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The pros and cons of China's new Foreign Investment Law

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China's new Foreign Investment Law will take effect soon. Linda Yang and Shihan Huang of law firm Yingke Law assess its likely impact.

In January 2015, China's Ministry of Commerce announced its draft Foreign Investment Law (FIL), with a view to seeking public opinion and contributions. On March 2, 2016, a spokesman suggested that the Ministry of Commerce would speed up making its amendments to bring the final version of the FIL closer to being enacted. This article will discuss the changes to be made as soon as the law is passed and examine the possible impact on international businesses.

China's existing three foreign investment laws will be invalidated if and when the new FIL is passed, which means a new model of "limited approvals with full-scale post facto reporting" will replace the existing model of case-by-case prior approval (or registration). Only foreign investments in items on a ‘negative list’ will need to be approved, and those items not on the negative list will be regulated by the domestic company law, the partnership law or other relevant laws. Meanwhile, all investments will need to fulfil reporting obligations and a new authority will be established that will be entitled to call on national security reviews of foreign investments.

Born of necessity

One reason for drafting the new FIL is that the existing three foreign investment laws were enacted decades ago, but Chinese law and regulation has been developing rapidly in recent years, particularly the company law. Indeed, problems occurring through conflicts between the existing foreign investment laws and changing rules are becoming increasingly common. For example, the new amended company law in 2014 replaced the ‘paid-up’ rules of registered capital with subscription rules. This has simplified the incorporation procedure and made the whole process quicker. However, foreign investments made before the 2014 company law was enacted are not entitled to such benefits.

A second reason for coming up with a new FIL is that foreign investment typically needs much more time to be approved by different authorities before it can enter the Chinese market. In its drive to become ever more attractive to foreign investment, China is keen to remove such time-consuming procedures.

Another significant reason behind China's new FIL is that on the one hand Chinese businesses need finance in overseas markets, but the old rules from the China Securities Regulatory Commission, the State Administration of Foreign Exchange and other supervisory bodies placed a great burden on the shoulders of Chinese enterprises in the manner in which they listed abroad or even made the listing impossible; and on the other hand foreign businesses want to make money in China, including from time to time a few restricted or prohibited industries. To get around this, some arrangements have been made that allow both Chinese and foreign businesses to meet these needs, such as the variable interest entity (VIE) arrangement, which enables businesses to operate without having to self-regulate, and the Chinese authorities to supervise such trends efficiently, providing a more stable market for both domestic and foreign investors.

A complete overhaul

The FIL brings with it a comprehensive reconstruction of the Chinese foreign investment legal system. The US, EU and Japan are involved in trade initiatives such as the Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership. Therefore, a new foreign investment law is necessary if China is to face these global challenges.

With regard to the changes under FIL, the first is that the authority will move its focus from supervising the organisational structures and business activities of foreign companies investing in China to post-investment supervision, which mainly concerns reporting obligations and national security.

The law will also allow foreign businesses to establish their business in China quickly and easily – in a few days in some cases – as well as enabling them to exit rapidly, if their products are not on the negative list. The existing law states that if a foreign investor sells its shares, it will require permission from both supervisory bodies and other shareholders in advance. Under the new FIL, the domestic company law will apply as foreign investments will receive 'national treatment'. The domestic company law also states that if a shareholder is to transfer their stock rights, the other shareholders can either agree to the transfer or, if they object to the transfer, purchase stock rights. In these instances, it will not be necessary to get permission from supervisory bodies if the business is not on the negative list.

New burdens

However, the FIL brings with it new burdens. Under the existing system, if an investment is approved in advance, as long as it operates in line with the activities approved, it can, to a large extent, go about its business freely and safely. Under the new FIL, foreign businesses will have to pay attention to compliance issues at all times, as there will be no authority to review the investors' activities in advance. In addition, it will be necessary for foreign investors to pay attention to their full-scale reporting obligations during their operation, as careless or false reporting may not only trigger the national security review, but also bring administrative penalties or even prosecution. Consequently, foreign investors would be well advised to engage with experts in the new foreign investment system to help with reports and related issues.

A second change is that, in addition to the standardisation of registration, the FIL will introduce a standard of 'actual control'. This means that the law-makers will decide whether an investment is foreign or Chinese by examining who is the ultimate decision-maker and ultimate beneficiary of an investment. This will have significant impact on foreign businesses investing in restricted or prohibited industries through a VIE structure.

Currently, foreign businesses are able to enter restricted markets free of investment restrictions through VIE arrangements. For example, a special purpose vehicle (SPV) established outside mainland China will initially set up a management company in the country. Meanwhile, a Chinese person (a legal entity) will incorporate an operating company in China. The operating company will carry out restricted businesses. It is legal for the operating company to carry out such businesses as has a Chinese shareholder. Then the management company will enter into management and consulting contracts with the operation company, which give the management company the right to control the operation company. In return it will charge a service fee equal to the net profit of the operation company. This arrangement is also supported by an equity pledge agreement, share option agreement, business operation agreement, authorisation agreement, trademark and intellectual property transfer agreement and a loan agreement. Therefore, foreign businesses are able to operate in restricted markets free of investment restrictions, such as value-added telecommunication.

However, under the new FIL, if it is found that the operating company is ultimately controlled by a foreigner (a person, organisation or state), the law will consider the operating company a foreign investor and hence restrict its operations, which means a VIE structure will no longer be of any use.

The negative list

An interesting risk to be addressed is that if a foreigner wants to invest in items on the 'negative list', one possible way for them to do so may be to hand over the right of control of the SPV (if the SPV is the top level) to the Chinese members of the VIE structure. The protection for the foreigner will require comprehensive and complete agreements in place covering every aspect of the business. However, if in practice the shareholder of the operating company is to transfer the assets maliciously, it would become difficult for the foreigner to decide whether or not to compete for the right of control. If they do not compete they will lose the assets, if they compete the VIE will lose its base of legality in China.

There are even debates suggesting that the VIE could become history. In what is a long, complex debate, it is felt that too much attention is drawn to the VIE structure rather than the negative list, which is key to the restriction of foreign investments. For example, Shanghai Free Trade Zone is piloting opening up its online data processing and e-commerce business to foreign investors. It is not yet clear what will be written on the negative list.

There are also other impacts on international businesses; for example, the FIL will have a synergistic effect with the incorporation of the measures of base erosion and profit shifting due to the full-scale reporting obligations.

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