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# Revamp of Foreign Investment Laws in China: More Opportunities or Challenges?

## Introduction

At the recent Thirteenth National People's Congress ("**NPC**") of the People's Republic of China ("**PRC**"), the PRC Foreign Investment Law (中华人民共和国外商投资法, "**Foreign Investment Law**") was passed by the NPC on Friday, 15 March 2019, and will come into effect from 1 January 2020. Though the revamp of the foreign investment regime has been in the works for several years, the passing of the Foreign Investment Law was rushed through in the midst of US-China trade dispute and lacking in details in several aspects.

Compared with its initial draft issued on 19 January 2015 which had 170 clauses, the newly-passed Foreign Investment Law only has 42 clauses, while serving as a basic law for foreign investment in China, replacing the existing three laws for foreign-invested enterprises in China ("**Three FIE Laws**"), namely the Law on Sino-foreign Equity Joint Ventures ("**EJV Law**"), the Law on Wholly Foreign-owned Enterprise ("**WFOE Law**") and the Law on Sino-foreign Contractual Joint Ventures ("**CJV Law**").

The Foreign Investment Law contains largely policy statements with few details even though it seeks to regulate the activities of foreign investment and foreign-invested enterprises ("**FIEs**") in China. Foreign investors and FIEs in China should understand what the new regime is and what issues are yet to be resolved, so that they may know what opportunities and challenges they face with this new foreign investment umbrella legislation in China.

## 1. WHAT IS THE NEW REGIME?

The scope and definition of foreign investment under the Foreign Investment Law is generally in line with traditional concepts of foreign investment and does not touch on controversial issues.

The Foreign Investment Law is to regulate investment activities **directly or indirectly** conducted by foreign individuals, enterprises and other organizations in the territory of China, including the following:

- (a) Greenfield investment - A foreign investor forms a foreign-invested enterprise within China alone or jointly with any other investor;

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- (b) Mergers & acquisitions - A foreign investor acquires any shares, equities, proprietary interest, or other similar interest in an enterprise within China;
- (c) Investment in new projects - A foreign investor invests in any newly-formed project within China alone or jointly with any other investor; and
- (d) Investments made by foreign investors in China in any other way stipulated by laws, administrative regulations or provisions of the State Council.

Some observers see the Foreign Investment Law as a response to the ongoing negotiations between China and the U.S. on trade dispute, with particular emphasis on the following “**Four Key Pillars**” – (i) market access (市场准入), (ii) promotion (投资促进), (iii) protection (投资保护) and (iv) administration (投资管理) of foreign investment in China.

### 1.1 Market Access for Foreign Investment (市场准入)

The Foreign Investment Law adopts a regulatory regime of national treatment plus negative list, which has been repeatedly mentioned and discussed in recent years.

The practice of the negative list was first implemented in China (Shanghai) Pilot Free Trade Zone in 2013, and later the concept was extended to the whole country. Under the regime of the negative list, foreign investors shall be treated equally as domestic investors when they invest into businesses which are not restricted or prohibited by the negative list from foreign investment. That is to say, foreign investors shall comply with relevant restrictions in the sectors prohibited or restricted for foreign investment, while in the encouraged and permitted sectors, foreign investors shall comply with, to the same extent, restrictions which apply to domestic companies. The table below sets forth the current negative lists which apply to different types of companies inside and outside of Free Trade Zones in China (“FTZs”).

Type of Company	Negative List (prohibited, restricted)	List of Encouraged Industries
FIEs outside FTZs	<ul style="list-style-type: none"> <li>2018 Negative List for Foreign Investment (外商投资准入特别管理措施(负面清单));</li> <li>2018 Market Entry Negative List (市场准入负面清单); and</li> </ul>	<ul style="list-style-type: none"> <li>2017 Catalogue of Industries for Guiding Foreign Investment (外商投资产业指导目录); and</li> </ul>

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	<ul style="list-style-type: none"> <li>• 2011 Catalogue for Guiding Industrial Restructuring (产业结构调整指导目录)<sup>1</sup></li> </ul>	<ul style="list-style-type: none"> <li>• 2017 Catalogue of Priority Industries for Foreign Investment in Central and Western China (中西部地区外商投资优势产业目录) (only apply in central and western China)</li> </ul>
FIEs inside FTZ	<ul style="list-style-type: none"> <li>• 2018 Negative List for Foreign Investment in FTZs (自由贸易试验区外商投资准入特别管理措施(负面清单));</li> <li>• 2018 Market Entry Negative List; and</li> <li>• 2011 Catalogue for Guiding Industrial Restructuring</li> </ul>	
Domestic Company	<ul style="list-style-type: none"> <li>• 2018 Market Entry Negative List; and</li> <li>• 2011 Catalogue for Guiding Industrial Restructuring</li> </ul>	<ul style="list-style-type: none"> <li>• 2011 Catalogue for Guiding Industrial Restructuring</li> </ul>

Under the negative list regime, only the negative lists can stipulate restricted or prohibited sectors and set restrictions on shareholding ratio held by foreign investors. To comply with the Foreign Investment Law, relevant authorities shall revise or abolish the restrictions on foreign investment which are not listed on the negative lists.

Theoretically speaking, foreign investment into industries which are not in the negative lists will not be subject to approval, provided that, for any investments that are subject to license and permit requirements, the FIEs shall still apply to the relevant authorities to obtain the requisite licences and permits before carrying on the relevant business.

It is worth noting that some regulatory bodies have issued regulations to restrict shareholding ratio held by foreign investors, for example:

- the currently effective Provisional Measures for the Administration of Medical Institutions in the Form of Sino-foreign Equity or Contractual Joint Venture expressly provides that the ratio of equity or rights and interests of the Chinese joint equity or co-operation party to a medical institution in the form of Sino-foreign equity joint venture or contractual joint venture shall not be less than 30%.
- the Interim Provisions on the Administration of Chinese-Foreign Joint Venture Talent Intermediary Agencies provides that the contribution made by the Chinese investor in a Sino-foreign joint personnel intermediary agency shall not be less than 51%.

<sup>1</sup> 2011 Catalogue for Guiding Industrial Restructuring has been revised in 2013 and some provisions are further revised by 2018 Market Entry Negative List.

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The foregoing equity percentage restrictions in the above two examples are not found in the 2018 Negative List for Foreign Investment in and outside FTZs.

### 1.2 Promotion of Foreign Investment (投资促进)

The Foreign Investment Law aims to create a “more level playing field” for foreign investment in China and has provided various measures to ease anxiety and reboot the confidence of foreign investors, including but not limited to the following measures:

#### (a) Equal Participation in Government Procurement

It is not uncommon that some local governments set forth certain conditions and requirements which indirectly disqualify FIEs for participation in the bidding process. The Foreign Investment Law emphasizes equal participation for FIEs in government procurement activities through fair competition and the products produced and services provided by FIEs in China shall be equally treated in government procurement according to the law.

#### (b) Equal Enjoyment of Incentive Policies

The Foreign Investment Law has provided that the state's various policies to support the development of enterprises shall equally apply to FIEs according to the law.

#### (c) Re-emphasis of FIE's Financing Channels

An FIE may seek financing according to the law by means such as the public offering of stock, corporate bond, and other securities.

### 1.3 Protection of Foreign Investment (投资保护)

The Foreign Investment Law has a separate chapter on the protection of foreign investment in China, which includes the following provisions:

#### (a) No Government Expropriation

The State shall not expropriate foreign investment, provided that, where the State expropriates foreign investment according to public benefit requirements in a special circumstance, statutory procedures shall be followed, and fair and reasonable compensation shall be paid.

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(b) Inflow and Outflow of Capital

Foreign investors may freely remit into or out of China, in Renminbi or any other foreign currency, their capital contributions, profits, capital gains, income from asset disposal, intellectual property royalties, lawfully-acquired compensation, indemnity or liquidation income and the like. Given that China still has foreign exchange controls on capital account, such inflow and outflow of capital would still need to comply with the regulations and measures of the PRC State Administration for Foreign Exchange (“SAFE”), unless there are new regulations issued by the SAFE or other authorities.

(c) No Forced Intellectual Property Transfer

The state shall, according to the law, protect the intellectual property rights of foreign investors and FIEs, protect the legitimate rights and interests of intellectual property rights holders and the relevant right holders, hold infringers accountable for infringement on intellectual property, and encourage technology cooperation on the basis of free will and business rules. In the process of foreign investment, technology cooperation conditions shall be determined by all investment parties upon negotiation, and no administrative organ or its working staff shall force the transfer of technologies by administrative means.

(d) Confidentiality Obligations of the Government and its Officials

The administrative organ and its officials shall keep confidential the trade secrets of FIEs they become aware of in the course of performing their duties and shall not divulge or illegally provide such secrets to others. This is a brand-new provision put forward by the final version of the Foreign Investment Law.

(e) No Government Intervention

In formulating standard documents concerning foreign investment, the governments at all levels and their relevant departments shall comply with laws and regulations and shall not illegally impair the legitimate rights and interests or increase any obligation of an FIE, illegally set any market access and withdrawal conditions, or illegally intervene in or affect any normal production and operation activity of an FIE.

(f) Government to Comply with its Commitments

Local governments at all levels and their departments concerned shall honour the policy commitments lawfully made to foreign investors and foreign invested companies and perform all contracts concluded according to the present law. If any policy commitment or contract needs to

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be changed due to national interests or public interests, changes can be made only within their statutory authority and relevant procedures shall be followed. In addition, foreign investors or FIEs concerned shall be properly compensated according to law for the losses incurred as a result of such change. The past decades have seen local governments make numerous commitments to FIEs to attract foreign investment into the local cities, but local governments have also defaulted on their own promises. This provision aims to protect foreign investors to pursue their interests against the government as long as such commitment is made by the government in accordance with the applicable law.

(g) Establishment of Feedback Mechanism

The state shall establish a feedback mechanism for FIEs, coordinate the improvement of major policy measures for complaints from FIEs, and responsively solve problems encountered by FIEs. Where an FIE deems that the administrative acts of an administrative organ or its working staff infringe on its legitimate rights and interests, it may seek resolution thereof through the feedback mechanism for FIEs.

### 1.4 Administration of Foreign Investment (投资管理)

(a) Form of Organisation and Structure of Organisation

With the upcoming abolishment of the Three FIE Laws, the form of organisation and structure of organisation as provided in the PRC Company Law, PRC Partnership Law and other relevant laws will apply to FIEs in China.

(b) Information Reporting

An FIE shall submit investment information to the commerce department through the enterprise registration system and the enterprise credit information publicity system. Currently, the information reporting is conducted on the Unified Business Platform of the PRC Ministry of Commerce (商务部业务系统统一平台). The content and scope of reporting of foreign investment information shall be determined under the principle of necessity, and investment information accessible by inter-department information sharing platform shall not be required to be submitted again.

(c) National Security Review and Anti-trust Review

The Foreign Investment Law prescribes general provisions that foreign investment into China shall be subject to the national security review and anti-trust review. Anti-trust review is well prescribed under the PRC Anti-trust Law and the relevant regulations. Regulations related to

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national security review include the Notice on Establishing a Security Review System for Foreign Investors' Mergers and Acquisitions of Domestic Enterprises released by the General Office of the State Council in 2011 and the Regulations on Implementing the Security Review System for Foreign Investors' Mergers and Acquisitions of Domestic Enterprises released by MOFCOM.

## 2. WHAT ARE THE KEY ISSUES YET TO BE RESOLVED?

The Foreign Investment Law has established a basic law for foreign investment in China. However, given its brevity, we expect more detailed implementation rules and regulations in due course to put into effect certain provisions in the Foreign Investment Law. We set out below some key issues which have not been clarified by the Foreign Investment Law.

### 2.1 Is the VIE structure still in the grey area?

The 2015 Draft Foreign Investment Law ("**2015 Draft Foreign Investment Law**") introduced the concept of "*de facto controller*" aiming to cover VIEs (Variable Interest Entities) as one type of foreign investment, which shocked the market and raised substantial concerns over the future of VIE structure in China. Some commentators even dubbed the 2015 Draft Foreign Investment Law as the VIE Killer. Therefore, any reference to "*de facto controller*" were deleted in their entirety in the 2018 Draft Foreign Investment Law ("**2018 Draft Foreign Investment Law**"). The approved Foreign Investment Law is consistent with the 2018 Draft Foreign Investment Law in this regard. So far, it may be safe to say that the VIEs are still in the grey area, but based on the current definition and scope of "Foreign Investment" the new law still leaves room for Chinese authorities to regulate VIEs as it includes "indirect" investment activities.

### 2.2 What does "Investment in Newly-formed Project" refer to?

An investment in a newly-formed project in China by a foreign investor solely or with other investors is one type of foreign investment under the Foreign Investment Law. However, the Foreign Investment Law does not further elaborate its forms (e.g. whether it refers to contractual agreements) and how to apply the existing foreign investment regulatory regime to such investment projects. We will need to wait and see whether the authorities will issue detailed regulations and measures.

### 2.3 What would be the implication for not mentioning investment by Hong Kong, Macao and Taiwan Investors in the Foreign Investment Law?

Under the Three FIE Laws, investment by Hong Kong, Macao and Taiwan investors are treated as foreign investment, subject to the CEPA (Closer Economic Partnership Arrangement) between mainland China and Hong Kong and the CEPA between mainland China and Macao. However,



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the scope of a foreign investor under the Foreign Investment Law does not mention investors from Hong Kong, Macao or Taiwan. Although without further clarification, investors from Hong Kong, Macao and Taiwan may be caught in an awkward situation where neither the Foreign Investment Law nor laws and regulations for domestic companies apply to them. In any event, we believe that there will be no change to such deemed-foreign-investment arrangements in practice.

### 2.4 Can foreign investors establish a joint venture company with a Chinese individual?

Under the PRC law, except for in the FTZs (e.g. Shanghai Pudong New District) or under certain special circumstances, a Chinese individual cannot be a shareholder of a Sino-foreign joint venture company established in China. According to a notice issued by the government of Shanghai Pudong New District, which will expire on 1 May 2019, any Chinese individual is allowed to establish a Sino-joint venture company in Shanghai Pudong New District. Besides, under the Provisions on Merger and Acquisition of Domestic Enterprises by Foreign Investors, Chinese individuals who are the existing shareholders of the target company are allowed to remain as shareholders of the target company after the completion of the acquisition by foreign investors.

The Foreign Investment Law only prescribes that foreign investors can incorporate an FIE with other investors but does not explicitly point out whether Chinese individuals fall within the scope of other investors. Detailed clarifications by the authorities in this regard are required.

### 2.5 How long does the transitional period last?

FIEs which are incorporated before 1 January 2020 have been granted a 5-year grace period to retain their original organizational forms.

The EJV Law and the CJV Law were first promulgated in 1979 and 1988 respectively. Although each law has been amended several times since their respective promulgation, certain provisions in the EJV Law and the CJV Law are still inconsistent with the PRC Company Law, such as decision-making authority, voting mechanism, dividend distribution and so on. The table below compares the differences among the Company Law, EJV Law and CJV Law. Shareholders of existing EJVs and CJVs should consider and make preparations to amend their joint venture contracts and articles of association.

Item	Company Law	EJV Law	CJV Law
Organisation Form	A limited liability company or a company limited by shares	A limited liability company or a	Either a limited liability company or a partnership



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		company limited by shares	between the JV parties
Decision-making authority	Shareholder's meeting	Board of directors	Board of directors or joint management committee
Candidate of legal representative	Chairman of board, executive director or general manager	Chairman of board	Chairman of board or joint management committee
Minimum number of directors or members of joint management committee	1	At least 3	At least 3
Term of office	No more than 3 years	4 years	No more than 3 years
Quorum	No less than 2/3 of the total voting power participating in a shareholder meeting for certain matters as provided in the Company Law. The quorum of shareholder's meetings to resolve other matters can be agreed between the parties.  No statutory requirement on the quorum of board meetings.	At least 2/3 of directors	At least 2/3 of directors or members of joint management committee
Minimum Number of Shareholder's / Board Meetings	No statutory requirements. It can be agreed in the Articles of Association.	At least once a year	At least once a year
Dividend distribution	Save as otherwise agreed by shareholders unanimously, dividend is distributed in proportion to shareholders' respective	distributed in proportion to shareholders' respective	In accordance with cooperation contract

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	equity holding percentage/ actual capital contribution.	capital contribution	
Operating Term of the Company	No statutory requirements.	It can agreed between the parties, except for certain special industries which must stipulate the operating term.	It must be stipulated in the contract.
Transfer of equity interest	Consent of more than half of the non-transferring shareholders	Unanimous consent	Unanimous consent

### Conclusion

Although the Foreign Investment Law is seen more as a motherhood statement, China has sent out a clear and positive message that it continues welcoming and encouraging foreign investment in China and endeavours to create a more level playing field for foreign investment in China. There is no doubt that China intends to reduce restrictions for foreign investment and improve the ease of doing business in China. However, pending more implementation rules to clarify or supplement certain provisions in the Foreign Investment Law, we expect that there will be more opportunities, as well as certain continuing challenges, for foreign investment in China.

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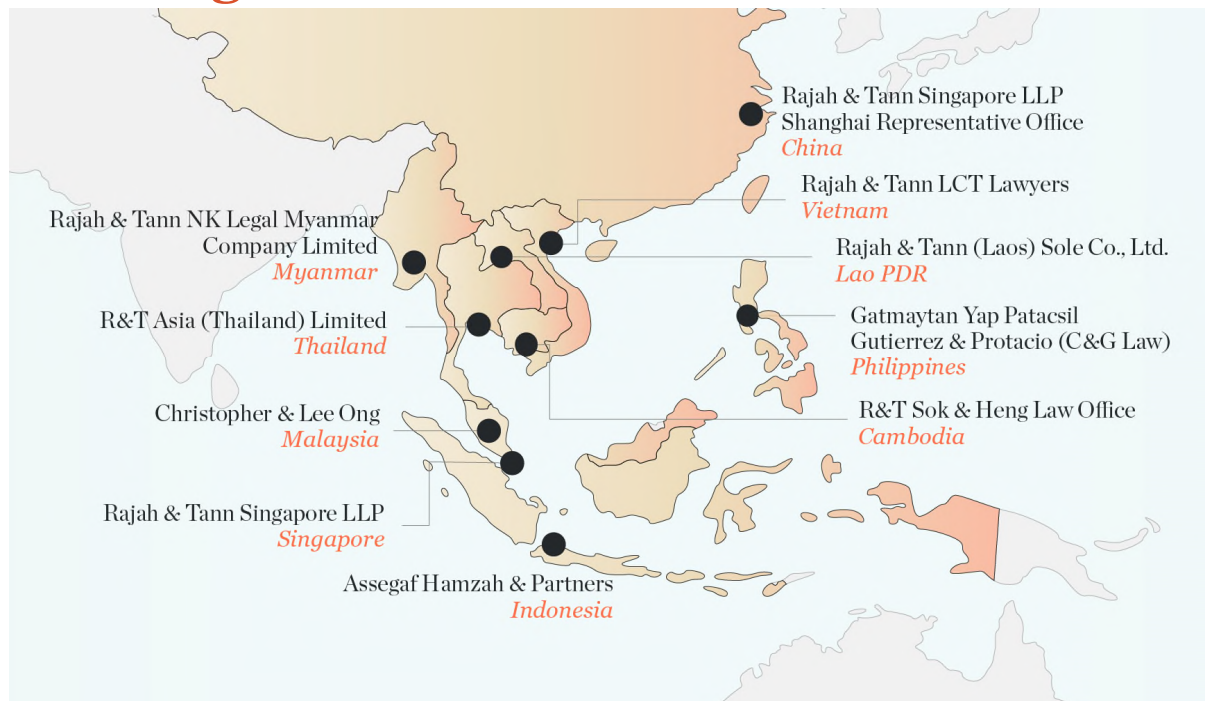
# Client Update: China

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