

In steady pursuit

A series of new policies recently released to attract foreign investment demonstrates China's aim to diversify foreign direct investment, channel money into the central and western regions, and encourage environmentally-friendly and high-tech industries to set up onshore. However, the rules are fairly general and more legislation will be needed for proper implementation

On April 6 2010, the State Council of China issued the *Several Opinions of the State Council on Further Improving the Work of Utilising Foreign Investment (Guo Fa [2010] No.9)* (国务院关于进一步做好利用外资工作的若干意见) (the Opinion). The Opinion reiterated China's policy of attracting foreign investment and specified certain new policies in favor of foreign investment in China.

By the end of 2009, the Chinese government had already approved 683,000 foreign-invested enterprises, and the foreign direct investment amount had achieved US\$945.4 billion. The industrial production revenue, tax collections and export revenue generated by foreign-invested enterprises (FIEs) respectively

accounted for 28%, 22.7% and 55.9% of the total amount generated in the whole country in 2009. In addition, FIEs last year directly created 45 million job opportunities. FIEs without any doubt have become a crucial constituent of the Chinese economy. Meanwhile, the world-wide financial crisis has made the Chinese government further realize the pressure of transforming China's economic development modes and adjusting its economic structure.

Given this background, the Opinion was issued to reflect the wishes of the Chinese government to better utilise foreign investment in order to let the FIEs fully exert their positive influence on technology innovation, upgrading of industries and balancing regional developments. In order to attract the desired overseas

investment, the government also aims to further optimise the foreign investment environment by simplifying the approval process, providing equal opportunities to FIEs in terms of competition with Chinese domestic companies and rendering more policy support to FIEs.

According to the Opinion, the PRC government will further revise the *Foreign Investment Industrial Guidance Catalogue* (外商投资产业指导目录) (the Catalogue), further delegate approval authority for foreign-invested projects to local government authorities, further expand the channels for foreign capital utilisation, and improve the foreign investment regulatory system.

HIGHLIGHTS OF THE OPINION

Guidance on revision of the Catalogue

Since its issuance in 1995, the Catalogue has been amended four times, the most recent being in 2007. Pursuant to the Opinion, the Catalogue will be further updated in line with the national industrial restructuring and revitalisation plan and to reflect the policies of opening more fields to the outside world, to encourage foreign capital to invest in the high-end manufacturing industry, high-tech industry, modern service industry, new energy resources industry, and energy conservation and environmentally friendly industries, and to strictly restrict heavy energy-consuming, highly-polluting and resources-demanding projects and low-level expanded projects with an over-capacity of production.

Delegation of the approval authority for foreign-invested projects to the lower level of approval authorities and lifting the approval threshold of the central government

The Opinion has provided a concrete adjustment to the current allocation of the approving powers to echo the central gov-



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ernment's determination of simplifying approval procedures. According to the Opinion, projects falling within the encouraged or permitted categories under the Catalogue with a total investment amount (including the increased amount of capital, similarly hereafter) of less than US\$300 million will be approved by the local government authorities, except as otherwise required to be approved by the relevant departments of the State Council pursuant to the *Catalogue of Investment Projects to be Approved by the Government* (政府核准的投资项目目录) issued on July 16 2004 as an attachment to the *Decision of the State Council on Reforming the Investment System* (国务院关于投资体制改革的决

定). Compared to the previously implemented rules, the Opinion has significantly lifted the approval threshold of the central government from US\$100 million to US\$300 million. In addition, as provided by the Opinion, except as expressly provided by laws and regulations, the departments of the State Council shall have the right to delegate their approval authorities to their respective local counterparts, and the establishment of service industry FIEs (excluding finance and telecommunication businesses) shall be approved by local authorities.

Certain specific policies to attract foreign investments

The Opinion has provided a number of specific policies and measures to further attract foreign investments in certain industries and regions, including without limitation:

- (i) Land-use-intensive projects of encouraged industries will be provided with land use right in priority, and the land use right grant price offered to such projects could be as low as 70% of the minimum price set by the generally applied standard;
- (ii) Multinational corporations are encouraged to establish their regional headquarters, R&D centers, procurement centers, financial management centres, settlement centres, cost and profit accounting centres and any other functional institutions in China;
- (iii) The government will further improve the foreign exchange administration of FIEs and simplify the procedures of settlement of registered capital in foreign exchange;
- (iv) Foreign investors are encouraged to invest in labour-intensive industries that can meet the environmental protection requirements in the middle-western region of China, and the *Catalogue of Priority Industries for Foreign Investment in Central and Western China (2008)* (中西部地区外商投资优势产业目录) will be further revised accordingly. FIEs operating in the eastern area are encouraged to shift their operations to the middle-western region. Particularly, foreign-invested banks are encouraged to set up branches and launch their business in the middle-western region of China.

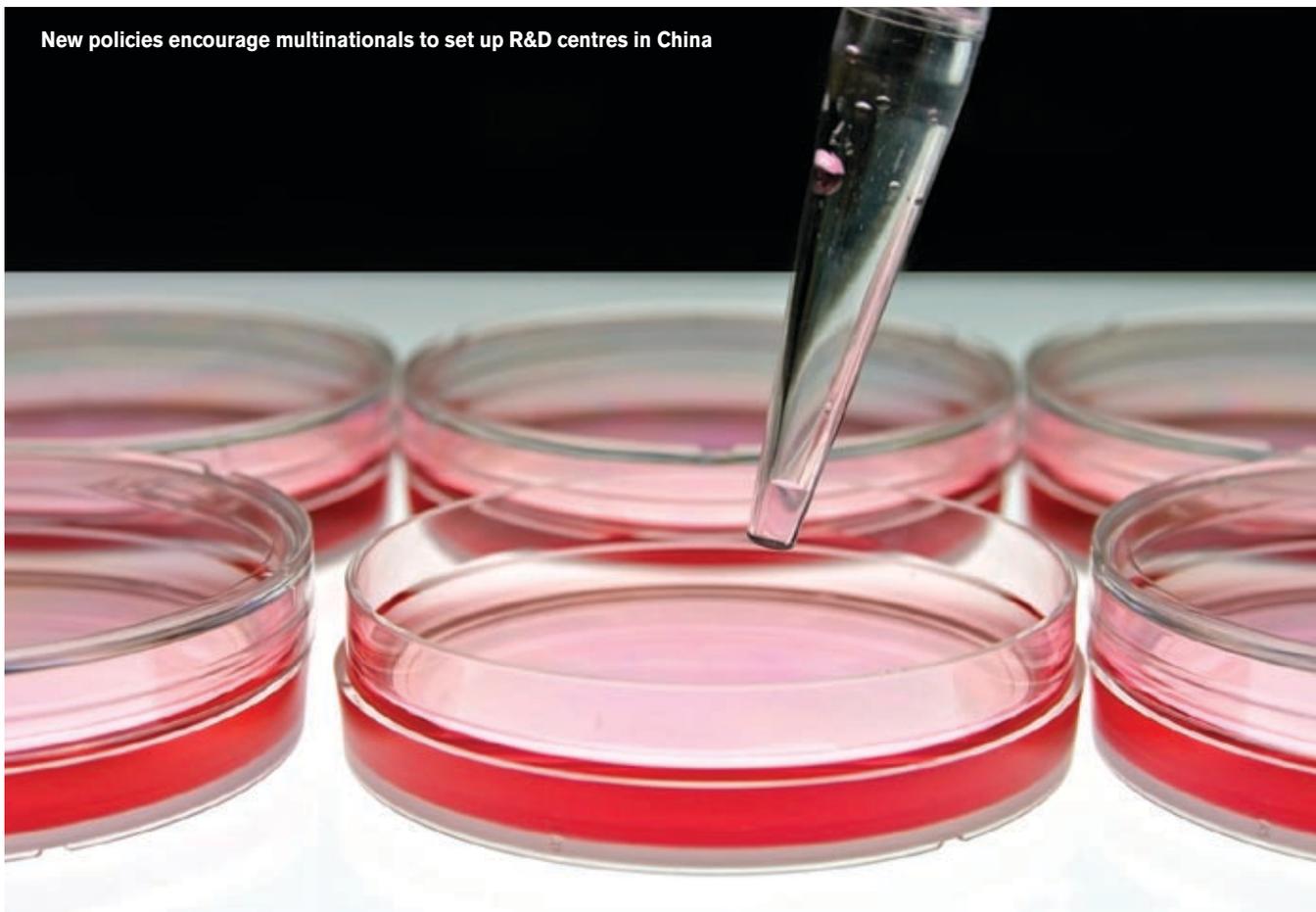
PRC government promotes diversification of utilising foreign capital

The Opinion has contributed an entire chapter to emphasise the encouragement of diversification of foreign capital utilisation, which to a certain degree has echoed the rapid development of the Chinese private equity industry in the past decade.

According to the Opinion, foreign investments are encouraged to establish venture capital enterprises, and private equity funds shall be actively utilised, while the relevant exit mechanism will be further improved. The Opinion brings support for A-share listed companies to take on domestic and foreign strategic investors, and it continues to support PRC enterprises to go for offshore listings subject to the national development strategies and their own development needs. In addition, qualified FIEs will be encouraged to list on the China domestic A-share market and issue corporate bonds and medium-terms notes.

In terms of cross-border mergers and acquisitions (M&As), the

New policies encourage multinationals to set up R&D centres in China



Opinion encourages foreign investment to participate in the reorganisation, merger and restructuring of domestic companies by way of, among others, equity transaction and M&A. In the meantime, the Opinion indicates the implementation of an anti-trust review and the need to speed up the establishment of a national security review system for foreign capital involving M&A.

NDRC Notice

Following in the direction of the State Council to attract foreign capital in a desired manner, the National Development and Reform Commission (NDRC) issued the *Notice Regarding the Delegation of Approval Authority for Foreign-Invested Projects* (国家发展改革委关于做好外商投资项目下放核准权限工作的通知) (NDRC notice) on May 4 2010. This notice delegates approval authority for foreign-invested projects with an investment amount of less than US\$300 million to provincial level authorities. Previously, the threshold triggering central NDRC approval was US\$100 million.

The NDRC is responsible for approving foreign investment projects involving fixed assets in various sectors. Historically the NDRC is vested with great discretionary power in reviewing proposed foreign investments from a macro-economic balance and safeguarding of the public interest perspective. The NDRC Notice also provides that the local counterparts of the NDRC shall further simplify the approval procedures, shorten the approval timeline and increase the transparency of the approval process.

SAIC Circular

On May 7 2010, the State Administration of Industry and Commerce (SAIC) promulgated the *Circular on Improving the Work for Serving the Development of Foreign-Invested Enterprises* (国家工商行政管理总局关于充分发挥工商行政管理职能作用进一步做好服务外商投资企业发展工作的若干意见) (SAIC Circular).

The SAIC Circular confirmed certain key policies provided in the Opinion, such as encouraging foreign investors to establish regional headquarters, R&D centres, procurement centres, finance management centres and accounting centres in China, and encouraging foreign investors to increase their investment in the middle and western regions of China. The SAIC Circular additionally emphasises the principles of widening the channel for diversified methods of foreign capital contribution and shows its encouragement of establishing foreign-invested partnership enterprises.

Particularly, the SAIC Circular, within the powers and functions of the SAIC, has offered certain detailed policies at the operational level.

i. Encouragement for the establishment of group companies

The SAIC Circular expressly encourages the conglomerate-encouraging management of FIEs in light of the rapid inflow of foreign capital and onshore expansion of existing FIEs. Foreign-invested holding companies are encouraged to take the lead in setting up

group companies. PRC parent companies of the to-be-established group companies are permitted to use “Group” or “(Group)” in their corporate names and their subsidiaries are permitted to adopt the name or abbreviation of the name of the group companies in their own corporate names.

ii. Support for debt-equity conversion as a form of capital contribution to FIEs

The SAIC Circular states that the conversion of creditor’s right of the shareholders of FIEs into registered capital will be positively supported, and the corresponding administrative measures will be actively explored for such purpose. Previously, as a matter of practice, it is not uncommon to see debt-equity conversion in domestic company restructuring, especially in the reformation of those traditional state-owned enterprises. In the case of FIEs, their foreign shareholders usually extend shareholders’ loans to such FIEs as a way to inject working capital, which, however, cannot be directly converted into equity investment in the FIEs due to various regulatory hurdles. Now the SAIC Circular has clearly acknowledged that debt-equity conversion as a method of capital contribution to FIEs will be endorsed.

iii. Encouragement of foreign investment in modern service and high-tech industries

Foreign investors are welcomed to invest in the modern service and high-tech industries in China. Previously, if an FIE desired to use “China” in its corporate name, its registered capital had to be no less than Rmb50 million. Now, the SAIC Circular lowers the threshold to Rmb30 million, provided that (i) the FIE shall carry out modern service business or high-tech business; and (ii) the majority of the equity interest of such FIE is held by foreign investors.

Mofcom Notice

The Ministry of Commerce (Mofcom), the watchdog overseeing the foreign investment sector in China, issued the *Notice Regarding the Delegation of Approval Authority for Foreign Investment* (商务部关于下放外商投资审批权限有关问题的通知) (the Mofcom Notice) on June 10 2010 to give clarification on the Opinion relating to its function. The key points of the Mofcom Notice are as follows:

i. Local authority in charge of foreign investment is delegated with broader approval power

To reflect the principle of the Opinion, the Mofcom Notice expressly provides that foreign-invested projects of the encouraged or permitted industries with a total investment amount (including the increased amount of capital, similarly hereafter) of less than US\$300 million (the Threshold) now can be approved by local counterparts of Mofcom. For foreign-invested projects that fall within the encouraged category with an investment amount beyond the Threshold, so long as there is no need for national comprehensive balance, the approving power is also with the local level. However, FIEs in the highly regulated finance and telecommunication sectors are still subject to the existing examination and approval system.

ii. Deregulation of approval on foreign-invested holding companies, foreign-invested venture capital enterprises and foreign-invested venture capital management enterprises

For foreign holding companies with a registered capital below US\$300 million, foreign invested venture capital enterprises (the FIVCEs) and foreign-invested venture capital management companies with total capital of less than US\$300 million, the approval power with regard to their establishment and change is now vested to local branches of Mofcom.

Prior to the newly introduced form of the foreign-invested partnership enterprise, FIVCEs in the form of a non-legal person cooperative joint venture enterprise was a prevailing form employed by various market-leading foreign private equity firms to structure their onshore Rmb funds. However, ever since the form of the foreign-invested partnership enterprise was available for fund formation in China, FIVCEs have generally lost their

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popularity in the market due to certain systematic hurdles under the mechanism regulating the FIVCEs. With the delegation of more approval power for the FIVCEs to the local Mofcom level, it still remains questionable whether the form of a FIVCE will thus become more attractive for the formation of onshore Rmb funds since those systematic hurdles will not be eliminated merely because of the approval level change. By comparison, the limited partnership enterprise, as an internationally-recognised form employed by private equity and venture capital investors, may appear to be more attractive in offering tax pass-through treatment with regards to enterprise income tax and flexibility in determining the allocation of rights and obligations, risks, and profits among the partners. In addition, the approval process applied for limited partnership enterprises are also less complicated.

iii. Determination of thresholds and legal implications

Pursuant to the Mofcom Notice, the Threshold shall be determined on the following basis: for foreign-invested joint stock company, the Threshold shall be calculated based on the registered capital, and for those foreign-invested joint stock companies transformed from normal FIEs, the Threshold shall be calculated based on the appraised net asset value. In the case of foreign M&As of domestic enterprises (the Foreign M&A), the Threshold shall be determined based on the total transaction amount. The Threshold with regard to Foreign M&A may have some practical legal implications for foreign investors structuring and executing Foreign M&A deals. In practice, there have been increasingly more and more Foreign M&As in the form of capital increase with premiums being paid by foreign investors, which are particularly popular for private equity investment deals. Under such transactions, only a portion of the purchase price becomes registered capital of the invested company,

which will be reversely calculated into a total investment, and the balance of the purchase price is invested as capital reserve. With the Mofcom Notice in place, for such capital increase deals, when determining the level of governmental approval, the total transaction amount instead of the total amount of investment will be taken into consideration.

Practical implications and conclusions

The Opinion, together with the implementing rules issued by Mofcom, the NDRC and the SAIC as introduced above, is anticipated to further attract foreign investors to invest in China and play a more important role in the Chinese market.

The most remarkable change made is probably to raise the total investment threshold for triggering approvals by central government authorities with respect to “encouraged” and “permitted” foreign invested projects. The approvals by local-level authorities may suggest a less complicated and less time-consuming approval process, as well as more flexibility when putting more creative investment terms in the transaction documents. The latter may happen because local authorities generally render more tolerance and understanding for creative transaction terms, particularly for



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equity financing types of deals. Although there is a clear indication of approval process and procedure simplification for most foreign investment projects, the central government’s control on sensitive industries may not be lifted in the near future. In these areas, more regulatory mechanisms may be introduced and implemented in a more stringent way. Firstly, although the central approval threshold for “encouraged” and “permitted” industries are significantly raised, the corresponding threshold for “restricted” industries remains unchanged. Secondly, the Opinion indicates the implementation of an anti-trust review and the need to speed up the establishment of national security review system for foreign capital involving M&A. These suggest that the regulatory control will be more focused on certain sensitive industries and their implications on the overall economy of the country.

The central government’s determination of better utilising foreign investment to facilitate China’s industrial upgrading and restructuring is fully indicated in the series of regulations. Certain key industries the Chinese government is keen to develop, such as the service outsourcing businesses, are specifically named in a paragraph in the Opinion. The Catalogue will be updated to reflect such policies, and certain preferential treatments shall be further introduced to show government support to foreign investment in the encouraged industries. In this regard, the Opinion specifically mentions that priority may be given to FIEs engaging in encouraged industries in terms of land use granting and favourable land

price may be offered accordingly. Besides, the SAIC Circular, within the SAIC’s authority, has offered some detailed benefits to encouraged industries such as lowering the investment threshold for FIEs engaging in the modern service industry and the high-tech industry to use “China” in their names. However, generally speaking, the Opinion and the relevant rules issued so far only provide basic principles for attracting foreign investment in the desired industries without deploying much detail. Follow-up rules still need to be further issued by various government authorities that may have the capacity to render preferential policies (for example, the tax authority or the land resources department) based on the spirit set by the Opinion.

The Opinion, together with the relevant rules also makes efforts to offer equal opportunities to FIEs in terms of their competition with pure Chinese domestic companies. In this regard, some measures have already been materialised. For example, the set-up of group companies by foreign-invested holding companies previously were only afforded to domestic group companies to enhance their competitiveness in domestic and international markets. With the extended application scope of this benefit to FIEs, it is anticipated that more and more mature onshore FIEs, especially those

holding companies, will leverage this new benefit to further enhance their brand recognition in the Chinese market. Allowing foreign investors to convert creditor’s rights into equity is also introduced by the SAIC Circular. This will bring in more flexibility when foreign investors contemplate their capital investment structures in China. However, further legislation efforts have to be made in order to bring such benefits into reality, including further

coordination among the various regulatory authorities.

Notably, the Opinion has emphasised the need to diversify the means of utilising foreign capital. Most of the principles set out under this topic relate to the encouragement of foreign investment in engaging in the capital markets of China and the utilisation of foreign capital markets. Particularly, the Opinion supports A-share listed companies’ acceptance of foreign strategic investors, and qualified foreign-invested enterprises will be encouraged to list on the China domestic A-share market. Currently, the legal regimes governing offshore strategic investors’ investment in Chinese listed companies and the listing of FIEs on the Chinese stock exchanges both have imposed certain restrictions on the transfer of shares by the investors, which are more stringent compared with those rules applied to investors of pure Chinese domestic companies. It still remains unclear whether such restrictions and any other hurdles may be further lifted by the competent authorities in charge to encourage the transactions in these fields.

Therefore, it still remains to be seen, how and to what extent, the general principles set out under the Opinion and the corresponding rules will be translated into practice. It is expected that further legislative efforts will have to be made by the various government authorities in order to fully realise the spirit set by the Opinion.

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