to foreign investors. The draft law defines "foreign investor" to include "natural persons without Chinese nationality," "enterprises incorporated in accordance with the laws of other countries or regions," foreign governments, "international organizations," and any domestic entity controlled by such persons or entities. These broad definitions are intended to capture any enterprises that are subject to "actual control" by foreign investors.

Variable interest entities

The new definition of FIE may substantially affect the currently-ambiguous legal status of variable interest entities ("VIEs"). Foreign investors seeking access to sensitive sectors have frequently used the VIE structure, which entails contractual arrangements between FIEs and Chinese companies to facilitate foreign investment in sectors where such investment would otherwise be prohibited or restricted. The draft law explicitly designates VIEs as FIEs, and MOFCOM has proposed three possibilities for how VIEs will be treated going forward. While this area of law remains unsettled, the practical effects of the change may be considerable: VIEs may be obligated to restructure their ownership arrangements, and future VIE-type arrangements may face heightened barriers to entry—or outright prohibitions on operation.

National security review process

The draft law includes a national security review process for *"any foreign investment that endangers or might endanger the national security."* While such a process already exists in China (generally analogous in purpose to CFIUS in the United States), the draft law seeks to build rules and structures around this process. Critically, the draft law does not outline specific criteria for determining when foreign investment might implicate national security interests. However, the proposed review process would evaluate a broad spectrum of business information, including how the investment would impact domestic firms. Accordingly, this process may still result in significant restrictions on inbound investment and appears to encompass economic and other factors not strictly related to national security.

The draft law anticipates that Chinese regulators will release a guide to the national security review process, which may assist prospective investors in determining whether to seek a review and how the national security review may affect a given transaction. Similar to the CFIUS process, China's national security review may be initiated by a voluntary notice or by the government's initiative. Notably, the draft law prohibits foreign investors from appealing an unfavorable decision.

Key Takeaways

MOFCOM's comments on the draft law make clear that the law is intended to ease the current administrative and regulatory burdens on foreign investment in China. However, the extent to which the draft law would actually create a more favorable climate for foreign investment remains unclear. Foreign investors may still encounter considerable barriers to entry, especially in politically or economically-sensitive sectors. Public comments on the draft law may be submitted to MOFCOM until February 17, 2015, after which the Chinese legislative process will continue.

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