

Regional

A New Era of Foreign Investment Regulatory Regime in China: State Council of China Issues Implementation Regulation of Foreign Investment Law

Introduction

Further to the new PRC Foreign Investment Law (“**Foreign Investment Law**”) which was passed on 15 March 2019 and has come into effect since 1 January 2020¹, the State Council of China promulgated the Regulation on Implementation of the Foreign Investment Law (中华人民共和国外商投资法实施条例, the “**Implementation Regulation**”) on 31 December 2019, which has also come into effect since 1 January 2020.

As the Foreign Investment Law now serves as the basic law for foreign investment in China and has replaced the previous three major laws for foreign-invested enterprises in China, the Implementation Regulation is very important to implement the principles and rules stipulated in the Foreign Investment Law. Thus, it was highly anticipated and many foreign investors hoped that it would provide clarity on the new measures introduced by the Foreign Investment Law.

The Implementation Regulation has addressed some concerns and issues which need to be urgently addressed or clarified. This shows the Chinese government’s commitment to further simplify the foreign investment process and level the playing field for foreign investors, while some issues may still require further policy clarification from the authorities.

The structure of the Implementation Regulation basically corresponds with the one of the Foreign Investment Law, and the four main chapters of the Implementation Regulation are: Investment Promotion, Investment Protection, Investment Administration and Legal Liabilities. We set out below some salient points of the Implementation Regulation.

¹ Please refer to our Client Update on “Revamp of Foreign Investment Laws in China: More Opportunities or Challenges” on the introduction and highlights of the PRC Foreign Investment Law which was issued in March 2019, and can be accessed [here](#).

Regional

One-Stop Registration System and Investment Information Reporting System

Since the promulgation of the PRC Sino-foreign Equity Joint Venture Law in 1979, the establishment and change of foreign-invested enterprises in China must be approved by the Ministry of Commerce or its local agencies (“**MOFCOM**”), and from 2016, China started to implement a parallel system of approval and filing (i.e. approval is required for investments in the field within the negative lists and filing is required for investments in the field outside the negative lists). The Foreign Investment Law and its Implementation Regulation have officially abolished the above foreign investment approval (and filing) regime, which in total has been adopted in China for 40 years.

Since 1 January 2020, the State Administration for Market Regulation and its local agencies (“**SAMR**”), being the registration authority in China, has now started to review whether the investment is within the negative lists or not when carrying out the registration of the foreign-invested enterprises. The SAMR is therefore the major administrative authority for the establishment and registration of foreign-invested enterprises to provide one-stop registration for foreign investors (except for the special approval for certain industries which shall be obtained separately).

The MOFCOM will instead be in charge of the investment information reporting system for foreign-invested enterprises and according to the Measures for Foreign Investment Information Reporting issued by the MOFCOM and the SAMR on 31 December 2019 (外商投资信息报告办法, the “**Information Reporting Measures**”), the initial report, amendment report, cancellation report and annual report will be required for direct and indirect investment activities by foreign investors and foreign-invested enterprises in China. The Information Reporting Measures provide that information that can be obtained through information sharing between the authorities (such as cancellation, domestic investment (including multi-level domestic investment)) does not need to be submitted separately. The Information Reporting Measures will help solve the problem of repeated information reporting and effectively reduce the burden on foreign investors or foreign-invested enterprises.

At the same time, the Information Reporting Measures also provide that the investment information submitted by foreign investors or foreign-invested enterprises shall be publicized to the public in accordance with the Interim Regulation on the Publicity of Enterprise Information (企业信息公示暂行条例) or (if the information is not mandatorily required to be publicized) with the consent of foreign investors or foreign-invested enterprises, and shall be publicized to the public through the National Enterprise Credit Information Publicity System (国家企业信用信息公示系统) and the Foreign Investment Information Reporting System (外商投资信息报告系统).

Regional

Strengthening the Enforceability of Investment Promotion Agreement/Arrangements with Local Government

When foreign investors invest into China, local governments often make a variety of commitments to attract foreign investments, such as the land use policies, supporting facilities, preferential tax treatment and other matters. There are also circumstances under which the local government may change or even refuse to perform such commitments after the investment has been contributed by the foreign investor. At the same time, foreign investors may face difficulties in enforcing investment agreements through arbitration or judicial procedures due to the lack of laws and regulations that clearly regulate such investment agreements, as well as concerns about the relationship with local government.

With the promulgation of the Implementation Regulation, the effectiveness and enforceability of the investment promotion arrangements have been addressed as follows:

- (a) Scope and Form of Governmental Commitment: The Implementation Regulation has clarified that the “**policy commitments**” as stipulated in Article 25 of the Foreign Investment Law refer to written commitments made by local people's governments at all levels and their relevant departments within their respective statutory powers on, *inter alia*, supporting policies applicable to investments made by foreign investors and foreign-invested enterprises in their regions, and preferential treatment and facilitation enjoyed by them, which commitment shall comply with the relevant laws and regulations. Given this, it also means that it is important for foreign investors and foreign-invested enterprises to obtain written commitments from the local government.

In addition, neither the Implementation Regulation or the Judicial Interpretation on Administrative Agreement Cases (as defined below) has provided how to define “*the policy commitments shall comply with relevant laws and regulations*”. The legitimacy of government commitment or government agreement still requires special attention in practice, and investors should strengthen the legitimacy review, and if necessary, consult lawyers, when negotiating with the government so as to ensure the effectiveness and enforceability of government commitments or government agreements.

- (b) Effectiveness and Enforceability of Governmental Commitment: The Implementation Regulation has stipulated that the local people's governments at all levels and their relevant departments shall perform the policy commitments made to foreign investors and foreign-invested enterprises in accordance with the law and perform various contracts concluded in accordance with the law. This has confirmed the effectiveness and enforceability of policy commitments.
- (c) Legal Liability of the Government in relation to Governmental Commitment: According to the Implementation Regulation, the governmental authority and/or its staff will be held liable if it fails to fulfill the policy commitments, or makes policy commitments beyond the statutory

Client Update: Singapore

2020 JANUARY

LAWYERS
WHO
KNOW
ASIA

Regional

power, or the content of policy commitments fails to comply with the provisions of any law or regulation.

The PRC Supreme People's Court issued the Rules on Several Issues concerning the Trial of Administrative Agreement Cases (最高人民法院关于审理行政协议案件若干问题的规定, “**Judicial Interpretation on Administrative Agreement Cases**”) which takes effect on 1 January 2020 and further clarifies the enforceability and recourses available for enforcement of investment agreements signed with the local government for the purposes of achieving the goals of government administration or public services by the local government. According to Clause 19 of the Judicial Interpretation on Administrative Agreement Cases, if the government authority fails to perform the obligation in accordance with the investment agreement, the people's court may, in light of the claims of plaintiff and subject to the law and the investment agreement, adjudge the defendant to continue performance of the investment agreement, take remedial measures, compensate the plaintiff's loss or pay the liquidated damages.

It should be noted, however, that it is advisable to avoid using arbitration as the way of dispute resolution when a foreign investor or foreign-invested enterprise signs the investment agreement with the local government. According to Clause 26 of the Judicial Interpretation on Administrative Agreement Cases, the arbitration clause in an administrative agreement should be deemed invalid unless otherwise provided by laws, administrative regulations or international treaties to which China is a party or a participant.

Application to Enterprises Invested by Foreign-invested Enterprises in China

The Implementation Regulation expressly clarifies that the relevant provisions of the Foreign Investment Law and the Implementation Regulation shall apply to investment made by foreign-invested enterprises in China.

Such provision indicates that the regulation of foreign investment in China will trace back to the ultimate shareholder and controller of foreign investment, that is to say, no matter how many levels of enterprises which may be set up by foreign investors in China, their direct and indirect investment in China will be regarded as foreign investment from a government regulatory perspective. This has shown a significant change of regulatory approach by the Chinese government.

Strengthening the Protection of Intellectual Property, Technology Transfer and Trade Secrets

The Implementation Regulation has explicitly strengthened the protection of intellectual property and addressed the concern of many foreign investors regarding the IP protection and mandatory transfer of

Client Update: Singapore

2020 JANUARY

Regional

technologies and has also specified the details of the trade secrets which shall be provided to the administrative authority, including the following:

- (a) IP Protection: China will strengthen the punishment of infringements of IP rights.
- (b) Technology Transfers: Government officials cannot force or induce foreign investors to transfer technology using relevant administrative methods described in the Implementation Regulation.
- (c) Trade Secrets: The Implementation Regulation limits the extent, scope, and exposure of materials concerning trade secrets which shall be provided to the authorities by foreign investors or foreign-invested enterprises, and the local government shall establish and improve its internal management system to protect such confidential information.
- (d) Legal Liability of Compulsory Technology Transfers: The governmental authority and/or its staff will be punished if they force or induce foreign investors to transfer technology using administrative means.

In addition to the rules provided in the Foreign Investment Law and the Implementation Regulation, there are other laws and regulations, or draft legislation being proposed in the PRC addressing similar concerns of foreign investors.

The PRC Trademark Law revised in 2019 has clearly stipulated the punitive compensation rules for malicious infringement of trademark rights, and the concept of punitive compensation has also been introduced into the tort liability part of draft civil code and the amendment of the PRC Patent Law. The Anti-Unfair Competition Law revised in 2019 has added a clause explicitly stipulating that the administrative authority and its staff shall not take the technology transfer as the condition for obtaining administrative licence. They shall not directly or indirectly require the technology to be transferred in the process of implementing the administrative licence. After the promulgation of the Foreign Investment Law, the State Council also amended the Regulation on the Administration of Technology Import and Export, which has reduced the liabilities of the transferor and provided more flexibility for the parties to negotiate the technology import agreements.

Generally speaking, the above laws and regulations will work together to ensure the protection of IP rights and the right of the transferor of technology. The trend of China's legislation is to achieve more effective protection of intellectual property by significantly increasing the cost of infringement to improve China's intellectual property protection and ensure that the technology transfer conforms to the principle of voluntary equality property protection.

China and U.S.A. just signed the Phase I trade deal (Economic and Trade Agreement Between the Government of the People's Republic of China and the Government of the United States of America) on 15 January 2020 (US time). The changes in the Foreign Investment Law, the Implementation Regulation and other relevant laws and regulations also reflect China's commitment under such trade agreement.

Regional

Chinese Natural Persons being Included in the Scope of Chinese Investors

Based on the previous laws and regulations, a Chinese national cannot set up a Sino-foreign joint venture enterprise with a foreign investor, subject to certain exceptions. Instead, based on the previous laws, a Chinese investor had to set up a company and use such company to set up a joint venture enterprise with foreign investors. This has, in practice, caused troubles to structure a Sino-foreign joint venture project. The Implementation Regulation has expressly clarified that Chinese investors include Chinese natural persons, which has solved this long-standing problem.

Conflicts with Other Laws and Regulations being Addressed

The Implementation Regulation has made it clear that the PRC Foreign Investment Law and the Implementation Regulation shall prevail in the event of any inconsistency between the previous regulations, policies and rules and the Foreign Investment Law and its Implementation Regulation.

Over the past 40 years, China has made a lot of laws and regulations in relation to foreign investment in China. With the promulgation of the Foreign Investment Law in March 2019, the relevant governmental authorities have started to clean up the relevant laws and regulations which may conflict with the Foreign Investment Law and the Implementation Regulation. The MOFCOM and some other governmental authorities have amended and repealed some regulations, however, there are still a large number of laws and regulations which may need to be amended or repealed. Although the Implementation Regulation has clearly set the principle on how to deal with the conflicts between the previous laws and regulations and the Foreign Investment Law and the Implementation Regulation, in practice, there may be still uncertainties if the previous regulations conflict with the new law.

Five-Year Transitional Period and Retaining Current Agreement

The Foreign Investment Law and the Implementation Regulation have provided a five-year transitional period from 1 January 2020 till 31 December 2024 for foreign-invested enterprises to adjust their organization form and structure. The equity or contractual Sino-Foreign joint venture enterprises established under the earlier Sino-Foreign Equity Joint Venture Law or the Sino-Foreign Contractual Joint Venture Law are likely to be most impacted by the Foreign Investment Law and the Implementation Regulation and the parties should consider how and when to make the adjustment in order to conform to the new regime within the transitional period.

It is notable that the Implementation Regulation clarifies that the methods for the transfer of equities or rights and interests, the income distribution, and distribution of remaining property, etc. which have been agreed in the joint venture contracts can be retained after such adjustment. The retention of the

Client Update: Singapore

2020 JANUARY

Regional

forementioned methods avoids the potential substantial re-negotiation of the joint venture contract and is helpful to maintain the stability of the transactions and foreign-invested enterprises.

If an existing foreign-invested enterprise fails to adjust its organization form or structure before 1 January 2025, the registration authority will not carry out any other registration matters for such enterprise and will publicize the failure of its adjustment.

Further Clarity Needed

As the Chinese government has taken a prudent approach in making this law and its implementation regulation, the Implementation Regulation does not touch on those sensitive or controversial issues, including the following:

(a) **Legality of VIE Structure**

Both the Foreign Investment Law and the Implementation Regulation keep silent on the legality of VIE structure which would mean that the legality of VIE structure is still in the grey area. Such issue used to be a keen concern of foreign investors and critics were hoping for details to be set out in the Implementation Regulation, but it would appear that China is deferring this issue.

Notwithstanding the above, it is notable that “foreign investment” in Article 2 of the Foreign Investment Law refers to “the investment activities directly or **indirectly** conducted by foreign individuals, enterprises and other organizations in the territory of China” and it includes “foreign investors acquire shares, equity, property shares or **other similar rights and interests of enterprises in China**”. Such definition is actually broad enough to cover the contractual rights under the VIE structure. It is therefore possible that the authority may issue new policies and/or rules regarding the VIE structure in the future. It is also notable that the restrictive industries in the negative lists will become less in the future which will make the VIE structure less important or necessary in the future.

(b) **Round-Trip Investment**

The draft of the Implementation Regulation used to stipulate that “subject to the approval of State Council, Chinese investors are allowed to invest through overseas structures without being restricted by the negative list of foreign investment”. Such arrangement has been deleted in the officially issued Implementation Regulation, which indicates that the round-trip investment by Chinese investors are still subject to the restrictions in the negative lists and other existing regulations on round-trip investment.

Regional

The Foreign Investment Law and the Implementation Regulation have marked a milestone change of China's foreign investment regime and a new era of foreign investment in China since the first law on foreign investment was issued in 1979.

As Chinese governmental authorities and the PRC Supreme People's Court have amended or repealed some laws, regulations and judicial interpretations, or are going to issue some new laws, regulations and judicial interpretations, we will keep following up on the development of the law and will prepare more legal updates on this topic. Please stay tuned!

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