

# GENERAL TRENDS OF FOREIGN INVESTMENT CONTROL IN CHINA: SOFTENING AND NEW CONSTRAINTS

*By Hubert Bazin and Henrick Emeriau, LPA-CGR avocats Shanghai*



LPA-CGR avocats

*Special issue compiled and edited by Marina Guérassimova and Professors David Chekroun, Gilles Pillet (ESCP Business School)*



*Hubert Bazin*



*Henrick Emeriau*

China maintained a positive growth in 2020 and 2021 and succeeded in attracting a domestic record 179 billion USD in foreign investments in 2021<sup>1</sup>, an increase of 20% from 2020. Until the beginning of the war in Ukraine, followed by a strict lockdown applied to Shanghai inhabitants during almost three months in the spring of 2022, foreign enterprises, especially from Europe and North America, have continued to invest in China to benefit from what has become a huge consumer market and an unrivaled industrial base. A key driver of this trend, the softening of Chinese laws and regulations governing foreign investment over the past few

years illustrates the will of China to open up to foreign economies.

However, the persistent trade war between China and the US, and more generally the commercial and political tensions with Western countries as well as the growing nationalist political stances of the Chinese regime, have fed discussions over a decoupling of China and the outside world. Albeit relaxing its control over low profile projects in the service and industry sectors, China has implemented various measures to better control foreign investments in strategic fields, following a path initiated by both the US and the European Union. New priorities and con-

<sup>1</sup> Investment Trends Monitor, UNCTAD, 19 January 2022

cerns, especially regarding environmental and climatic issues, also lead to the necessity to reassess investment models and related risks. At a time when globalization seems to recede, what lessons are there to take from these opposite movements?

### Further opening up of the Chinese market

Since its accession to the WTO in 2001, China has been under a constant pressure from its trade partners to further open its markets and relax its control over foreign investments, which resulted in a progressive simplification and harmonization of its foreign investment regime over the past two decades.

This process accelerated in 2016, when China cancelled the requirement for a prior administrative approval of foreign investment projects, except for certain sectors identified in a Negative List. Since that date and subject to the foresaid exception, the establishment of a foreign-invested enterprise (FIE), the increase of the registered capital of an existing FIE and the assignment of equity participations in a FIE are no longer subject to prior approval and must only be filed with the relevant administrations. Such filing can usually be completed online.

As regards sectors where foreign investments are restricted or prohibited, there exist two separate Negative Lists which are regularly updated by the National Development Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM): one applies to projects all over China, while the other applies specifically to investments in China's free trade zones (such as the Waigaoqiao free trade zone in Shanghai). The last versions of both Negative Lists, which are effective since January 1st, 2022, include respectively 31 (national list) and 27 (free trade zones list) sectors where foreign investment is either restricted or prohibited, a significant decrease from the 2017 national Negative List (63 sectors). Recent changes in the national Negative List include the removal of the cap on equity ratio that can be held by a foreign passenger car manufacturer (although it must be noted that investments in thermic motors vehicles projects are prohibited pursuant to special regulations) and generally a free access to almost all traditional industrial activities, while market research and survey activities have been allowed in the free trade zones. For those sectors which are not prohibited but merely restricted (for instance, social surveys) – the restriction consisting of a limited equity ratio applicable to foreign shareholders, the prior approval of the relevant administration is required. Depending on the amount of the investment, the approval may be granted at a municipal level or national level; for instance, in Shanghai

projects in the restricted sectors are approved by the municipal NDRC below 300 million USD and by the State NDRC above that threshold.

Apart from the Negative Lists, further opening-up measures (usually coming with certain tax and social incentives) have been implemented to promote certain areas, notably the Great Bay Area in Southern China and Hainan island. The latter is designed to become a gigantic commercial and touristic hub and a policy released in April 2021 announced future relaxations of market access conditions for activities such as health (online sale of drugs, clinical trials, R&D, esthetical surgery, transplants of organs), auctions, online videogaming, vocational training and civil aviation, which remain restricted or prohibited at the national level.

### Harmonization of the legal framework

Since the entry into force of the new Foreign Investment Law on January 1st, 2020, the special laws and regulations that previously governed foreign invested enterprises have been cancelled and all companies, irrespective of the nationality of their shareholders, are subject to the PRC Company Law. As a result, severe legal constraints that applied to the governance of Sino-foreign joint ventures have been lifted, such as the requirement for unanimous decision at the board of directors for all important matters (including any revision to the Articles of Association, assignment of equity participations, capital increase and dissolution or liquidation of the company). Henceforth, a qualified majority of two-thirds of the voting rights is legally required for the making by the shareholders of material decisions (revision to the Articles of Association, increase or reduction of the registered capital, combination, division, dissolution or transformation of the company), all other decisions being subject to simple majority rules unless otherwise provided for in the Articles of Association or shareholder's agreement. Meanwhile, a relaxation of the constraints applying to the cash payment of capital contributions or of equity transfer prices has been observed. Foreign investors have thus greater leeway to negotiate and adapt share purchase agreements and shareholders agreements to their needs, especially in terms of governance (for instance by providing for a representation of the shareholders at the board of directors and profit-sharing schemes that do not reflect their equity ratio), and implement more creative solutions, such as elaborate earn-out mechanisms or vesting clauses.

One may wonder, given the easing of market access conditions and the alleged full compliance by China with the principle of national treatment required under WTO rules that it claims to have achieved through legislation

harmonization, why foreign companies still extensively complain about the difficulties to do business in China and the fact that they cannot operate in China as Chinese companies operate in their own jurisdictions?

## Remaining controls and constraints

The non-convertibility of the Chinese currency, except for daily transactions, remains one of the major constraints faced by foreign investors in China, due to the strict foreign exchange control implemented by the banks upon delegation by the powerful State Administration of Foreign Exchange (SAFE). The remittance abroad of dividends or salaries paid to foreign nationals residing in China usually does not raise issues. However, advancing funds or invoicing services or technical assistance fees to Chinese subsidiaries, arranging bank financing from abroad or structuring share premiums within the frame of capital increases are generally confronted with numerous legal obstacles and practical challenges (strict thin capitalization rules capping the amount of foreign loans or advances, unreasonable requirements in terms of documentary evidences, etc.).

Besides, the implementation of new regulations (such as the opening up of new sectors) by the Chinese local authorities is sometimes far below expectation, while old practices are perpetuated: for instance, it is not uncommon that local administrative bureaus require the use of their own template of Articles of Associations or delay or refuse to issue necessary administrative licenses without which one cannot operate in certain industries, not to mention a protectionist or nationalistic stance in favor state-owned companies in oligopolistic sectors (such as telecoms, for which market access had been reluctantly conceded during the long negotiation of China's accession to the WTO, but which was in practice never opened to foreign investors) and certain advantages being given to state-owned companies in public procurements which discourage foreign companies to develop their activities in certain industries.

Meanwhile, one can also observe recent and rapid changes in the challenges and risks faced by foreign investors. Since the protection of the environment and the control of carbon emissions became a priority of the Chinese government, industrial investments are subject to administrative approvals which, in numerous provinces, require to go through lengthy discussions with local officials often resulting in refusal or stringent conditions being imposed. Controls are frequent and thorough, and non-compliance (even formal ones) may lead to heavy sanctions such as the administrative suspension or closing of factories. China is no longer the "world's workshop" that it was at the dawn of this century!

## A new National Security Review

More recently, China has established new regulations mirroring defensive measures put in place by the US and the European Union, namely the 2018 US FIRRMA and the 2019 EU FDI Regulation. Effective as from January 18, 2021, Chinese authorities implement a national security review process before approving any foreign investment in certain industries deemed sensitive: military, "critical" agricultural products, energy and resources, equipment manufacturing, infrastructure, transportation services, cultural products and services, information technology and Internet products and services, financial services, key technologies and "other critical areas". The list is broad and the condition of "criticality" is vague and subjective, depending entirely on the assessment made by the Chinese administrative authorities, without foreign investors having effective recourses in case of investment refusal. This results, de facto, in numerous business activities being closed to foreign companies in China although they are opened to Chinese investment in Europe or North America.

In September 2020, China also adopted a new regulation aiming to sanction foreign companies which would have suspended business relationships with or imposed discriminatory measures to Chinese companies based on foreign legislations or sanctions decided by a foreign government, in an effort to curb the so-called "unjustified extraterritorial application of foreign laws and measures", as do the US. This might trigger huge challenges for foreign companies which are required to comply with contradictory legal obligations in different countries.

In March 2021, the National People's Congress adopted the 14th five-year plan which outlines Chinese high ambitions and its willingness to have champions in the most advanced industries: AI, quantum mechanics, electrical vehicles, microchips, biotech, genetics, etc. These ambitions are supported by huge investments in innovation and R&D activities, but also the promotion of foreign investments (most cities and municipality-level districts having KPI related to foreign investments), especially in fields where China lags behind its foreign competitors. This may explain why foreign companies remain so keen to develop their business in China, despite regulatory constraints and significant obstacles to effective market access. The lasting "zero cases" Covid policy resulting in severe lockdowns and the growing tensions over the Taiwan issue in 2022 have however led numerous foreigners to leave China and some western companies to scale down their business activities, which will certainly impact the future trend of foreign investment in this country.