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Legal Updates

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Legal Updates

1. Interpreting the Foreign Investment Law: In a Nutshell

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On March 15, 2019, the *Foreign Investment Law of the People's Republic of China* was adopted at the Second Session of the Thirteenth National People's Congress. The law will become effective on January 1, 2020.

I. Before the Foreign Investment Law

What is past is prologue—adoption of the Foreign Investment Law is based on 40 years of China's opening-up. The well-known "three enterprise laws" and related foreign investment administrative systems took shape during China's opening-up and have been constantly updated and adjusted to adapt to the new challenges of the times. In recent years, however, such patchwork regulatory adjustments and partial system innovations have increasingly fallen short. The 2015 issuance of a consultation draft foreign investment law drew spirited debate; while views differed on specific provisions, everyone looked forward to the introduction of a unified basic law on foreign investment.

Fewer than three months elapsed from the initial deliberation of the draft Foreign Investment Law at the seventh meeting of the Thirteenth NPC Standing Committee on December 26, 2018 until its adoption by the National People's Congress on March 15, 2019. This speed reflects China's strong determination to introduce a basic foreign investment law.

II. Arrival of the Foreign Investment Law

The Foreign Investment Law is divided into 6 chapters and 42 articles. As the basic law for the new foreign investment legal system, the Foreign Investment Law establishes fundamental rules for the promotion, protection and access management of foreign investment. This article summarizes the main content of the Foreign Investment Law.

For a more detailed analysis of certain hot topics related to the Foreign Investment Law, you may refer to *Interpreting the Foreign Investment Law: Uncharted Waters*.

A. Consistency Between Domestic and Foreign Investment

The biggest highlight of the Foreign Investment Law lies in clarifying the principle of "consistency between domestic and foreign investment", which is not only embodied at the foreign investment access stage, but also continues to apply at the post-investment operating stage.

At the foreign investment access stage, the law specifies that foreign investment is subject to a pre-access national treatment plus negative list system. National treatment is provided to foreign investment outside the negative list and is administered in accordance with the principle of consistency between domestic and foreign investment. The negative list management system is not entirely new in China. Since 2013, when the Shanghai Free Trade Zone began piloting negative list and filing management systems, the negative list system has been implemented throughout China, underlined by revisions to the three enterprise laws and promulgation of related ministerial rules. The Foreign Investment Law, which has a higher level of superiority, establishes this system as the basic system for China's opening-up.

More specifically, the Foreign Investment Law expressly provides that the treatment of foreign investors and their investments at the investment access stage are not to be less favorable than those of domestic investors and their investments. In general, the investment access stage includes greenfield and M&A investment activities by foreign investors, such as initial set-up, acquisition and expansion. National treatment at this stage indicates that various investment activities of foreign investors should no longer be subject to special restrictions which target foreign direct investment, and foreign investors will enjoy the same rights and autonomy as domestic investors. The investment process will also be more convenient and flexible. On the other hand, national treatment is always accompanied by a negative list. The negative list refers to the special management measures for the access of foreign investment in specific industries, which is to be updated from time to time. In this sense, the greatest significance of the negative list is not in the specific areas open to investment and the extent of opening, but rather that it indicates China has entirely evolved from the previous "positive list" management model and clearly established that "all is permissible unless legally prohibited", which is more in line with the practices of market economies, greatly improving the transparency and predictability of foreign investment access.

In line with national treatment at the access stage, the Foreign Investment Law also establishes the principle of "consistency between domestic and foreign investment" at the post-investment operating stage. According to the Foreign Investment Law, all national policies supporting the development of enterprises will equally apply to foreign-invested enterprises. Unless otherwise stipulated by laws and administrative regulations, governmental authorities at all levels must not impair the legitimate rights and interests of or impose any additional obligations on foreign-invested enterprises, set any conditions for market access and exit, or intervene in any normal production and operating activities of foreign-invested enterprises. This indicates that the consistency principle will be applied to foreign-invested enterprise operations to the maximum extent. Limiting exceptions to only where permitted by "laws and administrative regulations" can also ensure to the greatest extent that implementation of this principle will not be interfered with by any particular governmental departments or local governments.

B. Consolidation of the Three Enterprise Laws

The three enterprise laws implemented during the decades of China's opening-up will be officially repealed as of the effectiveness of the Foreign Investment Law on January 1, 2020. Foreign-invested enterprises will no longer be divided into wholly foreign-owned enterprises, Chinese-foreign equity joint ventures, Chinese-foreign contractual joint ventures, and will instead be equally subject to the provisions of the *Company Law of the People's Republic of China*, the *Law of the People's Republic of China on Partnership Enterprises*, and other laws. Domestic and foreign-invested enterprises will be established and operated in accordance with unified rules. Arrangements for internal governance structures, rules of order, voting procedures, equity transfers and profit distribution will be fully compatible with those of domestic enterprises. Domestic and foreign-invested enterprises will no longer be divided into different working systems due to differences in their capital territoriality, and parties to foreign-invested enterprises may design and implement various arrangements and practices more flexibly.

For a more detailed analysis of how foreign-invested enterprises should adjust their governance structures during the transition period, you may refer to *Interpreting the Foreign Investment Law: Uncharted Waters*.

At the same time, the application of foreign enterprise-related laws has in the past caused confusion due to differences between these special and general laws, and between the provisions of new and old laws. Unifying the rules for foreign and domestic enterprises will act to dispel much of this confusion and cause the rules to be clearer and more explicit.

C. Investment Promotion and Protection

The Foreign Investment Law emphasizes the promotion and protection of investment in special chapters covering these aspects. Among these chapters, the protection of intellectual property rights, the prohibition of compulsory technology transfers, and the equal participation of foreign-invested enterprises in government procurement and equal participation in standard setting may be considered a positive response to recent public demands.

III. Outlook

The Foreign Investment Law establishes the framework and rules of the basic system for a new era of opening-up and marks the beginning of this new system. Realization of the many principles and requirements of the Foreign Investment Law depends on subsequent implementing regulations, more detailed rules and local regulations. In particular, to fully implement the principle of "consistency between domestic and foreign investment", it will be necessary for legislatures at all levels to examine existing laws, regulations and normative documents. At the access stage, legislatures at all levels need to further liberalize various substantive restrictions and requirements for foreign investment at the access stage (including greenfield investment and M&A), and to give foreign investors greater autonomy to enable them to design investment and transaction arrangements as flexibly as domestic investors. At the operating stage, it will be necessary to remove all additional requirements and limitations on foreign-invested enterprises, except in the case of special requirements set out in laws and administrative regulations, while also particularly focusing on the scope and content of such special requirements to avoid the creation of new restrictions on foreign investment.

It is conceivable that implementation of the Foreign Investment Law and the repeal of the three enterprise laws will lead to large-scale adjustments and a cleanup of various regulations based on decades-old regulatory approaches. The restructuring of the regulatory system brought by the Foreign Investment Law will be a larger task than the "clean-up" of regulations caused by the reform of the registered capital system and implementation of the negative list system. In this regard, our legal practitioners are both excited and curious: in one sense, a more relaxed regulatory environment provides space for innovative investment and transaction arrangements, the structures and terms of which can be more in line with market practices. In another sense, however, it is also necessary for legal practitioners to quickly master the new foreign investment regulatory system, to reflect upon how to reasonably utilize the new rules of the game so that investors and foreign-invested enterprises can eventually enjoy the benefits of further reform and opening-up.

2. Interpreting the Foreign Investment Law: Uncharted Waters

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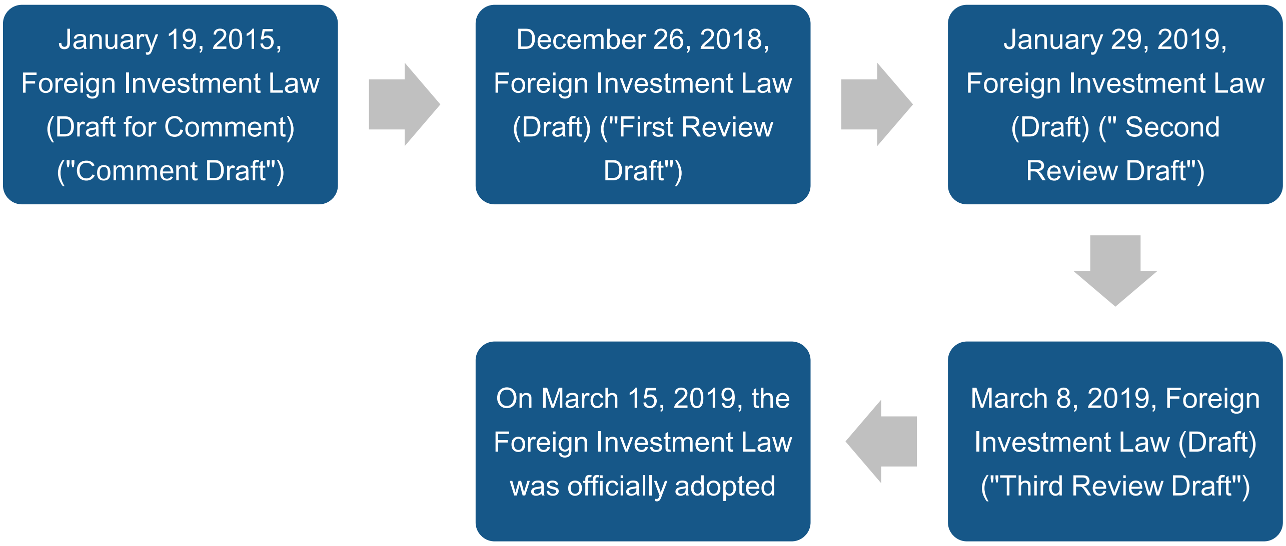
On March 15, 2019, the *Foreign Investment Law of the People's Republic of China*[1] was adopted at the Second Session of the Thirteenth National People's Congress, which will become effective on January 1, 2020. The law was adopted quickly following its first submission to the NPC Standing Committee for deliberation on December 23, 2018, reflecting the legislative body's strong determination to create a basic legal system to replace the "three foreign-invested enterprise laws"[2] and serve as the foundation for foreign investment in China.



The Foreign Investment Law provides clear provisions on issues of common concern for foreign-invested enterprises and their investors, such as the pre-access national treatment plus negative list system, the equal application of all national policies to foreign-invested enterprises, no expropriation of foreign investments under unexceptional circumstances, liberalization of inbound and outbound remittances, concentration of undertakings reviews and foreign investment security review systems. For more analysis, please see our related article, *Interpreting the Foreign Investment Law: In a Nutshell*.

However, the Foreign Investment Law has also left more than a few open questions, many of which remain topics of interest. This article will analyze these open questions.

I. Temporarily shelving VIE structure issues

The variable interest entity ("**VIE**") structure, also known as "agreement control" or "contractual

[1] http://www.npc.gov.cn/npc/xinwen/2019-03/15/content_2083532.htm

[2] Refers to the currently effective *Law of the People's Republic of China on Foreign-Capital Enterprises*, *Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures* and *Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures*.

arrangement", refers to the use of a series of agreements, rather than equity ownership, to achieve actual control of domestic operating entities and consolidation into the financial statements.

Since Sina completed its NASDAQ listing by adopting a VIE structure in 2000, VIE structures have been widely used by Chinese companies involved in foreign investment-restricted or -prohibited industries (such as TMT, private education, etc.) to raise foreign capital by creating red chip structures or completing overseas IPOs. However, currently effective Chinese laws and regulations have yet to clearly determine the nature of VIE structures.

Article 15 of the 2015 consultation draft of the Foreign Investment Law (the "**Comment Draft**") for the first time clearly defined VIE structures as a form of foreign investment. However, the first draft for deliberation in 2018 of the Foreign Investment Law ("**First Review Draft**") removed all provisions referring to "agreement control" or "actual controller". In their place, a catch-all clause was added which stipulated that "foreign investment" includes "investments made by foreign investors in China through other means as provided by laws, administrative regulations or by the State Council." This catch-all clause has been retained in the final Foreign Investment Law[3].

We tend to believe that the current focus of the Foreign Investment Law is to expand opening-up, clarify the pre-access national treatment plus negative list system, and ensure an equally competitive environment for domestic and foreign investors under the background of the coming 40th anniversary of reform and opening-up and continuation of Sino-U.S. trade frictions and consultations. The Foreign Investment Law temporarily shelves many controversial issues that are less urgent, leaving them for later legislative authorization, such as the legality of VIE structures and identifying foreign investment based on actual control rather than place of registration (i.e., the actual control concept proposed in the Comment Draft). Therefore, Article 2, para. 2 of the Foreign Investment Law leaves open the possibility that VIE structures may still be included in the regulatory scope of "foreign investment" through special laws, or administrative regulations or even normative documents formulated by the State Council.

For more analysis of VIE structures, please refer to our related article, *Interpreting Draft Foreign Investment Law from VIE Perspectives*.

II. The Foreign Investment Law applies to Hong Kong, Macao and Taiwan investors on a "reference or comparison" basis, with supporting regulations possibly to come

Hong Kong SAR, Macao SAR and Taiwan are a part of China, and are also classified as independent customs zones. Thus, investments from Hong Kong, Macao and Taiwan are regarded neither as entirely foreign nor entirely domestic. In practice, the Chinese government has long administered Hong Kong, Macao and Taiwan-sourced investments by reference to foreign investment laws.

In fact, Articles 162 and 163 of the Comment Draft stipulated that the law would apply by reference to investments in mainland China made by Hong Kong, Macao and Taiwan investors and overseas Chinese investors, except as otherwise provided by laws and administrative regulations. However, the First

[3] The clause reads as "investment made by foreign investors through other means as provided by law."

Review Draft removed these provisions, which were also missing from the final Foreign Investment Law.

In this regard, at a press conference on the Second Session of the Thirteenth National People's Congress held on March 4, 2019, Mr. Zhang Yesui, spokesperson for the Second Session, stated that: "In practice, the government administers Hong Kong, Macao and Taiwan investments by reference to foreign investment. The Foreign Investment Law will not change this arrangement for the application of law. And the relevant systems will be continuously revised and improved in accordance with practical needs, and further provide a more open and convenient business and development environment for Hong Kong, Macao and Taiwan investments[4]."

On the morning of March 15, Premier Li Keqiang held a press conference at the conclusion of the Second Session. While taking questions from journalists, Premier Li stated: "Hong Kong, Macau and Taiwan investment can refer to or comparatively apply the just-adopted Foreign Investment Law, and some of the institutional arrangements and actual practices that have worked well for a long time will continue to be followed, not only will this not disturb [investment], it will help attract investment from Hong Kong, Macau and Taiwan[5]." We expect that, in the future, the National People's Congress and its Standing Committee or the State Council may further introduce supporting regulations to clarify the laws that apply to Hong Kong, Macao and Taiwan investors and the enterprises which they establish in mainland China in order to attract Hong Kong, Macao and Taiwan investment.

III. Three types of foreign-invested enterprises need to adjust corporate governance structures during the transition period

In order to establish unified rules for domestic and foreign-invested enterprises, Article 31 of the Foreign Investment Law clearly stipulates: "The organizational form and organizational structure of foreign-invested enterprises shall be governed by the Company Law of the People's Republic of China and the Law of the People's Republic of China on Partnership Enterprises." Article 42 of the Foreign Investment Law further provides that the three foreign-invested enterprise laws will be repealed as of January 1, 2020, and that foreign-invested enterprises established under these laws before the Foreign Investment Law becomes effective may retain their original organizational form for a period of five years.

Thus, a majority of foreign-invested enterprises face the problem of completing necessary internal adjustments during this five-year transition period to comply with the Company Law, which will come to uniformly apply to both domestic and foreign-invested enterprises. These adjustments are not expected to be easy.

The Company Law sees significant differences compared to the currently effective Law on Chinese-Foreign Equity Joint Ventures and Law on Chinese-Foreign Contractual Joint Ventures, including but not limited to the following:

[4] http://www.npc.gov.cn/npc/zhibo/zzzb44/node_381.htm
[5] http://www.xinhuanet.com/politics/2019lh/2019-03/15/c_1124239569.htm

Matter	Company Law	Law on Chinese-Foreign Equity Joint Ventures	Law on Chinese-Foreign Contractual Joint Ventures
Highest authority	Shareholders' meetings	Board of directors	Board of directors or joint management committee
Minimum number of members	Permitted to have one executive director	No fewer than three directors	Board of directors or joint management committee may have no fewer than three members
Quorum	None	2/3 or more directors	2/3 or more members of the board of directors or the joint management committee
Term of directors	No more than three years	Four years	No more than three years
Voting mechanism for major matters	Approval by shareholders representing more than two-thirds of the voting rights	Unanimous approval by directors present at the meeting	Unanimous approval by members present at the meeting
Initial shareholder characteristics	Chinese natural persons permitted to participate in establishment	Chinese natural persons not permitted to participate in establishment	Chinese natural persons not permitted to participate in establishment
Profit distributions	Distributions based on proportion of paid-in capital, unless otherwise agreed by all shareholders	Distributions based on registered capital ratios	In accordance with contractual joint venture contract
Equity transfer restrictions	Approval by more than half of the other shareholders, unless otherwise agreed in the articles of association	Unanimous approval by the other shareholders	Unanimous approval by the other members

In practice, there is some controversy as to whether a joint venture can conform to the Company Law, whose provisions differ significantly from the Law on Chinese-Foreign Equity Joint Ventures. For example, can a joint venture stipulate in its contract and articles of association that a two-thirds affirmative vote of voting directors is required to approve a major event? And can a joint venture stipulate in its contract that equity transfers only require the consent of more than half of the other shareholders, or even stipulate that certain or all shareholders have the right to freely transfer their shares? Although there are no definite answers to these questions, and we believe the answers will vary depending on specific circumstances, the existence of such questions is sufficient evidence to prove that it has become difficult for the three foreign-invested enterprise laws to meet the needs of reform and opening-up.

With respect to the highest authoritative body, joint ventures will need to establish new shareholders' meeting systems to inherit rights from their boards of directors as described in the Company Law, and will need to establish new voting mechanisms. These adjustments will possibly result in conflicts between joint venture parties.

By contrast, a more pressing issue is whether existing foreign-invested enterprises during the transition period should comply with the new Foreign Investment Law by reference (and if so, how), or whether they should continue to comply with the then-repealed three foreign-invested enterprise laws (that is, will the laws remain effective for those existing foreign-invested enterprises?). We believe that these issues need to be clarified before the new Foreign Investment Law comes into effect on January 1, 2020.

IV. Foreign investment promotion policy to be carefully opened to local government, which is worth looking forward to

Both the First Review Draft and the Second Review Draft stipulated in Article 18 that "local governments at various levels may formulate foreign investment promotion policies within their statutory authority." Some local governments had long issued certain preferential policies in terms of taxation, income and finance in order to attract foreign investment which were all subsequently suspended by the *Circular of the State Council on Stocktaking and Regulation of Preferential Policies for Taxation and Related Issues (Guo Fa [2014] No. 62)*. Article 18 therefore raises similar concerns about local governments abusing their authority and uncertainty about the future suspension of similar local preferential policies.

Article 18 was revised in the Third Review Draft to further clarify that governments at or above the county level can only formulate policies and measures to promote and facilitate foreign investment within their statutory authority in accordance with the provisions of laws, administrative regulations and local regulations. This new provision was also adopted in the new Foreign Investment Law.

According to the Legislation Law, the legislative body, scope of application and legislative preconditions of local regulations are shown in the following table.

Local legislative body	Scope of application	Legislative preconditions
People's congresses and their standing committees of provinces, autonomous regions and municipalities directly under the central government	Provinces, autonomous regions, municipalities directly under the central government	Not in conflict with the constitution, laws, administrative regulations
People's congresses and their standing committees of the autonomous prefectures and cities divided into districts	Autonomous regions and cities, and limited only to matters related to urban and rural construction and management,	Not in conflict with the constitution, laws, administrative regulations and local regulations of the province or autonomous

Local legislative body	Scope of application	Legislative preconditions
	environmental protection, historical and cultural protection, etc. (except as otherwise provided by law)	region, and must be reported to the standing committee of the people's congress of the province or autonomous region for approval.

The highlight of the above amendment is to add “local regulations” to the legal basis for developing local preferential policies. In practice, except for some regions of strategic significance such as the Guangdong-Hong Kong-Macao Greater Bay Area, local governments will find it difficult to count on a national law basis for their local foreign investment promotion policies. “Local regulations” may address this concern by not causing the requirements under Article 18 to be too high so as to become impractical, but also not too low so as to invite abuses of authority.

It will be worthwhile to see how the local governments use the convenience provided by “local regulations” to formulate local foreign investment promotion and facilitation policies and measures.

Important Announcement

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