HERBERT SMITH FREEHILLS

CHINA INVESTMENT GUIDE

LEGAL GUIDE

2018 EDITION

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China's regulatory regime for foreign investment has continued to evolve. Incremental changes since the 2015 China investment guide include the introduction of a negative list approach for foreign investment into China, a filing system for foreign investment, relaxation of registered capital requirements and a new cyber security law. Bigger changes can be expected in the future with the introduction of the *Foreign Investment Law* which will likely replace the currently separate laws governing wholly foreign-owned enterprises, Sino-foreign equity joint ventures and cooperative joint ventures.

We are pleased to present this seventh edition of the *Herbert Smith Freehills China investment guide*, which covers both incremental changes and the anticipated *Foreign Investment Law.*

As with previous editions we draw upon our many years of experience in China to present an overview of China's regulatory regime for foreign direct investment and M&A. Except in passing, this guide does not address sector-specific requirements (of which there are many) for investing in China.

We trust you will find this seventh edition of the *Herbert Smith Freehills China investment guide* to be a useful tool in planning new, and managing existing, investments in China. Quality legal advice in relation to each specific investment is essential.

Herbert Smith Freehills LLP
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Herbert Smith Freehills LLP

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1. China today

Since opening up in 1979, China's economy has grown rapidly and its commercial law system has developed almost from scratch. Under President Xi Jinping's watch, the focus has shifted to the "rule of law", with the Communist Party's 18th Central Committee adopting a decision to comprehensively advance the "rule of law" (which in China comes with Chinese characteristics).

Although China's investment-driven growth model is facing challenges in the current global economic situation, China remains a significant investment destination.

A developing legal system

In 1979, publicly available laws and regulations were few and administrative discretion was paramount. Although the legal system has developed significantly since then, its development appears to have been ad hoc in many respects. For example, different laws and regulations regulate different types of companies available for foreign investment. Experimental (though binding) regulations are also issued pending the issuance of "final" regulations. From time to time, steps are taken to unify some aspects of China's foreign investment regime. The draft *Foreign Investment Law*, circulated for comment in January 2015, aims to unify laws among the various forms of foreign investment enterprises. Since 2016, China has been rolling out a number of reforms on foreign investment, in particular, the implementation of the negative list approach, to significantly relax the regulatory regime for foreign investment across the country (see Chapter 4 "FIE reform").

Outbound investment

The rapid growth of outbound investment continues to be a feature of the Chinese economy. Although not directly the concern of this publication, the outbound investment trend demonstrates the desire of many Chinese companies to become globally competitive. In turn, this is likely to make successful Chinese companies even more competitive in China, their home market.

WTO

China joined the WTO on 11 December 2001. Since then, China has become a more integrated member of the world's trading system. While anti-dumping and anti-subsidy actions have been increasing, the resolution of these disputes is now subject to WTO processes. Foreign investors have also benefitted from the opening of many sectors to foreign investment and China's commitment to reform its legal system relating to trade in goods and services, intellectual property and foreign exchange control.

China today

CEPA

The Closer Economic Partnership Arrangements with Hong Kong and Macau give Hong Kong and Macau businesses greater access to China's markets. Goods of Hong Kong or Macau origin can benefit from reduced tariffs in China. Hong Kong and Macau businesses have also been given greater access to various service sectors.

While the main text of CEPA was signed in 2003, annual supplements from 2004 to 2017 have progressively opened up investment opportunities for Hong Kong and Macau investors.

Ongoing reform

The following areas are generally recognised as in need of ongoing reform:

- **Intellectual property rights –** Despite substantial WTO-related reforms of China's intellectual property laws, establishment of intellectual-property courts, and some successful enforcement action, issues remain with the enforcement of intellectual property rights. Counterfeiting, piracy and theft of know-how are particular concerns.
- **Regionalism –** Economic and political differences can exist between central and local authorities, and between local authorities in different areas. Inconsistent national and local regulations are also not uncommon. The *Anti-Monopoly Law* seeks to address anti-competitive administrative action by regional authorities (see Chapter 47 "Competition law: behavioural provisions"). This may well become an enforcement priority in the coming year.
- **Judicial and arbitral processes –** The Supreme People's Court is giving increasing attention to improving procedures and enforcement (see Chapter 53 "Litigation"). The enforcement of foreign arbitral awards is more straightforward than it once was (see Chapter 54 "Arbitration").
- **Foreign exchange –** China is taking incremental steps to allow the full convertability of the Rmb. This is being done in parallel with the internationalization of the Rmb. Further liberalization can be expected.
- **Environmental issues –** The first few decades of China's development saw economic development take priority over environmental concerns. The result has been polluted air, water and soil on an unprecedented scale. China has, however, declared war on pollution and regulatory activity can be expected to increase. China has also sought to encourage environmentally-friendly investment and to actively discourage pollution-heavy industries. (See Chapter 45 "Environmental issues".)

Prospects

China has made great progress in establishing a legal system, particularly in relation to foreign investment, corporate and commercial matters. However, implementation of the law can be uneven and in many areas there remains a need for implementing rules that give guidance as to the practical details.

Relationships

It is often said that relationships (in Chinese, “guanxi”) are particularly important in China’s business context. However, relationships are never a substitute for a solid legal structure and operations that are compliant with Chinese law.

2. Your options in China

China's foreign investment regime recognises several types of companies that can be set up by foreign investors. These companies are commonly called foreign investment enterprises **(FIEs)**. Other common business arrangements are also available. The various alternatives are summarised below.

Investing

Investments in China may be through the establishment of green-field operations or through the acquisition of equity interests in, or assets of, an existing company. The resulting business operations must be registered in China.

The main types of investment vehicle available to foreign investors are:

- **Wholly foreign-owned enterprise (WFOE) –** A limited liability company with 100% foreign ownership (see Chapter 6 "Wholly foreign-owned enterprises (WFOEs)").
- **Equity joint venture (EJV) –** A limited liability company with both foreign and Chinese investors (see Chapter 7 "Equity joint ventures (EJVs)").
- **Cooperative joint venture (CJV) –** A joint venture with both foreign and Chinese investors. A CJV may be incorporated as a limited liability company or may exist as an unincorporated venture (see Chapter 8 "Cooperative joint ventures (CJVs)").
- **Foreign investment company limited by shares (FICLS) –** A share-issuing company with limited liability (see Chapter 9 "Foreign investment companies limited by shares (FICLS)").
- **China holding company –** A qualifying FIE that can invest in, and coordinate the activities of, the investor's China subsidiaries (see Chapter 10 "China holding companies").
- **Regional headquarters –** A qualifying FIE that can provide management and support services to the regional subsidiaries of an investor (see Chapter 11 "Regional headquarters").
- **Partnership –** A partnership with either general or limited liability; foreign investment in partnerships has been allowed since 1 March 2010 (see Chapter 12 "Partnerships").

Various considerations relating to the setting up of FIEs are addressed in Chapters 14 to 28 below.

WFOEs are the investment vehicle of choice for many foreign investors. WFOEs, however, are not permitted to engage in all activities and sectors. Reference should be made to China's Foreign Investment Industrial Guidance Catalogue and to sector-specific regulations to determine whether a WFOE is permitted for a particular business, or if a joint venture is required (see Chapter 5 "Open & prohibited sectors").

Other arrangements

The following arrangements may also be suitable for foreign companies wishing to carry out activities in China:

- **Representative offices –** These are set up in China to represent foreign companies (and their affiliates). A representative office itself is not a company. Significantly, representative offices are not permitted to engage in direct business activities (see Chapter 48 "Representative offices").
- **Manufacturing arrangements –** These can be structured as processing and assembly arrangements, compensation trade, or manufacturing arrangements. The main idea with each of these is that someone else manufactures your products. Protecting your intellectual property and maintaining quality control are key considerations in manufacturing arrangements (see Chapter 49 "Manufacturing in China").
- **Management contracts –** A foreign company may provide certain management services in return for a fee (see Chapter 50 "Management contracts").
- **Distribution arrangements –** A foreign company may appoint Chinese companies to distribute the foreign company's products in China. Protecting intellectual property is a key consideration in distribution arrangements.

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