

## China: Deregulation of the Foreign Direct Investment Regulatory Regime

***Changes would reduce costs and improve certainty and efficiency for many foreign-invested enterprises in China, and potentially spur further FDI.***

### Amendment

On September 3, 2016, the National People's Congress (NPC) adopted a Decision to amend the Wholly Foreign-owned Enterprise Law, the Chinese-foreign Equity Joint Venture Law, the Chinese-foreign Cooperative Venture Law and the Law on the Protection of Investment by Taiwanese Compatriots, replacing the current foreign direct investment (FDI) approval regime for a wide range of business sectors with a much simplified filing regime (Amendment). On the same day, the Ministry of Commerce issued a draft Interim Measures on the Filing of Establishment and Related Changes of Foreign Invested Enterprises (FIE Filing Measures), and invited comment submissions on the draft by September 22, 2016, after which the measures will be finalized and implemented on October 1, 2016.

These moves have come as no surprise as similar deregulation has already been rolled out on a trial basis in the Shanghai Pilot Free Trade Zone for more than two years (and in other subsequently established Free Trade Zones in Guangdong, Tianjin and Fujian for 15 months). The government had intended to roll out any successfully tested deregulation on a nationwide basis.

### Current regulatory regime

Currently, the establishment of a wholly foreign-owned enterprise, Chinese-foreign equity joint venture or Chinese-foreign cooperative venture (collectively, Foreign-Invested Enterprise or FIE) in a non-financial sector requires the approval of the Ministry of Commerce or its local counterparts (together, Commerce Authority) and the approved FIE's subsequent registration (*i.e.* formal establishment) with the local Administration for Industry and Commerce (AIC). For some of these FIEs, National Development and Reform Commission (NDRC) approval and/or another industry regulator's approval of the underlying industrial or infrastructure project of the proposed FIE, may also be required. For a Chinese-foreign cooperative venture (also known as contractual joint venture), any arrangement that allows the foreign party to recoup its equity investment on an accelerated basis, or the entrustment of the running of the cooperative venture to one of the joint venture parties or a third party, will also require Commerce Authority approval.

Once an FIE is established, any change in its name, legal address, total investment amount, equity capital, equity injection schedule, form of equity investment, shareholders and articles of association, any transfer of equity interest in the FIE and any merger, subdivision or liquidation of the FIE will require the prior approval of, at least, the Commerce Authority. Any amendment to or extension or termination of an

FIE's underlying joint venture contract, and any pledge of a wholly foreign-owned enterprise's assets, will likewise require such approval.

## **New regime**

Under the new regime, beginning October 1, 2016, government approval will no longer be required to establish FIEs that are not concerned with any of the Chinese government-imposed market access restrictions (each, a Deregulated FIE), or for such FIEs' abovementioned actions. Instead, the Deregulated FIE will be required to register its own establishment and certain changes thereafter with the AIC (which is procedural in nature), and file the event online with the designated Commerce Authority (Filing Authority) within 30 days after the event occurs. For an establishment, the investors have the option of filing even before the Deregulated FIE is registered with the AIC, as long as the proposed FIE name has been reserved with the AIC.

The Filing Authority is required to complete the filing process within three business days of receiving the application and all requisite and supporting information. Currently, the Commerce Authority is required to decide whether to approve or reject an application for FIE establishment, and for most changes to an established FIE, within 20 working days.

Joint venture contracts are apparently no longer required to be filed with, let alone approved by, the Commerce Authority.

## **Implications**

The Amendment and the draft FIE Filing Measures will greatly reduce the government's involvement in the establishment and subsequent reorganization of Deregulated FIEs, and will likely result in significant cost reduction and improvement in efficiency for Deregulated FIEs and their investors. Transaction and contract certainty will also improve as uncertainties over the availability of government approval and the approval's timing will no longer have to be factored into closing timetables. Additionally, there will no longer be a need for side agreements on joint venture arrangements, which the government considers not approvable, and which are potentially in conflict with approved contracts.

## **Outstanding issues**

### **Negative List**

While the implications of the Amendment and the proposed FIE Filing Measures are expected to be far-reaching, the Deregulated FIEs' scope has yet to be defined. The Chinese Government is working on a so-called, national "Negative List" that will set out the various types of business sectors and transactions for which market access requirements will apply. The Negative List will likely be modelled on the negative list currently in force in the four Free Trade Zones, with modifications based on the experience gained in those Zones as well as other wider considerations (such as the dynamics of similar negotiations under the proposed US-China Bilateral Investment Treaty). Once the Negative List is issued, Deregulated FIEs will mean those FIEs that are not concerned with any of the market access requirements set out in the list. Hence, the Amendment and FIE Filing Measures cannot be meaningfully implemented until the government issues the Negative List.

### **Role of NDRC**

Whether NDRC will retain a role in the establishment process of Deregulated FIEs that NDRC perceives as falling within its current jurisdiction is not entirely clear. NDRC may no longer play a role in the establishment process, but information on such FIEs that has been filed with the AIC and the Filing

Authority (or at least information relevant to NDRC's functions) may be instantly shared with NDRC to facilitate joint monitoring and supervision of the FIEs' activities. However, some of NDRC's existing authority over infrastructure, industrial and other projects will likely be retained, but may take the form of administrative permits that Deregulated FIEs will have to apply for after their establishment if they wish to implement such projects.

## **Foreign Investment Law**

The Amendment and proposed FIE Filing Measures will implement certain pressing changes required in the FDI arena, namely the need to streamline the role of the regulators during the establishment and life span of an FIE, in order to further the government's own reform as well as to inject fresh vitality into existing FIEs and spur FDI growth in China. The proposed Foreign Investment Law, which attracted widespread interest in the first half of 2015, involves a more fundamental redefinition of what constitutes foreign investment for regulatory purposes and, thus, a redefinition and expansion of the Ministry of Commerce's role. The law also resolves longstanding, complicated variable interest entity, or VIE, issues, which concern the fate and economic fortune of many important companies, both within China and abroad, as well as the jurisdictions of other industry regulators. Judging from the fact that the proposed law is not currently on the legislative timetable of the State Council, NPC and its Standing Committee for 2016, the new Foreign Investment Law will unlikely be adopted any time soon.

The draft FIE Filing Measures, however, calls for the filing of information on the ultimate actual controller of the FIE concerned, and of each investor in the FIE. The draft FIE Filing Measures is indicative of the government's intention (as reflected in the draft Foreign Investment Law) to redefine foreign investment based on the identity of the ultimate actual controller of the enterprise or asset in question, rather than the identity of the immediate investor in or owner of the enterprise or asset.

## **What remains unaffected?**

Importantly, the Amendment and draft FIE Filing Measures do not affect the current regime for obtaining clearance for anti-monopoly filings and national security filings, which will continue to apply to Deregulated FIEs.

Additionally, the current approval regimes for the following types of transactions will likely continue to apply to Deregulated FIEs:

- Foreign investors' acquisition of domestic enterprises
- Foreign investors' strategic investment in publicly listed companies
- Establishment of FIEs in which the equity a foreign investor contributes takes the form of the investor's equity interest in another Chinese enterprise

## **Conclusion**

For investors concerned with Deregulated FIEs, the age of freedom of contract is arriving. For those who are currently negotiating joint venture contracts or JV-related side agreements, this is worth bearing in mind. For those who have signed joint venture contracts and JV-related side agreements in the past, this may be a good time to review these signed contracts and assess what useful amendments can be made now or after October 1.

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