



JONES DAY
COMMENTARY

CHINA ADOPTS FIFTH CATALOGUE OF INDUSTRIES FOR GUIDING FOREIGN INVESTMENT

In the past, the Chinese government’s position with respect to foreign investments tended to encourage the volume and scale of investments, generally with little regard to the industries into which such foreign investments were directed. After many years of robust development by foreign investors, the Chinese government started focusing more on developing specific industries that, in its view, would yield the greatest benefits to Chinese society (e.g., foreign investments in more technologically advanced, sustainable, and environmentally friendly industries), while shifting its support away from encouraging foreign investments in the “overheated” high-energy-consuming and high-polluting industries.

This shift in China’s policy regarding foreign investments is reflected by the fifth Catalogue of Industries for Guiding Foreign Investment (the “2011 Catalogue” or “Catalogue”) promulgated by China’s National Development and Reform Commission (“NDRC”) and the Ministry of Commerce (“MOFCOM”) on December 24, 2011. The Catalogue, since its first release in 1995,

has served as important policy guidance for foreign investors who are interested in taking part in China’s rapid development and increased receptiveness to investment. The Catalogue classifies China’s industrial sectors into three categories: “encouraged,” “restricted,” and “prohibited.” Sectors that are not specifically listed in the Catalogue are considered to be “permitted” sectors. The 2011 Catalogue includes some notable changes from the previous version, which changes will be discussed in this *Commentary*.

Foreign investors could regard the Catalogue as an indicator that will show which industries are needed by the Chinese economy and those industries that are “restricted” and “prohibited” to foreign investors either for the purpose of protecting local business developers or because of national security concerns.

China implements varying policies in different categories of industrial sectors with regard to tax incentives and approval procedures. For example, local governments can approve foreign investment in the

“encouraged” and “permitted” categories (under a certain monetary amount), while foreign investment in “restricted” industrial sectors requires higher-level approval. Although corporate income tax reduction or exemption has not been available to foreign-invested companies since the 2008 tax reform, certain local governments do have other policies, such as subsidies or tax return for the local tax portion of the foreign investment in the “encouraged” industrial sectors.

The 2011 Catalogue reflects the Chinese government’s policy preferences and focuses on the following areas of development in China: (i) continued and enhanced receptiveness to foreign investment—the 2011 Catalogue has added several encouraged sectors and removed restrictions on shareholding of foreign investors from many sectors; (ii) upgrading the manufacturing industry—for example, the manufacture of recycled equipment and touch control systems has been added into the “encouraged” category; (iii) promotion of new strategic industries such as new energy, new materials, high-end equipment, and energy-saving equipment—for example, exploration and exploitation of unconventional natural gas resources and production of biomass fibers by utilizing new types of renewable resources and environmentally friendly process have both been added to the “encouraged” category; and (iv) development of a modern service industry—the 2011 Catalogue has included nine service sectors as “encouraged,” including intellectual property rights services, household services, and occupational skills training.

These policies were restated and confirmed by China’s Premier Wen Jiabao in the 2012 Government Work Report delivered at the National People’s Congress in Beijing on March 5, 2012, which emphasizes the Chinese government’s commitment to the new initiatives.

In this *Commentary*, we summarize and highlight the major changes in the 2011 Catalogue and Premier Wen Jiabao’s 2012 Government Work Report.

MINING INDUSTRY

China has long adopted a conservative attitude toward the exploration and exploitation of its natural resources by foreign interests, which is why many mining activities remain

in the “restricted” category. These include exploration and mining of high-aluminum fireclay, wollastonite, graphite, and other important nonmetallic metals; mining and mine selection of lithium mines and iron sulfur mines; and extraction of brine resources from salt lakes. However, it is interesting to observe that the 2011 Catalogue includes the exploration and exploitation of unconventional natural gas resources in the “encouraged” category. Although investment in this sector is limited to joint ventures, it shows that the government is favoring those industries that utilize new or sophisticated exploitation technology, such as shale gas.

MANUFACTURING INDUSTRY

Over the past 30 years of reform and opening up, China has achieved rapid development and at the same time has suffered the unfortunate side effects of unbalanced development and severe environmental degradation. According to the 2012 Government Work Report, China is in the process of upgrading its industry structure and promoting new strategic sectors such as new energy, new materials, and high-end and environmentally friendly technology.

These policies are evidenced by the changes made in the 2011 Catalogue. For example, the items added to the “encouraged” category are foreign investments in production of functional and ecological clothing; development and production of functional glass using new technologies; production of organic–inorganic composite cellular insulation materials; development and production of high-quality artificial crystals and thin-film transistor products; and manufacture of recycled equipment. Some sectors have been removed from the “restricted” category and are now permitted under the 2011 Catalogue, including the production of carbonated beverages and the manufacture of containers.

REAL ESTATE INDUSTRY

In order to control housing prices and excessive investment in the real estate market, China has continued to exert tight controls over both domestic and foreign investments in the real estate sector. This is further evidenced by the changes in the 2011 Catalogue, which moves foreign investment in the

construction and management of villas¹ from the “restricted” category to the “prohibited” category. Since as early as 2006, China has promulgated a series of regulations aiming to limit foreign investment in the overheated real estate market, which has raised the bar for all foreign firms intending to enter the Chinese real estate market. It has done so by implementing strict requirements on the form of investment, threshold of capital, financing, and other factors. Moreover, with regard to construction of villas, a number of regulations have been put in place since 2003, prohibiting domestic and foreign invested developers from investing in this housing category by restricting the supply of land for this purpose. Thus, foreign invested developers had been already constrained in this field prior to the promulgation of the 2011 Catalogue. The aforesaid change in the 2011 Catalogue could be regarded as a reiteration of the same policy and therefore does not reflect more material restrictions on foreign investment in the construction and management of villas.

MEDICAL INDUSTRY

In order to modernize its medical industry, China has taken a more open attitude under the 2011 Catalogue. For example, foreign investment in medical institutions and the wholesale and retail sales and distribution of medicine is removed from the “restricted” category and is now “permitted.” Similarly, production of biovaccines has been added to the “encouraged” category, and production of non-self-destructible disposable syringes, transfusion apparatus, blood transfusion apparatus, and blood bags has been removed from the “restricted” category and is now “permitted.”

While foreign investment in China’s hospital and medical facility market started in the 1980s, foreign investors were not allowed to establish wholly foreign-invested hospitals or other medical institutions. According to the 2011 Catalogue and other new regulations, China will be gradually removing the various restrictions on foreign investors’ shareholding percentage in joint ventures and eventually opening the market for wholly foreign-invested medical institutions.

MODERN SERVICE INDUSTRY

As pointed out by Premier Wen Jiabao in the 2012 Government Work Report, China will exert its efforts to develop modern service industries. According to Premier Wen, this will optimize the social and industrial structure, improve people’s living standards, and create more job opportunities. Under the 2011 Catalogue, China has opened several new service markets to foreign investors; for example, rural distribution, intellectual property rights services, household services, and occupational skills training have been added to the “encouraged” category, and foreign investment in goods auctions has been removed from the “restricted” category and is now “permitted.”

Prior to the promulgation of the 2011 Catalogue, only Hong Kong and Macau investors were encouraged to engage in trademark and patent agency services according to their respective Closer Economic Partnership Arrangements. Under the 2011 Catalogue, foreign investment in the full range of intellectual property services is now encouraged, including agency, transfer, registration, evaluation, and consultation services of patent, trademark, copyright, and other intellectual property rights.

FINANCIAL INDUSTRY

The 2011 Catalogue includes several notable changes with respect to foreign investments in the financial industry. The “startup investment enterprise” has been added to the “encouraged” category, and foreign investment in financial leasing companies has been removed from the “restricted” category and is now “permitted.” In accordance with the Interim Administrative Measures on Startup Investment Enterprises promulgated by the NDRC in 2005, the term “startup investment” means any equity investments in an unlisted and emerging enterprise being established or re-established (the “startup enterprise”), with the goal of deriving capital gains from share transfer after the invested startup enterprise becomes mature. This term is similar to

¹ “Villas” is similar in concept to “single family homes” and “townhomes” in the United States.

the definitions of “venture capital” and “private equity” from the perspective of foreign investors. China believes this positive move would effectively stimulate the development of emerging and high-tech companies.

Foreign-invested “startup investment enterprise” was categorized as “permitted” under the 2007 Catalogue. While some local governments have adopted various preferential measures to support the development of startup investment enterprises, the policy of the central government had fallen behind the incentives offered by local governments, hence startup investments’ change to “encouraged” from “permitted.” With this significant policy change in the 2011 Catalogue, we can expect more favorable policies to be implemented in this industrial sector.

CONCLUSION

Overall, the 2011 Catalogue reflects China’s continuous commitment to further expand its opening-up policy as the industries falling under the “encouraged” category have increased while the number of industries listed in the “restricted” and “prohibited” categories has fallen. However, these changes contained in the 2011 Catalogue signal that the Chinese government’s policy on foreign investment has become more mature and rational, such that volume and scale of the foreign investments are no longer the primary focus. The changes in the 2011 Catalogue reflect China’s determination to optimize the structure of foreign investments and to direct such investments into new technology, high-end sectors, and environmentally friendly industries. We expect that governmental authorities will be passing new laws, as well as revising existing ones, in the near future to support the policy shifts reflected in the 2011 Catalogue.

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