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Hot Topic: New 2015 Investment Catalogue

The new Catalogue for the Guidance of Foreign Investment Industries (the 2015 Catalogue) has been published, and will become effective on 10 April 2015. It sets out in detail which industries are "prohibited" for foreign investment, which are "restricted" (e.g. a (controlling) Chinese joint-venture partner may be required) and which are "encouraged" (incentives may be available). Foreign investment in any sector not on the list is automatically "permitted".

Especially the significant reduction of restricted industries from 79 to 38 is good news for foreign investors, since these sectors will now move to the "permitted" category.

Sectors added to the encouraged category including:

- accounting and auditing (the only restriction is that the chief partner must hold the Chinese nationality);
- senior care institutions (a sector that is receiving a lot of encouragement from the Chinese government generally).

Sectors moved to the permitted category:

- a wide range of manufacturing industries (e.g. certain chemicals, petroleum processing, medical products, equipment) and certain mining industries;
- e-commerce for technology, media and telecommunication (TMT);
- trust companies, and currency brokerage companies (restrictions on foreign-invested banks remain);
- 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.

Newly added to the restricted category are:

- medical institutions (Chinese joint venture required, but in practice this was already the case);
- pre-school and higher education (which follows the trend of restricting the education sector in general to Chinese controlled joint-ventures);
- manufacturing of complete motor vehicles, special purpose motor vehicles and motorcycles (Chinese joint venture partner holding at least 50%, and max. 2 joint ventures per foreign investor).

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Revolutionizing Foreign Investment

By Maarten Roos

Since the early 1990s, welcoming foreign investment has been one of the cornerstones for China's economic development, while at the same time foreign investors have continued to be subjected to stricter rules and procedures than their domestic counterparts. This is about to change with the new *PRC Foreign Investment Law*, which will simplify procedures for foreign investors to establish in China, and lift some of the remaining restrictions to foreign investment in specific industries.

The draft PRC Investment Law was published on 19 January 2015 for public comment, and is expected to be issued this year for implementation in early 2016 [*I read everywhere timing is uncertain and implementation is not expected before late 2016, and possibly later*]. The current draft will likely be subject to some further revisions, but some of the key principals are expected to remain.

1. The new PRC Foreign Investment Law replace the existing legal framework for foreign-invested enterprises, consisting of separate laws for wholly foreign-owned enterprises (WFOE's), equity joint ventures (EJV's) and cooperative joint ventures (CJV's) with foreign investment, as well as their implementing rules. Existing WFOE's and JV's will have three years to comply with the new rules.

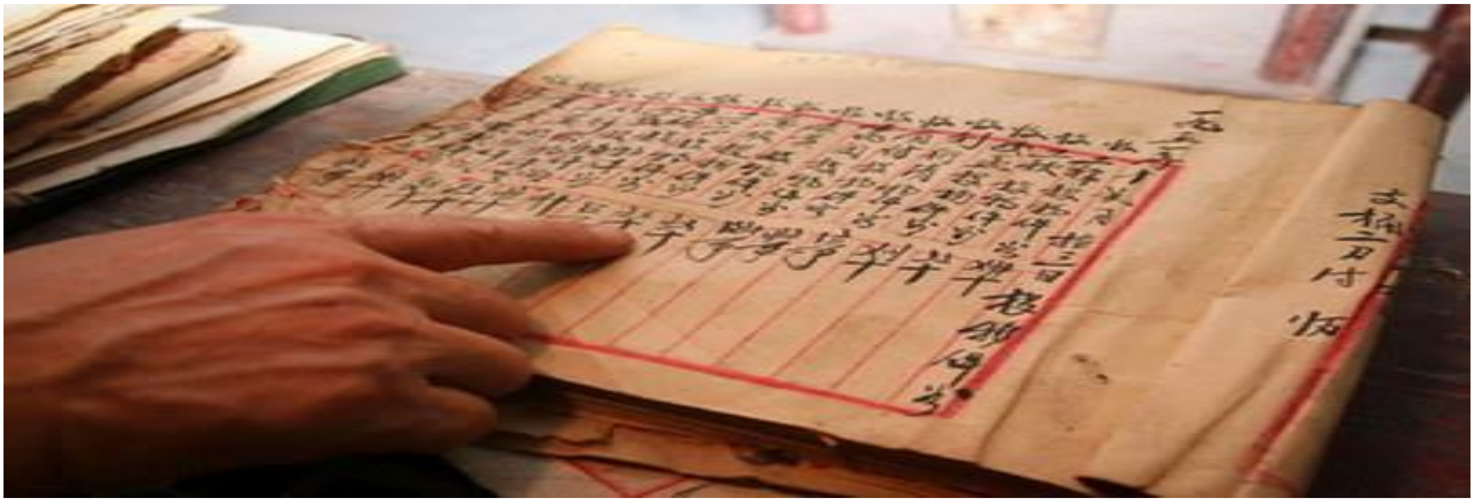
2. The approval procedures that currently apply to the establishment of foreign-invested enterprises will be replaced by a direct registration with the local Administration for Industry and Commerce (AIC), which will not only save time but also limit scrutiny on key documents such as the articles of association and joint venture contract (where applicable). Foreign investors will thus have more flexibility to make arrangements on a commercial basis, as long as they comply with the PRC Company Law.

3. Currently, the *Catalogue for Guidance of Foreign Investment Industries* determines whether foreign investment in a certain sector is encouraged, restricted or prohibited; foreign investment is permitted in all sectors not listed. This Catalogue will be replaced by a "Negative List" containing prohibited and restricted sectors, which is expected to be shorter. Only foreign investment in restricted sectors, or investments above a certain monetary threshold, will remain subject to approvals or, in some cases, a national security review, while no foreign investment will be allowed in the prohibited sectors.

4. Foreign investment is no longer defined with regard to ownership but rather, should reflect on control. As a consequence, round-trip investments by Chinese investors will no longer be subject to foreign investment restrictions. On the other hand, Variable Interest Entities (VIE) whereby a foreign company controls a domestically-owned business through a contractual arrangement will be regarded as foreign investment, as may other forms of foreign control such as long-term foreign financing and the acquisition of concessions to explore natural resources. The widespread use of VIEs to circumvent restrictions on foreign investment in prohibited or restricted sectors (e.g. media, internet) seems therefore no longer allowed when the new law comes into force. It is yet uncertain if and how existing VIEs (e.g. Alibaba, Baidu) in such sectors may continue to operate.

5. To counter the removal of prior approvals, including for routine changes such as of address, registered capital or even ownership, the *PRC Foreign Investment Law* introduces new reporting requirements, compelling foreign-invested companies to submit initial reports, subsequent reports and periodical reports on operational and financial performance, the actual controller of the investment etc. Considering that the law also introduces the principle of national treatment, it remains to be seen how this burden will be work in practice.

Interestingly enough, many of the provisions including the removal of approval procedures and the introduction of a Negative List, have already been successfully tested in the Shanghai Free Trade Zone. Many questions remain, including what will happen to tax and customs duty benefits that some foreign-invested companies have been enjoying. Nonetheless, the immediate conclusion remains that this law is the natural next in the gradual process of lowering barriers to foreign investment, and providing foreign-invested businesses with more freedom to engage in activities on commercial terms and in full and fair competition with domestic-invested counterparts.



Due Diligence: The Chinese Way

- ***By Rogier van Bijnen***

The article below is based on a weblog from the same author for the Dutch website MandA.nl

When I open the door of our conference room, I meet the counterparty for the first time – an older American gentleman and his Chinese (female) business partner. He has built a very successful global business, and has given her a carte blanche to run operations in China. Our client intends to buy all his non-Chinese activities and expressed interest in the China business as well, but only wants to decide after thorough due diligence. We're not even five minutes into the meeting when she suddenly starts shouting at her business partner that she hasn't seen any money yet, so she doesn't understand why he wants to give our client all kind of information about their business.

Once things have calmed down, we walk them through our bilingual due diligence questionnaire: 'Audited accounts over the past three years?' 'We don't have this.' 'Labor contracts?' 'All verbal.' 'Contracts with your customers?' Sometimes in writing, but usually all done over the phone. By the way, we won't disclose the identity of our customers until you have paid.' While we cover other topics in a similar way, I'm more and more relieved that our client only intends to buy their assets (primarily client relationships) in China, and not the equity in the company (which would come with a whole range of potential unknown liabilities).

Once the counterparty has left, I explain to the waclient that I can already predict the outcome of our due diligence: we will receive a shoe box with some random documents and there will be no such thing as a real "company", which is what his management in Europe believes there to be. The most important question in this case – whether the customer relationships at the heart of this transaction really exist – can probably only be answered by verifying the purported revenue received from these customers on the basis of bank statements and VAT payments. We will literally look over the shoulder of the target company's management when they log onto their bank account and the online tax registration system.

This story is not unique – even though our clients tend to focus on somewhat more sophisticated targets, the issues we generally encounter do not differ that much. Chinese companies are often quite reluctant to provide information or to fully cooperate with our due diligence. They quickly come to the view that information is commercially too sensitive to share and the Western style due diligence questionnaires are way too detailed and serve no clear purpose.

The result is that important information is often not disclosed, or if it is, only very late in the process. It is not unheard of for Chinese counterparties to deliberately withhold information that is unfavorable to them. Sometimes this is done by senior management who does not want to jeopardize the transaction, and sometimes by individual employees who made a mistake and don't want to lose face. One step further, intentionally providing incorrect or misleading information, is unfortunately not an exception either.

A recent eye-catching example is Caterpillar, which was forced to write off USD600m on a Chinese acquisition after inventory listed on the target's balance sheet turned out not to exist. In another case Deloitte had to let a listed client go after discovering that this client falsified bank statements to claim non-existing cash reserves, which reserves were independently confirmed by some of their bankers who were also part of the scheme.

Why do so many cases go wrong? In my view, an important reason is that it is far from easy to find good acquisition targets in China. Many of our clients face heavy competition – whenever there is a good target, the whole world jumps onto it – and often there is pressure from headquarters to push that China deal through. When, after months of lengthy negotiations, there is finally agreement on the commercial issues, nobody wants to hear that there are still outstanding issues from the due diligence.

Another reason seems to be that Western companies are much less prepared for fraud. In Europe or the U.S. one often starts with the assumption that a document is genuine unless there is an indication to the contrary, but in China I always take the exact opposite approach. When the other side is intentionally deceiving you, it often takes a full, multi-disciplinary due diligence to unravel this. Another good method is to imagine various ways of how the other side could defraud you, and then systematically rule these scenarios out during due diligence.

Whenever we start a due diligence exercise, we identify the key line items on the target's balance sheet and P&L and then try to verify each of them bottom-up during our investigation. This requires close cooperation between the various teams – if we take the target's annual sales volume for example, we lawyers need to confirm that this is backed up by written contracts, while the financial team needs to check that the payments have been actually received, and the technical/commercial team should confirm that it is likely that the target indeed physically produced such volume. It is quite difficult for the target to manipulate all these data points at the same time.

Such extensive due diligence is of course more costly than a high-level due diligence as is often seen in the West these days, but trust me, being scammed will turn out to be way more expensive.

In case you wonder what happened to the case at the beginning of this article: while we are still in the midst of our due diligence, I receive a phone call from the client that their board has approved the transaction and requires the purchase agreement to be signed as soon as possible. 'How about the due diligence?' I ask. 'Oh, almost forgot about that, just send me a summary or something. I trust them, it will all be ok.'

Circular 62: Curbing Investment Incentives

By Robin Tabbers

Introduction of Circular 62

In the past few years, local governments have actively introduced more and more incentives to attract foreign investors to their locality. Incentive-shopping by foreign investors has become a popular practice, and one result has been that local governments have seen their local part of the tax revenues from a lot of local business decrease significantly.

On 27 November 2014, the PRC State Council released new policies that are designed to curb such practices. Guofa [2014] No. 62 ('Circular') launches a comprehensive reform of various taxes and other preferential policies, specifically prohibiting local incentives for new investment and ordering the cancellation of previously-confirmed incentives.

Tackling the traditions of local governments to provide incentives to attract foreign investment

In the first decades of China's opening up, many foreign-invested companies could enjoy more favorable tax rates. When these were abolished in the last decade, local government throughout China started to introduce other local incentives to attract foreign investment. Common-seen examples of incentives and preferential policies include tax concessions, reductions and exemption of land royalties, counterpart funding, management services for foreign investment programs, financial guarantees and favorable interest rates. The establishment of special economic zones have helped local governments to market their incentives for specific industries.

Circular prohibits incentives

The new Circular specifically prohibits tax concessions, stipulating that '*except for the tax administration authority as prescribed in accordance with special tax laws and regulations,* *and the Law of the People's Republic of China on Regional National Autonomy, no region may develop preferential tax policies without the approval of the State Council*'. The Circular also prohibits reductions and exemptions of land royalties – land cannot be assigned at a preferential price. Other non-tax incentives such as waiving administrative fees and providing government funding are also prohibited, while state-owned assets may not be transferred at a preferential price. Reducing, exempting or postponing the collection of a company's portion of social insurance premiums is specifically prohibited and no company is permitted to pay premiums at a rate lower than the uniform one without the approval of the State Council. Other preferential policies in violation of laws include refunds, expenditures from retained revenue, fiscal rewards and subsidies, which shall all be resolutely canceled.

The regulation on counterpart funding and management services is vague; the Circular refers to 'other preferential policies shall be gradually regulated' are 'paying social insurance premiums and other operating costs on behalf of companies, granting preferential electricity prices and water prices, attracting companies from other regions to settle down in the regions or pay taxes in the regions by means of financial rewards or subsidies and the overall retaining or incremental refund of local fiscal revenues in some regions'. There is no also clear regulation related to monetary policies such as financial guarantee and favorable interest rates. Overall however, the message is clear: no more local incentives!

Previous incentives may be cancelled or curbed

Although the order from above clear establishes that past incentives must be cancelled, it remains to be seen whether local governments will so strictly execute and become compliant immediately.

Currently for example, negotiations are ongoing between several large foreign investors and relevant local governments, on the continuation of preferential policies in direct conflict with the Circular. More than ever, companies should liaise regularly with their local government and discuss the current status of incentives provided, and where possible negotiate for temporary relief. In any case there is pressure on local governments to act: The Circular calls for all regions and all relevant departments to carry out a special revise of contracts and agreements as concluded with companies, memorandums, minutes of meetings or talks as well as requests for instructions, reports and official replies in the form of 'one case one meeting'.

What does this mean for your decision-making regarding new investments in China?

When considering an investment in China, foreign companies should be focusing less on specific incentives that are offered, and much more on other commercial facts such as convenience of location, transportation, labor costs, infrastructure, location of sub-suppliers and customers, nearby ports, industry parks, overall living environment, expansion options, regional headquarters, service providers, and so on.