MAARTEN ROOS & ROGIER VAN BIJNEN

CORPORATE ACQUISITIONS AND MERGERS IN CHINA

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the decision to open many service sectors to foreign companies and allow foreig
invested companies to engage directly in international trade and domestic distr
bution. In 2008, China's tax laws stopped favouring foreign investment, b
China's top-notch infrastructure, the improving legal and administrative enviro
ments and the gradual build-up of its domestic market more than made up for th

[05] In recent years, some observers have seen China's development lose some
its shine. Indeed, it is becoming increasingly difficult for China to continue th
ferocious pace of development that it has kept up for so long, especially as domest
consumption and services are relied upon to bring the economy to the next leve
Problems such as income disparities, pollution, higher costs and corruption ar
becoming more obviously intrusive in a country of which many parts can now b
regarded as distinctly middle-income.

[06] Moreover, China's position in the world is also changing. The Western worl
is increasingly concerned about China's development, focusing on China's eco
nomic policies, the way it treats foreign businesses and the perceived slow pace o
market opening. The trade war that the United States started in July 2018 with tar
iffs on Chinese goods for alleged unfair trade practices continues to date. Pressur
from the United States and Europe could result in improvements to China's legal
environment, but there is also risk of a backlash against foreign companies operat
ing in China.

[07] In any case, the country's leaders are actively taking steps to respond and dea
with these challenges, while at the same time keeping a tight rein on politics. Pes
simists have been predicting the demise of the Chinese economic miracle for
decades, but so far China remains a very promising place for foreign companies to
take their business.

1.3 Trends in M&A

[08] While most foreign investors continue to invest in China through traditional
greenfield investment structures, the use of mergers and acquisitions (M&A) has in
recent years become an increasingly popular means to expand into China, not only
with large multinationals but also with mid-sized transnational companies and
even small- to medium-sized foreign businesses. Several developments have con-
tributed to this trend.

[09] First, China's fast-pace development is creating an increasingly competitive
economic environment, in which M&A presents a valuable channel to gain a head
start. Many foreign investors no longer have the time and patience to gradually
build their operations in China but instead opt for gaining market access, enlarg-
ing the customer base and/or taking on production capacity immediately.

[10] Second, many foreign investors choose an acquisition to take advantage of
opportunities resulting from domestic trends. Some years ago, for instance, the
privatization of State-Owned Enterprises (SOEs) and the sell-off of state-owned
assets increased the number of potential acquisition targets available to foreign

investors. At present, consolidations may be driven in part by efforts of industry
players to restructure and modernize the industrial landscape at the encourage-
ment of the government, creating new opportunities for foreign investors that have
sufficient capital and technical know-how to purchase a valuable position in the
market. The increasing importance of enhancing productivity through technical
applications, as opposed to the simple accumulation of resources, plays an impor-
tant role as well – especially considering the ever-increasing costs of labour and
other resources.

[11] A third explanation for increased inbound M&A activity is the gradual shift in
focus of foreign investors from manufacturing for their home markets to serving
the China market. Parts of China have already progressed from low-income to
middle-income, especially in first- and second-tier cities in the eastern parts of the
country. Recognizing this progress, metropolitan areas, such as the Yangtze River
Delta (around Shanghai), the Pearl River Delta (in southern China) and the area
around Beijing, form attractive markets for a wide array of products and services.
Establishing distribution networks, however, is expensive and time-consuming,
while manufacturing for and marketing to Chinese businesses and consumers
require knowledge of local preferences and customs. Acquiring an existing com-
pany can be a valuable stepping stone to procuring the knowledge and contacts
necessary to expand quickly into the Chinese market.

[12] *Finally*, there is no doubt that acquisitions by foreign investors have also
become increasingly practical. Regulators have done much to improve the regula-
tory framework for cross-border M&A activity, and acquisitions have become much
more straightforward to initiate and implement. Meanwhile, improvements in cor-
porate governance are leading to greater transparency in local companies and a
better understanding of Chinese business culture and the adoption of international
management practices have made the integration of a domestic company into a
global group less daunting. Although there are still plenty of hurdles, the combina-
tion of these developments has expanded the opportunity for investors to reap the
full benefits of a merger or acquisition.

[13] At the same time, some characteristic challenges remain. Besides legal restric-
tions and approval procedures that remain more complicated than in many other
jurisdictions, dealing with Chinese target companies often requires a lot of atten-
tion. Many Chinese businesses are organized in ways that are difficult for potential
foreign buyers to comprehend, and decision-making within such companies is
often far from transparent. Many private companies have grown up in a legal envi-
ronment that was (and to a certain extent, still is) not fully developed, which can
create risks that – at least on paper – are difficult to accept by foreign companies
that are used to doing business in a more mature legal environment. In other
words, suitable acquisition targets can be difficult to find, and for the good ones,
there may be more than one suitor. China's continued attractiveness as a growth
market gives the most bargaining power to sellers that are operating in accordance
with international standards.

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1.4 Structure of This Publication

[14] In Chapter 2 'Restrictions on Foreign Investment', we will discuss which restrictions foreign investors face when investing in China. This includes special regulations that apply to particular industries in which foreign investment remains prohibited or restricted, the need for special legal entities in other cases, licensing requirements for certain industries, requirements for approval or record-filing for foreign investments, additional restrictions for listed companies and foreign exchange controls. We will also discuss how restrictions have been gradually lifted by testing new policies first in free-trade zones, after which these are rolled out nationwide, and how the new *Foreign Investment Law*, adopted in March 2019 and to take effect on 1 January 2020, is providing for further liberalization, equality and protection. Finally, we set out some of the restrictions Chinese investors face when making outbound investments.

[15] Chapter 3 'Business Vehicles' is about the legal entities available to foreign investors in China. For now, when a foreign investor invests in a new or existing Chinese legal entity, the entity gets a special name and status: Foreign-Invested Enterprise (FIE). However, when the *Foreign Investment Law* takes effect in 2020, foreign investors will have to incorporate regular PRC business vehicles that are subject to the provisions of the *Company Law*. Furthermore, the general rules of the *Company Law* also apply to FIEs, unless specific FIE legislation states otherwise. We will, therefore, start Chapter 3 'Business Vehicles' by providing a basic overview of the PRC corporate legal framework under the *Company Law*. Thereafter, we will discuss each of the different kinds of FIEs available to foreign investors and the relevant establishment procedures and restrictions on capitalizing and financing FIEs. We will also discuss a few corporate forms available to foreign investors that are generally not considered FIEs.

[16] In Chapter 4 'Mergers & Acquisitions', various types of private M&A by a foreign investor will be discussed: the acquisition of an entire domestic-owned company, the partial acquisition of a domestic-owned company, the acquisition of an FIE, an investment by an FIE in a domestic-owned company, an offshore transaction, a subscription for newly issued equity, a share swap, an asset acquisition, a merger and the acquisition of state-owned assets. Each of these transactions is subject to different rules and regulations, and all require either government approval or a record-filing in the PRC. Note that public M&A falls outside the scope of this publication (although we will briefly touch upon this in the context of Chapter 2 'Restrictions on Foreign Investment').

[17] This publication reflects the state of the law until *31 October 2019*.

1.5 Abbreviations and Short-Form References

[18] In this publication, we refer to various government ministries and departments and certain legal concepts. At first mention, we will provide the full name as

well as its common abbreviation (e.g., Ministry of Commerce/MOFCOM, *Foreign-Invested Enterprise*/FIE), while in the remainder of the text we will refer to the abbreviation only. We provide a full list of all abbreviations used throughout herein at the beginning of the publication.

[19] Foreign direct investment in China is regulated by numerous laws, ministerial regulations and rules at the local level. In this publication alone, we refer to about a hundred and fifty pieces of legislation. Since the full names of Chinese rules and regulations tend to be unusually long, we have used a system of unofficial short-form names for each piece of legislation. At the end of this publication, we have included a table that lists their full names (both in English and Chinese), with relevant details (e.g., effective date and issuing authority).

[20] The short-form references to laws, rules and regulations are all stated in *italic font*. References to laws include the word *law* at the end (e.g., the *Company Law*), and references to rules and regulations are in most cases preceded by the year in which they were first promulgated (e.g., the *1983 EJV Implementing Rules*).

2 RESTRICTIONS ON FOREIGN INVESTMENT

2.1 Industries Restricted for Foreign Investors

2.1.1 The Foreign Investment Negative List

[21] In the past, the *Foreign Investment Catalogue* (and the *Central and Western China Catalogue* focusing on foreign investment in relatively underdeveloped areas in Central and Western China) was always the starting point for any research regarding restrictions on foreign investment in China. This catalogue, jointly issued by the Ministry of Commerce ("MOFCOM and the National Development and Reform Commission (NDRC), sets limitations to foreign investment in China. The catalogue was first introduced in 1995, and the last edition was completed in 2017. The catalogue contained a detailed list of specific industries divided into three categories: '"encouraged", "restricted" and "prohibited"'. Any industry that was not listed in the catalogue would automatically fall within the fourth category: 'permitted'.

[22] Over recent years, however, China has gradually implemented a system of negative lists – listing only those sectors that are '"restricted" or "prohibited"' to foreign investment. The first negative list was issued in 2014 for the Pilot Free-Trade Zone in Shanghai (*see* below), while the first nationwide negative list (applying nationwide but not in pilot free-trade zones) was issued in 2018 and later updated as the *2019 Foreign Investment Negative List*. The *Foreign Investment Catalogue* continued to exist until July 2019 when the last part of this catalogue – the determination of which sectors should be encouraged to foreign investment – became obsolete with the adoption of the *2019 Catalogue of Industries for Encouraged Foreign Investment*.

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[23] Over the years, every update of the catalogue/negative list has led to a slow but steady easing of restrictions on foreign investment. The *2019 Foreign Investment Negative List* is no exception: compared to the 2018 version, the number of sectors subject to restrictions was reduced from forty-eight to forty, and restrictions were eased in several sectors within the service, agricultural and manufacturing industries. To give some examples, in the value-added telecommunication service sector the restrictions on foreign investment in domestic multiparty communication store-and-forward business as well as call centres have been cancelled, and in the agricultural sector, foreign investment in the development of wild animal and plant resources is no longer prohibited.

[24] However, various sectors remain entirely prohibited to foreign investment (e.g., internet news services and online publishing services; news agencies; compulsory education institutions; and Chinese legal services), and in other cases, foreign investment is permitted but subject to restrictions, for example because the Chinese party must be the controlling shareholder (e.g., investment in the printing of publications; nuclear power plants; domestic water transportation).

[25] It has been mentioned that the first negative list was issued for the *China (Shanghai) Pilot Free-Trade Zone*, in 2014. In fact, several negative lists exist that do not apply nationwide but are still important. Part of the reason for the establishment of the first pilot free-trade zone in 2014 was to allow it to experiment with foreign investment for which the rest of China was not yet deemed ready. Since then pilot free-trade zones were established across the country and several of these have adopted their own negative lists. The *2018 FTZ Negative List* was the first negative list that covers all the free-trade zones and so may be seen as an attempt to create a level playing field – though local rules and variances continue to exist. Besides local significance, the negative lists of the pilot free-trade zones have considerable value in predicting which sectors may open to foreign investment nationwide in the near future.

[26] The latest version the *2019 FTZ Negative List* contains 37 items and contains many of the same prohibitions as the *2019 Foreign Investment Negative List*. However a few of the sectors prohibited or restricted for the rest of China are not listed in the *2019 FTZ Negative List* at all and are therefore permitted (e.g., fishing aquatic products in sea areas under Chinese jurisdiction and in inland waters; printing of publications); while for others, the restrictions are less severe. As such, the *2019 FTZ Negative List* continues to be a model for future liberalizations though with restrictions focusing on sensitive sectors, the process of further opening up may be slowing down.

[27] While the negative lists focus only on restrictions, the *2019 List of Industries for Encouraged Foreign Investment* now has the sole function to detail in which industrial sector's foreign investment is encouraged. Continuing previous policies, it also includes a separate section to stimulate foreign investment in certain specific areas in Central and Western China. Benefits available to the industries in this 2019 Encouraged List vary but may include tariff duty exemptions for imports of self-use equipment, preferential rates for corporate income tax and discounted prices for investment in land.

[28] Compared to the 2017 versions, the *2019 Catalogue for Encouraged Foreign Investment* expands the range of *encouraged* industries for foreign investment from 987 to 1108 sectors (*incl.* 415 items encouraged nationwide, and 693 items encouraged in Central and Western China). The main focus is on industries that China is trying to promote such as modern agriculture, advanced manufacturing, high technology, energy conservation and environmental protection as well as modern services. Some of the items that have been added in 2019 include: the electronic information sector (e.g., 5G core components, IC etching machines and cloud computing devices); the equipment manufacturing sector (e.g., industrial robots, new-energy cars and key components for smart cars); the modern pharmaceutical sector (e.g., key raw materials for cell therapy medicine and large-scale cell culture products); the new material industry (e.g., new materials for aerospace, monocrystalline silicon and large wafers); and in the service industry, the business service sector (e.g., engineering consultancy, tax and accounting), the commercial circulation sector (e.g., cold chain logistics, e-commerce) and the technology service sector (e.g., artificial intelligence, cleaner production, carbon capture and circular economy).

2.1.2 The Domestic Catalogue

[29] In addition to the *2019 Foreign Investment Negative List*, which only applies to foreign investors, the State Council has also issued the *Domestic Catalogue* (last amended in 2016), which applies to both domestic and foreign investors. This catalogue contains twelve categories of industries, and for each category, detailed investment projects have been described that require government approval. Given the sensitive nature of the projects in the *Domestic Catalogue*, such government approval may be difficult to obtain in practice.

[30] Most of the projects in the *Domestic Catalogue* relate to large-scale infrastructure projects, such as water reservoirs, power stations, coal mining, oil refining, rail and highways, telecom networks, petrochemicals, aerospace, and urban roads, bridges and tunnels. Other categories include automobile and tobacco manufacturing and large-scale theme parks and national tourism sites.

2.1.3 Preferential Treatment for Hong Kong, Macao and Taiwan Investors

[31] Investments in Mainland China made by an investor incorporated in Hong Kong or Macau may receive preferential treatment under the Closer Economic Partnership Arrangement (CEPA) (first signed in 2003, last supplemented in January 2019),[1] while Taiwan investors may benefit from the Cross-Strait Economic Cooperation Framework Agreement (ECFA) (signed in 2010). These arrangements

[1] In November 2015, an additional *Agreement on Trade in Services* was concluded, which made certain benefits available in the whole of China that were previously only available in Guangdong Province; *see* the *2016 Mainland Measures*.

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provide companies from Hong Kong, Macau and Taiwan preferential access to se eral sectors, including real estate, construction, education, recruitment, medic telecommunications, banking, securities and accountancy.

[32] The benefits, which vary per sector, include early market access (i.e., access t certain industries still closed for other foreign investors), lower entry requiremen (e.g., lower registered capital requirements) and larger equity holdings (i.e., a larger equity percentage may be held in some restricted industries compared t other foreign investors).

[33] *CEPA* imposes several qualification criteria in order to prevent foreign inves tors from outside Hong Kong and Macau from simply setting up a special purpos vehicle in one of these jurisdictions to enjoy the special benefits. The most impor tant requirements are that the Hong Kong or Macau company needs to be estab lished for at least three years, have substantial operations in Hong Kong or Macau and pay profit tax in Hong Kong or Macau.[2]

[34] However, no limitation is set on the ownership of the Hong Kong or Macau company. Therefore, an investor from, for example, Europe could consider acquir ing a company in Hong Kong or Macau that meets all these criteria, and then use this company as a vehicle to further invest in Mainland China.[3]

2.1.4 Circumventing Restrictions: Variable Interest Entities (VIEs)

[35] Given the appeal of China's economy and its businesses, Chinese companie and foreign investors do sometimes work together to circumvent some of the above restrictions, thereby enabling foreign investors to invest in Chinese industries tha would otherwise be closed to them. The most popular method is the so-called Vari able Interest Entity (VIE). Under a VIE structure, a Chinese-owned company (the VIE) holds all licences and carries out all activities prohibited or restricted for for eigners, while the foreign investor takes on the risk and benefit of the entrepre neurial activity.

[36] In practice, the foreign investor's vehicle – in some cases a foreign company but more often an Foreign-Invested Enterprise (*see* section 2.2 'Foreign-Invested Enterprises' below) – usually obtains a set of contractual rights vis-à-vis the VIE (e.g., pledges, voting arrangements, licensing agreements). These contractual rights allow the foreign investor's vehicle to exercise control over the VIE (so con solidation of the financial accounts is possible), with all economic benefits trans ferred back to it (allowing the foreign investors to enjoy the profits of the restricted business). As an example, many large Chinese companies operating in *prohibited* or *restricted* industries have used a VIE structure to get listed on an overseas stock exchange (e.g., Alibaba and Baidu).

[2] An enterprise incurring losses can still qualify if it has substantial business operations in Hong Kong or Macau.

[3] Similar rules apply for Taiwan under *ECFA*, but Taiwan has been a far less popular route.

[37] This structure is, however, not without risk. Besides the common challenge of practical control, it is unclear whether the contractual arrangements between a VIE and the foreign investor's vehicle are enforceable in the PRC given that they are clearly designed to circumvent the law. In fact, the first draft of the *Foreign Investment Law* (published for comments in 2015) specifically prohibited the circumvention of foreign investment restrictions through a VIE structure (*see* section 2.1.4 'Circumventing Restrictions: Variable Interest Entities (VIEs)' above). That these provisions were removed in the final version of the law may be a sign that China is not yet ready to tackle the structure – though this situation may not last forever.

2.2 Foreign-Invested Enterprises

[38] When a foreign investor establishes or acquires equity in a Chinese company, such company becomes what is generally referred to as an Foreign-Invested Enterprise (FIE) – a special designation for a Chinese company that is owned wholly or partially by one or more foreign investors. The various legal entities available to foreign investors will be extensively discussed in Chapter 3 'Business Vehicles', and at this point, a brief summary of these legal entities is sufficient.

[39] It should be noted that when the *Foreign Investment Law* becomes effective on 1 January 2020, companies that are newly established with foreign investment or domestic companies that are acquired (whole or in part) by foreign investors will no longer be subject to the rules that now apply to FIEs. Instead, these companies will be subject only to the *Company Law* and be treated the same as companies with Chinese investment only, particularly in respect of organizational form, corporate governance and standard of conduct. However, existing FIEs will be permitted to continue their current corporate form during a five-year transition period, and so in the near future little will change for these existing FIEs. Moreover, there is little information available on how these FIEs will be turned into 'ordinary' legal entities, and so it seems early to start anticipating this development. As such and at least for now, understanding the types of FIEs that are available to foreign investors remains an important part of understanding China's legal landscape.

[40] The Foreign-Invested Enterprises available for foreign investment in China include:

(a) Wholly Foreign-Owned Enterprise (WFOE)
(b) Equity Joint Venture (EJV)
(c) Cooperative Joint Venture (CJV) and
(d) Foreign-Invested Company Limited by Shares (FICLS).

[41] In common terminology, several other abbreviations are used as well. The most common examples are the Foreign-Invested Holding Company (FIHC) and the Foreign-Invested Commercial Enterprise (FICE). In each of these cases, the name is not to indicate another type of FIE; instead, it is about the function of the company (e.g., an FIHC is a company whose predominant function is to invest in

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other domestic entities, while an FICE is a company engaged in trading and distri-bution). As such, an FIHC could be a WFOE, EJV or FICLS.

[42] The FIE is subject to requirements or restrictions that do not apply to 'ordi-nary' domestic legal entities. As a result, foreign investors have less freedom com-pared to domestic investors when structuring their investments in China. The mo[st] important restrictions include approval requirements or a record-filing for inco[r]-poration, rules on thin capitalization and less freedom to select a tailor-made co[r]-porate governance system.

[43] As background, when China permitted foreign investment for the first time i[n] 1979 through joint ventures, a general law for all companies had yet to be adopted. The Chinese government, therefore, had to create special legislation in order t[o] enable foreign investment (first the *EJV Law* and later also the *WFOE Law* and *CJ[V] Law*). This practice of having distinct entities for foreigners became so embedde[d] in the Chinese legal system that it was never completely abolished, even after th[e] introduction of the *Company Law* in 1993 and subsequent amendments. Howeve[r], as mentioned, this is going to change with the *Foreign Investment Law* taking effec[t] on 1 January 2020.

[44] Three other vehicles available to foreign investors (but not considered a[s] FIE). are:

(1) Representative Office (RO) – not considered an FIE since an RO is not a Chinese legal person
(2) Foreign-Invested Partnership (FIP) – not considered an FIE since an FIP i[s] not an enterprise, but a partnership and
(3) *Domestic subsidiary of an FIE* – not considered an FIE, since it is a regula[r] Chinese company without any direct foreign shareholding.

2.3 Industry-Specific Restrictions

[45] There are over a hundred business activities in China that require additional industry-specific licences. These restrictions, which apply to both domestic and for-eign investors, are currently scattered over numerous regulations and rules issued by various industry regulators. Prior to making any investment, a foreign investor should, therefore, not only check the *Foreign Investment Negative List* to confirm whether the investment is permitted but also whether its particular business activity or industry is subject to any specific regulations.

[46] In order to make it easier for businesses to identify whether their activities require a licence, in March 2016, NDRC and MOFCOM published the *Draft Market Access Negative List* (pilot version), setting out which business activities are prohib-ited in China and which activities are subject to licensing. The *Draft Market Access Negative List* was effective in the Free Trade Zones (*see* section 2.7 'Pilot Free Trade Zones') on a pilot basis, while the official *Market Access Negative List* has been rolled

out nationwide in 2018. Note that the *Market Access Negative List* applies to both domestic and foreign investors and is different from the *Foreign Investment Negative List* discussed above (section 2.1.1 'The Foreign Investment Negative List') that only applies to foreign investors.

[47] Even though domestic investors are generally subject to similar restrictions, for some regulated business activities, different rules and regulations still apply if these are carried out by an FIE. The criteria to qualify for relevant licences can, therefore, be more burdensome, or at least different, for foreign investors com-pared to the rules that apply to their domestic peers.

[48] Industry regulations may set a minimum amount of registered capital that a foreign investor needs to contribute to its legal entity in China; although, the *2015 FIE Registered Capital Decision* removed this requirement for many industries. Another common requirement is a minimum of net assets that the foreign investor itself needs to have on its books. Foreign investors may also need to prove a certain track record, such as a minimum number of years of operating history in the rel-evant industry and experience criteria for key personnel it intends to dispatch to China. Soft criteria may include a clean history (e.g., no past convictions or viola-tions of laws) and the requirement to have all necessary operating systems in place.

[49] Criteria with respect to the foreign investor itself (e.g., assets or experience) are known to be problematic when the foreign investor prefers a China set-up via a new special purpose vehicle (e.g., in Hong Kong), since this SPV will have no assets and operating history. It is then at the discretion of the local regulator to determine whether it will accept any evidence that this SPV's ultimate parent satisfies the rel-evant criteria. We have seen examples of industry regulators interpreting the rel-evant rules with flexibility, while others simply reject the application.

[50] All qualification criteria regarding the foreign parent obviously apply when an FIE obtains its initial licence for the relevant business activity, but they also need to be complied with when a foreign buyer acquires a domestic target. In such case, the buyer needs to demonstrate that it meets all relevant qualification criteria for the foreign parent, otherwise the transaction will not be approved.[4]

[51] Examples of activities for which specific requirements apply in case of foreign investment include *construction* (skill qualification required and certain work expe-rience criteria apply for foreign managers),[5] *medical treatment* (the Chinese side to hold at least 30%, minimum CNY20m total investment and certain experience cri-teria),[6] and *telecom* (minimum registered capital requirements, foreign ownership restrictions, and criteria regarding experience and operating history).[7]

[4] Article 4 *2006 M&A Rules*; Art. 4 *1997 FIE Acquisition Rules*.
[5] *2002 FIE Construction Measures*; *2003 FIE Construction Implementing Rules*.
[6] *2000 FIE Medical Institutions Interim Measures*; there are however opening-up initiatives, *see* the *2013 Shanghai FTZ WFOE Medical Institutions Tentative Measures* for the Shanghai Free Trade Zone and the *2014 WFOE Hospitals Notice* on a pilot in seven (city) provinces; CEPA also relaxed certain criteria for Hong Kong and Macau investors.
[7] *2008 FIE Telecom Enterprises Provisions (revised in 2016)*.

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[52] Like in many jurisdictions, financial services are heavily regulated in China. Foreign investors may be subject to additional scrutiny as well. For example, foreign investors in domestic insurance companies need to meet more onerous qualification requirements in terms of profit track record, total assets and credit rating compared to their domestic competitors.[8] A foreign investor in a foreign-invested securities company is also subject to more onerous qualification requirements and, in some cases, first needs to qualify under a special regime (such as the CEPA with Hong Kong) before it is permitted to invest. However, even in financial services China is making steps to relax control; in a recent circular, the State Council cancelled restrictions on the business scopes of financial institutions, such as foreign banks, securities companies and fund management companies.[9]

2.4 Investment Approvals

[53] All foreign investment in China (both greenfield and M&A) requires either government approval or a record-filing. In contrast, PRC investors often do not require such investment approval or record-filing, and even when they do, they usually face less scrutiny. However, we have seen much improvement in the past few years. In section 2.4.2 'MOFCOM Approval or Record-Filing', we will discuss the recent cancellation of MOFCOM approval for industries outside the *Foreign Investment Negative List*, while in section 2.7 'Pilot Free Trade Zones', we set out the exceptions that already apply in the *Shanghai Free Trade Zone* and some other free trade zones, while further liberalization is expected after the *Foreign Investment Law* takes effect in January 2020 (section 2.8 'The Foreign Investment Law').

[54] The key PRC regulators approving foreign investment are MOFCOM and NDRC. In addition, the State Administration for Market Regulation (SAMR) (previously known as the *State Administration for Industry and Commerce*) is responsible for company registration and issuing of business licences (no business in the PRC is allowed to operate without such licence). When it comes to the conversion of foreign exchange into CNY or the cross-border transfer of funds, the State Administration for Foreign Exchange (SAFE) is the key regulator. If state-owned assets are involved, the State-owned Assets Supervision and Administration Commission (SASAC) and the Ministry of Finance (MOF) are the relevant regulators. Several industry regulators become relevant when investments fall within their scope of authority.

2.4.1 NDRC Approval or Record-Filing

[55] In the past, most foreign investment projects (both greenfield and M&A) were subject to NDRC approval, but this changed with the introduction of the *2014 NDRC Approval Rules*, while the *2017 NDRC Approval Rules* provide for further relaxation.[10] Under these new rules, NDRC approval is only required for foreign investment projects if the relevant industry is listed in (a) the *Foreign Investment Negative List* (*see* section 2.1.1 'The Foreign Investment Negative List'),[11] or (b) sections 1-10 of the *Domestic Catalogue* (*see* [29]). Any foreign investment that does not fall within these categories only requires a record-filing with NDRC.[12] In practice, however, for many projects, no such record-filing is made, while foreign investors still manage to get all other approvals described below and obtain a business licence for their FIEs (this is mainly true for companies in the service and trade industry and for smaller projects that require relatively little investment). The reason for this is that the authorities in charge of other relevant approvals and granting the business licence carry out their work independently from NDRC. However, failure to complete the record-filing with NDRC may cause problems if the FIE, later on, intends to increase its investment or invests in projects that are subject to NDRC approval.

[56] NDRC approval needs to be sought at the central government level, at the provincial level or with the local authorities. The higher the level of approval, the more time and effort the process is expected to take. All projects in the *restricted category* of the *Foreign Investment Catalogue* with a value of at least USD2bn also need to be filed with the State Council, which is China's highest legislative organ. Investments in the *restricted* category require central government approval if these are at least USD300m, while below that threshold, provincial-level approval must be obtained. The relevant approval authority for each of the industries mentioned in sections 1-10 of the *Domestic Catalogue* is specified in this catalogue itself.[13]

[57] A foreign investor seeking NDRC approval needs to submit a project application report that includes basic information on the project and the foreign investor, an analysis of the utilization of resources and the impact on the environment and a social and economic impact analysis. In case of an M&A project, additional information needs to be provided on the acquisition details, the financing thereof, the business operations and any arrangement on the use of proceeds by the seller.[14] Other information to be submitted includes incorporation documents, financial statements, bank letters regarding creditworthiness and site-related opinions (e.g., an environmental impact report). Like most approval procedures in China, NDRC has the freedom to require any additional documents as it deems fit.[15]

[58] The criteria applied by NDRC when deciding whether to grant approval are:

[8] *2014 Insurance Equity Interest Measures.*

[9] Article1(2) *2019 Improving the Use of Foreign Investment Circular.*

[10] The *2014 NDRC Approval Rules* were amended in the same year by the *2014 NDRC Approval Rules Amendment*. Note that under the old rules, NDRC approval was in practice not always sought nor enforced by authorities (including NDRC itself).

[11] In the *2017 NDRC Approval Rules*, approval for *encouraged* industries with restrictions has been removed, but given the new *Foreign Investment Negative List*, it is expected that *encouraged* industries with restrictions still require approval, since these are included in the *Foreign Investment Negative List* and, therefore, are classified as *restricted*.

[12] Articles I, II *2017 NDRC Approval Rules*.

[13] Article I *2017 NDRC Approval Rules*.

[14] Article 8 *2014 NDRC Approval Rules*.

[15] Article 10 *2014 NDRC Approval Rules*.

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(a) compliance with PRC laws and regulations (including the *Foreign Investment Negative List* and industry-specific rules)[16];
(b) compliance with national or regional development plans;
(c) whether resources are to be developed reasonably and utilized efficiently;
(d) no negative effects on national security or ecological safety; and
(e) no material impact on the public interest.[17]

[59] NDRC should decide on the application within twenty working days from its acceptance thereof, and such a deadline can be extended with an additional ten working days.[18] Note that the authorities will decide when an application is complete and thus accepted, and so, in practice, the application can take much longer. NDRC is supposed to engage a qualified advisory body within four working days from acceptance of the application to advise it on the matter; NDRC is also allowed to solicit the opinion of the public for projects that may materially affect public interests and certain experts for significant projects.[19]

[60] There are only a few reports of projects rejected by NDRC. One of them was Arcelor Mittal's attempt to become the largest shareholder of Valin Steel Tube & Wire Co. Ltd. NDRC rejected the transaction because it deemed that the relevant steel industry policy did not allow a foreign investor to purchase a controlling stake, after which Arcelor Mittal amended the transaction structure and became the second-largest shareholder.

[61] As mentioned above, foreign investment projects that do not require NDRC approval only require a simple record-filing. The documents for such record-filing are quite straightforward and include, for example, the basic particulars of the parties involved, their corporate registrations and a letter of intent on the nature of the investment. Should the record-filing not be accepted, the relevant authority is required to issue a written opinion or explanation within seven working days. In practice, such rejection should only occur if the project breaches PRC laws and regulations (e.g., non-compliance with the *Foreign Investment Negative List*).[20]

2.4.2 MOFCOM Approval or Record-Filing

[62] The incorporation or acquisition (including subscribing for new equity) of a PRC legal entity by a foreign investor, or the merger of an FIE with another PRC legal entity, requires approval from or a record-filing with MOFCOM.[21] Together

[16] Note that the *2017 NDRC Approval Rules* still refer to the abolished *Foreign Investment Catalogue* and have not yet been formally amended to reflect the introduction of the *Foreign Investment Negative List*. However, it is generally expected that NDRC will refer to the *Foreign Investment Negative List* when deciding whether or not to grant investment approval.
[17] Article 16 *2014 NDRC Approval Rules*.
[18] Article 15 *2014 NDRC Approval Rules*.
[19] Article 14 *2014 NDRC Approval Rules*.
[20] Articles 18–20 *2014 NDRC Approval Rules*.
[21] Exceptions are Foreign-Invested Partnerships (section 'Foreign Invested Partnership (FIP)') and Representative Offices (section 'Representative Office (RO)').

with the NDRC approval process set out above, MOFCOM approval or record-filing is usually considered one of the key steps for any foreign investment project (unless the approval of an industry regulator comes instead of MOFCOM approval, *see* section 2.4.4 'Industry Regulator Approvals' below).

[63] Until October 2016, MOFCOM approval was required for *all* foreign investment (unless an industry regulator has such authority). This changed with the *2016 FIE Filing Decision*, which replaced the approval requirement with a record-filing system for the incorporation of, and subsequent changes to (e.g., mergers, acquisitions, share issuances, increase of registered capital), Foreign-Invested Enterprises that operate outside the restricted industries of the *Foreign Investment Negative List* (in section 2.1.1 'The Foreign Investment Negative List' we explained that this list includes all *prohibited* and *restricted* industries). This is considered a milestone in China's foreign investment policy, since removing the burdensome and time-consuming MOFCOM approval requirement significantly simplifies foreign investment in non-restricted industries.[22]

[64] If a transaction involves any restricted industry that is included in the *Foreign Investment Negative List*, MOFCOM approval is still required,[23] and at application, an enterprise must confirm whether such restrictions apply.[24]

[65] Unlike the NDRC approval process, where the same rules apply for greenfield and M&A investments, no uniform set of regulations exists for the MOFCOM approval and record-filing process. Not only do different rules apply to greenfield and M&A but also each type of M&A transaction is governed by another set of rules. For example, different rules apply if the target is owned by domestic or foreign shareholders, if it is listed or if it enters into a merger.

[66] Given that different laws apply, we will describe the MOFCOM approval and record-filing process in more detail when we discuss the different types of investment. In Chapter 3 'Business Vehicles', we will set out this process for greenfield operations, and in Chapter 4 'Mergers & Acquisitions', for private M&A. Below, we will limit ourselves to making some brief general observations.

[67] First of all, it is not yet clear whether anything will change after the *Foreign Investment Law* becomes effective in January 2020. One could argue that since the law promises national treatment for industries outside the *Foreign Investment Negative List* (*see* [117] below), no special record-filing should be required for those industries, but it remains to be seen whether this will indeed be implemented.

[68] Until then, each incorporation, issuance of equity, acquisition or merger that involves foreign investors, regardless of its scale, industry or proposed activities, is subject to approval by, or a record-filing with, central MOFCOM or its local commission of commerce at provincial, municipal or district level. At which level

[22] *2016 Negative List Announcement*; Arts 2, 5, 6 *2016 FIE Filing Measures*; *2016 FIE Filing Decision*.
[23] Note that strategic investments in listed companies (*see* [96]) also still require MOFCOM approval under the *2005 Foreign Strategic Investment Measures*, even if the relevant industry is outside the *Foreign Investment Negative List*.
[24] *2019 Foreign-Invested Registration Opinions*, Art. 4.

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