

## Client Alert

September 2016

### China Further Liberalises Regime for Administration of Foreign-Invested Enterprises

On September 3, 2016, the Standing Committee of the National People's Congress passed the *Decision on the Amendment of Four Laws*<sup>1</sup> including the *Law of the People's Republic of China on Wholly Foreign Owned Enterprises* (the "**Decision**"), which amendment will become effective on October 1, 2016. Under the Decision, a recordal system ("**Recordal System**") for the establishment and administration of corporate changes of foreign-invested enterprises ("**FIEs**") in "*industries that are not subject to special administration measures for entry*" is now implemented on a nationwide basis.

On the same day, the Ministry of Commerce (the "**MOFCOM**") released a draft of the *Interim Measures for the Administration of the Recordal of the Establishment and Change of Foreign-Invested Enterprises* (the "**Draft Measures**") for public comment until September 22, 2016. Under the Draft Measures, which will come into effect from October 1, 2016, "*industries that are subject to special administration measures for entry*" are basically those which will be listed in a "negative list" for foreign investment (the "**Negative List**"), similar to the ones that have been adopted in the four pilot free trade zones ("**FTZs**") in Shanghai, Guangdong, Tianjin and Fujian.

The Decision and the Draft Measures represent China's attempts to further relax the regime for the administration of FIEs on a nationwide basis.

#### 1. Removal of Market-entry Approval; Promulgation of the New Negative List

The Draft Measures, once promulgated, means a nationwide launch of the Recordal System now in place in the FTZs. In the FTZs, only foreign investments in the restricted industries on the negative list are still subject to the decades-long examination and approval system by MOFCOM and/or its local counterparts.

At the same time, the Negative List is expected to be promulgated simultaneously with the official release of the Draft Measures. The Negative List will supersede the *Catalogue for Guiding Foreign Investment in*

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<sup>1</sup> The four laws are the *Law of the People's Republic of China on Sino-Foreign Equity Joint Venture*, the *Law of the People's Republic of China on Sino-foreign Cooperative Joint Venture*, the *Law of the People's Republic of China on Wholly Foreign Owned Enterprises* and the *Law of the People's Republic of China for Protection of Investments of Taiwan Compatriots*.

*Industries.* We expect that the Negative List will be similar to the negative lists for foreign investments that are currently being adopted in the FTZs.

## 2. Reporting and Recordal Regime

Under the Draft Measures, the provincial, sub-provincial and municipal branches of MOFCOM (or their equivalents in the FTZs) (“**Commerce Authority**”) will be responsible for administering the Recordal System.

### *(a) Formation of Newly Established FIEs*

Foreign investors may report and record the establishment of a FIE prior to the issuance of a business license to it. Alternatively, the FIE can file for such recordal with the Commerce Authority after the issuance of its business license. This seems to be a major change to the long-established two step approval and registration system for the establishment of FIEs. However, based on our current experience of establishment of FIEs in the FTZs, the local Administration for Industry and Commerce bureaus (“**AICs**”) likely will still insist on issuing the business license after the recordal with the Commerce Authority has been completed.

In China, domestic companies may become FIEs as a result of an acquisition by a foreign investor. Such acquisition is regulated by the Circular 10 - the *Regulations for the Acquisition of Domestic Enterprises by Foreign Investors*, which provides for the two step approval and registration system. Based on the provisions of the Draft Measures and the recordal form attached to it (which just addresses greenfield FIEs), it would seem that the simple Recordal System does not apply to FIEs that are established as a result of an acquisition. The acquisition of a domestic company by foreign investor would still be subject to the two step approval and registration system.

### *(b) Corporate Changes of FIEs*

Under the Draft Measures, a FIE is required to report to and record with the Commerce Authority any major change within 30 days after such change is made. Major changes include:

- change of basic company particulars such as name, registered address, type of enterprise, term, industry, type of business, business scope, registered capital, total investment, organisation, legal representative, ultimate controller;
- change of information of the shareholder;
- transfer and pledge of the FIE’s equity;
- merger, de-merger and termination;
- early recoupment of investment by a foreign investor of a Sino-foreign cooperative enterprise;
- pledge of assets of a wholly foreign-owned enterprise\*;
- entrustment management of a Sino-foreign cooperative enterprise\*.

*(\*these items are additional to those that currently apply to the Recordal System for FIEs in FTZs.)*

***(c) Effective Date of Corporate Changes***

The Draft Measures further state that the changes discussed in paragraph (b) above are deemed to occur when the highest authority of the FIE (*being the board of directors for Sino-foreign joint ventures and the shareholder for wholly foreign-owned enterprises*) passes the relevant resolution approving the change. In light of such change, we expect that for intra-group transactions, the recordal and registration of such changes likely will become post-closing matters, hence provide more certainty on the timing for these transactions. However, a prudent party to a transaction with third parties likely will still require, as conditions precedent to closing, evidence of the completion of the recordal with the Commerce Authority and registration with the AIC of the corporate changes.

***(d) Documentation and Procedures for the Recordal***

The entire recordal process will be completed online. The necessary paperwork for the recordal has been simplified to include a recordal form, the supporting documents, a letter of undertaking and the identity documents of the foreign shareholders and legal representative (only required in case of the change of shareholders or legal representative).

The Commerce Authority will only perform a cursory review of the documents to confirm their completeness and accuracy and that the relevant matter is registrable under the new Recordal System. The recordal will be completed within three business days after receipt of the full set of documents.

Based on our experience of implementing corporate changes of FIEs in the FTZs, in addition to the filing online, the officials still require the online forms to be printed, signed and then re-submitted. Furthermore, the officials could always request additional information and documents under the Draft Measures and thus defer the timeline. Therefore, the actual time for recordal in practice could be longer than expected.

The Recordal System and the simplified documentation requirement are premised on the assumption that a FIE, its shareholders and their representatives themselves will comply with the relevant corporate governance and articles of association of the FIE. While the legal representative of the FIE signing the undertaking could assume personal liability for any false declaration, the parties will need to have additional safeguards to ensure compliance with the relevant corporate governance.

A new feature required under the Recordal System is the disclosure of information relating to the “ultimate controller” of the FIE and the shareholder of the FIE. Ultimate controllers of an entity include the following:

- (i) persons that have more than 50% shares or voting rights in such entity;

- (ii) persons that have less than 50% shares or voting rights but have sufficient voting rights to significantly influence the resolutions of such entity; and
- (iii) persons that otherwise have significant influence on the operational, personnel, financial and technological matters of such entity.

This new disclosure requirement no doubt will increase the administrative burden on foreign investors. In certain cases, such as foreign investors which are private equity funds or listed companies, it may be difficult to identify who the “ultimate controller” is.

### 3. Supervision

The Commerce Authority may periodically conduct spot-checks against non-compliance with the Draft Measures. Findings of non-compliance can be shared with other government agencies and will be stored in MOFCOM’s database.

In the event of any non-compliance, the defaulting FIEs will be ordered to rectify, terminate the illegal operation, divest the equity/assets in question (in the case of the performance by the FIE of any business prohibited for foreign investment), and be subject to a fine capped at RMB30,000.

### 4. Legal and Practical Issues

#### *(a) Reconciliation with Other Laws and Regulations*

Given the Decision only amends certain sections of the FIEs laws, inconsistencies inevitably exist/arise between the Decision/Draft Measures and other foreign-investment laws that still need to be addressed. For example, the *Several Regulations Concerning Changes in Equity Interest of Investors in Foreign-Invested Enterprises* still require the transfer of equity in any FIE to be approved by MOFCOM and/or its local counterpart. Neither the Decision nor the Draft Measures clearly supersede these regulations.

Under the *Administrative Measures for the Record-filing of Foreign Investment in Pilot Free Trade Zones*, the effective date of changes involving the renewal of a FIE’s business license will be the date when the renewed business license is issued, not the date of the passing of the relevant resolutions.

We believe that the general trend of the Chinese government is to further liberalise the administration of FIEs. Nevertheless, in light of the volume of the laws/regulations containing conflicting provisions, we expect that it will take some time for government officials across the nation to uniformly implement the Draft Measures in practice and local variations are bound to exist in the short term.

#### *(b) Coordination between Government Agencies*

Coordination issues may arise between Commerce Authority and other government agencies regulating different operational matters of FIEs. Under the current foreign investment regulatory regime, government

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agencies such as the AIC, the State Administration of Foreign Exchange, and the State Administration of Taxation will only process respective registrations for the FIE after the proposed establishment/change of a FIE have been approved by MOFCOM and/or its local counterparts. In practice, we expect that these authorities will still require evidence of recordal before effecting the registrations notwithstanding the provisions of the Draft Measures.

It will require considerable efforts to amend existing regulations and/or for the various authorities to align their practices in order to ensure a smooth transition and the establishment of a truly simplified system for the establishment and corporate changes of FIEs.

## 5. Conclusion

Pending the promulgation of the Foreign Investment Law<sup>2</sup>, the Draft Measures is a significant step towards the further liberalisation of the administration of FIEs on a nationwide basis.

Foreign investors should review proposed transactions relating to their FIEs in China and assess whether changes to their transaction documents might be required under this new regime. They should also be prepared for the uncertainties in the local implementation of the new regime and accordingly budget sufficient time and resources.

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<sup>2</sup> See our client alert: [Draft Foreign Investment Law will overhaul regulation of foreign investment in China](#), February 2015

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