China issues a new consolidated law on foreign investment

On March 15, 2019, the National People’s Congress (NPC) of the People’s Republic of China (PRC) passed the Foreign Investment Law of the People’s Republic of China (the “Foreign Investment Law”). The Foreign Investment Law will come into effect on January 1, 2020. The Foreign Investment Law was formulated to further expand opening up to and promotion of foreign investment, protect the rights and interests of foreign investors, standardize the regulation of foreign investment, drive the formation of a new structure for comprehensive liberalization, and promote the healthy development of the socialist market economy. The Foreign Investment Law sets out many broad principles and initiatives that should help create a more level playing field and improve the legal regime for foreign investors in the PRC. However, more details are likely needed regarding its interpretation and implementation before foreign investors will see concrete changes and benefits. Below, we summarize noteworthy features of the new law.

Definition of Foreign Investment

The Foreign Investment Law defines foreign investment as direct and indirect investment activity conducted by foreign individuals, corporations, or other organizations in the PRC, including the establishment of foreign-invested enterprises (“FIEs”), acquisition of shares, equity, assets and other similar interests in PRC enterprises, investment in new projects in the PRC independently or jointly with other investors, and other forms of foreign investment indicated by the State Council (Article 2). However, the Foreign Investment Law does not specify whether the requirements of current regulations governing acquisitions of domestic companies by foreign investors will remain in place.

Because the concept of "indirect" investment under the Foreign Investment Law is not defined, it is not yet clear what effect the Foreign Investment Law will have, for example, on the existing regulations governing foreign-invested holding companies or whether it is intended to cover variable interest entity (VIE) structures (discussed further below).

Unlike past laws governing FIEs, the Foreign Investment Law does not establish a minimum percentage of foreign ownership to qualify as an FIE (the threshold under past FIE laws was 25%). Presumably, any interest in an entity held directly or indirectly by a foreign investor will result in the entity being governed by the law as an FIE. However, the existing regulations governing entities with foreign investment under 25% will need to be repealed or amended in order for FIEs with foreign investment of less than 25% to be treated the same as other FIEs.

The Foreign Investment Law also does not expressly specify that it applies to investments by Hong Kong, Macau and Taiwan investors. According to a report issued to the NPC by the NPC Constitution and Law Committee on March 12, 2019, these investments will be classified as special domestic
investments. It is expected that current policies on foreign investment for now will continue to apply to investments by Hong Kong, Macau and Taiwan investors.

Promotion of Foreign Investment

The Foreign Investment Law provides for national treatment for foreign investors operating in the PRC and sets out several broad principles for promoting foreign investment, which include:

1. a system of pre-entry national treatment plus a negative list for foreign investment will be implemented (Article 4);
2. the state’s policies supporting enterprise development are equally applicable to FIEs (Article 9);
3. FIEs are guaranteed fair competition and products produced and services provided by FIEs in the PRC shall be treated equally in government procurement (Article 16);
4. FIEs may raise funds through public offerings, corporate bonds, and other means (Article 17); and
5. local governments, acting in accordance with law, administrative regulations, and local laws and regulations, and within their statutory authority, may formulate foreign investment promotion and facilitation policies and measures, and governments at all levels will further improve their services for foreign investment by simplifying procedures, improving efficiency and optimizing government services (Articles 18 and 19).

Under administrative regulations previously issued by the Ministry of Commerce (MOFCOM), a system of pre-entry national treatment plus a negative list for foreign investment has already been essentially in place nationwide since late 2016, with the nationwide negative list updated most recently in July 2018, so it remains to be seen what changes if any to the existing system are contemplated by the Foreign Investment Law.

Similarly, although existing government procurement laws and regulations already contain provisions on fair treatment and non-discrimination with respect to government procurement generally, foreign investors have long complained of local favoritism in government procurement. Therefore, it is hoped that detailed implementation and stricter enforcement of these general provisions in the Foreign Investment Law will lead to changes in the actual procurement practices of local governments and state-owned entities.

Protection of Foreign Investment

The Foreign Investment Law also sets out various protection principles for foreign investments, including the following:

1. The state will not expropriate foreign investments. If expropriation is required in the public interest, expropriation shall be imposed according to legal procedures, and the FIEs concerned shall promptly receive fair and reasonable compensation (Article 20). “Fair and reasonable compensation” is not defined so presumably this will still be negotiated on a case by case basis.
2. The capital contributions, profits and capital gains, intellectual property rights royalties, asset disposal proceeds, indemnity or compensation and liquidation proceeds received in the PRC according to law may be freely transmitted inward and outward in accordance with the law, denominated in Renminbi or foreign currencies (Article 21). Inward and outward remittances are still subject to the purview of the foreign exchange regulator and the banks. This provision by itself does not alter existing foreign exchange regulations that apply to FIEs and payments to foreign investors, so it is not certain if any changes will be immediately forthcoming in this respect.

3. The intellectual property rights of foreign investors and FIEs will be protected in accordance with the law and legal liability will be pursued for any infringement of intellectual property rights. The administrative organs and their staff shall not use administrative means to force the transfer of technology. The conditions for technological cooperation shall be negotiated by investing parties on the basis of equality and fairness (Article 22). This provision may help allay some of the political pressure China is currently facing from many foreign governments regarding alleged forced technology transfers; however, because it only prohibits the use of administrative means, there will likely still be concerns that other means could be utilized to coerce the transfer of technology held by foreign parties. For example, it remains to be seen whether any changes will be made to the existing Management Regulations on Technology Import-Export from 2001 which provide that a Chinese licensee of foreign technology owns any improvements it makes and prohibit a foreign licensor from restricting the licensee's use of such improvements.

4. Administrative organs and their staff will be bound by non-disclosure obligations with respect to business secrets learned during the performance of their duties (Article 23).

5. When formulating normative documents concerning foreign investment, unless otherwise provided for by laws and administrative regulations, all levels of government shall not impair or reduce the legitimate rights and interests of FIEs or increase their obligations and shall not set market access and exit barriers, or interfere in or affect the normal production and operation activities of FIEs (Article 24).

6. Local governments and their relevant departments must abide by policy commitments to and contracts with foreign investors and FIEs made according to the law (Article 25). If the local government needs to amend its contractual undertaking because of changes in national policies, it should compensate the loss of the foreign investor.

7. The state will establish a complaint mechanism for FIEs, coordinate and improve major policy measures for handling FIEs or their foreign investors' complaints, and promptly address problems reported by FIEs or their foreign investors. Where the FIEs or their foreign investors consider that the administrative organs or their administrative acts infringed upon the FIEs and their foreign investors’ lawful rights, such FIEs and foreign investors may apply for administrative review or institute proceedings in the people’s courts, in addition to the above complaint mechanism (Article 26). Due to the lack of detail regarding this complaint mechanism, it is not clear how it will differ from existing administrative
litigation procedures, and whether it will offer any realistic and practical recourse to foreign investors that are subject to unfair or illegal treatment by government authorities or officials. Presumably, any new system to be established will be put in place in due course and detailed in future implementing regulations.

Foreign Investment Reporting System

The Foreign Investment Law provides that the state will establish a foreign investment information reporting system, and a foreign investor or FIE must submit investment information to MOFCOM through the enterprise registration system and the enterprise credit information publicity system. The Foreign Investment Law does not specify what information will be required, and how this system will differ from the reporting system currently in place for foreign investors and FIEs.

National Security Review

The Foreign Investment Law states that a foreign investment security review system will be established (Article 35). It is not clear how this system will differ from the current national security review system in place since 2011 under relevant MOFCOM notices, and more particularly, whether it will expand national security reviews to sectors other than those currently specified under relevant rules. However, this provision of the Foreign Investment Law does represent a new development which may not be welcomed by foreign investors in so far as it specifies that decisions made about National Security Review cases are final and immune from challenge through administrative review or litigation.

Impact on existing FIEs (non-VIEs)

One of the most substantial developments under the Foreign Investment Law is the nullification of the existing legal framework governing FIEs in place since 1979, namely the Sino-Foreign Equity Joint Venture Law (“EJV Law”), the Sino-foreign Cooperative Joint Venture Law, and the Wholly Foreign-Owned Enterprise Law (collectively, the "FIE Laws").

Under the Foreign Investment Law, existing FIEs would be granted a transitional period of five years to maintain their organizational structures, but what other changes need to be made by existing FIEs during the transitional period requires further clarification. Since the constitutional documents of existing FIEs are governed by the existing FIE Laws, abolishing the FIE Laws means removing the legal basis for the constitutional documents of the existing FIEs. It also means that Chinese and foreign joint venture partners may need to reorganize, and likely renegotiate, their corporate and governance structures to comply with the relevant laws at the end of the five-year transition period.

For example, under the EJV Law, the board of directors was the highest decision making authority of the joint venture, and there was no shareholder meeting. Under the Company Law however, a shareholders meeting is required.

In addition, existing rights of consent and first refusal in respect of equity transfers under the EJV Law will be weakened under the Company Law, such that minority investors may find themselves having to negotiate to
maintain existing restrictions on transfers in their current joint venture agreements after the transition period.

We expect that during the transitional period, the local bureau of the State Administration for Market Regulation (essentially the business registry) in practice may require an FIE to update its articles of association and joint venture agreements to be in line with the Company Law before they will process any corporate changes. As such, it will be advisable for foreign investors to start contemplating what amendments will need to be made to joint venture agreements to avoid any delays in processing any corporate changes.

For new FIEs however, it will result in more equal treatment and consistency with domestic companies, given that the legal requirements and organization of both domestic companies and FIEs will now be based on the Company Law and the Partnership Law. Notwithstanding, the Foreign Investment Law provides that regulations on foreign investors’ investment in banking, securities, insurance, etc. or the financial markets such as securities market and foreign exchange market will prevail.

The abolition of the EJV Law and the provisions thereunder requiring that the parties to an equity joint venture share profits, risks and losses in proportion to their respective contributions to registered capital may offer greater flexibility for foreign investors in this respect and open the door for parties to joint ventures to provide for preference share structures that allow one party to enjoy disproportionate profits returns or early recoupment of investments.

Impact on VIEs

Variable interest entity (“VIE”) structures, which are based on contractual arrangements, are typically used by companies who wish to attract foreign investors or go public overseas and often operate in sectors in which foreign investment is restricted, particularly in the technology, media and telecommunications, and education sectors. The first draft of the Foreign Investment Law issued in 2015 sought to include foreign investments through VIE structures under the ambit of foreign investment, which led to much controversy and debate in the market.

The Foreign Investment Law does not expressly regulate VIEs as a type of foreign investment; however, as it seeks to regulate "indirect" foreign investment, it leaves the door open for the Chinese government to later issue regulations on VIEs. Under the Foreign Investment Law, where a foreign investor invests in a field prohibited by the negative list, relevant departments will order the investor to cease the investment activities, dispose of the shares and assets or take any other necessary measures to restore the status quo preceding such investment and will confiscate illegal gains. In sectors that are restricted under the foreign investment negative list (rather than prohibited), the relevant authorities will order the investor to rectify, and if the investor refuses, the foregoing measures may be taken. Where foreign investors’ investment activities violate provisions in the negative list, the foreign investors will be legally responsible for such violation according to law in addition to being dealt with according to the foregoing provisions (Article 36).
Conclusion

The Foreign Investment Law is commendable with respect to the principles it sets forth to create a more equal legal framework for foreign investors and a system to promote and protect foreign investment. However, because it lacks many details, contains broad and sometimes vague provisions, and repeals the existing legal framework for FIEs, in practice the Foreign Investment Law may result in less certainty and more confusion for foreign investors in the short to medium term, until such time as more details, clarification and implementing regulations are provided. Foreign investors and existing FIEs should therefore closely track related regulatory developments and implementation measures that follow.