Hot to trot: China's State Council orders further liberalization to turn the tide on foreign direct investment in China

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Hogan Lovells

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Overview

On 12 January 2017, China's State Council issued the *Expansion of Liberalization and the Active Utilization of Foreign Investment Circular Several Measures* (国务院关于扩大对外开放积极利用外资若干措施的通知, Guo Fa [2017] No. 5), (the **"State Council Liberalization Measures"**). The State Council Liberalization Measures set out framework policies to promote further liberalization of certain sectors of the Chinese economy to foreign direct investment ("**FDI**"), against a background of China imposing new foreign exchange controls on outbound direct investment ("**ODI**") by Chinese investors as a result of China's concerns that its outflows of foreign currency are exceeding its inflows, leading to capital flight, a reduction in China's foreign exchange reserves and downward pressure on the Renminbi. Please read our recent client note on China's recently imposed foreign exchange controls and their impact on ODI in particular here. In short, China appears to be attempting to balance the books after a period where domestic concerns have grabbed the headlines with the *Counter-Terrorism Law*, the *National Security Law* and the *Cybersecurity Law* all being passed in the last two years.

The State Council Liberalization Measures consist of 20 policies that are divided into three broad categories namely:

- relaxing market access restrictions;
- further levelling the playing field by providing for requirements to treat domestic capital companies ("**Domestic Companies**") and foreign invested enterprises ("**FIEs**") equally; and
- further/other efforts to attract FDI.

For each policy, the State Council has specified the government organs that are responsible for implementing each measure. The State Council Liberalization Measures also require the National Development and Reform Commission (**"NDRC"**) and the Ministry of Commerce (**"MOFCOM"**) as the two key FDI approval/record filing agencies to step up supervision and investigation work in collaboration with the relevant departments to ensure that the various policies and measures are implemented.

On the face of it, the State Council Liberalization Measures send a very positive message that China will go further in opening up previously closed or half-closed sectors, including through M&A activities. However, it remains to be seen how these policies will be implemented and whether the industry regulators who have historically had a tense and competitive relationship, and which have been hostile to foreign investment will cooperate in the practical implementation of these reforms.

Background

On 3 September 2016, the Standing Committee of the National People's Congress, the Chinese parliament equivalent, issued a new *Decision on Amending Four Laws* which took effect on 1 October 2016. Under this decision, the FIE approval system will be converted into a record-filing procedure for FIEs that are not in particularly sensitive sectors. On 8 October 2016, the NDRC and MOFCOM issued the *Announcement [2016] No. 22* to define "special market access administrative measures" as follows:

- those items on the so-called Negative List which in turn the Chinese authorities have pinned to the areas which are in the "restricted" or "prohibited" categories under the official policy document listing the policy on foreign investment in certain sectors, the *Guidance Catalogue for Foreign Investment Industries* the latest version of which took effect on 10 April 2015 (the "**2015 Catalogue**"); and

- those items which are in the "encouraged" category in the 2015 Catalogue, but which are subject to foreign equity percentage restrictions, or where there are specific requirements relating to senior managers in such FIEs (e.g. the senior person must have Chinese nationality).

On the same day, MOFCOM issued the *Record-Filing of the Establishment of, and Changes to, Foreign Invested Enterprises Interim Measures* (the "**Interim Measures**") to detail the record-filing procedures. As such, for the setting up of FIEs not subject to special administrative market access restrictions imposed by the State, the approval procedure was replaced by record filing. This is thought to be the most significant change to FDI regime since it was put in place in the 1980s.

On 7 December 2016, prior to issuing the State Council Liberalization Measures, NDRC and MOFCOM jointly released a draft *Guidance Catalogue for Foreign Investment Industries (Revised)* (the "**New Catalogue**") for public comment. The New Catalogue makes structural changes to the previous catalogue, notably replacing the "restricted" and "prohibited" sectors with the negative list. The State Council Liberalization Measures follow this principle and reemphasize the reduction or removal of market access restrictions for foreign investors.

Highlights

Further expanding liberalization

Under the State Council Liberalization Measures, 2015 Catalogue and relevant policies and regulations shall be revised to relax restrictions on the market access of foreign investors to the service sectors, manufacturing industry, the mining industry and other sectors.

The detailed liberalization measures for different sectors are summarized in the chart set out in the Schedule.

Further creating a level playing field

The State Council Liberalization Measures place emphasis on treating domestic and foreign investment enterprises more equally through the following measures:

- All regions and departments must ensure consistency on the implementation of State's policies and regulations. No region or department may increase restrictions on FIEs without authorisation.
- The relevant departments shall stick to uniform standards and time periods for reviewing applications for business-related licenses and qualification applications of FIEs as compared to those for Domestic Companies.
- FIEs will be allowed to participate in China's standardization work in a fair manner alongside Domestic Companies.
- FIEs will be allowed to take part in the bidding process for government contracts on a fair and equitable basis without discrimination compared to Domestic Companies.
- Intellectual property ("**IP**") rights of FIEs will be strictly protected in accordance with laws and regulations. The Chinese government will encourage relevant international organizations to set up IP arbitration and mediation centers in China.
- FIEs will be allowed to expand financing channels by listing on Main Board, Small and Medium Enterprise Board, Growth Enterprise Market and New Third Board, or by issuing enterprise bonds, convertible bonds and other debt instruments.
- The government will intensify the reform of the registered capital of FIEs. Minimum registered capital requirements for FIEs shall be eliminated unless laws specifically require.
- High-caliber overseas individuals will be

given more support in starting up new businesses in China. Foreign nationals who are high-caliber individuals and hold a permanent residence permit shall be given the same treatment as Chinese nationals in establishing science and technology-related enterprises in China.

Further enhancing efforts to attract foreign investment

The State Council Liberalization Measures also outline the following policies to promote FDI:

- Local government incentives to encourage FDI will be permitted: All regions must proactively carry out efforts to promote investment based on local realities. The local governments are allowed to formulate their own policies to attract foreign investment within the limits of their respective legal authorities.
- Supporting certain regions to absorb enterprise relocations: FIEs are encouraged to relocate their operations to the less developed central, western and north-eastern regions of China. The FIEs will be able to access preferential tax, land and financing treatments in these regions.
- Encouraging FDI projects where intensive land use required: FIEs and Domestic Companies shall be subject to land-use policies on an equal basis. Foreign invested industrial projects that fall under the "encouraged" category in the 2015 Catalogue shall continue to enjoy land supply on a priority basis, and the reserve price of its land transfer may be determined at not less than 70% of the national minimum price.
- Reforms of the centralized management of foreign and local currencies: Multinational companies are encouraged to set up regional headquarters, procurement centers, settlement centers and other functional agencies in China and will be permitted to manage their local and foreign currencies centrally through cash pooling type arrangements.
- Improving the system for managing the foreign debts: The same standards shall be applied to Domestic Companies and FIEs in managing foreign debt. The foreign exchange management regimes of enterprises will be enhanced to improve the ability of, and convenience for, FIEs to obtain overseas financing.
- Simplifying the foreign investment administration system: The pre-entry national treatment and negative list approach will be adopted with respect to the management of foreign investment.

Impact

China has clearly been jolted into action by the levels of recent capital outflows, and having gone through a period of introspection, is now looking to try and reverse the trend by cooling down ODI and encouraging FDI. The State Council Liberalization Measures clearly suggest that China is now becoming increasingly concerned about FDI levels and the relocation of FDI projects to countries with a lower cost base than China and hence needs to go deeper and further in terms of liberalizing various sectors to bring in more FDI.

If properly implemented, these policy measures will go a long way towards addressing some of the main concerns that foreign investors in China have been drawing to the Chinese government's attention over the past few years. However, the devil is in the detail of the implementation of these broad-brush, top-down policies. The important question is whether different departments within the Chinese government will work together to implement the State Council Liberalization Measures in a uniform way nationwide before the current term of the State Council will come to an end in March 2018.

Conclusion

The State Council Liberalization Measures are long on good intentions and short on implementing details: for example, notwithstanding the high hopes that many foreign investors held in the light of China's World Trade Organization commitments in sectors like telecoms and the Internet, real progress on the road to liberalization of these sectors has been slow and pitted with false dawns, such as the liberalization policies in the Shanghai Free Trade Zone, where those who did apply for telecoms licenses for example, found themselves confronted with additional requirements and barriers that were not set out in the legislation. There is no obvious reason for thinking that this time around will be any different.

Therefore, the conclusion is that the State Council Liberalization Measures give a very positive message that China is looking to reinvigorate the FDI sector, but that, of itself, is not enough: in order to make a real difference, it needs to be matched by concrete actions and changes on the ground supported by implementing legislation at the national and local levels. Above all, it needs an approach by the industry regulators that is consistent with the spirit and intent of the new policies, coupled with genuine will to open up to foreign investment in a meaningful way, rather than just tinkering around at the edges.

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Schedule

<u>Note:</u>

There are three main categories of liberalization measures that are to be adopted by the relevant authorities under the State Council Liberalization Measures:

- for sectors where the restrictions are to be **lifted**, the background in the columns below under "Specific liberalization measures" are shaded in green;
- for sectors where the restrictions are to be **relaxed,** the background in the columns below under "Specific liberalization measures" are shaded in blue;
- for sectors where the restrictions are to be **liberalised in an orderly fashion,** the background in the columns below under "Specific liberalization measures" are shaded in orange; and
- for sectors where there is no specific liberalization measures *per se* but administrative and/or fiscal policies have been included to encourage FDI the background in the columns below under "Specific liberalization measures" are shaded in yellow.

Some reforms mentioned in the State Council Liberalization Measures are elaborated on the New Catalogue; see the "Specific liberalization measures" column below for further details.

Sector		**Restrictions Before the State Council Liberalization Measures**	**Specific liberalization measures**
Service Industry	Banking Financial Institutions	A single overseas financial institution and its affiliated parties under its control or joint control are only allowed to invest in not more than 20% of the equity interests in a single Chinese-funded commercial bank as promoters or strategic investors; Multiple overseas financial institutions and their affiliated parties under their control or joint control are only allowed to invest in not more than 25% of the equity interests in a single Chinese-funded commercial bank as promoters or strategic investors; Overseas financial institutions investing in rural small and medium-sized financial institutions shall be banking financial institutions.	
	Securities Companies	A foreign invested securities company is limited to engaging in the underwriting and sponsorship of ordinary RMB-denominated shares, foreign shares, treasury bonds and corporate bonds, the brokerage of	

Sector		Restrictions Before the State Council Liberalization Measures	Specific liberalization measures
		foreign shares, and the brokerage and proprietary trading of treasury bonds and corporate bonds upon establishment, and may apply for expanding its business scope two years after establishment if it satisfies relevant conditions; The proportion of FDI in a securities company shall not exceed 49%.	
	Securities Investment Fund Management Companies	The proportion of FDI in a securities investment fund management company shall not exceed 49%.[1]	
	Futures Companies	Chinese parties shall be the controlling shareholders.	
	Insurance Institutions, Insurance Intermediaries	In the case of life insurance companies, the proportion of FDI shall not exceed 50%.	
	Accounting and Audit	The senior partner shall be of Chinese nationality.	Restrictions removed from the New Catalogue
	Architectural Design	• To apply for the granting of, or an upgrade to an engineering design qualification in China, the foreign investment party must submit at least two engineering design achievements in the past; • Subject to an approval system.	
	Rating Services	Rating services are in the "restricted" sector under the 2015 Catalogue	Restrictions removed from the New Catalogue
	Telecommunications	For companies engage in value-added telecommunications services, the proportion of foreign investment must not exceed 50% (excluding e-commerce);[2]	

[1] Noting that it is now possible, subject to certain restrictions, to establish an FIE (wholly foreign owned enterprise ("**WFOE**") or equity joint venture) private fund manager registered with the Asset Management Association of China (see for example, FIL Investment Management (Shanghai) Company Ltd, a WFOE established by Fidelity, the fund manager).

[2] Certain exceptions exist in the Shanghai Free Trade Zone.

Sector		**Restrictions Before the State Council Liberalization Measures**	**Specific liberalization measures**
		For companies engage in basic telecommunications services, the proportion of FDI must not exceed 49%.	
	Internet	FDI is prohibited in the operation of news websites, online publication services, online audio and video program streaming services, business premises for Internet access services, and Internet cultural business (excluding music).	
	Culture	FDI is allowed in the production of radio and TV programs and movies, but limited to Sino-foreign cooperative joint ventures; Foreign investments is prohibited in: • operating news agencies; • publishing books, newspaper and periodicals; • publishing and producing audio-visual products and electronic publications; • operating all radio stations, television stations, radio and television channels (frequencies), radio and television transmission and coverage networks (transmitting stations, relay stations, radio and television satellites, satellite uplink stations, satellite receiving and transmitting stations, microwave stations, monitoring stations, and cable radio and television transmission and coverage networks); • operating radio and television program production and operating companies; and • operating movie production companies, distribution companies and cinema	

Sector		Restrictions Before the State Council Liberalization Measures	Specific liberalization measures
		companies.	
	Education	FDI is allowed in the operation of higher education institutions, ordinary senior high schools and pre-school education institutions, but only in the form of Sino-foreign cooperative joint ventures lead by Chinese parties; *(Being led by Chinese parties means that the principal or major persons in charge of administrative matters of an institution of higher learning shall be of Chinese nationality, and that the Chinese members of the council, board of directors or joint management committee of an education institution run by Sino-foreign cooperation shall not be less than half of the total)* FDI is prohibited in the operation of compulsory education institutions.	
	Transportation	FDI is restricted from engaging in railway passenger transport business and water transport (with Chinese parties as the controlling shareholders); Highway passenger transport business is in the "restricted" sector under the 2015 Catalogue; Air traffic control business is in the "prohibited" sector under the 2015 Catalogue.	Restrictions for highway passenger transport business removed from the New Catalogue
	FDI particularly encouraged in manufacturing-related service sectors, such as industrial design and innovation, engineering consulting, modern logistics and inspection and certification services.		
Manufacturing Industry	Rail Transport Equipment	FDI is permitted in the manufacturing of track transportation equipment but only in a form of Sino-foreign equity/cooperative joint ventures.	
	Motorcycle	FDI is allowed in the	

Sector		**Restrictions Before the State Council Liberalization Measures**	**Specific liberalization measures**
	Manufacturing	manufacturing of motorcycles subject to the condition that the Chinese parties must hold at least 50% of the equity interests.	
	Fuel Ethanol Production	FDI is allowed in the production of fuel ethanol but only in the form of a joint venture with the Chinese parties as the controlling shareholders.	
	Oil and Fat Processing	FDI is allowed in processing of edible oil and fats but only in the form of a joint venture with the Chinese parties as the controlling shareholders.	
	FDI particularly encouraged in high-end, intelligent and green manufacturing.		
Mining Industry	Oil Shale, Oil Sands, Shale Gas and other fields of unconventional oil and gas as well as mineral resources	FDI is allowed in the exploration and exploitation of Oil Shale, Oil Sands, Shale Gas and other fields of unconventional oil and gas but only through Sino-foreign cooperative/equity joint ventures.	Restrictions removed from the New Catalogue
	Foreign cooperation projects in oil and natural gas sectors	The cooperative regions for cooperative exploitation of oil and gas resources shall be decided by State Council, and general exploitation plans for cooperative exploitation of oil and gas resources shall be approved by the departments designated by the State Council.	Under the State Council Liberalization Measures, the approval system will be replaced with a record-filling system
Construction		Various restrictions imposed on FDI around hard to obtain (or upgrade) construction enterprise qualifications for site surveys, works, design, project management and so forth. Overlapping qualifications for project management issued by different regulatory bodies.	FDI in the construction of infrastructure by concession contracts, including energy, transportation, water conservation, environmental protection, and municipal public utilities projects to be encouraged.

Sector	Restrictions Before the State Council Liberalization Measures	Specific liberalization measures
Research and Development("**R&D**")	• The funds for carrying out research and development by a foreign-invested R&D centres shall be no less than USD2 million; • Establishment of R&D centres with foreign investment in the forms of equity joint ventures, cooperative joint ventures, and wholly foreign-owned enterprises shall be subject to the examination and approval of the relevant provincial examination and approval authority; • The establishment of an R&D branch company or independent research and development division inside a FIE shall be subject to the examination and approval of the relevant examination and approval authority for establishment of foreign-invested enterprise according to its corresponding authority limit.	• FDI particularly encouraged in building R&D centres, technical centres and postdoctoral research stations in cooperation with Domestic Companies and research institutions; • FDI particularly encouraged in undertaking projects under the national science and technology plan based on reciprocity ; and • Applying incentive policies, such as R&D cost deductions and those offered to high and new technology enterprises and R&D centres on an equal footing with Domestic Companies.

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