

# News

## Foreign Investment Law in China

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On 19 January 2015, the Chinese Ministry of Commerce submitted a draft Foreign Investment Law (“Draft”) for public consultation. The draft is rather comprehensive and – if adopted – will change the handling of foreign-related investments as well as merger and acquisition transactions in China radically.

The Draft basically overhauls the key legal regulatory structure that has guided foreign investments in China for almost 40 years, and it will be a significant milestone in the process towards a more transparent and consistent market for both foreign and domestic investments.

The Draft contains 170 articles and – when passed into law – it will abolish the comprehensive approval system and replace it with one that will require only limited entry permits. The Sino-Foreign Equity Joint Venture Law of PRC, Sino-Foreign Cooperative Joint Venture Law of PRC and the Wholly Foreign Owned Enterprises Law of PRC will be abolished upon the adoption of the Draft.

The Draft addresses the changing nature and volume of foreign investment in China and, more precisely, it reflects China’s current economic situation as compared to the economic situation prevailing when China first opened its market to foreign investment in the 1970s.

Some of our observations of the crucial points of the Draft include:

### *New approval system*

The Draft transforms from the current “case by case approval” to a “national standard plus Special Administration Measure Catalogue” approach to the foreign investment projects in China. Under the current rules, foreign investors must apply for a pre-approval from the Ministry of Commerce or its local branches, and this approval may be delayed at the wide discretion of the authorities. While the Draft would facilitate the foreign investment greatly (except for projects on the negative list); the new system focuses a good deal more on registration and post-investment reporting.

In most cases, pre-approval will no longer be needed for foreign investment and merger and acquisition projects. Registrations made under the Company Law of PRC will apply, and the projects will receive national standard handling, although they will be subject to more extensive reporting requirements than the rules applicable to domestic investments.

### *Pre-approvals*

Pre-approval will still be required in a few circumstances if, for instance, the investment is listed on the Special Administration Measure Catalogue (“Negative List”). The Negative List will set out projects subject to restrictions or prohibitions against foreign investment, the restrictions depending on the industry sector and the aggregate size of the investment. When reviewing foreign investments in restricted sectors, the Ministry of Commerce may also seek the opinion of relevant regulatory agencies or stakeholders or submit the issue for public hearing.

The Draft sets out the criteria applicable to the review of projects on the Negative List. The factors to be considered include impact on national security, energy resources, environment protection and employment, among others. The Draft also provides the approval authorities with different approval options for projects appearing on the Negative List.

#### *Policies supporting foreign investors*

The Draft provides for the establishment policies to support foreign investment and includes a provision that clearly states that foreign investments are protected from expropriation. The Draft also provides possible dispute resolution mechanism, under which foreign investors may appeal decisions made by administrative approval authorities. Finally, there are also quite a few monitoring provisions regarding foreign investment activities and the related penalties if the requirements are not met accordingly.

#### *National security reviews*

The Draft requires that foreign investors going through the approval process explain the national security implications of their investment, and it should be noted that any form of foreign investments in any industries may be subject to a national security review. Foreign investors are offered the option of submitting their projects to the national security review process voluntarily and various parties are permitted to raise national security concerns for any foreign investment projects.

Foreign investors should consider carefully whether to initiate the review process; if they choose not to do so, other interested parties, including their commercial competitors, may do so, thus exposing the foreign investors to the threat of an adverse ruling, including any costs and related penalties. National security review decisions cannot be appealed against or be subject to judicial review; however, the Draft allows foreign investors to take measures to mitigate any potential harm in the proposed investments through negotiations with the panel before a final decision is reached.

If proposed foreign investment projects fail to obtain national security clearance, the Ministry of Commerce may order the cessation of the foreign investment, the divestiture of the relevant equity interest, and the disposal of the relevant assets of other such measures needed to eliminate potential harms to the national security. The foreign investor will be responsible for all related losses.

#### *Variable interest entities*

Up until now, the variable interest entity ("VIE") has been developed to enable foreign investment participate indirectly in the sectors in which foreign investments are subject to restrictions or prohibitions. However, the Draft will bring the VIE structure into the scope of foreign investments. The Draft will regulate the VIE structures by adopting "actual control" criteria to determine whether an investment is a foreign investment or not.

"Actual control" under the Draft will include the ability to exert decisive influence on the operational, financial, personnel or technological matters of the entity in question through contract, trust or other means. If the VIE structure establishment is actually controlled by the foreign investment in order to operate in the sectors on the Negative List, such foreign investments will be illegal by not complying with the rules and, therefore, could be subject to penalties, including divestiture and disposal of relevant interests or assets, confiscation of illegal gains, and fines from RMB 100,000 to RMB 1,000,000, or even up to 10% of the amount invested.

It is not clear what will happen to the existing VIEs controlled by the foreign investors and whether it will be possible for the structure to continue to operate. Once it passes into law, the Draft might be followed up by an explanatory note that explains the possible treatment of VIE investments.

#### *Transition period*

Companies that have been established under the prior foreign investment laws will have a three-year period in which to be registered as either companies under the Company Law

of PRC or partnerships according to the PRC Partnership Law. The three foreign-investment laws stated above will presumably still be applicable to some extent during this three-year period. At present, financial industry, such as security companies, investment banking and the like, will not be subject to the Draft directly, and the relevant authorities will still be responsible for any new rules or regulations.

The Draft is certainly a big step towards a further opening of the market for foreign investment and making the system more transparent. Once the final form of the Draft has been adopted, we assume that many of the issues will be subject to some refinery and refurbishments and we will naturally follow up on them accordingly.

#### *Contact*

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If you would like to know more about the Draft, please contact:



**Søren Meisling**

Partner  
T +45 72 27 33 17  
E sme@bechbruun.com



**Rachel Cao**

Certified Chinese lawyer  
T +45 72 27 34 30  
E rcao@bechbruun.com