

Brave New World: China's New Foreign Investment Law

On March 15th, 2019, the National People's Congress, China's top legislation body, promulgated a new *PRC Foreign Investment Law* (《中华人民共和国外商投资法》, "**FIL**"), which is set to come into effect on January 1st, 2020. The FIL will replace and repeal the existing *PRC Foreign Invested Enterprise Law* (《中华人民共和国外资企业法》), *PRC Sino-Foreign Equity Joint Venture Law* (《中华人民共和国中外合资企业法》) and *PRC Sino-Foreign Cooperative Joint Venture Law* (《中华人民共和国中外合作经营企业法》) (collectively, "**FIE Laws**"), as a single unified guiding document to regulate foreign investment in China.

China's first attempt to reform its foreign investment regime was in January 2015, when the legislation was circulated for public consultation under a slightly different Chinese name from that of the FIL -- 《中华人民共和国外国投资法 (草案征求意见稿)》 ("2015 **Draft**"). The 42-provision FIL differs significantly from the more specific 170-provision 2015 Draft, and sets out general principles to promote foreign investment in China by enhancing protections for foreign investors' rights and interests and addressing concerns concerning unequal market access, weak intellectual property protection and forced technology transfers. The new law is viewed by some commentators and foreign media as a positive response to the concerns raised by the U.S. and European companies during the ongoing US-China trade war.

Related Capabilities

- Foreign Banks and Financial Institutions
- Investment Management
- China

National Treatment and Greater Protection of Foreign Investment

- **Broader Market Access – Pre-entry National Treatment and Negative List Approach**

According to Article 4 of the FIL, a pre-entry national treatment and negative list approach will be taken to ensure that foreign investors are to be treated no less favorably than domestic investors during set up, acquisition and expansion. A negative list regulating market entry by foreign investors was first released in 2013 for Shanghai Pilot Free Trade Zone. The nationwide negative list was then released in 2016 after the negative list regime had been tested in other pilot free trade zones in 2015. The most recent version of the negative list was issued on June 30th, 2019.

The 40-item restricted/prohibited industry list was much shorter than previous versions. Articles 40 and 41 of the FIL subject foreign investment to separate regulation in the financial sector including banking, securities, insurance and foreign exchange, and there are restrictions on market entry for investors from countries or regions which place discriminatory, restrictive or similar measures on Chinese investment.

- **Protection of Intellectual Property and Trade Secrets**

Article 22 of the FIL emphasizes the protection of intellectual property rights of foreign investors and FIEs. It encourages technology collaboration between foreign investors and their Chinese counterparts on a fair and voluntary basis, and bars government officials from using administrative measures to force technology transfers. Article 23 of the FIL imposes obligations on administrative or other officers not to disclose foreign investors' and FIEs' trade secrets to any third party of which they become aware during the performance of their duties. These two articles aim to protect foreign investors and FIEs from illegal government interference, which is intended to address the concerns of some foreign investors. However, the definition and legal consequences arising from "forced technology transfer" are left unclear in the FIL. Again, we will need to await the issuance of implementing regulations to see how such commitments will be carved out in practice.

- **Other Major Measures for Promoting and Protecting Foreign Investment**

Apart from broader market access and intellectual property protection, the FIL also introduces the other measures to promote and protect foreign investment, such as assurances that foreign investors will be given adequate opportunity to comment on foreign investment related laws in process¹, equal participation in formulating standards², equal participation in government procurement projects³, assurances that they will be able to take FIEs public on stock exchanges by way of share or bond issuances or raise money through other means⁴, prohibition from arbitrary expropriation, assurances of due process and fair compensation⁵, freer movement of cross-border remittances⁶, and requirements for governments to honor policy commitments made to, and contracts lawfully entered into with, foreign investors and/or FIEs.⁷

Management of Foreign Investment

- **Foreign Investment Information Reporting System**

A foreign investment information reporting system will be established according to Article 34 of the FIL, according to which foreign investors or FIEs are required to submit investment information to competent commercial administration authorities. Chapter 5 of the 2015 Draft stipulated rules for the reporting system, setting out details such as who shall make the report and by when, what to report and how to report. This entire chapter was replaced by Article 34 of the FIL. We expect to see in due course more detail as to how the future reporting system will differ from the current "National Enterprise Credit Information Publicity System" operated by State Administration for Market Regulation.

- **National Security Review**

Article 35 of the FIL states that investment which harms or could harm national security is subject to national security review, and that a decision for a national security review is final and cannot be challenged or appealed. China's national security review ("NSR") regime has been gradually put into place since 2011. Article 35, as opposed to Chapter 4 of the 2015 Draft, only restates the existence of the national security review regime. It does not clarify practical questions including the triggers of such review, review standards, review procedures etc. Also, it is not clear whether the existing laws and regulations will continue to be applied or be replaced

by further implementing regulations of the FIL. Currently, with few published cases since 2011 and no implementing regulations or interpretations issued, foreign investors should be prepared to proactively manage uncertainty arising from the NSR risk in sensitive industries.

Impact on Foreign Invested Enterprises

Existing FIE Laws will be repealed and replaced by the FIL as of January 1st, 2020. Thereafter, FIEs must comply with the *PRC Company Law* (《中华人民共和国公司法》) and the *PRC Partnership Enterprise Law* (《中华人民共和国合伙企业法》) in the same manner as their domestic counterparts. Further, a five-year transitional period is granted to existing FIEs established to bring themselves into line with the FIL after it comes into effect in 2020.

FIEs established under the FIE Laws can maintain their existing organizational and corporate governance structures until the fifth anniversary after the FIL comes into effect. This means shareholders/partners of existing FIEs have to revisit corporate governance terms and amend the constitutional corporate documents including the articles of association and the joint venture contract to comply with the unified corporate regime. For example, the highest decision making body of an equity joint venture under the current FIE Laws is the board of directors, which should be changed to the shareholders' meeting to accommodate the *PRC Company Law*. As such, foreign investors of such existing FIEs should start to consider how to adjust their existing corporate governance structures (i.e. scope of authority of the board and the shareholders, composition of the board and allocation of voting power etc.) to reflect the current *PRC Company Law*.

Foreign investors that set up a joint venture before January 1st, 2020, will still be subject to the FIE Laws, which means they have to change their corporate governance in five months' time to comply with the FIL. Absent implementing rules addressing this situation, such foreign investors should consider delaying establishment to avoid renegotiation of corporate terms.

Expectation of Clarification of Definition of Foreign Investment

Article 2 of the FIL defines foreign investment as investment activities, directly or indirectly, conducted by foreign individuals, companies, or other organizations in China. More specifically, investment falling within the following four categories will be regulated by the FIL:

1. establishment of a foreign invested enterprise (“**FIE**”) in China individually by a foreign investor or jointly by a foreign investor with other investor(s);
2. acquisition of shares, equity, property or other similar rights and interests of a Chinese domestic enterprise;
3. investment in a new project in China individually by a foreign investor or jointly by a foreign investor with other investor(s);
4. investment in other forms as stipulated in laws, administrative regulations or permitted by the State Council.

Under the current foreign investment regime, Chinese individuals are not eligible to set up a new FIE together with foreign investors. The FIL is silent on the eligibility of Chinese shareholder/partner to become a party to a foreign investment. So, literally interpreted, unless otherwise provided by other new laws, regulations or rules, it appears that Chinese individuals can be investors in foreign investment projects after the current FIE laws are repealed.

The FIL is not clear on the definition of “indirect investment” – will the nationality of an investor be determined by the nationality of its ultimate controller or merely by such investor’s nationality or place of incorporation? Also, the FIL does not address the question about whether a variable interest entity (“**VIE**”) will be governed by the foreign investment regime. The VIE structure is a contractual arrangement commonly used by Chinese companies in restricted or prohibited industries to foreign investment that seek to be financed or listed outside China. Such investment structures have been tolerated by the Chinese government for many years. The 2015 Draft addresses the VIE issue by treating domestic enterprises controlled by foreign investors as *de facto* foreign investors (Article 11) and imposes penalties on schemes (including contractual arrangements) that circumvent foreign investment restrictions or prohibitions (Article 149). Although the FIL does not adopt the “control” approach in the 2015 Draft, it is still not clear whether the VIE structure is covered by the catch-all category of “investment in other forms as stipulated in laws, administrative regulations or permitted by the State Council” as set out in Article 2 of the FIL.

Conclusion

The FIL purports to create a more level playing field and a more stable, fair, consistent and predictable foreign investment regime, and to enhance the protection of the rights and interests of foreign investors. While it can be considered a positive sign in support of foreign investment by the PRC government, the FIL is still only a high level guidance document in the style and form of other high level PRC legislation with vague language and lacking provisions in respect of detailed implementation. In particular, the scope of foreign investment and how information reporting and national security review systems work are left without definition. The uncertainty of the FIL, as well as enforcement of the FIL at all levels, still remains unclear. More detailed implementing regulations are expected in due course which should help foreign investors ascertain the law’s full impact.

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¹ See Article 10 of the FIL

² See Article 15 of the FIL

³ See Article 16 of the FIL

⁴ See Article 17 of the FIL

⁵ See Article 20 of the FIL

⁶ See Article 21 of the FIL

⁷ See Article 25 of the FIL