

Legal Commentary

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Comments on the Regulations for the Implementation of the Foreign Investment Law (Draft for Comment)

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Evolution of policy on FIE foreign exchange capital in equity investment

On November 1, 2019, the Ministry of Justice issued for public comment the *Regulations for the Implementation of the Foreign Investment Law of the People's Republic of China (Draft for Comment)* (the “**Draft Regulations**”), jointly drafted by the Ministry of Justice, the Ministry of Commerce, and the National Development and Reform Commission. The Draft Regulations, which will serve as the implementing regulations for the *Foreign Investment Law of the People's Republic of China* (the “**Foreign Investment Law**”), aim to further clarify the principled provisions and requirements of the Foreign Investment Law and to facilitate its implementation.

Main contents

I. Promote and protect investment

The Draft Regulations reiterate the principle of promoting and protecting foreign investment, and further detail the relevant provisions of the Foreign Investment Law. The main contents of the Draft Regulations include:

1. Broadening the forms and types of foreign investment in China by specifying that foreign investors may co-invest with Chinese natural persons and that foreign investment includes non-equity investment (Articles 3 and 4);
2. Requiring the government to hear and consider opinions from foreign parties (including foreign chambers of commerce) in the process of formulating relevant laws on foreign investment, and specifying the methods for foreign-invested enterprises (“**FIEs**”) to participate in standards setting work (Articles 10 and 15);
3. Requiring governments at all levels to publish relevant policies and guidelines for foreign investment and to adopt a unified and transparent foreign investment management system (Articles 10, 11 and 21);

4. Establishing a foreign investment positive list and continuing to implement preferential policies; clarifying that governments must not arbitrarily breach their commitments made in accordance with the law (Articles 13, 28, and 29);
5. Specifying at the administrative regulation level that foreign investors may receive preferential treatment when they make reinvestments with profits obtained through domestic investment (Article 14);
6. Further clarifying issues of concern for foreign investors, including (1) detailing circumstances of foreign exchange control violations (Article 23); (2) clearly requiring establishment a punitive compensation system and an expedited collaborative protection mechanism for intellectual property infringement (Article 14); (3) detailing circumstances of illegal forced technology transfers (Article 25); and (4) strengthening government protection of enterprise trade secrets (Article 26).

II. Equal treatment of domestic and foreign investment

The Draft Regulations further detail requirements for governments at all levels and emphasize that domestic and foreign investment are equals in the process of policy formulation and implementation by:

1. Specifying that governments must not discriminate against foreign investment and should fairly handle foreign investment applications when formulating and implementing policies and regulations in connection with capital arrangements, land supply, tax and fee exemptions, licenses and permits, project declarations, job title evaluations, and human resources (Article 9);
2. Prohibiting the government from requiring FIEs to be subject to technical requirements that are higher than mandatory standards, and further specifying that FIEs must not be compelled to use voluntary standards or group standards (Article 16);
3. Specifying that the government shall undertake legitimate inspections and fair competition reviews when formulating regulatory documents on foreign investment (Article 27);
4. Clarifying that conditions and procedures be consistent for domestic and foreign investment in respect of market entry administrative licenses, additional requirements will not be imposed on FIEs such as additional examination criteria, procedures and documents (Article 37).

III. Clarify transition arrangements for unifying the three FIE laws

The Draft Regulations clarify certain arrangements for the transition to the Foreign Investment Law from the currently effective “three foreign investment laws” by:

1. Stipulating a six-month legal change period in addition to the five-year transition period of the Foreign Investment Law, extending the enterprise change period and specify the legal consequences of failing to handle changes within the prescribed period (Article 42);
2. Specifying that the existing profit distribution arrangements of equity or contractual joint ventures will not be affected by organizational structure adjustments, and guaranteeing the existing interests of all investors (Article 43).

Observations

Despite these highlights, many provisions in the Draft Regulations still await further clarification and adjustment, including:

I. Ambiguity in the definition and supervision of non-equity investment

As mentioned above, Article 4 of the Draft Regulations specifies that foreign investment includes non-equity investments (i.e. new project investments in China, which refer to investments by foreign investors in specific projects in China without establishing an FIE or acquiring shares, equities, asset interests, or other similar interests in domestic enterprises), which broadens the forms and types of foreign investment in China. However, the current provisions of Article 4 are too general for uniform supervision. In this regard, we recommend that the Draft Regulations refer to the description of foreign investment activities stated in the January 2015 public comment draft of the Foreign Investment Law¹ to clarify whether certain circumstances constitute “foreign investment”:

1. Financing provided for one year or more to projects in China;
2. Obtaining concessions for the exploration and development of natural resources, or concessions for the construction and operation of infrastructure in areas under Chinese jurisdiction; and
3. Obtaining real estate rights in China such as land use rights and housing ownership rights.

From another perspective, the Draft Regulations lack relevant provisions on access management and in-process and ex-post supervision with regard to the above-mentioned forms of investment, which could cause these forms of investment to become impractical due to a lack of systems and rules.

II. Limited exemption of foreign investment restrictions for round-trip investments

According to Article 35 of the Draft Regulations, round-trip investments can be exempted from negative list market access restrictions. However, this exemption is not conducive to attracting foreign investment because it only applies to round-trip investments of overseas enterprises established and fully owned by Chinese investors, and emphasizes 100% Chinese capital, which excludes a large number of other overseas enterprises that are established for offshore financing purposes by Chinese investors. In addition, Article 35 also provides that only upon State Council approval are round-trip investments not subject to access restrictions. This level of examination and approval is set too high and could result in being unable to obtain approvals in practice.

III. Ambiguity in the supervision of FIE domestic reinvestment

In current regulatory practice, it is unclear whether a domestic enterprise invested in by an FIE (excluding the three types of foreign-invested investment enterprises) is a “foreign-invested enterprise” or a “domestic / domestic-invested enterprise”. According to Article 2 of the Foreign Investment Law, foreign investment includes “direct or indirect” investment activities of foreign investors, so foreign investment should also include domestic reinvestments by foreign investors through domestic

¹ In Chinese, 《中华人民共和国外国投资法（草案征求意见稿）》.

enterprises under their control. On the other hand, domestic reinvestments by a domestic enterprise should not be considered foreign investment where a foreign investor merely owns shares in the enterprise but has no control. However, the Draft Regulations do not define and distinguish among FIE reinvestment activities. This lack of higher-level regulatory guidance will make it difficult to unify regulatory policies among the various departments and commissions in respect of FIE reinvestment and will result in inconsistencies in practice.

IV. Market regulation department review may result in a new barrier to foreign investment access

According to Article 38 of the Draft Regulations, if a foreign investor applies to establish an FIE in an industry listed in the market access negative list, the market regulation department will examine whether the FIE meets the shareholding ratio and senior management requirements when handling the FIE's registration. Although the Draft Regulations also stipulate that the market regulation department need not repeat the review if the relevant competent authorities have already reviewed the application, in general, the relationship between market access approval and registration review remains ambiguous. According to the currently valid pre-examination and approval catalogue for industry and commerce registration, competent authority approval is a pre-requisite for registration of FIEs in negative-listed industries and foreign investors are required to hold an approval certificate when registering with the market regulation department. If the market regulation department still examines whether the requirements are met at the time of registration, it may result in a second substantive review and constitute an additional barrier to entry.

V. The meaning of “overseas Chinese” needs further clarification

According to Article 44 of the Draft Regulations, “investments made by overseas Chinese within the territory of China shall be governed in reference to the Foreign Investment Law and these [Draft Regulations]”. “Overseas Chinese” refer to Chinese citizens who permanently reside abroad, including those (1) who have obtained long-term or permanent residency in their country of residence and have been residing in the country for two consecutive years, and the cumulative time of residence in the country is no less than 18 months within two years; or (2) who, although not having obtained long-term or permanent residency in their country of residence, have obtained a legal residence permit in the country for five consecutive years or more and have resided in their country of residence for cumulatively no less than 30 months within five years, while Chinese citizens who study or take business trips abroad are not considered overseas Chinese.² For purposes of implementing the regulations, there is a need to clarify the meaning of overseas Chinese in connection with foreign investment at the administrative regulation level under the principle of “priority based on permanent residence and center of economic interest”.

The Foreign Investment Law will come into effect in fewer than two months. We expect the regulators to adjust and improve the Draft Regulations after reviewing opinions and suggestions from various circles to lay a solid foundation for the upcoming Foreign Investment Law.

² Provisions of the Office of Overseas Chinese Affairs of the State Council on Defining the Identities of Overseas Chinese, Chinese Foreign Nationals, Returned Overseas Chinese and Their Family Members.

Important Announcement

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