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China Issues New Foreign Investment Catalogue:

Another Step Towards the Opening Up of the China Market

By Wenfeng Li (Counsel, Beijing) and Suat Eng Seah (Partner, Shanghai)

On March 13, 2015, China's National Development and Reform Commission ("**NDRC**") and the Ministry of Commerce ("**MOFCOM**") formally issued an amended version of the Catalogue of Industries for Guiding Foreign Investment, which will become effective on April 10, 2015 (the "**New Catalogue**").

1. Background

The Catalogue of Industries for Guiding Foreign Investment (the "**Catalogue**") is a key legal document in which the Chinese government classifies foreign investment by industry sector as "encouraged", "restricted", or "prohibited" (foreign investment in a particular industry is deemed to be "permitted" if it is not included in the Catalogue), and sets forth applicable foreign ownership percentage restrictions and form of investment (such as equity joint venture or cooperative joint venture) for foreign investment in certain industry sectors.

The Catalogue was initially issued in 1995 and has been amended from time to time. The currently effective Catalogue is the amended version of the Catalogue that came into effect in January 2012 (the "**Current Catalogue**").

2. Major Changes in the New Catalogue

The New Catalogue will bring significant changes to the Current Catalogue once it becomes effective on April 10, 2015. More specifically,

(i) "Encouraged" category

While the number of industry sectors in the encouraged category will remain largely unchanged compared with the Current Catalogue, restrictions on foreign ownership percentage and form of investment (e.g., Sino-foreign joint venture) will be removed for certain industry sectors such as planting and cultivation of traditional Chinese medicine herbs, design and manufacturing of embedded automotive electronic integration systems, civil aviation airborne equipment and yachts, accounting and auditing services. In addition, certain emerging industry sectors such as development and application of IOT (internet of things) technologies, development and manufacturing of fire and rescue equipment for large public buildings, high-rise buildings and other large facilities, and establishment and operation of senior citizen homes will be added to the encouraged category.

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(ii) "Restricted" category

Industry sectors in the restricted category will be reduced from 79 to 38, most of which are in the agriculture, mining, chemical, pharmaceutical and real estate industries. A notable change with respect to the services industries is the removal of e-commerce, direct sales, mail orders, online sales and rail cargo transportation from the restricted category.

With respect to newly added industry sectors, foreign investment in higher education institutions will be moved from the encouraged category in the Current Catalogue to the restricted category in the New Catalogue and foreign investment in pre-school education institutions will also be added to the restricted category. In addition, the New Catalogue will require foreign-invested education institutions to be led by the Chinese parties, which means that the head of the education institution must be a Chinese citizen and at least 1/2 of the members of the governing body of the education institution must be appointed by the Chinese parties. Besides, foreign investment in medical institutions will be added to the restricted category once the New Catalogue comes into effect.

(iii) "Prohibited" category

The industry sectors in the prohibited category will remain largely unchanged compared with the Current Catalogue.

(iv) Regulatory transparency

The New Catalogue states at the end that the application of the New Catalogue is subject to the bilateral arrangements between the mainland China and Hong Kong / Macao / Taiwan, and the free trade zone agreements and investment treaties between China and other countries. The New Catalogue also states that the industry sectors in the restricted and prohibited categories also include those provided for by *national laws and regulations* (emphasis added) and international treaties to which China is a party. In this regard, a notable change to the Current Catalogue is the deletion of the statement in the Current Catalogue that its application is also subject to the special regulations or industry policies of the State Council.

According to MOFCOM, these language changes to the Current Catalogue are intended to improve regulatory transparency so that foreign ownership percentage restrictions are all set forth in the Catalogue, which probably explains why the New Catalogue restates the foreign ownership restrictions in the automotive industry and certain financial services sectors that are provided for by the Automotive Industry Development Policy issued by the NDRC in May 2004 and various other laws and regulations applicable to the financial services sector respectively.

3. Preliminary Observations and Comments

The New Catalogue represents another step that China has taken to promote the opening up of its market while the Chinese economy continues to be an integral and important part of the world economy. As one of the key legal documents for the Chinese foreign investment regulatory regime, the New Catalogue is expected to have significant implications for foreign investment in China once it becomes effective. Based on our reading of the New Catalogue, we have the following preliminary observations and comments:

(i) By reducing foreign ownership percentage requirements in, and adding emerging industry sectors to, the encouraged category, and reducing industry sectors in the restricted category, the New Catalogue will further promote foreign investment in China's various manufacturing industries, particularly in the environmental protection, renewable energy and high technology sectors, which is also a reflection of China's growing confidence in the strength of Chinese domestic manufacturing companies and China's efforts to become a global manufacturing power house.

Having said that, with respect to manufacturing industries, the New Catalogue still contains foreign ownership restrictions even in the encouraged category. For instance, foreign investment in the R&D and manufacturing of automotive electronic bus network technologies and electronic controllers for electric power steering systems is limited to Sino-foreign joint venture, whereas there is no such restriction in the R&D and manufacturing of certain other similar automotive parts and systems in the New Catalogue. It is worth noting that this restriction was not contained in the draft of the New Catalogue that was published by the NDRC for public comment in November 2014.

(ii) With respect to foreign investment in China's service sectors, while the removal of e-commerce from the restricted category is a welcome development for foreign investors, the progress that the New Catalogue has made in further opening up China's service sectors is relatively small because most of the relaxing changes that the New Catalogue will make are unrelated to the service sectors. In certain cases, it appears that the New Catalogue has added additional service sectors to the restricted category.

An example in this regard is the medical institution sector. The New Catalogue will move foreign investment in medical institutions from the permitted category to the restricted category and limit the form of investment to Sino-foreign joint venture. While the current Chinese laws and regulations generally require foreign investment in medical institutions to be in the form of Sino-foreign joint venture, a regulation jointly-issued by the National Health and Family Planning Commission and MOFCOM in July 2014 permits foreign investors to establish and operate wholly foreign-owned hospitals in Beijing, Tianjin, Shanghai and another four provinces as a pilot program. In fact, the 2014 regulation was issued to implement one of the principles set forth in the State Council's Certain Opinions on Further Promoting the Development of Healthcare Services Sectors issued by the State Council in September 2013, which is to further relax requirements for Sino-foreign medical institutions and gradually expanding the pilot program of permitting the establishment and operation of wholly foreign-owned medical institutions. Therefore, it seems that the New Catalogue's addition of medical institution to the restricted category (with form of investment limited to Sino-foreign joint venture) has sent a mixed message with respect to the treatment of foreign investment in medication institutions. In addition, as there is no geographic exception in the New Catalogue, it is unclear how this 2014 regulation will be reconciled with the New Catalogue.

The education sector is another example. The New Catalogue will move foreign investment in higher education institutions and pre-school education institutions from the encouraged category and the permitted category respectively to the restricted category and will additionally require them to be led by Chinese parties.[1]

(iii) With respect to regulatory transparency, the publication of the draft New Catalogue by the NDRC in November 2014 for public comments is another positive sign that the Chinese regulators, including the NDRC, have been making efforts to further improve regulatory transparency. But a comparison of the draft of the New Catalogue issued for public comment and the final version of the New Catalogue indicates that, in the final version of the New Catalogue, only approximately 21 substantive changes were made to the total number of approximately 420 entries of industry sectors in the draft of the New Catalogue. Among these changes, 8 are minor changes and 14 changes are newly-added restrictions on foreign investment that had not been included in the original draft of the New Catalogue.

Considering that there was a period of almost four months during which the public were invited to comment on the draft of the New Catalogue and that a relatively small number of substantive changes were incorporated into the final version of the New Catalogue, it is worth exploring how all stakeholders (particularly foreign investors) can be more actively and efficiently involved in the public comment process with the Chinese regulators with respect to new laws and regulations that the Chinese regulators will issue in the future.

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1. We noted that the "being led by Chinese parties" requirement exists in the current Chinese law because the Regulation on the Sino-foreign Cooperative Education issued by the Ministry of Education in March 2003 requires that at least 1/2 of the members of the governing body of Sino-foreign cooperative education institutions be appointed by Chinese parties and the head of such education institutions be a Chinese citizen. But it's unclear why this particular restrictive requirement that is unrelated to foreign ownership percentage is added to the New Catalogue, whereas other existing restrictive requirements applicable to foreign investment in the education industry and other industries are not added.

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Regional Contacts:

Hong Kong
Partners:
Akiko Mikumo (Asia Managing Partner and office head)
Albert Cho
John Fadely
Peter Feist
Henry Ong
Soo-Jin Shim

29/F Alexandra House
18 Chater Road
Central, Hong Kong, PRC
Tel: +852 3476 9000

Beijing
Partners:
Steve Xiang (office head)
Li Li

2001 China World Office 2
1 Jianguomenwai Avenue
Beijing 100738, PRC
Tel: +86 10 6535 5200

Shanghai
Partners:
Steve Xiang (office head)
Suat Eng Seah
Anthony Wang

30/F Tower 2, Jing An Kerry Centre
1539 Nanjing Road (W)
Shanghai 200040, PRC
Tel: +86 21 6016 6300