

CHINA'S FOREIGN INVESTMENT REGIME BEGINS NEW CHAPTER

Last March, China unveiled its new Foreign Investment Law (“**FIL**”) to great fanfare, but it wasn't until the end of the year that the State Council released, at the very last minute, the final version of the *Implementing Regulations for the Foreign Investment Law* (“**Implementing Regulations**”) to facilitate the FIL's implementation¹. Both the FIL and its Implementing Regulations came into effect on 1 January 2020, forming the new fundamental legal basis for China's foreign investment framework. In this Client Alert, we summarise the highlights of the Implementing Regulations, as well as the potential implications for foreign investments in China under the new regulatory regime.

LEGISLATIVE BACKGROUND

The Ministry of Justice and other government departments released a draft version of the Implementing Regulations in November for public comments (“**Draft Version**”). As the FIL stipulates only the major principles for governing foreign investment in China, the Implementing Regulations were expected to introduce detailed rules and guidance on its implementation. The final version contains some obvious changes that seem to have taken into account such comments.

DEFINITION OF ‘FOREIGN INVESTMENT’

Article 2 of the FIL provides a definition of “foreign investment” by including direct and indirect investments of foreign investors and listing four types of foreign investments:

- (1) Establishment of foreign-invested enterprises (“**FIEs**”) individually or jointly with other investors;
- (2) Acquisition of shares, equity, property shares, or other similar rights and interests in an enterprise in the PRC;
- (3) Investment in a new project individually or jointly with other investors; and
- (4) Investments by other means.

New Projects

The Implementing Regulations do not further clarify the meaning of “new project” in category (3) above. Previously, the Draft Version had defined it as a specific construction project invested by foreign investors without establishing an FIE or obtaining any shares, equity, property shares or other similar rights and interests in an enterprise in the PRC, but this definition does not appear in the final version. Thus, it is not clear whether “new project” may include investment projects such as natural resources exploration and exploitation or infrastructure construction carried out by foreign investors in China, which must be registered with the Administration for Market Regulation (“**AMR**”) but for which setting up an FIE is not necessary. Clarification of its meaning is thus needed to guide practice.

¹ Please refer to our previous Client Alert, [China Adopts Long-Awaited Foreign Investment Law](#), for more background information on the FIL.

Chinese Individual Investors

Under China's previous foreign investment regime, Chinese natural persons were not allowed to set up Sino-foreign joint ventures with foreign investors unless they were original shareholders of a domestic company that was converted into an FIE upon acquisition by a foreign investor, in which case they may remain shareholders of such company. Based on the new definition of foreign investment under the FIL, the Implementing Regulations clarify that "other investors" in categories (1) and (3) above may be Chinese natural persons. That is, Chinese individuals are now permitted to directly participate in foreign investment as Chinese investors. On 1 January 2020, the Shanghai AMR issued the first business licence for a newly established FIE in which a Chinese individual is a shareholder.

Round-Trip Investments

Under the Draft Version, round-trip investments may be exempted from the Negative List for foreign investment if the investor is wholly owned by an individual, legal person (excluding FIEs), or other organisation of China and such investment has been reviewed by the relevant department and approved by the State Council. The final Implementing Regulations do not contain this provision, and we thus understand that round-trip investments by Chinese investors will be considered foreign investments subject to the Negative List.

Variable Interest Entities ('VIEs')

The legality of VIEs has been a hot topic since the first draft of the FIL in 2015, under which VIE structures were regulated. Foreign investors often use VIE structures to gain control, through contractual arrangements, of domestic enterprises engaging in industries restricted or prohibited to foreign investment. Considering the huge controversy caused by this early draft of the FIL, the FIL and Implementing Regulations take a conservative approach and are silent on this topic, leaving VIEs in their legal grey area. However, the FIL's definition of foreign investment offers flexibility for Chinese regulators: "Other similar rights and interests" in category (2) is left undefined and category (4) serves as a catch-all clause, so there is room for authorities to regulate VIEs in the future.

Investment by FIEs

In the past, the regulation of investments by FIEs, in particular multi-level investments, in China was not crystal clear. Under the *Interim Provisions on Investments within China by Foreign-Invested Enterprises* (effective as of the date hereof), investors were to refer to the *Catalogue of Industries for Guiding Foreign Investment* when making such investments, but only first-level investments by FIEs were expressly regulated and subject to the catalogue².

Now, Article 47 of the Implementing Regulations states that any investment by FIEs in China will be subject to the FIL and the Implementing Regulations. As such, it appears that all levels of investment by FIEs will fall under the scope of the FIL. This may create some practical issues for foreign investors, FIEs, and even Chinese regulators. It remains to be seen how such investments will be regulated in practice.

² The *Catalogue for the Guidance of Foreign Investment Industries* has been repealed and replaced by the Negative List since 2018.

FOREIGN INVESTMENT FACILITATION AND PROTECTION

Government Obligations

The FIL establishes a “pre-market access national treatment plus negative list system” for foreign investment, and the Implementing Regulations reinforce equal treatment for domestic and foreign investment, as well as assure the transparency of foreign investment-related normative documents. For example, the Implementing Regulations call for the equal treatment of domestic enterprises and FIEs with respect to government funds, land supply, tax deductions, and qualifications, as well as in reviews of applications to authorities. Foreign investment-related normative documents must also be disclosed in a timely manner and in accordance with PRC laws, while undisclosed documents cannot serve as the basis for foreign investment administrative measures.

Furthermore, for documents closely related to the business activities of FIEs, reasonable time must be provided between their disclosure and actual implementation. Equal treatment principles have been reflected in other aspects of the Implementing Regulations as well, such as applicable compulsory standards, government procurement, and intellectual property protection.

The FIL sets forth the general principle not to expropriate foreign investments; expropriations under special circumstances are subject to due course and timely, fair and reasonable compensation. The Implementing Regulations further stipulate that any expropriation must be non-discriminatory and that compensation must be made based on the market value of the investment. In addition, foreign investors have recourse to an administrative review or litigation if they do not accept an expropriation decision.

Under the FIL, local governments are required to comply with the policy commitments that they lawfully made to foreign investors and the contracts they have entered into. The Implementing Regulations clearly define “policy commitment” as any written commitment made by any level of government or department within their legal authority to provide supporting policies, preferential treatment and facilitation conditions for foreign investment within their jurisdiction, provided that such policy commitment complies with PRC laws and regulations. Article 28 of the Implementing Regulations goes further to stipulate that such policy commitment or contract may not be repudiated or discharged on the grounds of changes to administrative divisions, re-election, adjustments to organisations or functions, or changes to personnel assignments or duties. If a change to a policy commitment or contract is made in consideration of state or public interests, the government must provide fair, reasonable and timely compensation to the foreign investor or FIE for its losses.

IP Protection

The FIL explicitly requires the protection of the intellectual property (“IP”) rights and trade secrets of foreign investors and FIEs, while prohibiting forced technology transfers. Based on this principle, the Implementing Regulations call for harsher punishment for IP rights infringement, strengthening of IP-related administration, and equal protection of the IP rights of foreign investors and FIEs.

With respect to the prohibition of forced technology transfers by administrative authorities and officials, the Implementing Regulations expand the scope of “administrative authorities and officials” to cover organisations that exercise public affairs and their officials. They also list prohibited administrative measures (e.g. administrative licences, inspections, penalties, enforcement) designed to force technology transfers.

To protect trade secrets, under the Implementing Regulations, authorities may only require documents containing trade secrets from foreign investors or FIEs on a need-to-know basis, and government personnel whose work is unrelated to the performance of regulatory duties may not access such documents. Moreover, authorities must establish an internal management system with effective measures for protecting trade secrets, and when sharing information with other authorities, trade secrets must be kept confidential to prevent their disclosure.

Legal Liabilities of Governments and Officials

The final version of the Implementing Regulations contains a new Chapter V, which spells out the legal liabilities of government authorities and officials when they:

- (a) cause unequal treatment between FIEs and domestic enterprises when making or implementing policies;
- (b) place illegal restrictions on the equal participation of FIEs when formulating or amending standards, or impose specific technical requirements for FIEs that are higher than compulsory standards;
- (c) place illegal restrictions on the remittance of funds in or out of China by foreign investors;
- (d) fail to fulfil policy commitments, or make policy commitments beyond their legal authority or that do not comply with PRC laws and regulations;
- (e) cause differential or discriminatory treatment of FIEs in government procurement; and
- (f) force a technology transfer.

This chapter shows the Chinese government's effort to protect the interests of foreign investors and FIEs. However, the Implementing Regulations do not detail the specific liabilities for violations by authorities or officials, only that violations will be investigated and liabilities imposed. As such, these provisions will be very difficult to enforce in practice.

FOREIGN INVESTMENT ADMINISTRATION

Information Reporting System

Since China opened the door to foreign investment, foreign investment has been subject to the administration of the Ministry of Commerce ("**MOFCOM**"). Before the year 2020, MOFCOM approval was required for foreign investments within the Negative List and for those investments outside the Negative List, filing must be made. One of the biggest highlights of the Implementing Regulations is that MOFCOM will step almost completely back from foreign investment supervision and only supervise through an online reporting system. In this regard, MOFCOM jointly promulgated with AMR the *Measures for Reporting Information on Foreign Investment* ("**Reporting Measures**") and other supporting rules, which have all been effective since 1 January 2020. Foreign investors and FIEs are now required to submit the following reports (as applicable) via the enterprise registration system and the national enterprise credit information publicity system:

- (a) initial report, for establishment or acquisition of a non-FIE;
- (b) modification report, for any change to the FIE;
- (c) deregistration report, for deregistration or change into domestic enterprise; and
- (d) annual report.

Although investments by FIEs are brought into the regulatory scope of the FIL, under the Reporting Measures, FIEs do not need to separately report such investments (including multi-level investments) to MOFCOM, as AMR will directly share the information upon completion of registration/filing or submission of annual reports to AMR.

Foreign investments will still be subject to the approval of or filing with the National Development and Reform Commission (“**NDRC**”), industry-specific approvals, if applicable, and company registration with AMR. Under the Implementing Regulations, competent authorities must check whether a particular foreign investment is subject to the Negative List when performing their duties. To avoid overlaps and conflicting views, AMR clarified in a recent notice that it will not re-review any foreign investment that has obtained an industry-specific approval from the competent authority³.

National Security Review System

The FIL contains a broad outline of the national security review system for foreign investment, in which review decisions are final. The Implementing Regulations were expected to elaborate on this topic, but they only restate the principle. As such, we understand that the current rules regarding national security review will continue to apply to mergers and acquisitions of domestic enterprises by foreign investors⁴.

IMPACT ON EXISTING FIES

Governing Law

Under the previous foreign investment regime, joint venture contracts must be governed by PRC law. Despite the repeal of several foreign investment-related laws and regulations upon the implementation of the FIL, the *Contract Law* still provides for such requirement. As such, we understand that joint venture contracts must still be governed by PRC law under the new regime.

Transition Period

The FIL grants a five-year transition period during which existing FIEs may maintain their current organisational forms. The Implementing Regulations clarify that during the transition period, existing FIEs may also modify their corporate governance structure to align with requirements of the *Company Law* or *Partnership Enterprise Law*. However, as from 1 January 2025, existing FIEs that failed to complete the changes required will not be able to register other matters with AMR and such incompliance will be publicly disclosed. It remains unclear with respect to such FIEs, whether the original joint venture contract, articles of association, and/or corporate resolutions will still be effective after 1 January 2025.

There was also concern that the FIL requirement for existing FIEs to modify their governance structures would open the door for joint venture partners to discuss other topics. However, the Implementing Regulations clarify that terms on equity transfers, profit distributions, and residual property distributions that have been agreed between partners in a joint venture contract may remain unchanged.

³ *Notice of the State AMR on Effective Work on Registration of Foreign-Invested Enterprises for the Implementation of the Foreign Investment Law* (Guo Shi Jian Zhu (2019) No. 279), effective from 1 January 2020.

⁴ The current rules mainly refer to the *Notice of the General Office of the State Council on the Establishment of a Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (Guo Ban Fa (2011) No. 6) and *MOFCOM Provisions on the Implementation of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (MOFCOM Announcement (2011) No. 53).

OUTLOOK

In the last week of 2019, to facilitate the implementation of the FIL, the People's Supreme Court issued a judicial interpretation on the effectiveness of foreign investment contracts and MOFCOM issued two notices abolishing many foreign investment-related documents⁵, all of which came into effect on 1 January 2020. The United States and China also recently agreed on a trade deal after two years of fraught negotiations; it is possible that the FIL played a role in closing the deal as a signal of China's resolve to further open up its economy. Indeed, a new chapter for China's foreign investment regime has opened and the foreign investment landscape in China will undoubtedly be reshaped. We expect that the FIL, its Implementing Regulations, and their supporting documents will bring positive and significant changes to the foreign investment environment in China.

Nevertheless, it remains to be seen how the Chinese authorities will further clarify the FIL and Implementing Regulations on topics that remain ambiguous. We will closely monitor China's development of foreign investment rules and regulations and keep you informed of any updates and their potential implications. 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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⁵ *Decision of MOFCOM on the Abolition of Certain Rules* (MOFCOM Order (2019) No. 3) and *Decision of MOFCOM on the Abolition of Certain Normative Documents* (MOFCOM Announcement (2019) No. 59).

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