Legal Flash

China's spectacular foreign investment transformation

March 2019

In brief

As part of the ongoing reform of China's regulation of foreign investment, the National People's Congress approved a new Foreign Investment Law ("**FIL**") on 15 March 2019. When it takes effect on 1 January 2020 it will replace existing laws, providing greater flexibility for foreign investors, particularly in relation to joint ventures. Foreign investors should monitor the release of implementing regulations and be prepared to make changes to their existing investments as well as assess new opportunities, including in sectors previously restricted to foreign investment.

Background and highlights of the Foreign Investment Law

The Second Session of the 13th National People's Congress reviewed and approved the FIL of the People's Republic of China ("中华人民共和国外商投资法"), which will officially take effect on 1 January 2020. This critical reform of the foreign investment legal framework started back in 2015, when a draft called "Foreign Countries Investment Law of the People's Republic of China" (中华人民共和国外国投资法) was released for public comment (the "**2015 Draft**"). After nearly four years of very little activity, the legislative process recently accelerated and was concluded in less than three months after the release of an updated draft law at the end of 2018. The accelerated timetable was possibly due to a recent slowdown in the Chinese economic growth, and the need to reassure foreign investors in the context of the Sino-US trade war. The FIL continues a recent trend towards easing restrictions on, and the regulation of foreign investment in China. Recent developments have included a general move to replace approvals with filings for the establishment of wholly foreign owned enterprises ("**WFOEs**"), providing greater access to online information about companies in China, and relaxing the domestic shareholding requirements for joint ventures in various sectors, including financial services and insurance.

The provisions of the FIL are fairly generic so the impact of the FIL will depend on the content of supporting policies and regulations we anticipate will be adopted in the coming months. That said, the FIL contains a number of important protections for foreign investors as well as changes to the way in which joint ventures are set up and governed. The following sections set out below some of the highlights of the FIL and our preliminary comments on the issues they raise for foreign investors.

New definition of foreign investment and "VIEs"

- The FIL now defines "foreign investment" as an investment activity in China "*directly or indirectly carried out by foreign natural persons, enterprises and other organisations*". Whilst the determination of foreign investment still primarily refers to the nationality of the shareholders, it recognizes "indirect" ways of making investment, suggesting the law will also consider ultimate shareholders. Previously, the nationality of the direct controlling person was the determining factor for the definition of "foreign investment". Chinese domestic enterprises "controlled" through investments by foreign investors were regarded as foreign investment and were subject to foreign investment regulations. Further, companies invested by foreign invested companies ("**FIE Re-invested Companies**") were regulated in a similar manner to a domestic company (except for the business the regulated industry). Clarification will be needed to see whether FIE Re-invested Companies and their subsidiaries will be treated as foreign invested companies.

- The 2015 Draft provided that foreign investment by means of *"holding interests in domestic enterprises through contracts, trusts, etc"* would be a regulated form, clearly aiming at restricting the use of so-called variable interest entity ("**VIE**") structures. The final version of FIL is silent on the use of VIE structures, only indicating that foreign investment can be in a form of "***any other means*** *as provided by laws, administrative regulations or the State Council"*. Foreign investors utilising VIE structures will be pleased that the FIL does not outright prohibit their use and should continue to monitor developments in this area.

Investment protection and promotion

The FIL will replace the current laws and regulations governing the three traditional types of foreign-invested enterprises (equity joint ventures, cooperative joint ventures and wholly-foreign owned enterprises) ("**Three Laws**"). In doing so, the FIL seeks to address long-standing demands of foreign investors for a fairer, competitive market environment in China, in which foreign investors and their domestic counterparts would be treated in a similar manner. The FIL provides a number of welcome assurances for foreign investors, including the following:

- no governmental authority may force the transfer of any technology by administrative means;
- foreign-invested enterprises have an equal right to participate in government procurement activities through fair competition, which aims to address concerns from some foreign invested entities ("**FIEs**") regarding some tender procedures in which there was a perception that domestic companies would be favoured;
- the FIL recognises the right for foreign-invested enterprises to raise funds by means of public offering of securities such as shares and corporate bonds or by any other means;
- the FIL emphasises that foreign investors' compensation for violations of contracts or commitments by governmental authorities should be based on "legally made" policy commitments and "legally concluded" contracts;
- authorities should comply with laws and administrative regulations in formulating normative documents concerning foreign investment;
- authorities should strictly keep policy commitments lawfully made and perform all contracts lawfully concluded; and
- local governments above county level can develop their foreign investment promotion and faciliation measures (a power that was previously substantially limited since the promulgation of the "*Notice of the State Council on Reviewing and Regulating Preferential Policies for Taxation and Other Aspects*" in 2014).

Investment Management and National Security Review

The FIL has officially established the new management system containing the following foundations that shall apply to all foreign investment:

- "Pre-establishment of national treatment" and "negative list" (Article 28);
- Ministry of Commerce ("**MOFCOM**") Information reporting (Article 34); and
- National security review (Article 35).

Article 28 provides that for investment areas which are not included in the Negative List, the national treatment will be extended to the "pre-estalishment stage" (i.e. "*the treatment given to foreign investors and their investments at the investment access stage shall be no less favourable than domestic investors and their investments*"). However, in the absence of further implementation details, it is perhaps too early to tell whether the "pre-establishment of national treatment" could translate into the abolishment of certain specific conditions imposed only on foreign investors who invest in certain sectors.

The FIL provides that "the content and coverage of foreign investment reports shall be based on necessity and information available through the governmental information sharing system shall not be further required to be reported". Given most of the information filed with the MOFCOM currently overlaps with that provided to the State Administration for Market Regulation ("**SAMR**") and is available on the current "Enterprise Credibility Information Publication System", it may mean that a much simpler foreign investment information reporting system may soon replace the current MOFCOM filing system (which is now handled separately to the SAMR process).

The national security review is briefly addressed in the FIL, although it is an area still requiring further detailed rules.

Impact on existing foreign investment enterprises

While the precise impact of the FIL on existing foreign investments will depend on the detailed implementation rules, the following are some likely implications:

Implications on the current filing and approval systems

The FIL provides a new framework for future investment management, as follows:

- in terms of projects, where approval or filing is required for foreign investment projects, the applicable provisions of the State shall be followed; and
- in relation to regulated sectors, if a foreign investor intends to invest in an industry or sector where a licence is required, the foreign investor must complete the licensing formalities in accordance with the law.

The FIL is silent on MOFCOM's approval power in relation to investments falling under the Negative List or the role of the National Development and Reform Commission ("**NDRC**"), which will be further addressed and clarified in subsequent regulations.

Joint ventures

The FIL provides that the FIEs shall follow the Company Law (which applies to domestic companies) and the Partnership Enterprise Law and other applicable laws in terms of form, organs and operating procedures. A five-year transition period is provided in the FIL for the changes to be applied to existing entities.

Whilst we will need to see the implementation regulations to understand all implications, some of the potential key areas of changes are illustrated below (taking an equity joint venture as example):

Item	Equity Joint Venture Law	Company Law
Highest Authority	Board of directors	Shareholders' meeting
Directors	At least 3 directors, with directors' seats allocation by reference to the contribution ratio	1 executive director is permitted and the law is silent on the seat allocation
Majority Rule for Certain Major Items	Directors - All directors presented at the board meeting	Shareholders - 2/3 votes
Natural person investor	A Chinese citizen is not allowed to be the shareholder (except in the case where special provisions otherwise provide (e.g. as a result of acquisitions or JV established in the Pudong area, Shanghai))	No restriction
Capital contribution	Contribution can be in the form of cash, buildings, workshops, machines, or other materials, industrial property, know-how, or a right to use a site. In the case of non-cash contribution, the value can be determined by agreements among parties.	Contribution can be in the form of cash, cash in-kind, intellectual property right, land use right, or other non-monetary properties that may be assessed on the basis of cash and may be transferred according to the law, which potentially allow a variety of forms of contribution (including the equity of other companies). However, the value of the non-monetary properties shall be assessed and verified (which means it does not allow an agreement by parties in relation to the values)
Profit distribution	Distribution shall be in accordance with the registered capital ratio	Distribution shall be in accordance with the actual contribution ratio between shareholders or as otherwise agreed by all shareholders
Equity Transfer	Consent by all other shareholders	More than 1/2 votes from the remaining shareholder, plus pre-emptive rights, unless articles of association provide otherwise
Fund reserved before profit distribution	Three funds, namely "reserve funds", "reward and welfare funds for employees", and "enterprise development funds". The ratio of the fund can be decided by the board, which can be, in theory, zero in practice.	Mandatory contribution to the statutory reserve fund of 10% of profits, until the reserve fund represents 50% of the company's registered capital.

Total investment

The concept of total investment is a unique concept in relation to FIEs. The main functions of the total investment are:

(a) to calculate the borrowing allowance of FIEs; and

(b) to quantify the value of the foreign capital (either in the form of equity and debts) that are to be brought by a foreign investment at the stage of investment introduction.

This concept does not exist in the Company Law and was never applied to domestic companies. The question is therefore whether such concept will remain after the entry into force of the FIL. We note that, since the introduction of macro-prudential management of full-covered cross-border financing in 2017 under *"Notice of the People's Bank of China on Matters concerning the Macro-Prudential Management of Full-Covered Cross-Border Financing"* ("**Notice 9**"), foreign-invested enterprises have already been given the right to choose to adopt a different system for the debt allowance, and to use the calculation applicable to purely domestic companies, roughly based on their net asset value rather than a difference between the total investment and registered capital. The Notice 9 provided that, at the end of the transition period (11 January 2018), the authorities would consider whether to change the whole system for all FIEs. Whilst the corresponding regulations have not been adopted yet, it is possible that the FIL will accelerate this reform and align the debt allowance calculation for all enterprises, whether domestic or foreign-invested.

Recommendations and implications for foreign investors

While it is intended that eventually the foreign invested enterprises will be regulated in the same way as domestic companies (subject to industry categories in the Negative List), substantial work remains to be done before such a goal is achieved. In advance of implementing regulations being released, foreign investors should take the following steps:

1. Review existing joint venture contracts and articles of association for existing joint ventures, and consider how they would need to be amended to become consistent with the Company Law whilst reflecting the original intention of the investors (or opportunities for renegotiation of terms in light of the FIL).
2. Identify potential opportunities for new investment in sectors previously restricted to foreign investors, or the potential to expand the business scope of existing companies. For example, even if the out-bound travel agency business does not fall under the Negative List, the current law does not allow such business to be operated by an FIE (unless it is established in the Free Trade Zone). This business may become available for FIEs following the introduction of the FIL.
3. Consider utilizing the existing FIEs, including holding companies, to achieve integrated business goals for foreign investors in China.
4. Consider opportunities for restructuring FIEs are regulated in the same way as purely domestic companies and rules applied to the domestic companies shall theoretically be applied to the foreign invested companies.
5. Prepare for a possible slowdown or delays in officials handling applications/filings during the transition period (between now and 1 January 2020) as well as a short period thereafter), as there will be inevitable changes to be made to the existing systems in order to implement the simpler and more streamlined foreign investment regulation process announced by the FIL.

About us

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