China's State Council Publishes New Guidance on Regulation of Outbound Investment

September 8, 2017

China Outbound

On August 18, 2017, the General Office of China's State Council released to the public new guidance regarding the regulation of outbound investment. The guidance is set forth in a notice, dated August 4, 2017, forwarding "guiding opinions" (the "**Opinions**") from the National Development and Reform Commission ("**NDRC**"), Ministry of Commerce ("**MOFCOM**"), People's Bank of China ("**PBOC**"), and the Ministry of Foreign Affairs ("**MFA**") to relevant government authorities throughout China.[1] The Opinions introduce a new taxonomy of "encouraged," "restricted," and "prohibited" categories of outbound investment transactions, but they do not clearly define such categories or explain the consequences of such classifications. Thus, although the Opinions provide some information as to the Chinese government's current approach to regulating outbound investment, market participants will need to await further guidance or new regulations before the full implications of the Opinions can be understood.

Contents of the Opinions

Encouraged, Restricted, and Prohibited Investment

Most notably, after affirming the Chinese government's commitment to promoting "rational," "well-ordered," and "healthy" outbound investment, the Opinions create a new taxonomy of "encouraged," "restricted," and "prohibited" outbound investment:

- **Encouraged Investment**. The Opinions provide that outbound investments that promote various general policy goals should be encouraged. The Opinions do not enumerate particular categories of encouraged investments. Rather, the Opinions instruct the government authorities:

    1. to promote outbound infrastructure investment that benefits the construction of the "Belt and Road" and connections with neighboring infrastructure;
    2. to steadily develop overseas investment that promotes the export of advantageous production capacity, quality equipment, and technology standards;
    3. to strengthen the investment cooperation with foreign high-tech and advanced manufacturing enterprises and to encourage enterprises to set up overseas R&D centers;
    4. to participate in the exploration and development of energy resources such as oil gas and minerals on the basis of careful evaluation of economic benefits;

[1] *Notice of the General Office of the State Council on Forwarding the Guiding Opinions of NDRC, MOFCOM, PBOC and MFA on Further Guiding and Regulating the Direction of Outbound Investments*.

5. to expand agricultural cooperation with foreign partners, develop win-win investment cooperation in agriculture, forestry, animal husbandry, fisheries and other fields; and
6. to promote, in an orderly manner, overseas investment in trade, culture, logistics, and other services fields, and support qualified financial institutions to set up overseas branches and overseas services networks and to conduct business in accordance with laws and regulations.

- **Restricted Investment**. The Opinions provide that outbound investments that are inconsistent with China's "diplomatic policy of peaceful development," "strategy of mutually-beneficial opening-up," and "macro-control policy" should be restricted. Such investments expressly include:

    1. investments in sensitive countries or regions (defined similarly to NDRC's and MOFCOM's current regulations);
    2. investments in "real estate, hotels, cinemas, entertainment, sports clubs, etc.;"
    3. establishing overseas equity investment funds or investment platforms without specific industrial projects;
    4. investments that use obsolete production equipment that does not meet the technical standard requirements of the target country; and
    5. investments that do not meet the environmental protection, energy consumption, and safety standards of the target country.

    The Opinions instruct NDRC, MOFCOM, and the State Administration of Foreign Exchange ("**SAFE**") to conduct verification and approval review of the investments in clauses (1) through (3).

- **Prohibited Investment**. The Opinions provide that outbound investments that impair or may impair China's national interests or national security are prohibited. Such investments expressly include:

    1. investments involving the export of core technologies and military industry products without Chinese government approval;
    2. investments involving any technology, process, or product whose export is prohibited;
    3. investments in gambling or pornography industries;
    4. investments prohibited by international treaties that China has concluded or acceded to; and
    5. other investments that impair or may impair China's national interests or national security.

Safeguard Measures

The Opinions include various "safeguard measures" for outbound investment. The safeguards are generally drafted as instructions to improve the regulation of foreign investment: e.g., "enhance authenticity and compliance review of outbound investment and prevent fake investment activities;" "guide domestic enterprises to enhance their supervision and management of overseas enterprises controlled by them;" or "support the development of relevant domestic intermediaries." The safeguards grant the government authorities receiving the Opinions broad discretion to interpret and implement their terms.

Only in one respect do the safeguards distinguish between encouraged, restricted, and prohibited investments. For encouraged investments, the safeguards provide that "tax, foreign exchange, insurance, customs, and information services" should be promoted. For restricted investments, the safeguards provide that the enterprises contemplating such investments should be "guided to act prudently and given necessary guidance tailored to the particular circumstances." Finally, the safeguards provide that prohibited investments are to be "strictly administered" and "controlled by practical and effective measures."

General Instructions

The Opinions instruct the government authorities, in accordance with the Opinions' other terms, to "enhance organization leadership, planning, and coordination," "fulfill [their] responsibilities," "quickly formulate corresponding supporting policy measures," "make solid progress in related work," and "ensure that actual results are achieved."

Commentary

Several features of the Opinions are notable.

The Opinions do not amend or replace the existing regulations. The Opinions leave in place the NDRC, MOFCOM, and SAFE regulations governing outbound investment and do not clearly indicate that such regulations will be amended in the future. The instruction to "formulate… policy measures" suggests that the underlying regulations *may* be revised. But for now the Opinions should be understood only as instructions as to how to administer the existing regulations.

However, the Opinions provide no specific guidance as to how to administer the existing regulations to encourage or restrict the new categories of outbound investment. Other than with respect to prohibited investments and the three categories of restricted investment that are to be subject to verification and approval by NDRC, MOFCOM, and SAFE, the Opinions provide no direction as to *how to encourage* or *how to restrict* the respective categories of outbound investment. For example, in the case of NDRC's record-filing process, the existing regulations set forth filing requirements, deadlines for NDRC's action, and the factors that NDRC must consider in determining whether to grant a "record-filing notice." The Opinions offer no direction as to how such requirements or considerations should be altered in the case of encouraged investment or restricted investment that is still subject to record-filing. Thus, even if NDRC's regulations are to be revised to reflect the Opinions, the Opinions offer no indication as to what changes such new regulations will effect.

The investment categories are broadly drafted and overlapping. The investment categories set forth in the Opinions leave significant ambiguity as to how particular investments will be classified. It is unclear, for example, to what extent the "establishment" of investment funds without specific industrial projects (a restricted investment) includes limited partnership investments in offshore private equity funds. Similarly, many investments in the entertainment industry (which are restricted investments) may be argued to serve the policy goal of promoting "culture… or other service fields" (and thus an encouraged investment). The Opinions do not say how such conflicts should be resolved.

The categories are not exhaustive. Likewise, the categories leave significant gaps, in that investments could seem to be neither restricted nor prohibited, nor clearly promote the policy goals of encouraged investments. An investment in the U.S. financial industry is a possible example. Indeed, the Opinions invite a comparison to China's inbound investment regulations, set forth in the *Foreign Investment Industry Guidance Catalogue*.[2] Such regulations categorize a long list of industries in China as "encouraged," "restricted," or

[2] 外商投资产业指导目录（2017 年修订）.

"prohibited" for foreign investment—but they are understood to treat all industries that are not so classified as "permitted." In the case of outbound transactions, the Opinions do not make clear whether a class of "permitted" investments will exist, or how such investments will be handled.

The status of the transaction structures targeted for scrutiny in December 2016 is unclear. On December 6, 2016, NDRC published a series of questions and answers from itself and MOFCOM, PBOC, and SAFE (the "**December 2016 Q&A**").[3] The December 2016 Q&A announced that increased scrutiny would be applied to several categories of outbound investments: (i) investments in "real estate, hotels, cinemas, entertainment, sports clubs, etc.;" (ii) significant investment in non-core businesses; (iii) investments by limited partnerships; (iv) "small-parent-big-subsidiary" investments; and (v) "quick-establishment-quick-exit" investments. The Opinions mention only the first such category (as the second type of restricted investment). But the Opinions do not expressly supersede the December 2016 Q&A. This leaves the other four categories of such investments—which have never been clearly defined—in limbo: Either they are subject to heighted scrutiny, per the still-effective December 2016 Q&A; or they are no longer subject to heightened scrutiny, as suggested by their omission from the enumerated list of restricted investment in the Options.

The Opinions leave in place one of the greatest practical challenges for outbound investment transactions: the inability of Chinese investors to enter into binding agreements prior to obtaining the key Chinese government approvals. Article 25 of NDRC's principal regulations governing outbound investment[4] requires an outbound investor, "prior to signing any final and legally binding [investment agreement]," to obtain from NDRC a "record-filing notice" (for transactions subject to record-filing) or a "verification and approval document" (for transactions subject to verification and approval)—unless such investment agreement provides that it will become effective only upon receiving such approvals. This provision precludes a Chinese investor from making a binding commitment to pay a reverse termination fee if such approvals are not obtained. When feasible, parties often address this issue by requiring the Chinese party to fund an offshore escrow account (with funds already offshore) or to obtain an offshore letter of credit from an offshore financial institution at the time of signing a transaction, both of which can increase the cost of the transaction for the Chinese party. The Opinions give no indication that this provision will be changed, even in the case of encouraged investments. In fact, one of the "basic principles" contained in the Opinions is that regulators will supervise outbound investments "*before*, during, and after"(emphasis added) the transactions. This suggests that regulators may continue to act as a gatekeeper for Chinese investors entering into binding outbound agreements, despite the costs to Chinese parties.

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We will continue to monitor these developments closely, and we are well-positioned to assist clients in understanding how these developments may affect their potential transactions.

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[3] NDRC, MOFCOM, PBOC, and SAFE Representatives Answer Reporters' Questions [发展改革委，商务部，人民银行，外汇局四部门负责人会记者问], December 5, 2016.

[4] NDRC, Administrative Measure for the Verification and Approval and Record-Filng of Outbound Investment Projects [境外投资项目核准和备案管理办法], dated April 8, 2014, and effective May 8, 2014, as amended.

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