

Legal Updates & News

Legal Updates

MOFCOM Further Delegates Foreign Investment Approval Authority

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On March 12, 2009, the Ministry of Commerce of the PRC ("MOFCOM") posted on its official website two circulars: the Notice of Ministry of Commerce on Further Enhancement of the Approval Scheme for Foreign Investment [Shang Zi Han No.7 (2009)]("Circular 7"), effective March 5, 2009, and the Notice of Ministry of Commerce on Delegation of the Approval Authority on Establishment of Foreign Invested Holding Companies [Shang Zi Han No.8 (2009)]("Circular 8"), effective March 6, 2009.

Related Practices:

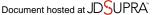
Mergers & Acquisitions

These two circulars, together with other recent circulars and the Foreign Investment Handbook[1] recently issued by MOFCOM, indicate a major shift in MOFCOM's foreign investment approval policy, which has been in place for over 30 years. With this change, MOFCOM has effected a delegation of its approval authority over foreign investment to its local counterparts. The practical impact of the new policy is that, with the exception of certain large-scale and high-profile projects that will still require central level approval, foreign investment projects will now be approved at the local level. Given that, in practice, local governments in China tend to take a more wideopen, pro-investment stance than the central authorities, it is expected that this delegation of authority may result in quicker and more readily obtainable approvals for most foreign investment projects. We highlight below key aspects of the new policy regimen.

1. Delegation of approval authority for FIE establishment and subsequent changes

Since the reform of the investment oversight regimen implemented by the State Council in 2004, MOFCOM has exercised the authority to approve foreign investment projects with total investment[2] of not less than: (i) USD100 million, for foreign-invested entities ("FIEs") within the "encouraged"[3] or "permitted" industries, and (ii) USD50 million, for FIEs falling under any of various designated "restricted" industry categories (collectively, the "Approval Threshold").

Under Circular 7, MOFCOM has delegated its approval authority for the establishment of FIEs (and subsequent changes with respect to such FIEs) within the encouraged industries entirely to its provincial counterparts ("Provincial MOFCOM")[4] and the State Economic and Technology Zones, unless "overall national adjustment" [5] is required in connection with such FIEs. "Changes" subject to approval include increases or decreases in registered capital, amendments to constituent documents, changes to business scope and terms, changes of shareholders, and merger and division and amendment of the



contracted payment methods for registered capital. One point unclear under Circular 7 is whether such delegation includes the approval for termination and dissolution of FIEs. Further clarification from MOFCOM may be needed on this point.

Under Circular 7, MOFCOM has also delegated to its local counterparts ("Local MOFCOM", 地方商务主管部门) MOFCOM's authority to approve changes in FIEs established with the approval of MOFCOM itself. However, the following exceptions are still subject to MOFCOM approval: (i) increases to registered capital in an amount above the Approval Threshold that are subject to approval from National Development and Reform Commission; and (ii) changes resulting in the replacement of a Chinese entity by a foreign entity as the FIE's controlling shareholder. "Local MOFCOM", while not clearly defined, is generally understood to include MOFCOM's counterparts at the provincial, municipal and other local levels. However, further clarification from MOFCOM on the implementation and division of such delegated authority at the local levels may be forthcoming.

Circular 7 also stipulates that MOFCOM's local counterparts in vice-provincial cities [6] and the State Economic and Technology Development Zones also enjoy the same approval authority previously delegated to Provincial MOFCOM, unless stipulated otherwise in specific regulations.

2. Delegation of approval authority relating to foreign-invested joint stock companies ("FISCs") and foreign-invested holding companies ("FIHCs")

Previously, incorporation and changes to an FISC required MOFCOM approval. With the promulgation of Circular 50, the approval for establishment and changes with respect to an FISC with registered capital below the Approval Threshold was subsequently delegated to Provincial MOFCOM. Under Circular 7, MOFCOM has further expanded the scope of this delegation. Henceforth, even if the registered capital of an FISC in encouraged industries is above the Approval Threshold, the Provincial MOFCOM has the authority to approve its establishment and other designated changes, provided that no overall national adjustment is required.

To date, MOFCOM has always retained approval authority with respect to FIHCs. Circular 8 now authorizes Provincial MOFCOM to approve the establishment and changes with respect to an FIHC with registered capital of not more than USD100 million. However, one-off increases in the registered capital exceeding USD100 million still require MOFCOM approval. In addition, approvals for changes with respect to FIHCs whose establishment was originally approved by MOFCOM under Circular 8 has also been delegated to Provincial MOFCOM with the exception of one-off increases in registered capital exceeding USD100 million or shareholder changes. Circular 8 emphasizes that Provincial MOFCOM may not further delegate its authority over FIHCs to local sub-branches.

3. Cross-border inbound acquisition approvals

In addition to the well-established "total investment" concept referenced in the Regulations on Mergers with and Acquisitions of Domestic Enterprises by Foreign Investors promulgated in August 2006 ("**M&A Rules**"),[7] Circular 7 sets out a new concept, "transaction amount" (交易额), as a bright-line for demarcating jurisdictional authority over mergers with and acquisitions of domestic enterprises by foreign investors or FIEs ("**M&A Transactions**"). Circular 7 provides that M&A Transactions with transaction amounts equal to or less than the Approval Threshold will be subject to approval of Local MOFCOM.[8]

The following M&A Transactions remain subject to MOFCOM approval: (i) round-trip investments, namely any transaction in which a domestic PRC company or national exchanges onshore assets or equity interests for shares of an offshore company which directly or indirectly controls such assets or equity interest; (ii) transactions involving "key industries", having influence on national economic security or resulting in the transfer of actual control of a domestic enterprise holding a well-known trademark or historic Chinese name; and (iii) foreign investors' strategic investment in or acquisition of domestic companies listed on Chinese stock exchanges.

The Handbook has also clarified that transfers of equity in an existing FIE should be governed by the Provisions for the Changes in Shareholder Interests in Foreign Invested Enterprises[9] and the M&A Rules should not apply. This stipulation provides welcome clarity for the interpretation of Clause 55 of

the M&A Rules,[10] but it does not alter existing requirements that continue to mandate MOFCOM approval for "round-trip investment".

4. Other delegation of foreign investment approval authority

The recently promulgated circulars of MOFCOM also demonstrate that MOFCOM, in addition to delegating its administration over FIE approvals, has loosened its supervision in certain other areas as well. For example, Circular 7 stipulates that approval from MOFCOM is no longer required for the early release of imported equipment of FIEs under Customs' supervision.

Similarly, Circular 7 provides that MOFCOM approval is no longer required for the approval of the establishment of branches by FIEs within China. As long as the registration of an FIE branch is approved by the relevant Administration Bureau on Industry and Commerce, a filing with the relevant Local MOFCOM will be sufficient, unless other requirements are imposed by specific regulations. For example, under the Regulations on Administration of Foreign Invested Advertising Enterprises, establishment of branches by an FIE engaged in the advertising business requires approval from Provincial MOFCOM.

For the establishment of branches by FIEs outside China, approval is still required, but pursuant to Circular 7, MOFCOM has now delegated its approval authority in this respect to Provincial MOFCOM. Provincial MOFCOM is also authorized to further delegate such approval authority to its counterparts at the municipal level.

The increasingly popular Foreign Invested Venture Capital Enterprise vehicle has also been the object of approval authority decentralization. Under Circular 9, MOFCOM has delegated its authority to Provincial MOFCOM and the State Economic and Technology Development Zones for the establishment of and changes to Foreign Invested Venture Capital Enterprises and Foreign Invested Venture Capital Administration Enterprises, with registered capital equal to or less than USD100 million. Changes to such enterprises whose establishments were originally approved by MOFCOM may now be approved at the provincial level with the exception of increases of registered capital in excess of USD100 million or changes to "requisite investors" (analogous to general partners).

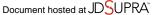
5. Approval authority retained for Regulated Industries (专项规定行业),<mark>[11]</mark> Special Industries (特定产业)<mark>[12]</mark> and Macro-regulated Industries (宏观调控行业)<mark>[13]</mark>

MOFCOM has retained its oversight role for FIEs in Regulated Industries, Special Industries or Macroregulated Industries, which are all relatively new concepts in the foreign investment area and will need further clarification and elaboration. The approval process on FIEs in these categories remains largely unchanged from existing practice although there has been some gradual liberalization.

Regulated Industries primarily encompass service industries which have gradually been opened to foreign investors under China's WTO commitments, such as telecommunications, mining, film production, international couriers, and shipping. Notably, wholesale and retail businesses were formerly classified as Regulated Industries, and on September 12, 2008, MOFCOM promulgated Circular 51 to allow Provincial MOFCOM to approve the establishment and alterations of FIEs in wholesale and retail businesses. Although some areas have been removed from the Regulated Industries category, there are certain exceptions such as distribution of audio-visual products and the sale of books and periodicals, which are still in the catalogue of Regulated Industries under the Handbook and subject to MOFCOM approval. The Handbook suggests that MOFCOM will probably further delegate its approval authority on certain Regulated Industries to Local MOFCOM branches in the near future. (Please refer to Footnote 11 for more details.)

Special Industries are understood to include selected manufacturing industries such as automobile manufacturing, cement, electrolyzed aluminum and coal chemical processing whereas Macro-regulated Industries include steel, cement, electrolyzed aluminum, shipbuilding and real estate. These sectors are all considered sensitive, and preliminary indications suggest that MOFCOM will retain tight oversight over FIE projects in these areas for the foreseeable future.

6. Observations

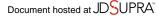


The general thrust of this new approval regimen suggests that MOFCOM's function will evolve to focus more on policy making, supervision of its local counterparts, and selected areas of regulatory focus such as anti-monopoly review, round-trip investments, key pillars of industrial policy and politically sensitive sectors. Nonetheless, MOFCOM will continue to monitor foreign investment and supervise its local counterparts through its internal filing, reporting and statistics systems. Once an approval on foreign investment is granted by a Local MOFCOM, the Local MOFCOM is required to file with MOFCOM Foreign Invested Enterprises Approval Filing Forms, as well as copies of approval documents and approval certificates.

In practice, being subject to MOFCOM approval has been considered as a burden for foreign investment, as central-level approvals are usually more difficult to obtain than local approvals, and the approval process is often frustratingly time-consuming. The trend of decentralization of foreign investment approvals suggests that MOFCOM intends to streamline administration and facilitate foreign investment, possibly in response to recent concerns over a perceived rise in global protectionism in the area of cross-border investment approvals. In this regard, the new circulars may represent a welcome liberalization of approval policy although transaction approvals will still require careful planning and analysis on a case-by-case basis.

Footnotes

- [1] As used herein, "Circular 21" refers to the Notice of the Ministry of Commerce on Further Simplifying and Regulating the Foreign Investment Administration [Shang Zi Han No.21 (2008)] issued by MOFCOM effective on 26 August 2008; "Circular 50" refers to the Notice of the Ministry of Commerce on the Delegation of Approval on the Alteration of Foreign Invested Joint Stock Companies and Foreign invested Enterprises [Shang Zi Han No.50 (2008)] issued by MOFCOM effective on 11 August 2008; "Circular 51" refers to the Notice of the Ministry of Commerce on the Delegation of Approval Authority on Foreign Invested Commercial Enterprises [Shang Zi Han No.51 (2008)] issued by MOFCOM effective on 12 September 2008; "Circular 9" refers to the Notice of Ministry of Commerce on the Approval Matters relating to the Foreign Invested Venture Capital Enterprises and Foreign Invested Venture Capital Administration Enterprises [Shang Zi Han No. 9 (2009)] issued by MOFCOM effective on 5 March 2009; and "Foreign Investment Handbook" refers to the Administration Handbook on the Entry of Foreign Investment issued by MOFCOM in December 2008.
- [2] The total investment refers to the aggregated amount of construction capital and working capital as required by the production scale under the agreements and articles of an FIE. It is the sum of the registered capital and any anticipated additional debt of an FIE.
- [3] Under the Catalogue of Industries for Guiding Foreign Investment jointly issued by the National Development and Reform Commission ("NDRC") and MOFCOM (the most recent one came into effect on 1 December 2007), foreign investment projects in specific industries are classified into three categories: encouraged industries, restricted industries and prohibited industries. Any projects not included in the said Catalogue are deemed as permitted industries. Approval requirements on the projects usually depend on the total investment amount of the projects and the above-said classification of the projects.
- [4] Provincial MOFCOM include the administrative departments of commerce at the provinces, autonomous regions, municipalities directly under the central governments (直辖市), municipalities separately listed on the state plan (计划单列市), vice-provincial cities (see footnote 6) and Xinjiang Production and Construction Corps.
- [5] Although not clearly defined by laws, we understand overall national adjustment issues are involved in (i) foreign invested projects with substantial capital investment from the government and/or substantial commitment of China bank financing; (ii) foreign invested infrastructure projects, major industrial projects, electronics equipment and communications projects, aeronautical and astronautical projects or mining



projects that are of importance to the nation's economy and the people's livelihood and the 'distribution of productive forces'; (iii) foreign invested projects with substantial use of land, projects involving the substantial use of forestry land or projects that may highly consume fresh water resources or may destroy or pollute fresh water resources; and (iv) foreign-invested projects which require substantial import or export quotas or license. In practice, projects in these categories need to be approved by NDRC and MOFCOM.

- [6] Vice-provincial cities refer to Harbin, Changchun, Shenyang, Ji'nan, Nanjing, Hangzhou, Guangzhou, Wuhan, Chengdu and Xi'an.
- [7] The Regulations on Merger and Acquisition of Domestic Enterprises by Foreign Investor was promulgated by MOFCOM, the State-owned Assets Supervision and Administration Commission of the State Council, the State Administration of Taxation, the State Administration for Industry and Commerce, the China Securities Regulatory Commission, and the State Administration of Foreign Exchange on 8 August 2006 and effective as of 8 September 2006, which is commonly referred to as Circular 10.
- [8] According to the Handbook, if either the transaction amount or the total investment is at or above the Approval Threshold, the relevant M&A Transaction shall be approved by MOFCOM. Circular 7 and the Handbook also have different provisions on the thresholds for MOFCOM approval. Under the Handbook, projects with transaction amounts of USD100 million in encouraged and permitted industries or USD50 million in restricted industries shall be approved by MOFCOM; while under Circular 7, such projects shall be approved by Local MOFCOM. We understand that Circular 7 as officially promulgated by MOFCOM shall supersede the stipulation under the Handbook since the Handbook is not an official document issued to public, but an internal guide book used by local MOFCOM officials.
- [9] The Provisions for the Changes in Shareholder Interests in Foreign Invested Enterprises was issued by the Ministry of Foreign Trade and Economic Cooperation effective on 28 May 1997.
- [10] Under Clause 55 of the M&A Rules, acquisition of shareholders' equity interests in an FIE or capital increase of an FIE by foreign investors shall be governed by the existing laws, administrative regulations concerning FIEs, and the provisions concerning changes in the shareholding structure of FIEs while matters not covered therein shall be handled by reference to the M&A Rules. It used to be unclear exactly how matters would be handled by reference to the M&A Rules.
- [11] Under the Handbook, Regulated Industries (专项规定行业) include the following: *lease financing, telecommunications, *non-oil-gas mineral resources exploration (restricted category) and mining, *film production, *infrastructures (above the threshold), *international couriers, *wholly-owned shipping companies, aviation, *railway cargo transportation, *accounting firms, *travel agencies, *direct sales, *agent of performance for business, medical treatment, oil and gas (coal seam gas) mining, asset disposal, *auctions, *distribution of books, magazines, periodicals, audio-visual products and venture investment enterprises. The Handbook indicates that MOFCOM will further delegate the approval authority on those industries indicated by an "*".
- [12] Under the Handbook, Special Industries (特定产业) refer to industries for which the State Council and NDRC promulgated specific industry policies and development plans. Special Industries mainly include industries of automobile, steel, cement, electrolyzed aluminum, pulp and paper, shipbuilding, coal chemical processing, and oil processing, etc.
- [13] Under the Handbook, Macro-regulated Industries (宏观调控行业) mainly include industries of steel, cement, electrolyzed aluminum, shipbuilding and real estate.