

Foreign Investment in China

An Introduction



Law with “Chinese Characteristics”

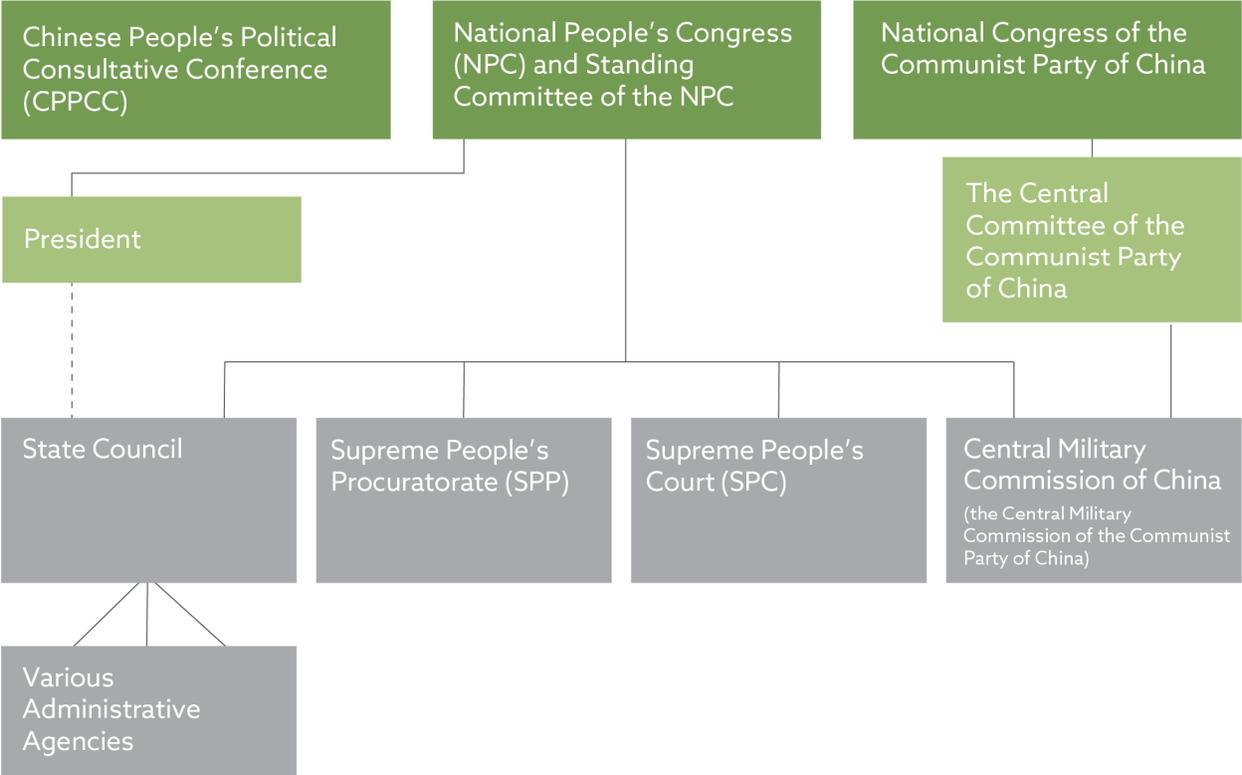
China presents some of the world’s most exciting opportunities, and a unique set of cultural, legal and political challenges. It has a distinct legal regime that in many respects cannot be understood by direct reference to Western standards. Chinese legislation is typically drafted in broad terms that give civil servants and judges wide discretionary authority to interpret the rules in line with policy changes and China’s developing market economy. In addition, ongoing reform and regulatory change in China continues to present both challenges and significant opportunities for investors.

The following is a brief introduction to some of the key laws and regulations that impact foreign investors in China today and areas where continued change is expected in the next few years.

Basic Principles of Foreign Investment

China’s Government

Any discussion of China’s government – or its legal system – begins with the Chinese Communist Party. Party officials supervise every legislative, administrative and judicial body within the government hierarchy and are charged with supervising China’s formidable state-owned enterprises that continue to play a major role in China’s economy.



As illustrated in the chart above, the highest legislative institution in China is the National Peoples' Congress (NPC). The State Council is China's highest administrative authority. China's various administrative agencies, many of which directly supervise the commercial activities of foreign-invested businesses in China, are established under the State Council. The Supreme People's Court (SPC), together with the Supreme People's Procuratorate (SPP), are China's highest judicial institutions.

China's legislative hierarchy begins with the Constitution of the People's Republic of China. Laws are enacted by the NPC or its Standing Committee. Administrative regulations are promulgated by the State Council. Local decrees are issued by the local People's Congresses, and various types of binding regulations, notices and opinions are issued by China's administrative agencies at the central level in Beijing or by the local People's Governments.

The SPC and SPP publish judicial interpretations of key provisions of significant laws that should be given strong guiding weight by the lower courts. As a general principle, unlike common law jurisdictions, courts in China are not legally bound by precedent decisions of the higher courts. However, in an effort to bring greater certainty to China's judicial system, in 2010, the SPC issued the Provisions on Case Guidance Work to provide a type of judicial "guidance". These "guiding cases" have the following characteristics:

- the judgment is final and effective;
- the subject matter is of broad concern to the public;
- the relevant legislation provides only general principles;
- the subject matter is ordinary; and
- the case involves an area of the law that is complex or new.

Since December 2011, in an effort to provide even further clarity, the SPC issued 16 batches of "guiding cases" and confirmed that the lower courts are required to refer to the guiding cases when adjudicating cases that involve similar circumstances.

The Foreign Investment Catalogue and Business Scope

As an overall principle, a general purpose company (in other words, an entity with an unrestricted business scope) is not permitted in China. Commercial entities in China must operate pursuant to an approved scope of business activity.

Foreign investment in China is generally governed by China's Catalogue for Guiding Foreign Investment in Industry ("Foreign Investment Catalogue"), which has generally been updated every few years and reflects the government's broader policies and plans for the economy. Until October 2016, foreign investors had to undergo a governmental approval and registration process before investing or operating in China. Effective from October 1, 2016, China simplified its foreign investment regime and set forth a so-called "Negative List" – a list of "special entry administration measures." If an industry is listed on the Negative List, a foreign investor must undergo an approval process before investing. If an industry is not listed on the Negative List, no approval process is required; a foreign investor only needs to make a notification filing with the relevant Chinese governmental authority. These amendments to the Foreign Investment Catalogue in 2016, including the introduction of the Negative List, brought about a significant simplification of China's foreign investment rules and regulations.

In 2017, China's Foreign Investment Catalogue was updated again (the "2017 Catalogue") and imported the concept of the Negative List directly into the 2017 Catalogue. The 2017 Catalogue is now divided into two large categories: (1) an "Encouraged Category" listing industries in which foreign investment is encouraged, and (2) a "Negative List" of industries in which a foreign investor would first need to undergo a special administrative approval process before investing.

The Negative List is further divided into two categories: (a) a "Restricted Category," and (b) a "Prohibited Category." The Restricted Category includes certain industries where foreign investment is permitted but subject to certain shareholding restrictions, administrative approvals and other special administrative measures. A few industries included in the Restricted Category also fall within the Encouraged Category, which means that foreign investment in those industries will also benefit from the preferential policies for encouraged projects. The Prohibited Category lists those industries in which no foreign investment is permitted.

In total, there are 63 industries listed on the Negative List, 28 of which are in the Prohibited Category and 35 industries are in the Restricted Category.

In summary:

- Businesses in the Prohibited Category are not open to foreign investment.
- Businesses in the Restricted Category are open to foreign investment, and all of them are also included the Negative List and are therefore subject to an approval process and may also be subject to ownership caps or other limitations.
- Businesses in the Encouraged Category may be eligible for certain incentives and most of them (331 out of 348) require only a notification filing.
- Businesses in the Encouraged Category that are also in industries on the Negative List (17 industries) may receive foreign investment, but a foreign investor would need to undergo an approval process before investing, and may also be subject to ownership caps and other restrictions.
- Industries not listed in the 2017 Catalogue are considered to be "Permitted" for foreign investment and require only a notification filing. Foreign investments in a business that falls within the "catch-all" Permitted Category will not subject a foreign investor to any special restrictions or administrative measures compared with a domestic investor.

In line with China's economic transition, China is steering investments away from low value-added, labor-intensive businesses in favor of high value-added and technologically advanced manufacturing and strategic technologies in goods and services. The 2017 Catalogue reflect this priority. Below are some examples:

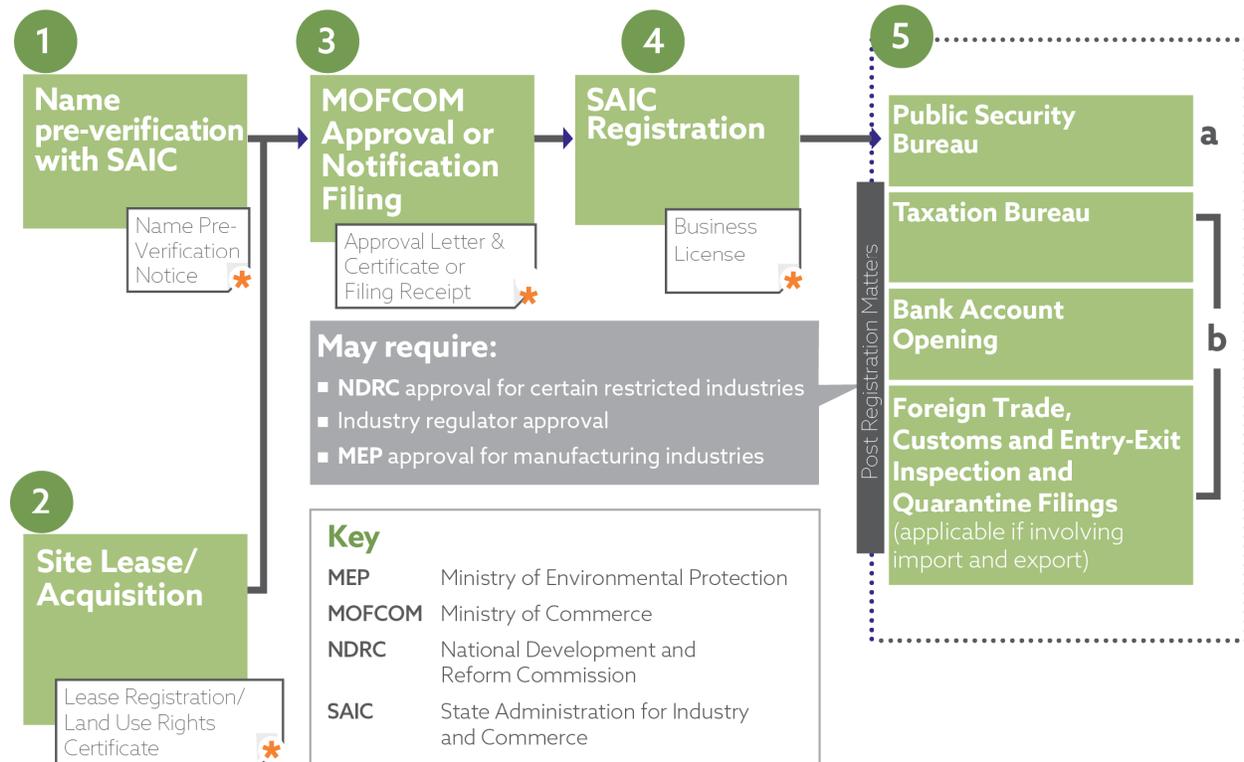
Category	Number of Industries	Some Examples
Encouraged	<ul style="list-style-type: none"> • 348 industries (of which 17 industries are on the Negative List and subject to the approval process). 	<ul style="list-style-type: none"> • Research and development centers and incubators for new and advanced technologies, new product development and enterprises • Environmental pollution treatment and monitoring technologies

	<p>The remaining 331 industries in the Encouraged category are subject only to a filing process.</p>	<ul style="list-style-type: none"> • Manufacturing of key automotive parts and components and research and development of key technologies • Construction and operation of urban subway, light railway and other track transport • Service institutions for the elderly, the disabled and children
<p>Encouraged and on the Negative List</p>	<ul style="list-style-type: none"> • 12 industries (also subject to special shareholding or senior management restrictions). 	<ul style="list-style-type: none"> • Track and railway transportation equipment (limited to EJV & CJV) • Exploration and development of oil and natural gas (limited to EJV & CJV) • Construction and operation of nuclear power stations (with Chinese parties as the controlling shareholders) • Construction and operation of electricity network (with Chinese parties as the controlling shareholders)
<p>Permitted</p>	<ul style="list-style-type: none"> • Industry sectors not listed in the 2017 Catalogue are viewed as “Permitted” for foreign investment and require only a record filing. 	<ul style="list-style-type: none"> • No specific examples provided, as this is a catch-all category
<p>Restricted – All are on the Negative List</p>	<ul style="list-style-type: none"> • 35 industries – all of these industries are on the Negative List and therefore require that the foreign investor undergoes an approval process. • Other industries restricted by law or international treaties. 	<ul style="list-style-type: none"> • Value-added telecommunication services (VATS) • Basic telecommunication services • Manufacturing of automotive whole vehicles, special use vehicles and motorcycles • Banks, insurance companies and security companies
<p>Prohibited – All are on the Negative List</p>	<ul style="list-style-type: none"> • 28 industries – all of these industries are on the Negative List and foreign investment is not permitted in any manner. • Other industries prohibited by law or international treaties. 	<ul style="list-style-type: none"> • Postal companies; domestic express mail delivery business • Social investigations • News agencies • Operation of news websites, online publication services, online audio and video program streaming services, business premises for Internet access services, and internet cultural business (excluding music)

Foreign-Invested Enterprise (FIE)

If a foreign investor wishes to own equity interests in a company incorporated in the PRC, it must establish a new entity as, or convert an existing domestic entity into, some form of FIE. An FIE is subject to the restrictions on foreign investment set out in the 2017 Catalogue.

The typical regulatory process for establishing an FIE is illustrated below.



Notes

1. MOFCOM approval is required if the investment falls within the Negative List, otherwise only a notification filing is required, which could be done before or after the issuance of business license.
2. Depending on the location, a foreign trade filing may need to be processed before customs registration and filing with Entry-Exit Inspection and Quarantine Bureau may need to be processed after bank account opening.
3. References to MOFCOM, SAIC, NDRC and MEP include their local counterparts.

As illustrated above, whether undergoing an approval process, a notification filing process and/or a registration process, a number of administrative agencies are involved. These include the industry regulator for a project, National Development and Reform Commission (NDRC), the Ministry of Commerce (MOFCOM) and the State Administration for Industry and Commerce (SAIC). If a foreign investment project involves state-owned assets, the approval of the State Assets Supervision and Administration Commission (SASAC) is required. In addition, once a newly established (or newly converted) FIE receives a business license in China, the FIE must then carry out a series of ancillary registration procedures with other government agencies relevant to the FIE's business, e.g., tax and customs authorities.

For businesses in industries that are not on the Negative List, only a notification filing with MOFCOM's local counterpart is necessary. This is a significant change from the past where an FIE would need to undergo a

lengthy and uncertain approval process with MOFCOM (or its counterpart). Under the new rules, a notification filing with the local MOFCOM can now be completed within three working days, before or after the issuance of an FIE's business license according to applicable laws.

For businesses in industries on the Negative List, if the total amount of a proposed foreign investment in a business falling within the Encouraged or Permitted Category is above US\$300 million, the investment must be approved by MOFCOM at the central government level. The approval thresholds for Restricted investments are lower. Foreign investment projects with a total investment below the applicable thresholds only need approval from the lower levels within China's governmental hierarchy (i.e., would not need approval at the central government level in Beijing).

Investments that fall under the Restricted Category are also subject to NDRC's (or its local counterpart's) verification, while most of the Encouraged or Permitted investments are only subject to a notification filing with NDRC (or its local counterparts). In practice, however, NDRC verification and filing are not consistently implemented or enforced.

Total Amount of Investment and Registered Capital

Each application to establish an FIE must specify its registered capital (equity capital) and total investment, which then must be approved by (if the industry is on the Negative List) or filed with governmental authorities. Registered capital is defined as the total amount of capital subscribed by the investor(s) in the company and registered with the authorities. There is no minimum legal requirement for the registered capital of an FIE (unless the FIE falls into a regulated industry, e.g. insurance, banking and shipping, in which case certain minimum regulatory capital requirements will apply). An FIE is, however, subject to an upper limit on the amount of a "total investment" it may have. "Total investment" is the sum of the FIE's registered capital and its foreign debt borrowing capacity. The difference between the total amount of investment and the registered capital therefore represents the maximum ability of the FIE to take on registered foreign debt. The following table sets out the minimum required ratios of registered capital to total investment, which effectively place an upper limit on the FIE's ability to incur registered foreign debt:

Total Investment	Minimum Required Ratio of Registered Capital to Total Investment
Less than or equal to US\$3 million	70% of total investment
More than US\$3 million and less than or equal to US\$10 million	Higher of 50% of total investment or US\$2.1 million
More than US\$10 million but less than or equal to US\$30 million	Higher of 40% of total investment or US\$5 million
More than US\$30 million	Higher of 33.33% or US\$12 million

In 2016, the Chinese government began to offer FIEs an alternative method of determining the amount of foreign debt that can be borrowed. According to a Bank of China notice, effective from May 2016, the

maximum ability of an FIE to incur registered foreign debt may also be determined based on its net assets and certain other specific factors, rather than the difference between the total investment and registered capital. In practice, we understand that an FIE can now either choose to adhere to a limit based on its net assets or alternatively on the minimum permitted ratio of its registered capital and total investment when it plans to incur foreign registered debt.

Market Entry

Acquisitions

Foreign investors may enter the Chinese market or expand their existing presence using onshore or offshore acquisition or investment structures. For onshore acquisitions and investments, a foreign investor can acquire or invest directly in an operating entity in China or directly acquire assets in China. For offshore acquisitions and investments, a foreign investor can acquire or invest in an offshore company that holds an operating asset in China. An offshore acquisition generally is not subject to any examination or approval process under Chinese law, though certain notice or reporting obligations to Chinese governmental authorities may arise.

Acquisition of Domestic Company or Business by Foreign Investor

An onshore acquisition (whether of equity or assets) of an existing domestic Chinese company by a foreign entity is generally subject to a detailed examination and approval regime. There is limited flexibility to structure the transaction in this case. For example, the purchase price must be based on an appraisal conducted by a China-licensed appraisal institution and the purchase price generally must be paid in full (including any holdback against vendor warranties) within three months of closing.

In an equity acquisition, the target must first be converted into an FIE and will be the successor to any claims, debts and employment relationships of the domestic company. The FIE may continue to use existing licenses, permits and regulatory approvals, however, such continuing use is subject to review by the applicable industry regulator.

In an asset acquisition, a foreign investor will generally first establish a new FIE as the acquisition vehicle. The new FIE will not succeed to any claims, debts and employment relationships of the domestic company, except to the extent contractually agreed between the acquiror and the seller. The seller is required to provide notice to creditors and prepare a formal plan for employee resettlement. The licenses, permits and other regulatory approvals of the seller ordinarily may not be transferred to the acquiror. This can prove challenging in regulated industries due to the timeframe required for the acquiror to obtain new licenses and permits and the fact that ownership of or right to use the assets to be acquired is often a prerequisite to obtaining the relevant licenses and permits. It is worth noting that a transfer of assets by a domestic company to an FIE comprising only part of its business may not necessarily be subject to approval. Each transaction should be reviewed on its merits to determine if approval is required.

Share and asset transactions (both onshore and offshore) may be subject to a merger control review if the parties to the transaction meet specific thresholds under China's Anti-Monopoly Law (AML). In addition, under China's national security review rules, the government has broad power to stop or

unwind any transaction that gives or is perceived to give a foreign investor “control” over an enterprise in a “key industry” that could impact China’s “economic security.”

Acquisition of an Equity Interest in an FIE by a Foreign Investor or Another FIE

The rules governing foreign investment in newly-formed FIEs apply in nearly the same manner to investment in existing FIEs. Any acquisition by a foreign investor of an equity interest in an FIE whose business is in an industry on the Negative List is subject to a detailed examination and approval procedure (this procedure applies to both secondary acquisitions of outstanding interests from existing owners of the FIE as well as interests issued directly by the FIE). For existing FIEs whose business is not in an industry on the Negative List, an acquisition by a foreign investor of an equity interest in the FIE requires only a simple notification filing with the local counterpart to MOFCOM. Other than that difference (between the approval process and the filing process), the majority of the other rules apply in a similar manner. When acquiring interests in an existing FIE, foreign investors should note that while all existing claims, debts and employment relationships of the FIE prior to its acquisition remain, the benefit is that the foreign-invested FIE generally will be permitted to continue to use the licenses, permits and other regulatory approvals of the domestic company.

An acquisition by an FIE of an equity interest in another FIE is also subject to a detailed government examination and approval process, if its business is in an industry that is in the Restricted Category for foreign investment, as all industries in the Restricted Category are also on the Negative List. In addition, all such changes must abide by parameters in the 2017 Catalogue and the rules related to transfers of state-owned assets, if applicable.

Acquisition by FIEs of Equity Interests in Domestic Companies and Other Investments

Most FIEs are permitted to purchase equity interests in existing domestic-invested limited liability companies, or to form new companies, subject to applicable Chinese foreign investment restrictions (including those set out in the 2017 Catalogue). The purchase by an FIE of an equity interest in a domestic-invested company, or its establishment of a new company, requires approval if the investee company will operate in a Restricted industry under the 2017 Catalogue. If the investee company will operate in a Permitted or Encouraged industry, approval is generally not required except where foreign ownership limitations apply, but the investment must be registered with SAIC (or its local counterpart).

Operating Vehicles

China’s foreign investment regime offers several choices of legal entity to use for an operating vehicle, including a Sino-foreign Equity Joint Venture (EJV), two types of Sino-foreign Cooperative Joint Ventures (CJV), a Wholly Foreign-Owned Enterprise (WFOE) and a Foreign-Invested Company Limited by Shares, commonly known as a “joint stock company” or an “FICLS.” Each type of entity presents a foreign investor with various benefits and limitations.

Joint Ventures

Equity Joint Venture (EJV)

An EJV is an independent legal person with limited liability established for a fixed term (usually 10-50 years). It may engage in any commercial activity within its authorized scope of business. An EJV does not issue shares. Instead, the Chinese and foreign investors hold “equity interests,” and they incur liability and receive profit distributions based strictly on the value of their respective contributions to the EJV’s registered capital.

The management organization of an EJV has three tiers: a board of directors, a supervisory board (or alternatively one or two supervisors) and management personnel. Unlike most limited liability companies in China, the EJV’s highest authority is its board of directors (rather than its shareholders’ assembly), and its members are appointed by the investors roughly in accordance with the ratio of their respective capital contributions. Any modification to the EJV’s constitutional document certificates of association as well as certain other major decisions require the unanimous consent of its shareholders through their representatives on the board, as well as government approval (if it operates in an industry on the Negative List).

Cooperative Joint Venture (CJV)

A CJV may take the form of an independent legal person with limited liability or alternatively exist as a purely contractual arrangement in which no separate legal entity is created and where its investors bear unlimited direct liability for its obligation; however, this latter form is rarely used today. As compared to an EJV, a CJV offers a more flexible capital structure - apart from contributions to registered capital, its investors also may provide “cooperative conditions,” which may include assets or other items that in the case of an EJV would not be acceptable forms of contributions to its registered capital, such as leases, services or assets that are difficult to value. The investment in a CJV are permitted to fix the ratio at which the CJV’s profits are to be distributed. A foreign investor in a CJV generally may recover its capital investment at an accelerated rate during the operating term of the joint venture, as long as the Chinese investor takes ownership of the CJV’s assets at the conclusion of the term. Guaranteed returns, however, are prohibited for all projects.

In most other respects, a CJV is generally subject to the same rules and regulations as an EJV. CJVs are most commonly used for projects involving large fixed assets, such as real estate development and infrastructure. A foreign investor also may find the CJV form useful where a joint venture is required, for either regulatory or business reasons, but one party does not possess the cash or other assets necessary to establish an EJV.

Wholly Foreign-Owned Enterprise (WFOE)

A WFOE is an independent legal person with one or more foreign corporate or individual investors. Like EJVs, WFOEs do not issue shares and the investors hold equity interests based on the value of their respective capital contributions. The term of operation of a WFOE is typically between 10 and 30 years.

Management control is one of the principal advantages of a WFOE. The governance structure of a WFOE, like most companies, is largely dictated by the PRC Company Law. Unlike an EJV, a WFOE’s highest authority is its shareholders, though the shareholders are permitted to delegate most of their

powers to a board of directors or an executive director. Where there is more than one foreign investor, the investment is often made through an offshore holding company as the laws of the offshore jurisdiction generally provides the investors greater flexibility in determining their respective rights and obligations.

Foreign-Invested Company Limited by Shares (FICLS)

An FICLS is an independent legal person with limited liability that issues shares of equal value and may be used as a listing vehicle. In order for a company to qualify as an FICLS, foreign shareholders must normally hold at least 25%, but less than 100%, of its outstanding shares.

An FICLS may be established by the “promoter method,” where the promoters subscribe to all of the company’s initial issued shares, or by the “share float method,” in which the promoters subscribe to a portion of the company’s initial issued shares and the balance of the company’s initial issued shares are sold to the public. Foreign shareholders must pay cash for the shares of a listed FICLS, while foreign investors acquiring shares of an unlisted FICLS may use cash, machinery and equipment, proprietary technology, or land-use rights as consideration.

Following three consecutive years of profitability, an existing FIE may be reorganized as an FICLS. In the case of a state-owned enterprise or collective enterprise, it may be reorganized as an FICLS after five years of operation and three consecutive years of profitability if one or more foreign shareholders acquire at least 25% of its shares.

Research and Development Center (R&D Center)

A R&D Center is generally organized as an EJV, a WFOE or a branch of an existing FIE that meets certain minimum qualification thresholds and engages principally in R&D activities. Qualified R&D Centers are eligible for various benefits, including favorable tax rates, refunds and exemptions as well as various government subsidies and incentives.

Bonded Zone and Free Trade Zone FIEs

Most major cities in China have established “bonded zones” – areas created to encourage foreign companies to establish FIEs for the manufacturing and processing of goods for export. FIEs established in bonded zones were historically permitted to conduct various support services inside the zones, including marketing and exhibition, trading, warehousing, trade financing, packaging and transportation. Prior to China’s entry into the WTO, these “bonded zones” FIEs were commonly used to circumvent foreign ownership restrictions on companies involved in the import and distribution of foreign goods in China.



Post-WTO, EJVs and WFOEs are permitted to obtain foreign trade and distribution rights, and as a result the attractiveness of “bonded zones” to foreign investors has diminished. However, for certain businesses, such as logistics companies and certain manufacturers of products for export utilizing a high percentage of imported parts, bonded zones still presents significant tax efficiencies.

In 2013 the China (Shanghai) Pilot Free Trade Zone was established, to further promote commodities trading, financial markets, liberalization of foreign exchange controls and cross-border investments. Building on the success of the Shanghai Free Trade Zone, three new free trade zones were established in Guangdong, Fujian and Tianjin in April 2015. Before China adopted the Negative List in October 2016, the free trade zones offered relaxed restrictions on foreign investment in some industries and simplified procedures for FIEs. While these comparative advantages were diminished with the enactment of the Negative List in October 2016 and its subsequent incorporation into the 2017 Catalogue, companies in these free trade zones continue to enjoy flexibilities in areas such as foreign exchange control and customs supervision.

Branches

As a general matter, foreign companies are not permitted to establish branches in China, other than in a very limited number of areas including the banking sector. China enacted general legislation in 1994 governing the establishment of a branch by foreign companies. However, apart from the very limited exceptions mentioned above, the government has not yet issued any of the required implementing regulations or procedures to actually enable foreign companies to set up branches in China. Under its WTO accession protocol, China may indefinitely delay granting permissions for the establishment of foreign company branches.

In contrast, an FIE is permitted to establish branches outside of the district or city where the FIE is registered. A branch of an FIE may engage in the full range of business operations permitted under the business scope of the FIE, and may issue invoices and collect revenue on behalf of the FIE. An FIE branch does not have a legal existence independent from its parent FIE and the establishment by an FIE of a branch does not require approval from MOFCOM, regardless of whether its business scope falls under the Negative List (although separate regulatory approval may be required in certain industries). Instead, the FIE may register the branch directly with the SAIC office where the branch is located and record the branch registration with the SAIC office in the location where the FIE is registered.

Investment Vehicles

China offers an increasing range of investment vehicles for foreign investors, including the following:

- A foreign-invested investment enterprise (Holding Company), which permits multinationals to consolidate their China and Asian regional subsidiaries;
- A Regional Headquarters investment company (RHQ), which may serve as a holding, management or investment company;
- A Foreign-Invested Venture Capital Enterprise (FIVCE), which may engage in a limited scope of venture capital-style investment activities; and
- A Foreign-Invested Partnership enterprise (FIP), which may be used as an investment vehicle, subject to certain capital conversion and portfolio investment restrictions.

Holding Companies and Regional Headquarters (RHQ)

The Holding Company vehicle was designed to provide benefits for entities/individuals with significant investments in China. Accordingly, the minimum investment thresholds for Holding Companies are steep. A Holding Company may be established as an EJV or a WFOE. Unlike other FIEs, a Holding Company is treated as a foreign investor and may invest in any industry or sector, subject to the 2017 Catalogue and its authorized scope of business. It may be used to centralize and provide a variety of services to its subsidiaries, including sales agency and distribution, after-sales services, procurement, logistics, financial support, human resources management, technical support and training, equipment leasing and market consulting. It may also establish an R&D Center to procure goods in China for export, and to conduct trial sales of affiliate company products in China.

A Holding Company is exempt from income tax on dividends received from its subsidiaries in China, and it may incur higher levels of debt than other FIEs (e.g., four times the amount of paid-in registered capital, or, if the registered capital is at least US\$100 million, six times the paid-in registered capital.) A Holding Company also may obtain certification as a “regional headquarters,” or “RHQ,” which may be eligible for local incentives and other forms of preferential treatment. Various local rules also enable the direct establishment of an RHQ that is subject to a lower minimum capitalization requirement than a Holding Company and that is permitted to engage in certain investment and management activities and to provide centralized services to its regional subsidiaries or affiliates. Moreover, with the approval of China’s banking regulator, an RHQ may establish a finance company and provide financial services to the Holding Company/RHQ and its subsidiaries.

Foreign-Invested Venture Capital Enterprise (FIVCE)

An FIVCE may be established as a non-legal person or as a limited liability company. It can have anywhere from two to 50 investors, including one or more foreign individuals or other entities, and is required to have one “requisite investor.” The requisite investor must be a well-established venture capital entity that meets certain minimum capitalization and management personnel qualifications. The procedure to establish an FIVCE is similar to the procedure to establish most other types of FIE, except that MOFCOM is also required to consult with the relevant department in charge of the administration of science and technology.

An FIVCE is permitted to invest in privately held technology companies, subject to the categories in the 2017 Catalogue. An FIVCE also is permitted to provide consulting and management services to its invested enterprises and it may be permitted to provide management services to other venture capital enterprises. To carry out investment activities within an Encouraged or Permitted industry sector, an FIVCE is required to complete a filing procedure with the MOFCOM office where the target enterprise is located. If the target operates within a restricted industry, however, an FIVCE must obtain approval from this local MOFCOM prior to making an investment in the target.

Capital contributions by foreign investors to an FIVCE must be made exclusively in the form of cash in a freely convertible currency, and all such capital contributions are subject to China’s foreign exchange control regime. Unlike most types of FIE, an FIVCE is permitted to make equity investments in China using foreign currencies.

The sale of an FIVCE's equity investments also is subject to the restrictions set out in the 2017 Catalogue, and an FIVCE is required to carry out recordal and annual reporting procedures for its investment and divestment activities. An FIVCE that is in the form of a limited liability company is subject to enterprise income tax; an FIVCE that is in the form of a non-legal person is treated for tax purposes as a pass-through entity by most local tax authorities, though remittances of capital gains out of China are subject to withholding tax.

Partnership Enterprise (FIP)

An FIP may be established by foreign entities or individuals, with or without Chinese partners. They do not require MOFCOM's approval and may be established by carrying out a registration procedure with SAIC, although SAIC is then required to notify the relevant MOFCOM office.

An FIP can be organized as a general partnership, where the partners have joint and several liabilities, or as a limited partnership, where the liability of at least some partners is limited to the respective amount of their subscribed capital. An FIP organized as a limited partnership must have at least one general partner and cannot have more than 50 partners.

An FIP offers greater flexibility to its investors as compared to more traditional FIE entities such as EJVs or WFOEs. The partners in an FIP are free to structure their profit and interest-sharing relationships without regard to a capitalization ratio. The governance and management organization of an FIP is also free from the rigid requirements imposed on other types of FIE legal entities (in particular EJVs). The partners of an FIP are generally free to capitalize and govern an FIP, and share in its profits as they see fit, with these agreed arrangements typically memorialized in a partnership agreement or deed.

Representative Office (RO)

An RO has traditionally been one of the most common ways for foreign investors to establish an on-the-ground presence in the China market. An RO is a liaison office for a foreign company, which is legally liable for its acts. An RO lacks the status of an independent legal person and is generally prohibited from conducting business activities (including technical services and after-sales services) in its own name. There are, however, certain exceptions to this general prohibition—for example, RO may introduce and promote products, conduct market research, engage in technical exchanges, and interface with customers and government agencies. Limited exceptions to these business scope restrictions have been recognized for legal, accounting and tax service providers, for foreign banks, insurance companies and securities firms, and for businesses, such as airline offices, where bilateral or multilateral treaties prevail over domestic law.

Since 2011, the government has tightened the rules on the establishment, amendment and administration of ROs and curtailed the use of ROs by foreign investors. Under current rules, only companies that have been in existence for at least two years are permitted to establish an RO, thereby preventing a foreign investor from using a new offshore holding company or special purpose vehicle to establish an RO. In addition, an RO may register no more than three representatives in addition to a chief representative. This rule effectively limits the number of non-mainland Chinese that are permitted to work for an RO as each individual must be registered as a representative. Chinese nationals cannot be directly employed by an RO but have to do so through a foreign employment service company (a "FESCO").

The operating term of an RO may not be longer than the term of its foreign head office, and an RO is required to undergo an annual approval procedure to ensure the continuing validity of its registration certificate, to confirm the lawful existence of its head office, and to describe its operating situation and audited expenses, revenues and costs.

Although most ROs are not permitted to receive revenue due to their liaison status, most are still subject to income tax in China calculated on either (1) a deemed basis using a cost-plus calculation based on the RO's expenses, or (2) an actual basis recognizing the fees or commissions generated as a result of the RO's activities.

Contractual Arrangement – Variable Interest Entity (VIE) Structure

One type of business operating arrangement that has exploded in both popularity and controversy is the VIE structure. A VIE structure is commonly used when a proposed project is subject to foreign investment restrictions, or when a value-added telecommunications services (VATS) license is required.

VATS include internet data center services, content delivery network services, domestic internet protocol virtual private network services, internet access services, online data processing and transaction processing services, domestic multi-party communications services, storage and forwarding services, call center services, information services, and code and protocol translation services. An FIE that provides VATS is required to obtain a VATS operating license from the Ministry of Industry and Information Technology (MIIT).

VIE structures, typically involves the establishment of an onshore operating company owned by Chinese nationals (OpCo) to hold the licenses (such as a VATS license) and operate a business in a prohibited or restricted industry. Foreign investors in this business would invest in an offshore holding company which, through itself and through one or more WFOEs that it holds, exercises operational and financial control over the OpCo through a set of contractual arrangements. Under these arrangements, the revenue/profits of the OpCo flow to the offshore holding company (including any WFOE that the offshore holding company interposes between itself and the OpCo), and the accounts of the OpCo the offshore holding company and any of its relevant WFOEs under the VIE structure are consolidated at the offshore holding company level. The VIE structure allows foreign investors to tap into otherwise prohibited or restricted industries, and has therefore proven popular over the past decade. The first well-known VIE structure was adopted by the Chinese online media company, Sina Corp. in its 2000 NASDAQ listing. Other high-profile companies such as Alibaba and Baidu have also adopted VIE structures.

By way of background, foreign ownership interests in VATS licensed FIEs are generally restricted to 50%. Exceptions to this 50% limit are granted for e-commerce businesses (with no foreign ownership cap) which require a VATS license for online data processing and transaction processing services, and for certain VATS licensed FIEs located in a free trade zone. Although the applicable laws technically permit an FIE with no more than 50% foreign ownership to engage in VATS, in practice, it could be difficult for an FIE to obtain a VATS operating license from MIIT. Under the 2015 Telecommunication Business Catalogue issued by MIIT, the range of services listed under the VATS category and thereby requiring MIIT approval has increased. By way of example, SaaS (Software as a Service) is required to have a VATS license for "information services", and PaaS (Platform as a Service) and IaaS (Infrastructure as a Service) are required to have a VATS license for "internet data center services".

The benefits of the VIE structure must be considered in light of the risks arising due to an increasing level of scrutiny by the Chinese authorities and courts. If strictly enforced, the underlying contracts of a VIE structure may be declared invalid on the basis that they “conceal illegal intentions within a lawful form” to bypass restrictions on foreign investment in China. It is also worth noting that if China issues the new Foreign Investment Law in a form similar to the draft circulated for comments on January 19, 2015, it could potentially negatively impact VIE structures. The draft law looks through VIE structures to deem foreign ownership to be present in situations where a domestic company is effectively controlled by foreign companies. The legal risks surrounding the VIE structure should be carefully and closely monitored at this stage.

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Glossary of Acronyms

AML	Anti-Monopoly Law
CJV	Cooperative Joint Venture
EJV	Equity Joint Venture
FICLS	Foreign-Invested Company Limited by Shares
FIVCE	Foreign-Invested Venture Capital Enterprise
FIE	Foreign-Invested Enterprise
FIP	Foreign-Invested Partnership
MIIT	Ministry of Industry and Information Technology
MOFCOM	Ministry of Commerce
NDRC	National Development and Reform Commission
NPC	National People's Congress
RHQ	Regional Headquarters
RO	Representative Office
SAFE	State Administration of Foreign Exchange
SAIC	State Administration of Industry and Commerce
SASAC	State Assets Supervision and Administration Commission
SPC	Supreme People's Court
SPP	Supreme People's Procuratorate
SPV	Special Purpose Vehicle
VAT	Value-Added Tax
VATS	Value-Added Telecommunication Services
VIE	Variable Interest Entity
WFOE	Wholly Foreign-Owned Enterprise

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