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China's New Foreign Investment Catalogue Comes into Effect

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Today marks the coming into effect of the newly amended *Catalogue for Guidance of Foreign Investment in Industry* (外商投资产业指导目录) (the "Foreign Investment Catalogue" or "Catalogue"), issued December 24, 2011 by the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM).

This Alert discusses briefly the implications of the new Catalogue for foreign investors. The Catalogue represents relatively limited changes to its predecessor, issued in 2007. It reflects the planning priorities set forth in China's 12th Five Year Plan, which was promulgated by the National People's Congress in March, 2011, as well as the State Council's *Opinions on Further Improving the Utilization of Foreign Investment* (国务院关于进一步做好利用外资工作的若干意见) ("the 2010 Opinion"), issued April 2010, with liberalized foreign investment rules relevant to development of information technology, "clean" technology, high-technology manufacturing, and the service sector.

BACKGROUND

The Chinese government issued the first version of the Foreign Investment Catalogue in 1995. Since then, the Catalogue has been revised several times, with the most significant revisions issued in 2002, 2004 and 2007. The most recent version of the Catalogue became effective on December 1, 2007.

The Foreign Investment Catalogue classifies projects into a number of categories. "Encouraged," "restricted" and "prohibited" projects are expressly enumerated in the Catalogue. Projects that are not specified in the Catalogue fall under the "permitted" category by default. Whether a particular project falls within the "encouraged," "permitted" or "restricted" category affects the regulatory approval process the project is subject to and may affect what tax and other incentives may be available. In many instances, the Catalogue also specifies caps on foreign shareholding, by requiring that investment be in joint venture with a Chinese partner and in some cases capping the percentage interest of the foreign investor.

OVERVIEW OF AMENDMENTS

Major Changes to the "Encouraged" Category

Mining:

- The 2007 Catalogue had listed the exploration and development of seabed methane gas as encouraged for foreign investment. The new Catalogue has broadened language referring to "unconventional natural gas resources," listing shale gas and seabed gas hydrate as examples. Investment must be in joint venture.

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Food processing:

- The 2007 Catalogue had listed production of natural food additives and ingredients as being encouraged, but limited foreign investment to joint ventures. The joint venture requirement has been removed in the new Catalogue.

Textile manufacturing:

- The 2007 Catalogue had provided broadly that manufacture of specialized industrial-use textiles using high or new technology was encouraged. The new Catalogue narrows the scope of this language, specifying both the function of the textiles and the technology used.

Chemical manufacturing:

- A number of chemical projects have been removed from the encouraged category, and the scope of other encouraged projects narrowed through use of more specific definitions.

Pharmaceutical manufacturing:

- A number of products have been removed from the encouraged category.

Transportation vehicle and equipment manufacturing:

- Manufacture of complete automobiles is no longer in the encouraged category.
- The new Catalogue has added to the encouraged category the manufacture of specified key components for new-energy vehicles (NEVs), including certain types of battery and battery components; battery and motor management systems; and certain types of electric vehicle drive motors. Manufacture of the specified battery types is permitted only in an equity joint venture with foreign ownership of no more than 50%.

Electronics and communication equipment manufacturing:

- A number of adjustments have been made to the Catalogue reflecting changes in IT technology. For example, manufacture of large-format color printing equipment is no longer in the encouraged category. However, development and manufacture of next-generation Internet system equipment based on IPv6 and manufacture of touch-control systems (touch screens, touch modules, etc.) have been added.

Other manufacturing:

- A number of “nonmetal mineral” products have been added to the encouraged category, principally products used in the manufacture of clean energy or Cleantech products, such as manufacture of conductive glass for the solar power sector.
- The 2007 Catalogue had listed the manufacture of various specialized equipment in the Cleantech sector in the encouraged category, including equipment for management and recycling of waste plastics, electronic equipment, rubber and batteries. In the new Catalogue, additional types of equipment have been added to the encouraged category, including equipment for management and recycling of waste textile products, mechanical products and tires. More specific definitions have been provided in the description of waste treatment equipment and equipment for the prevention and control of pollution that are eligible as encouraged category products.
- Manufacture of specified nuclear power plant equipment is no longer in the encouraged category.

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Services:

- Venture capital, consulting services in relation to logistics, intellectual property right (IPR) services and “household” services have all been added to the encouraged category.

Education:

- Vocational training has been added to the encouraged category.

Major Changes to the “Restricted” Category

Mining:

- The new Catalogue adds high alumina refractory cement, wollastonite, and graphite as three nonmetal ores, in addition to diamonds, the mining of which is in the restricted category.
- The new Catalogue also adds extraction and refining of lithium and sulfur iron ore and the refining of brine resources from salt lakes to the restricted category.

Food processing:

- The new Catalogue extends the scope of the types of edible oils and grains the processing of which is in the restricted category.

Pharmaceuticals:

- The 2007 Catalogue placed wholesale and retail sales of pharmaceutical products in the restricted category and also required the Chinese party to hold a controlling interest in any business with 30 or more outlets selling different products. Notably these provisions have been removed, meaning that wholesale and retail sales of pharmaceutical products are now in the “permitted” category.

Wholesale and retail trade:

- Auction of commercial products, franchise business, commissioned agency business, and management service business have all been removed from the restricted category.
- Construction and operation of large-scale agricultural markets has been added.
- Distribution of audio-visual products is still in the restricted category and still requires a cooperative joint venture, but the Chinese joint venture partner no longer needs to hold a controlling interest.

Financial services:

- Financial leasing is no longer in the restricted category.

Real estate:

- Villa projects (i.e., construction of single-family homes) have been moved from the restricted to the prohibited category.

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Infrastructure Management:

- The 2007 Catalogue placed construction and management of natural gas, heating, and public sewage systems in large cities in the restricted category. This is no longer the case in the new Catalogue.

Education:

- The 2007 Catalogue placed investment in ordinary senior high schools in the restricted category and also required investment to be through an equity or a cooperative joint venture. The new Catalogue narrows the requirement, specifying that investment must be through a cooperative joint venture.

Social Welfare:

- The 2007 Catalogue placed investment in medical institutions in the restricted category and also required investment to be through an equity or a cooperative joint venture. This is removed in new Catalogue, reflecting State Council policy to liberalize foreign participation in the operation of hospitals.

Major Changes to the “Prohibited” Category

Post and Telecommunications:

- Domestic express letter delivery services have been added to the prohibited category.

Internet:

- The 2007 Catalogue placed news websites, web-streaming audio-visual programming, operation of locations for access to the internet, and online cultural operations all in the prohibited category. The new Catalogue excludes music from this categorization.

DISCUSSION OF IMPLICATIONS

Approval of New Foreign Investment Projects

If particular projects fall under the “encouraged,” “permitted” or “restricted” category, foreign investors can invest in those projects as long as applicable restrictions on foreign ownership are complied with and appropriate level of government approval can be obtained. It goes without saying that foreign investment is not allowed for projects under the “prohibited” category.

Investing in a project categorized as “encouraged” for foreign investment has a number of implications. For example, provincial as opposed to central authorities have greater authority over the project. In addition, certain tax benefits may be available, depending on the circumstances. Conversely, categorization of a project as “restricted” for foreign investment does not, at least in principle, mean the project is off-limits to foreign investment. It does, however, mean that the project may be subject to heightened regulatory scrutiny.

Examples of the approval authority of different levels of government over different categories of project include as follows:

- Approval of provincial or equivalent authorities is generally also sufficient for projects in the “encouraged” and “permitted” categories if total investment is less than US\$300 million. For “restricted” category projects, provincial

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approval is sufficient only if the total investment is less than US\$50 million. Projects in the “permitted” or restricted” category over the foregoing amounts must be approved by MOFCOM and NDRC.

- Provincial authorities may often delegate their approval authority to municipal or other lower level government authorities. However, provincial authority to approve a “restricted” category project may not be delegated.
- State Council approval is required for projects in the “restricted” category if total investment exceeds US\$100 million, but is generally required for projects in the “encouraged” category or “permitted” category only if total investment exceeds US\$500 million.

Implications for Existing Foreign Investment Projects

The amendments to the Catalogue have prospective and not retroactive application.

To the extent, for example, that a wholly foreign-owned enterprise was established in compliance with the then-current Catalogue to engage in a project that would now, in light of the new Catalogue, be permitted to be undertaken only with a Chinese joint venture partner, there is no requirement for the project to be restructured in order to comply with the limitations of the new Catalogue. To that extent, it is “grandfathered.”

However, the new Catalogue may be applied in the future to the enterprise, were it to undertake a significant corporate transaction requiring government approval, such as a capital increase, equity transfer or overseas initial public offering (IPO). According to an official at the NDRC, the requirements of the new Catalogue would then apply. It is difficult to predict specifically how the new Catalogue would apply to these situations. Taking the example above, it is possible, that a Chinese joint venture partner would need to be added to the enterprise as a condition of the government approval being granted for the transaction.

Interplay with Western Catalogue

The Foreign Investment Catalogue provides a general guideline for foreign investment throughout the country. Less restrictive policies sometimes apply in respect of foreign investment projects in the Western and Central regions of China, in accordance with the *Catalogue of Priority Industries for Foreign Investment in the Central-Western Region* (《中西部地区外商投资优势产业目录》) (the “Western Catalogue”).

The current version of the Western Catalogue was jointly issued by NDRC and MOFCOM on December 23, 2008. The 2010 Opinions contemplate that the Western Catalogue will be revised in order to encourage foreign investment in the Western and Central regions of China in labor-intensive, environmentally friendly projects.

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