

## CHINA ADOPTS LONG-AWAITED FOREIGN INVESTMENT LAW

On 15 March 2019, the National People's Congress ("**NPC**") of the People's Republic of China ("**PRC**" or "**China**") approved the *PRC Foreign Investment Law* ("**FIL**"). Once it goes into effect on 1 January 2020, it will reshape the regulatory regime that has governed foreign investment in China for decades and form the new fundamental basis for the foreign investment legal framework in China. In this client alert, we summarise the highlights of the FIL as well as the potential implications for foreign investors.

### LEGISLATIVE BACKGROUND

The first draft of the FIL, issued by the Ministry of Commerce on 19 January 2015 ("**2015 Draft**"), was quite detailed and comprehensive. It attempted to unify the current fragmented laws governing foreign investment in China but was shelved when it caused tremendous controversy. After almost four years, legislative progress picked up remarkably when a new draft was released for public comments on 26 December 2018 ("**2018 Draft**"). Within the next three months, during which there were several rounds of discussion and modifications, the NPC had approved the final version. This fast-track law-making process for the FIL shows China's efforts to ease concerns about its investment environment and, perhaps, smooth negotiations with the United States on trade.

According to the explanation accompanying the FIL, which outlines the background and principles for drafting the FIL, the FIL aims to further open the Chinese market to foreign investors and create a more stable, transparent, predictable and fair investment environment for them.

Compared with the 2015 Draft, the FIL adopts a more simplified legislative approach, setting aside issues that remain controversial and extensively reducing the length, from 170 articles and 11 chapters to just 42 articles and six chapters, promulgating only the principles and basic rules for regulating foreign investment.

*The Foreign Investment Law will reshape the regulatory regime that has governed foreign investment in China for decades.*

### DEFINITION OF 'FOREIGN INVESTMENT'

Under the FIL, "foreign investment" is defined as investment activities directly or indirectly conducted by foreign investors (i.e. foreign individuals, enterprises or other organisations) within China. In particular, foreign investment occurs when a foreign investor:

- Establishes a foreign-invested enterprise, either individually or jointly with any other investor;
- Acquires shares, equity, property shares, or other similar rights and interests in an enterprise within the territory of China;
- Invests in a new project within China, either individually or jointly with any other investor; or
- Invests in any other means stipulated under laws, administrative regulations, or provisions of the State Council.

A foreign-invested enterprise (“**FIE**”) refers to an enterprise invested entirely or partly by one or more foreign investors and registered in China in accordance with its laws.

In terms of the third investment category above, the FIL does not specify what constitutes a “new project” by foreign investors. It is unclear whether this term encompasses other types of investment that was included in the definition of “foreign investment” under the 2015 Draft, which went beyond the activities traditionally considered to be foreign investment and listed above. For example, the 2015 Draft included within the scope of “foreign investment” instances where a foreign investor (i) obtains concession rights for the exploration and exploitation of natural resources or for the construction or operation of infrastructure within the territory of China or other regions under the jurisdiction of China; or (ii) acquires real estate rights, such as domestic land use rights and real estate ownership, within the territory of China. Whether these types of investment by foreign investors would fall under the third category of “foreign investment” as listed in the FIL remains to be seen.

Moreover, under the 2015 Draft, “foreign investors” included domestic enterprises that are controlled by non-PRC nationals, overseas registered entities, or other organisations. This provision essentially subjected variable interest entities (“**VI**Es”), which have been widely used by foreign investors to gain control of domestic enterprises engaging in sectors restricted or prohibited to foreign investment through contractual arrangements, to the foreign investment regulatory regime. The most controversial aspect of the 2015 Draft, the articles that would invalidate VIE structures have been left out of the FIL, leaving VIE structures in their legal grey area. It remains to be seen how the regulatory position on VIEs will evolve, whether they will be caught by the catch-all clause of the definition of foreign investment or be considered indirect investment by foreign investors under the FIL.

*Compared with its drafts, the Foreign Investment Law places more emphasis on the facilitation and protection of foreign investment.*

## FOREIGN INVESTMENT FACILITATION AND PROTECTION

Compared with its previous drafts, the FIL places more emphasis on the facilitation and protection of foreign investment, a reflection of the Chinese government’s determination to attract foreign investors. Below we summarise major developments in these two aspects that may be of greatest concern for foreign investors:

### IP protection

Intellectual property has been one of the most disputed topics in the trade war between China and the U.S. U.S. authorities have long accused the Chinese government of forcing foreign companies to give proprietary technology to their Chinese partners. To address forced technology transfer concerns, the FIL expressly stipulates protections for IP rights held by foreign investors and FIEs and encourages technology cooperation based on the principles of voluntariness and commercial norms. It also stipulates that the conditions for technology cooperation must be determined based on negotiation of the parties, while Chinese administrative officials may not force technology transfers using administrative measures.

Furthermore, the FIL expands protection to trade secrets, requiring Chinese administrative officials to keep confidential any trade secrets they learn during the performance of their duties. Violators may be penalised or face criminal liabilities.

### Foreign exchange control

China's foreign exchange control has long been a concern for foreign investors. Article 21 of the FIL specifies the types of funds that foreign investors may freely remit into or outside China in RMB or foreign currency. They include contributions, profits, capital gains, income from asset disposal, royalties, lawfully obtained reimbursements or compensation, and income from liquidation.

### Obligations of governments

Article 20 of the FIL provides that China may not expropriate investments of foreign investors. In special circumstances where such expropriation does occur, it is subject to due process and fair and reasonable compensation must be given to the foreign investor.

The FIL requires all foreign investment-related normative documents formulated by any level of government or their departments to be in compliance with PRC laws and regulations. Without legal basis, governments and their departments are prohibited from impairing the rights or increasing the obligations of FIEs, setting conditions for market entry or exit, and interfering with their normal operation.

Furthermore, local governments are required to comply with commitments they lawfully made to foreign investors and the contracts they have entered into. If such commitments or contracts change due to state or public interest, they must compensate the FIE or their investors for their losses in accordance with laws.

### Complaint mechanism

Article 26 of the FIL establishes a complaint mechanism for FIEs, attempting to address issues encountered by FIEs or their investors, in particular administrative acts taken by Chinese administrative organs that violate their legitimate rights and interests.

*One of the main highlights of the Foreign Investment Law is the principle of consistency between domestic and foreign investment.*

## FOREIGN INVESTMENT ADMINISTRATION

### Pre-market access national treatment plus negative list

The General Provisions of the FIL explicitly confirm that foreign investment is subject to the "pre-market access national treatment plus negative list system". The negative list, which determines market access for foreign investors, was started in 2013 in the China (Shanghai) Pilot Free Trade Zone and expanded nationwide in 2018, but this is the first time the "national treatment plus negative list system" has been written into a basic law.

"Pre-market access national treatment" refers to the administrative measures applicable during the market access stage. Under the FIL, foreign investors and their investments will be entitled to treatment not less favourable than domestic investors and their investments. This national treatment principle will apply to all foreign investments not included on the negative list.

One of the main highlights of the FIL is the principle of consistency between domestic and foreign investment. "Equal treatment" is repeated throughout the FIL to ensure that domestic investment and foreign investment are subject to a unified set of rules. For example, Article 9 provides that FIEs are equally qualified for state policies that support enterprises; Article 15

grants FIEs the right to equal access to the formulation of industry standards; and Article 16 states that FIEs may fairly participate in government procurement projects.

### Information reporting system

The 2015 Draft included a chapter explaining the detailed and complicated reporting requirements for foreign investors. However, the FIL only requires FIEs to report through the “enterprise registration system” and “enterprise credit information publicity system”, while the scope of reporting must be based on the principle of necessity. These revisions greatly release FIEs from complicated and time-consuming reporting obligations.

### National security review system

The 2015 Draft also included a chapter specifying the detailed national security review system, while the FIL only has one article on the establishment of the national security review system. It does not mention the scope, authority, factors, application or procedures. However, it does stipulate that the review decision, issued in accordance with PRC laws, is final. As such, foreign investors may not be able to appeal national security review decisions through a re-review or litigation. While there are already regulations on national security review, we expect Chinese authorities will issue separate implementing rules with more details.

*Once the Foreign Investment Law goes into effect, FIEs will be subject to the PRC Company Law and PRC Partnership Law in terms of their organisational form, structure, and operating rules.*

## IMPACT ON EXISTING FIES

Currently, FIEs are established and regulated pursuant to the *PRC Sino-Foreign Equity Joint Venture Law*, *PRC Sino-Foreign Cooperative Joint Venture Law*, *PRC Wholly Foreign-Owned Enterprise Law*, and their implementing measures (“**FIE Laws**”). Once the FIL goes into effect, the FIE Laws will be formally repealed and FIEs will be subject to the *PRC Company Law* and *PRC Partnership Law* in terms of their organisational form, structure, and operating rules.

Sino-foreign joint ventures may be impacted the most by these changes. One major change they must implement is to their corporate governance. Currently, under the FIE Laws, the highest authority of a joint venture is its board of directors; while under the *PRC Company Law*, the shareholders’ meeting would be the highest authority. The FIE Laws and *PRC Company Law* also differ in terms of board composition, board meeting quorum, voting mechanism, and equity transfer restrictions, the adjustment of which may result in conflicts between joint venture partners.

Another point worth noting is that under the FIE Laws, joint venture contracts must be governed by PRC law. It is unclear whether this requirement will be continued when the FIL comes into force. The *PRC Contract Law* also stipulates that joint venture contracts must be governed by PRC law, so if this restriction will be removed, the *PRC Contract Law* may also need to be amended.

In short, to comply with the *PRC Company Law* once the FIL comes into force, joint venture partners will need to renegotiate the terms of their cooperation in respect of their company’s organisational form, structure, and operating rules. This process may open up further aspects to negotiation and cause great uncertainty and unpredictability for foreign investors.

Finally, the FIL grants a five-year transition period from the date it goes into effect during which existing FIEs may maintain their current organisational forms. However, it is unclear whether

they must complete the changes required to comply with the *PRC Company Law* within this transition period, and if they don't, whether they will be forced to do so by authorities. It also remains to be seen how implementing measures will be drafted to ensure the transition.

## OUTLOOK

The FIL, as a unified national law for foreign investment, marks a new era in China's foreign investment regulation. However, as it sets forth only the principles and framework for foreign investment regulations, it remains to be seen how these principles and framework will be implemented in practice. To ensure a smooth transition, government departments are expected to introduce detailed implementing regulations and guidance as soon as possible.

Given the broad terms of the FIL, we recommend foreign investors to closely monitor developments in terms of China's foreign investment rules and regulations. We will also keep you informed of any changes and their potential impact. Please do not hesitate to contact us should you require more information on how your business operations may be impacted by these legislative changes.

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