Update China Desk

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English Version

For whom the bell tolls – the end of the EJV, CJV and WFOE

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At the beginning of this year, China's Ministry of Commerce (MOFCOM) released a draft of its upcoming Foreign Investment Law (FIL) for public debate, which if implemented will overhaul the current foreign investment regime and with it the traditional foreign investment vehicles that have been the main mode of foreign investment in the last two decades – the equity joint venture, the cooperative joint venture, and the wholly foreign-owned enterprise.

The draft incorporates the approval regime that was first implemented in 2013 on a pilot basis in the Shanghai Free Trade Zone (FTZ). An investment's approval would therefore hinge upon its respective size and specific sector, which is determined by a so-called "negative list". [1] Pre-approval procedures and requirements would be relaxed in all sectors deemed non-"restricted" and reduced to mere filing procedures. Investments in "restricted" sectors would however still require a "market entry permit".

FTZ „Negative List"

MOFCOM released the most recent version of this negative list in April (MOFCOM FTZ negative list) which is applicable to all FTZ and further reduced the number of restricted sectors from formerly 139 to 122. Thus further opening the market and gradually moving towards national treatment of foreign investors. However sensitive sectors like the internet, e-

[1] Outside the FTZ foreign investments are categorized by the Foreign Investment Catalogue into „encouraged", „permitted", „restricted" and „prohibited", pending approval on a case by case basis.

commerce [2], banking e.g. still remain largely closed off to foreign investment.

Definition of FIE

The FIL breaks with existing FIE regulations by defining a Foreign Invested Enterprise (**FIE**) as a domestic enterprise established in China but controlled by a foreign investor, which also encompasses any type of control exerted by way of contractual or trust arrangements.

Under the current FIE Laws a "foreign investor" is defined as anyone or any entity incorporated outside of China irrespective of their source of capital or who they are controlled by. Should the FIL be passed into law then any acquisitions or incorporation by FIEs in China will be regarded as a foreign investment activity.

Impact on VIE structures

This would have a dramatic impact on the widely used Variable-Interest-Entity (VIE) structures. VIE are a means to facilitate the offshore financing of PRC companies doing business in "restricted" sectors. The foreign offshore entity controls the Chinese onshore company – whose equity is owned by Chinese nationals – via one or more WFOEs that have contractual agreements with the Chinese company, thus circumventing the said investment restrictions. The Chinese shareholders merely act as nominee shareholders within this structure.

While the Chinese authorities have tolerated the VIEs in the past, it remains uncertain how they will be affected should the proposed FIL come into effect. The draft is silent on this matter. Consequently it must be assumed that Chinese companies in a VIEs structure operating within "restricted" sectors would be deemed to be a FIE and thus violate against foreign investment restrictions, pending approval.

However MOFCOM issued an explanatory note in which it indicated that existing VIEs will not automatically be obsolete but rather open to review. This also depends on the scope of the future "negative list". Since China has gradually loosened its foreign investment restrictions in line with its accession to the World Trade Organization, there is room for optimism that sectors which now are barred from foreign investment will be opened up in the near future.

[2] Investment rules have been loosened since January 2015, lifting investment ratio restrictions in certain e-commerce sectors.

“Escape Valve”

In June 2015 the Ministry of Industry and Information Technology (MIIT) announced that it plans to implement a nationwide pilot program modeled after a program already implemented in the FTZ, allowing 100 % foreign ownership of e-commerce businesses (online data processing and transaction processing). This might be seen as an attempt to calm foreign investors and provide them with an “escape valve”.

Impact on corporate governance structures of EJV, CJV and WFOE

The FIL would not only affect the VIE structures but all current foreign investment vehicles, e.g. EJV, CJV and WFOE, as they would have to amend their constitutional documents to conform with the Company Law of the PRC which differs from the current FIE laws in corporate governance structures. The draft mandates a transition period of three years.

National Security Review

While the draft removes certain investment hurdles, it allows the authorities to scrutinize foreign investments more closely by implementing a “National Security Review” (NSR) system, which will be triggered if “the proposed foreign investment would have or possibly have national security concerns”. NSR decisions would be exempt from any administrative or judicial review, giving the Chinese authorities the power to block any proposed foreign investment or acquisition.

Furthermore the draft stipulates a reporting system, requiring FIEs to submit annual or quarterly reports, depending on the scope of the enterprise and report any changes to the investment project.

Conclusion

The FIL draft marks a first step in a major overhaul of the foreign investment regime. While it remains uncertain when and in which form it will be enacted into law, it is indicative of future developments. China incrementally moves towards a national treatment of foreign investments, while developing means to bar foreign investments in areas it deems sensitive (NSR and Anti-Monopoly Law). The removal of approval requirements in non-“restricted” sectors will ease foreign investment and is a welcome development. Yet the draft also leaves many questions unanswered, especially how current VIE structures will be affected and at what point a domestic enterprise becomes “controlled” by a foreign investor. These issues will be a matter of debate in the legislative process and hopefully be addressed in the final version.

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