

## Reforming China's Legal Administration of Foreign Direct Investments

### *A Shift from the Substantial Review and Approval System to the Filing for Record System*

By Pillsbury's China Practice Group

*As of October 1, 2016, the current substantial examination and approval process required by the approval authorities (Approval Authorities, i.e., the Ministry of Commerce (MOFCOM) or its local counterparts) for the establishment and subsequent changes of foreign invested enterprises (FIEs) will be simplified to a filing system, as long as the FIEs in question are not engaged in industries included on the national Negative List. MOFCOM has also published the draft Interim Administrative Measures regarding Filing for Records of the Incorporations and Changes of Foreign Invested Enterprises (Record-filing Measures) for public comments by September 22, 2016, with the final version set to take effect on October 1, 2016. These legal changes will substantially lessen regulatory burdens on foreign investors and speed up the regulatory registration process for the establishment of FIEs in China.*

On September 3, 2016, the Standing Committee of the National People's Congress of the People's Republic of China (the PRC) adopted the Decision on Changing the Wholly Foreign-Owned Enterprise Law of the People's Republic of China and three other laws on foreign investment (the Decision).<sup>1</sup> This article outlines the current legal regime on the administration of foreign direct investment (FDI) in China, explains the shift from the substantial review and approval system to the record-filing system, details how the record-filing system will be implemented in China and offers our thoughts on the major issues to be

<sup>1</sup> In addition to the *PRC Wholly Foreign-Owned Enterprise Law* (WFOE Law) adopted by the NPC on April 12, 1986 and amended October 31, 2000, the other three laws amended by the Decision are: the *PRC Sino-Foreign Equity Joint Venture Law* (EJV Law) adopted by the NPC on July 1, 1979 and amended April 4, 1990 and March 15, 2001, the *PRC Sino-Foreign Cooperative Joint Venture Law* (CJV Law) adopted by the NPC on April 13, 1988 and amended October 31, 2000, and the *PRC Law on the Protection of Investment by Taiwan Compatriots* adopted by NPC Standing Committee on March 5, 1994.

further addressed for the implementation of the amendments to the four relevant laws as specified in the Decision and the final version of the Record-filing Measures.

## I. CURRENT LEGAL REGIME ON THE ADMINISTRATION OF FDI IN CHINA

In the decades since the beginning of the opening-up policy in 1979, China has developed a comprehensive set of laws and regulations to regulate foreign investments, among which, the WFOE Law, the EJV Law, the CJV Law and their respective implementing rules are the key legislation, together with the PRC Company Law. In addition, there are separate rules governing various aspects of foreign investment related issues, such as acquisitions by foreign investors of PRC domestic companies, equity changes in FIEs, mergers and splits of FIEs, and re-investment in mainland China by FIEs.

By publishing the *Foreign Investment Industrial Guidance Catalogue* (Guidance Catalogue) since 1995,<sup>2</sup> China classifies foreign investment activities into four categories: (i) Encouraged, (ii) Permitted, (iii) Restricted, and (iv) Prohibited.<sup>3</sup> Foreign investment in the first three categories is subject to substantial review and approval of the constitutional documents of the FIEs (such as joint venture contracts and articles of association) by the Approval Authorities before any foreign investor can register with the competent Administration for Industry and Commerce (AIC, i.e., the company registry in China) for the establishment of an FIE. Approval Authorities must approve the incorporation of FIEs and any subsequent changes to the FIEs.<sup>4</sup> Certain changes to any FIE (such as amendments to the constitutional documents, equity changes and transfer and increase or decrease of total investment and registered capital) are also subject to the review and approval by the Approval Authorities.

## II. A SHIFT FROM APPROVAL SYSTEM TO RECORD-FILING SYSTEM

Over the years, the approval system has faced criticisms mainly in the following aspects:

- The lengthy statutory timelines for the Approval Authorities to issue approvals, which vary from thirty to ninety business days, depending on the matters to be approved—even though, as a matter of fact, many Approval Authorities have improved their efficiency and may grant approvals within ten business days.
- The substantial review of FIEs' constitutional documents has raised concerns by FIEs and foreign investors that the Approval Authorities can interfere with their flexibility in doing business.

The Approval Authorities have been aware of the fast-changing environment for foreign investment in China and the demands of foreign investors and FIEs for more openness, transparency and efficiency. Thus they started trials to improve the current administrative regime for FDI. From October 2013, China started certain trial pilot programs in the Shanghai Free Trade Zone, Guangdong Free Trade Zone, Fujian Free Trade Zone and Tianjin Free Trade Zone (collectively, the FTZs). Under the trial pilot programs, foreign investment in the FTZs in areas which are not on the Negative List is no longer subject to the Approval Authorities' approval. Instead, a simple record-filing system was established.<sup>5</sup> MOFCOM now

<sup>2</sup> Amended in 1997, 2002, 2004, 2007, 2011 and 2015.

<sup>3</sup> As a matter of fact, the Guidance Catalogue only included three categories, i.e., (i) Encouraged, (ii) Restricted, and (iii) Prohibited. Any activities not included in the Guidance Catalog are deemed to be permitted.

<sup>4</sup> Such as changes of the registered capital and total investment amounts, registered address, business scope, director(s), supervisor(s), legal representative, equity transfer, amendment to the articles of association and joint venture contracts (for EJV and CJV), termination of FIEs, etc.

<sup>5</sup> Based on the trial experience of the FTZs, on April 8, 2015, MOFCOM published the *Administrative Measures regarding Record-filings for Foreign Investment in FTZs (Trial)* (Record-filing Measures for FTZs) and the General Office of the State

believes that the trial record-filing system, which has been successfully tested in those FTZs, is ready to be applied nationwide.

### III. THE RECORD-FILING SYSTEM

1. Scope of Filing. The incorporation and defined subsequent changes of FIEs which are not on the Negative List to be published are subject to record filings after the Decision abolishes the approval system for the same subject matters.

Investment companies, venture capital investment enterprises and equity investment enterprises with foreign investor ownership are considered to be foreign investors. The record-filing system will also apply to FIEs backed by those three types of investors.

2. Flexible Filing Timeline and Fast Record-Filing. For the incorporation of FIEs, record filings can be made either before the issuance of the business licenses by the AIC but after the FIEs obtain the AIC's name pre-approvals, or within thirty days after the issuance dates of the business licenses of the relevant FIEs. For corporate changes of FIEs, record filings must be made within thirty days after the relevant changes take place.<sup>6</sup> Article 6 of the Record-filing Measures clarifies that changes take place when the highest authority of any FIE passes relevant resolutions for the proposed changes.

The Approval Authorities will complete the record-filings within three business days if it confirms that the relevant filings fall within the scope of the record-filings as specified in the Record-filing Measures.

Approval Authorities will no longer issue approval letters or certificates of approval for matters which are subject to record-filings, and instead, will issue record-filing receipts to foreign investors or FIEs.

3. Efficient Online Filing and Simplified Documentation Requirements. The record-filing should be made through an on-line filing system only. Approval Authorities will not require filings of the constitutional documents of the FIEs (such as the articles of association or joint venture contracts), bank creditworthiness reference letter, feasibility study reports, lease agreements, board and shareholder resolutions, and appointment / removal letters of directors, supervisors and legal representative. However, some of the above will still be required to be submitted to the AIC for AIC registrations and issuance of the business license.

The Approval Authorities will require certain new information under the record-filing system, such as information regarding the ultimate controlling shareholders of FIEs and foreign investors,

■ Council published the *Special Administrative Measures (Negative List) on Foreign Investment Access to FTZs* (Negative List for FTZs), both of which took effect thirty days after being published.

<sup>6</sup> Article 6 provides for a defined scope of changes which are subject to the record-filing system. The changes include: (i) FIE's basic information, such as the company name, registered address, type of business vehicles (i.e. WFOE, EJV, CJV or companies limited by shares), operation term, investment industry, business scope, registered capital and total investment amounts, information about directors, supervisors, ultimate controlling shareholders, contact person, etc.; (ii) basic information regarding FIEs' investors, including company name, nationality (for individual investor) or place of registration (for corporate investor), amount of subscribed registered capital, methods and timeline for capital contribution, information regarding ultimate controlling shareholders of investors; (iii) changes of equity interest (for WFOE and EJV) or cooperative conditions (for CJV), including equity pledge; (iv) merger, split or termination; (v) mortgage or transfer of assets of FIEs. In addition, Article 6 also provides two additional CJV-related items which are subject to record-filings: accelerated recovery of investment by any foreign investor and entrusted operation and management of a CJV, which we believe should be very rare nowadays.

including name, place of registration / nationality, the certificate of incorporation / passport / ID card, etc.

4. Breach of Record-filing Measures. In the event of any breach of the Record-filing Measures, such as failure to make record-filings on time, providing false, misleading information, conducting activities listed in the Negative List without proper approval, etc., and if the relevant FIEs / foreign investors fail to rectify such breach within a certain period specified by the Approval Authorities, they may impose a fine ranging from one to three times the amount of illegal income, but the fine is capped at RMB 30,000.

#### IV. ISSUES TO BE CLARIFIED AND POSSIBLE FOLLOW UP DEVELOPMENTS

The shift from an approval system to a record-filing system symbolizes China's desire to create a simplified and efficient environment for foreign investment. To ensure the smooth implementation of the record-filing system, certain major issues need to be addressed as soon as practical.

1. Negative List. A nationwide Negative List must become effective simultaneously with the Record-filing Measures because it will define the scope of application of the Record-filing Measures.

As a reference, the current Negative List for FTZs is more or less a combination of the Restricted and Prohibited industries of the Guidance Catalogue plus certain additional items, such as takeover of domestic enterprises by foreign investors, strategic investment in listed companies by foreign investors, etc., which must be handled in compliance with current laws and regulations; *i.e.*, Approval Authorities' approvals are required.

We anticipate that the nationwide Negative List might be similar to the Negative List for the FTZs referred to above.

2. Guidance Catalogue. Many expect that the Guidance Catalogue will be abolished and be replaced by a nationwide Negative List. However, in the template filing forms attached to the draft Record-filing Measures, FIEs or foreign investors need to confirm whether or not their FIE is in the Encouraged industries or if it falls within the list of dominant industries of the mid-west region of China. Therefore, the Approval Authorities will need to define the Encouraged industries somewhere if the Guidance Catalogue is to be abolished.
3. Transition Period. The Approval Authorities need to address how to handle applications submitted before October 1, 2016 based on the approval system for matters which are subject to record filings based on the Record-filing Measures—will the Approval Authorities return the applications and request the applicants to make online record filings?
4. Takeover of Domestic Companies by Foreign Investors and Reinvestment by FIEs in China. In the Record-filing Measures for FTZs, it is provided that takeover of domestic enterprises by foreign investors, and reinvestment by FIEs in China are subject to the current rules, *i.e.*, Approval Authorities' approvals are required except for reinvestment by FIEs in Encouraged or Permitted industries. The Record-filing Measures are silent on this. We hope these issues will be addressed either in the final Record-filing Measures as a general principle or will be addressed in the Negative List.

5. Revising Outdated Regulations under the Approval System. Many regulations and rules previously published by the Approval Authorities and other governmental authorities need to be abolished or amended to eliminate the requirements for substantial review and approval by the Approval Authorities and to reflect the concept of the record-filing system.

## V. CONCLUSION

The Decision, Record-filing Measures and the nationwide Negative List, if fully implemented, will lessen substantially the regulatory burdens for the establishment and subsequent changes of FIEs engaging in activities which are not on the national Negative List.

These changes offer flexibility to foreign investors to determine the transaction documents and articles of association of FIEs, which are no longer required to be submitted to the Approval Authorities for review and approval. The elimination of examination and approval procedures will shorten the investment time.

Since the effective date of the Record-filing Measures will be October 1, 2016 and the time left for public comments is very short, we anticipate that no major revisions will be made to the final version of the Record-filing Measures. Nonetheless, we hope certain issues yet to be answered, as discussed above, will be addressed by the Approval Authorities. We also anticipate that the governmental authorities other than MOFCOM (such as the AICs, the National Development and Reform Commission and the State Administration for Foreign Exchange) may also change their respective administrative rules in the administration of FDI.

We will closely monitor the latest developments and keep you updated on any further changes.

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