

Great leap forward for China's Foreign Investment Law?

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Proposed sweeping changes in China's draft Foreign Investment Law ('**Draft FIL**') could have profound impact on the country's foreign investment landscape if it comes into force. Investors – both foreign and local – might well benefit in considering the key aspects of the Draft FIL¹.

The legislative process will gestate over a period of time when stakeholders, including the various ministries and regulators, will be consulted – it is rumored the Draft FIL may become effective in one form or another within the next 18 months.

From our analysis of the Draft FIL, three general themes are evident, namely:

- (i) the consolidation and simplification of the various disparate strands of China's foreign investment laws such that equal treatment of domestic and foreign-invested companies would transpire *save for* certain sensitive industries (i.e. industries characterized as 'prohibited' or 'restricted', or to be published in a so-called '**Negative List**') where local ownership and control is required
- (ii) a paradigm shift towards substance over form as to whether an entity will be treated as a foreign or domestic entity if its core business falls within the Negative List. This will affect variable interest entity ('**VIE**') structures, which are currently used to navigate ownership and control issues in restricted industries (generally in the internet, education, media, real estate sectors)
- (iii) requirement for national security review for foreign investments into China.

We consider the Draft FIL a welcome development as it brings China closer to international norms. It aligns with the concept of a gradual and orderly transition of the Chinese economy to a more market-based one, which began with the formation of China's Special Economic Zones in the '80s.

However, clarification of certain substantial unknowns would be beneficial:

- (i) Content of the Negative List is not known. We are, however, comforted by the reduction of such sensitive industries within the free trade zones. It would be quite odd if the Negative List will be more restrictive than what is now permissible in these zones, plus China is unlikely to knowingly contravene its international and bilateral treaty obligations.
- (ii) Uncertainty exists as to how existing VIEs will co-exist within the new law and if grandfathering provisions will be provided; also for companies contemplating an IPO or placement in the short term, the Draft FIL has placeholders for these, suggesting likely at least some flexibility for current VIEs.
- (iii) Clarity is needed regarding structuring options for private equity investments (veto rights/change of control/claw-backs and anti-dilution provisions) and ownership issues to clearly distinguish actual control of company and any potential issues regarding the Negative List and VIE structures.
- (iv) National security standards are not clear and bestow wide discretion.

Overall, the proposed Draft FIL has the potential to usher in a period of fundamental reform allowing significantly more leeway for market forces to develop the Chinese economy as it moves to a more developed stage of its economic development.

Jonty Lim

Director, Deal Advisory
Phone: +86 (21) 2212 3232
Email: jonty.lim@kpmg.com

Mark Harrison

Partner, Deal Advisory
Phone: +86 (21) 2212 3620
Email: mark.harrison@kpmg.com

KPMG China,
50th Floor, Plaza 66, 1266 Nanjing West Road, Shanghai
200040, China
Tel +86 (21) 2212 2888 Fax +86 (21) 6288 1889

Source: 1) Foreign Investment Law of the People's Republic of China (Draft) 中华人民共和国外国投资法 (草案征求意见稿), 19 January 2015 .