INVESTING IN CHINA
- NEW CHALLENGES, PROBLEMS AND ISSUES
- (Written by Mary Zhu under the editorial supervision of Adriana Morrison)

REGULATORY REGIME FOR FOREIGN INVESTMENT

Economic Overview

Foreign Direct Investment ("**FDI**") into China declined in 2012 due to the slowdown in global economic growth, persistent European debt crisis and rising labour costs at home.

Statistics published by the Ministry of Commerce of the People's Republic of China ("**MOFCOM**")[1] indicate that, in 2012, FDI inflows fell 3.7 percent to US$ 111.7 billion. The number of newly approved foreign-invested enterprises ("**FIE**") amounted to 24,925, down by 10.06 percent from 2011.

Despite these statistics, international investors continue to regard China as economically-competitive and remain committed to the Chinese market. For example, the American Chamber of Commerce in South China published a study[2] reporting that approximately 90 percent of the participants were satisfied with the overall business environment in China. Participants also reported a more than 40 percent increase in 3-year investment budgets over last year's results. An investigation by the Europe Union Chamber of Commerce in China[3] indicated that 86 percent of European companies are considering further expansions to their current operations in China.

Impact of WTO Membership

China joined the World Trade Organisation ("**WTO**") in 2001, and committed to open and liberalize its regime and offer a more predictable environment for foreign investment.[4]

It remains difficult for foreign investors to expand into certain industries in China. However, China has been credited with opening a portion of its market to foreign investors over the decade since joining the WTO. The MOFCOM data indicates an increase by 35.2 percent in FDI inflows between 2007 and 2012[5].

---

[1] MOFCOM, "Statistics of FDI in January-December 2012", released 23 January 2013, available in Chinese and English (accessed 25 August 2013).
[2] See the 2013 "*White Paper" on the Business Environment in China* (accessed 17 August 2013).
[3] *Business Confidence Survey 2013* (accessed 17 August 2013).
[4] Press release, "WTO successfully concludes negotiations on China's entry", 17 September 2001.
[5] Compare 2012 figures at note 1 with 2007 figures available at MOFCOM, 'Statistics of FDI in January-December

The focus of foreign investment into China has been shifting from the labor-intensive, manufacturing sector to high value-added industries.

Catalogue for the Guidance of Foreign Investment Industries

It is a central policy of the Chinese government that foreign investment into China complies with government guidelines. One such guideline is the Catalogue for the Guidance of Foreign Investment Industries (the "**Catalogue**").

The Catalogue categorizes industries into those that are encouraged, permitted, restricted or prohibited for foreign investment. The first version of the Catalogue was issued in 1995 and it is revised periodically to keep pace with changing economic policy. The latest version was issued in 2012 and is the fifth revision, replacing the 2007 version upon coming into effect as of 30 January 2012.

The 2012 version of the Catalogue continues the trend towards opening up the economy, consistent with China's WTO commitments. For example, more items were added to the encouraged category, while several items were removed from the prohibited and restricted categories. While sole foreign shareholding is not permitted, the required minimum Chinese shareholding was reduced for several items.

The changes in the 2012 version of the Catalogue reflect the Chinese government's intentions for foreign investment. China is aiming to upgrade the types of foreign investments made in China by creating incentives for investments to shift from low value-added, high-pollution industries to high value-added, technologically-advanced industries, and expects foreign investment support this by providing access to modern, advanced technologies.

Regulatory Authorities

Foreign investment is regulated by a number of statutorily-designated authorities in China. The MOFCOM is responsible for formulating policy on FDI and approving applications to establish FIEs.

The State Administration for Industry and Commerce ("**SAIC**") and its local counterparts are the registration and licensing authority. This agency is responsible for registering and regulating FIEs.

Other regulatory authorities include tax bureaus, financial bureaus, the State

2007", 21 January 2008 (accessed 17 August 2013).

Administration of Foreign Exchange and the General Administration of Customs.

INVESTMENT VEHICLES

Types of Investment Vehicles

International investors have a number of investment vehicles for FDI into China, including setting up of subsidiaries, branches or representative offices of foreign companies. Subsidiaries are commonly set up as a wholly foreign-owned enterprise ("**WFOE**") or a Sino-foreign joint venture ("**JV**"). Other vehicles include cooperative businesses, joint exploitations and foreign-funded shareholding companies.[6]

Capital Contributions

The PRC *Company Law* that came into force on 1 January 2006 lowered the transaction costs associated with incorporating a FIE in China.

All companies incorporated under PRC law, including FIEs, must have a minimum amount of registered capital. Registered capital is the total capital contribution of all the investors that is registered with the SAIC. Limited liability companies ("**LLC**") such as WFOEs and JVs have a minimum registered capital requirement of RMB 30,000 for a multiple-shareholder LLC and RMB 100,000 for a single-shareholder LLC. However, the minimum registered capital investment required may be higher in certain circumstances. For example, the establishment of a freight forwarding agent enterprise requires minimum registered capital of RMB 5 million.

Registered capital can be paid in installments. The initial contribution must not be less than 20% of the total registered capital amount and must be made within 3 months of the issuance of a business license. The balance can be paid within 2 years.

FIEs must also have an approved amount of "total investment". Total investment is the total amount required to establish the planned project and achieve its intended scale of production as set out in the joint venture contract or articles of association of the FIE. The PRC authorities set a minimum ratio of registered capital to total investment for FIEs. Total investment is not subject to contribution time limits or supervision.

Wholly Foreign Owned Enterprises vs. Joint Ventures

[6] See MOFCOM, "Overview of FDI in China", 14 June 2004.

A WFOE is an LLC entirely owned by foreign shareholders. Such shareholders can be foreign individuals, enterprises or other forms of economic entities and have total control within the limits of PRC laws. A WFOE is a subsidiary, but not a branch, of a foreign enterprise. The Catalogue and other PRC regulations set out in which industries a WFOE structure is permitted.

A JV involves both foreign and domestic investment. A JV vehicle is often used in industries in which a WFOE structure is not permitted. The Catalogue sets out the industries in which a Chinese partner is required for foreign investors. A JV may also be the preferred vehicle for foreign investors who are new to the Chinese market or who lack sufficient capital.

EJVs vs. CJVs

JVs can be further categorized as Sino-foreign equity joint ventures ("**EJV**") and Sino-foreign contractual joint ventures ("**CJV**").

Foreign and Chinese parties can set up an EJV under the *Law of the PRC on Sino-Foreign Equity Joint Ventures* and its implementing rules. The foreign shareholder's investment contribution must be at least 25 percent of the total registered capital of an EJV. The foreign and Chinese parties to the venture share the profits and bear the risks and losses in proportion to their respective contribution to the registered capital of the EJV.

The establishment and operation of CJVs falls under the regulatory scheme of the *Law of the PRC on Sino-Foreign Contractual Joint Ventures* and its implementing rules. Parties to a CJV can decide how to allocate profits and losses, and such allocation does not have to be in proportion to their capital contributions and can change over the life of the CJV.

MERGERS AND ACQUISITIONS

Acquisition Structures

Mergers and acquisitions ("**M&A**") involving foreign investment in China are regulated by the *Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* ("**Order No. 10**"). Order No. 10 sets out the procedure for foreign investment in domestic companies, which can be done through an asset acquisition or an equity acquisition.

In an asset acquisition, the foreign investor establishes an FIE and, through the FIE, purchases an asset of a domestic company and operates that asset.

Alternatively, the foreign investor can purchase an asset of a domestic company and establish, with such asset as the registered capital, an FIE to operate the asset.

In an equity acquisition, the foreign investor purchases an equity interest of an existing shareholder of a domestic Chinese company or subscribes to increased capital of a domestic company, thus converting the domestic company to an FIE.

M&A involving foreign investment must be in compliance with the Catalogue in the following ways:

- In an industry where foreign investors cannot be sole shareholders, the M&A cannot result in 100 percent foreign shareholding of the target company.

- In an industry that requires the Chinese party to be the majority or controlling shareholder after the M&A, the Chinese party must remain in control of the target company.

- In an industry restricted to foreign investment, no M&A resulting in foreign shareholdings is permitted.

In addition, all M&A must adhere to other requirements including industrial policy, land use policy, environmental protection policy, fair completion and regulations on state-owned assets transfer (if applicable).

Due Diligence

It is advisable for foreign investors considering entering into an M&A transaction in China to conduct their own due diligence and use publicly available information to make decisions concerning investment location, control and risk management. The foreign investor should consider factors including governance arrangements and compliance, the strength of the company's professional management, financing arrangements, the sector and market context, and the company's track record with partners.[7] Foreign investors should be cognizant of potential transparency and misrepresentation issues when collecting information about Chinese companies.

Procedure

An application for an asset or share acquisition must be submitted to the MOFCOM for approval. The application is to include the following:

---

[7] David Cogman, "Due diligence in China: Art, science, and self-defense" *McKinsey Quarterly,* July 2013.

- Resolution regarding consent to sale of the assets or shares;
- Articles of association of the FIE (for an asset acquisition);
- Share transfer agreement or asset purchase agreement;
- Certification of the notice or announcement of the domestic enterprise to the creditors and description on whether or not the creditors have submitted any objection;
- Notarized and legalized identity certification or registration certification of the foreign investors;
- Employee arrangement plan for the domestic company; and
- Assets/shares evaluation report

The MOFCOM has 30 days to determine whether to approve the application. Upon an approval, the acquisition must be registered with the SAIC within 30 days. Registration procedures must then be carried out with taxation, customs, and other authorities.

Practically, an asset acquisition will be more time-consuming than an equity acquisition, because a new FIE must be established either ahead of or subsequent to the purchase of assets.

Post-Acquisition Management

Completion of an M&A transaction is only the first step of an acquisition strategy. Post-acquisition management is a significant challenge and may result in additional complications when foreign investors are involved. It is prudent to plan the integration of corporate culture, human resources management, brand management, and financial management, among other things, prior to engaging in the foreign investment transaction.