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# China's New Foreign Investment Guidance Catalogue

By Woon-Wah Siu and Liang Tao

*On March 10, 2015 the National Development and Reform Commission (NDRC) and Ministry of Commerce (MOFCOM) of the People's Republic of China (PRC) jointly released a new Foreign Investment Guidance Catalogue, which will come into force on April 1, 2015. Other than some clarifying changes, the 2015 Catalogue is substantially the same as the draft released earlier for public comments.*

## General

The 2015 Catalogue retains the framework of classifying Chinese industries into "encouraged," "restricted" and "prohibited" categories (industries not listed are "permitted"); however, it substantially reduces the restrictions on foreign investment currently in place. The 2015 Catalogue lifts restrictions on foreign investment in dozens of service and general manufacture industries and relaxes Chinese ownership requirements. Although foreign investors still have to operate in some of these industries through Sino-foreign joint ventures, control by the Chinese partners will no longer be required. In addition, the 2015 Catalogue permits establishment of wholly foreign-owned enterprises (WFOEs) in a number of industries.

## More WFOE-Permitted "Encouraged" Industries

Under the current Catalogue (2011 Catalogue), dozens of industries categorized as "encouraged" are subject to restrictions on the form of foreign investment or Chinese ownership requirements. Specifically, foreign investors in those industries are required to work with Chinese partners through joint ventures or partnerships. Certain "encouraged" industries also require more than 50 percent Chinese ownership.

However, under the 2015 Catalogue, Chinese ownership requirements and form of investment restrictions will be removed from more than half of the "encouraged" industries, which means that foreign investors in these industries can operate their businesses in China through WFOEs. These "WFOE-permitted" industries include accounting (however, the chief partner must be a Chinese national); the construction and operation of rail transit such as city metro and light rail; operation of performance venues; design and manufacture of transportation equipment such as aircraft engines and engine parts and components; airborne equipment for civil aviation and yachts; manufacture of electric machinery and equipment such as power transmission and transformation equipment; and manufacture and R&D of automobile electronic devices, such as manufacture of embedded electronic integrated systems.

## Fewer "Restricted" Industries

The 2015 Catalogue will remove more 40 industries from the "restricted" category, allowing foreign investors to invest in those industries without restrictions on forms of investment or Chinese ownership requirements.

Under the 2015 Catalogue, the following industries are "permitted" to foreign investors:

1. Many manufacturing industries, but excluding arms and ammunition manufacturing (which remains "prohibited") and manufacturing of whole units of automobile, special automobiles, agricultural vehicles and motorcycles (which are currently in the "permitted" category)

2. E-commerce for technology, media and telecommunications business (TMT), but excluding any value-added TMT business (which remains "restricted" and subject to 50 percent or more Chinese ownership requirement)

3. Development of tracts of land, construction and operation of high-class hotels, high-class office buildings and international exhibition centers, investment in real estate secondary market and real estate brokerage

4. Operation of golf courses and villas and entertainment venues

5. In the 2011 Catalogue, banks, non-bank financial institutions, trust companies, and currency brokerage companies are in the "restricted" category. Only banks will remain in the "restricted" category in the 2015 Catalogue[1]

6. Currently, provision of legal services by foreign investors is "restricted". The 2015 Catalogue removes the legal industry from the "restricted" category. The 2015 Catalogue retains the prohibition of Chinese law related consulting services that appear in the earlier draft, but it has clarified that providing information on the impact of the Chinese legal environment is excluded from such prohibition.

## Rollbacks

While the 2015 Catalogue lifts or eases many restrictions, some industries will be rolled back and be under tighter control.

[1] The 2015 Catalogue includes the China Banking Regulatory Commission (CBRC) regulations on foreign ownership in banks. Specifically, the maximum foreign ownership in Chinese bank is capped at 20 percent for any single foreign financial institution investor (including its affiliates) and 25 percent if the investor group includes more than one foreign financial institution.

## Auto Industries

The manufacture of whole units of automobile, special automobiles, agricultural vehicles and motorcycles is currently “permitted.” However, they are also subject to the Policy on Development of Auto Industry issued by NDRC in 2004 (Auto Industry Policy). To conform to the NDRC’s policy, the 2015 Catalogue adds these industries to the “restricted” category. Specifically, the Chinese shares in Sino-foreign joint venture manufacture of whole units of automobile, special automobiles (excluding agricultural vehicles) and motorcycles may not be less than 50 percent. Each foreign investor will be allowed to establish no more than two joint ventures in China to manufacture whole units of automobiles of the same category (passenger cars, commercial cars or motorcycles). However, a joint venture may acquire and own existing domestic automobile manufacturers.

## Medical Institutions Industry

The 2015 Catalogue makes the medical institutions industry “restricted,” and investors will only be able to operate medical institutions through cooperative joint ventures or equity joint ventures, while the industry is currently “permitted.”

## Educational Services

The 2015 Catalogue imposes more stringent restrictions on foreign investment in the educational sector, which excepting high school education is currently “permitted.” Higher education and day-care are “restricted” and limited to cooperative joint ventures with Chinese control. High school education remains “restricted” with Chinese control. Compulsory education – grades 1 to 9 – will be “prohibited.”

## Some Observations

Despite the rollbacks, the new catalogue shows an encouraging trend.

Note that some industries may be subject to specific, additional restrictions imposed by agencies having jurisdiction over those industries. In the case of the automobile industry and the banking industries, the 2015 Catalogue includes amendments to conform to the auto and banking industry regulators’ rules, but NDRC and MOFCOM may not have taken into account restrictions put in place by other agencies in every other case. The statement contained at the very end of the 2011 Catalogue, "if there are any other specific rules or industry policies published by the State Council, the specific rules or industry policies shall prevail," is absent from the 2015 Catalogue. In any case, it is prudent to check other regulations.

Even in the two instances where NDRC and MOFCOM made changes to conform to other regulators’ rules, some clarification may still be needed. Currently, agricultural vehicles are “permitted” but subject to the Auto Industry Policy’s Chinese ownership requirements. The 2015 Catalogue’s conforming Chinese ownership requirement does not appear to expressly apply to agricultural vehicles. It is possible that the agricultural vehicle industry was left out of the 2015 Catalogue inadvertently and the regulators intended that industry to continue to be subject to the Chinese ownership requirement under the Auto Industry Policy.

While the 2015 Catalogue includes essentially the CBRC’s restrictions on foreign ownership on Chinese banks, it is silent as to the CBRC’s restrictions on foreign ownership on Chinese trust companies. Under CBRC rules, the maximum foreign ownership in a Chinese trust company is capped at 20 percent for any single foreign financial institution investor (including its affiliates) and each single foreign financial institution (including its affiliates) can own interests in no more than two Chinese trust companies. Even though the CBRC restriction on foreign ownership of Chinese trust companies, unlike the restriction on foreign ownership of Chinese banks, does not expressly include a cap on foreign ownership where more than one foreign financial institution investor (including its affiliates) is involved, we do not believe that the regulators would approve multiple foreign financial institutions to invest jointly in a Chinese trust company such that their joint ownership of the investee would exceed what the regulators deem to be acceptable foreign ownership level.

The 2015 Catalogue requires foreign investors to invest in the medical institution industry through either cooperative joint ventures or equity joint ventures and certain sectors in the educational services industry through cooperative joint ventures. Investors in cooperative joint ventures do not have to share management power and profits in proportion to their investment—those issues can be negotiated between the joint venture parties. The most desirable aspects of a cooperative joint venture from a foreign investor's perspective are that foreign investors can get their investment returns before the Chinese partner can participate in the profits distribution. The downside of a cooperative joint venture is that the joint venture agreement will be subject to stricter review by the approving authorities. Furthermore, some local governments discourage such a form of foreign investment in view of the apparent disadvantage to the Chinese partner. It will be interesting to see how difficult or easy it will be for foreign investors to form cooperative joint ventures in the medical institution industry and educational services industry.

Finally, MOFCOM published the draft Foreign Investment Law for public comments in January. That draft proposes the creation of a Foreign Investment Special Administration Catalogue (the Special Catalogue), which would be used to identify industries in which foreign investment is restricted or prohibited, much like the Negative List issued by the Shanghai Free Trade Zone. At this time, it is anybody's guess as to when the Foreign Investment Law will be adopted and, if it is adopted, what the fate of the Foreign Investment Guidance Catalogue will be.

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If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

Woon-Wah Siu (bio)
Shanghai
+86.21.6137.7924
woonwah.siu@pillsburylaw.com

Liang Tao (bio)
Shanghai
+86.21.6137.7932
liang.tao@pillsburylaw.com

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