



Foreign Investment Law: What Foreign Investors Should Know about This Landmark Legislation

EXECUTIVE SUMMARY:

In brief, the newly released Foreign Investment Law:

- acts as a unified law with general principles while leaving large open spaces for the promulgation of specific implementing rules;
- clarifies and confirms the pre-entry national treatment plus a negative list administrative system;
- reaffirms China's commitment to IP rights protection, and explicitly prohibits forced technology transfer by administrative measures;
- stipulates that cross-border funds can be remitted freely;
- clarifies that foreign investment shall not be expropriated;
- introduces confidentiality obligations of governmental authorities and their officials to better protect business secrets; and
- provides a transitional period allowing the three types of FIEs to maintain their current corporate structure for five years upon nullification of Three FIE Laws.

Introduction

By the end of 2018, China has set up roughly 960,000 foreign-invested enterprises ("FIEs") with an accumulated foreign investment over USD 2.1 trillion, making it the second largest country in the world in terms of attracting foreign investment¹. On March 15, 2019, the Second Session of 13th National People's Congress passed the People's Republic of China Foreign Investment Law ("FIL"), which will come into force on the first day of 2020 ("Effective Date"). In the face of current international trade tensions, the issuance of the first unified FIL sends a strong signal to foreign investors that Chinese Government wishes to continue correcting legal drawbacks to attract foreign investment, to further open its market, to better protect investors' legitimate rights and interests, and to foster an open-up environment favorable to doing business.

To create a unified legal framework and to change the current regulatory regime, FIL clearly states that Three FIEs Laws² will be repealed when FIL comes into effect in 2020. Unlike Three FIEs Laws detailing specific requirements, the newly released FIL only contains 42 articles, serving as a unified and fundamental law with broad principles on foreign investment matters. To give a general understanding of the FIL, we hereby highlight the following points.

I. What is the definition of foreign investment under FIL?

FIL defines foreign investment as direct or indirect investment activity conducted by foreign individuals, enterprises, or other organizations in the territory of China, through the following four ways:

Greenfield investment	the establishment of FIEs individually or jointly with other investors
Mergers & acquisitions ("M&A")	acquisition of shares, equity, assets and other similar interests in Chinese domestic enterprises;
Investment in new projects	investment in new projects in the PRC either independently or jointly with other investors; and
Other approaches	making investments through other means provided by laws, administrative regulations or the State Council.

FIL only provides a basic definition, and it remains unknown for detailed explanation of the above. We take few examples here:

First, FIL stipulates that foreign investment includes both direct investment and indirect investment; however, it leaves a door open for the indirect investment as no further clarification have been provided. It is not yet clear on whether it is intended to cover the concerned variable interest entity structures ("VIE")³ as well as reinvestment made after direct investment, for example, greenfield investment or M&A made by FIEs who has already been incorporated by foreign investors or the subsidiaries of FIEs.

Second, FIL does not specify whether it applies to investments made by Hong Kong, Macau and Taiwan investors⁴.

Third, "M&A" and "Investment in new projects" need further clarifications as they are written intentionally in a vague way.

II. How are foreign investors better protected under FIL?

We highlight below some particularly noteworthy provisions.

1. Pre-entry national treatment plus a negative list administrative system ("NN system")

To ensure that domestic and foreign enterprises can compete on a level playing field, since late 2016, a nationwide record-filing system has been adopted gradually, which means that the NN System introduced in FIL has essentially been implemented nationwide. FIL, for the first time, clarifies and confirms it in legislation with the status of a law by stating that foreign investors enjoy equal treatment and market access with domestic investments, except in excluded sectors specified in the Negative List⁵. For foreign investors, when entering into China, it shall first examine the Negative List whether its industry is restricted in the Negative List, and in such case it is subject to governmental approval. For industries not listed in the Negative List, foreign investors are given equal treatment to domestic Chinese investors. For example, if any permit requested for wine business, all investors, regardless foreign or domestic investors, shall apply for a license first before conducting the wine business. FIL adds one article to reaffirm that foreign investors will receive equal treatment when applying requested licenses.

Moreover, under the current record-filing system, FIEs are still subject to two parallel sets of laws, Three FIE Laws as well as the PRC Company Law, leading to potential conflicts between the two sets of laws. However, as a unified law, FIL clarifies that the organization form shall be subject to the provisions of the PRC Company Law, and Three FIEs Laws will be repealed (we will discuss this point later), which will put an end to the confusion caused by the conflicts.

It is noteworthy that FIL also provides that the State shall establish a foreign investment information reporting system as well as a national security review system; however, it is not clear yet how these two systems will differ from the current systems in place. The details are expected to be stipulated by specific interpretations.

2. Protection on Intellectual Property Rights ("IP Rights")

FIL reaffirms China's commitment to IP Rights protection of foreign investors and FIEs, by clarifying that "IP Rights of foreign investors and FIEs will be protected in accordance with the law and legal liability will be pursued for any infringement of IP Rights".

One of the major issues of current US-China trade war is alleged "Forced technology transfer" in China. FIL expressly stipulates that governmental authorities and their officials are prohibited from using administrative means to force foreign businesses to transfer their technology. The conditions for technological cooperation shall be negotiated by investing parties based on equality and fairness.

Currently, there are no concrete sanctions mentioned in FIL to provide a deterrent to governmental authorities and their officials who still try to force transfer of technology. However, FIL sets forth a general sanction that if a governmental official abuses his/her power, such official shall be subject to punishment in accordance with the law.

3. Cross-border funds remittance

FIL specifically lists certain funds that can be remitted, including "capital contributions", "profits", "capital gains", "intellectual property rights royalties", "income from asset disposal", "indemnity or compensation" and "liquidation proceeds", and clarifies that the currency of such remittances can either be Renminbi or foreign currencies. In addition, FIL emphasizes that such funds can be remitted freely. It is noteworthy that it is still subject to foreign exchange policies in place.

4. Equal treatment in government procurement

FIL clearly sets forth that FIEs are entitled to fairly participate in government procurement activities, and products manufactured or services provided by FIEs shall be treated equally.

According to PRC Government Procurement Law, the government shall procure domestic goods and the definitions for the domestic goods shall be further clarified by relevant regulations of the State Council. However, from the legislative point of view, it is not clear whether products made in China by FIEs shall be treated as "domestic goods". As stated by FIL, FIEs will receive equal treatment when participating in government procurement, and we assume detailed interpretation will be issued to clarify whether products produced by FIEs can enjoy equal treatment as the ones produced by domestic invested companies.

5. Non-expropriation and compensation

FIL stipulates that the State shall not expropriate foreign investors' investment except under special circumstances where required by the public interest. In addition, expropriation or requisition shall be made pursuant to statutory procedures and FIEs concerned shall promptly receive fair and reasonable compensation. The new regulation concerning non-expropriation may be referring to the wording written in numerous bilateral investment treaties. For example, in Sino-France Agreement on the Reciprocal Protection and Protection of Investments, it defines that neither contracting party shall take any expropriation measures against investments made by the counterpart, except those measures which are carried out for public purpose, on the basis of non-discriminatory nature, in line with relevant legal procedures and with appropriate compensation in case the expropriation measure is adopted.

The following matters are not clear yet. First, "public interest" is a term open to interpretation. Previously in practice, the land of FIEs has been expropriated due to the change of urban plans, however, it is hard to infer whether change of urban plan falls within the concept of "public interest". Second, it is still not clear on how to calculate or determine the "fair and reasonable compensation".

6. Governmental official's confidentiality obligations

Many foreign investors or FIEs concern about the potential leakage of their business secrets when going through mandatory governmental formalities in China. For example, a foreign food and beverage company fears its trade secrets will be divulged when registering its products with PRC Food and Drug Administration. To protect aforesaid business secrets, FIL provides that governmental authorities and their officials shall keep confidential the business secrets of foreign investors or FIEs learned during the performance of their duties and shall not disclose to others.

FIL also makes governmental officials criminally liable if they do so. It is the first time that the criminal liability of governmental authorities who fail to protect business secrets of foreign investors and FIEs is written in a regulation at a level of law⁶, however, more detailed measures should be released.

Item	PRC Company Law	EJV	CJV
Highest governance authority	Shareholders' meeting	Board of directors	Board of directors or joint management committee
Board composition	Board member shall comprise 3-13 members, unless otherwise agreed by all the shareholders; Instead of establishing a board, the company can alternatively appoint one executive director	At least 3 directors	At least 3 directors or members of joint management committee
Term of directors	Up to 3 years	4 years	Up to 3 years
Voting mechanism for important matters	Passed by shareholders representing 2/3 of votes shares	Unanimous consent of directors attending the meeting for important decisions	Unanimous consent of directors attending the meeting or the joint management committee
Initial shareholder	Chinese individual permitted	Chinese individual not permitted ⁷	Chinese individual not permitted for important decisions
Distribution of profits	In proportion to paid-in capital, unless otherwise agreed by all the shareholders (which is more flexible)	In proportion to registered capital contribution	in accordance with cooperative joint venture contracts
Transfer of shares	Passed by a simple majority of votes casted by shareholders, unless otherwise agreed by shareholders.	Unanimously agreed by other shareholders.	Unanimously agreed by other cooperatives

III. What we shall pay attention to during the five years' transitional period?

One of the most substantial developments under the FIL is the nullification of Three FIE Laws in which three major foreign investment channels, i.e. wholly foreign-owned enterprise ("WFOE"), equity joint venture ("EJV"), and Sino-foreign cooperative joint venture ("CJV") were established. On the one hand, FIEs to be incorporated after the Effective Date shall comply with PRC Company Law. On the other hand, for the FIEs established before the Effective Date, to implement smoothly, FIL clarifies that the existing WOFEs, EJVs, CJVs would be granted a transitional period of five years to maintain their organization with PRC Companies, which means they need to adjust their organization form to be in compliance with PRC Company Law within 5 years after FIL comes into force; however, what changes need to be made during the transitional period requires further clarification.

To give basic understanding on what to be adjusted in the future, by comparing the PRC Company Law, we list some discrepancies will be faced by EJV and CJV for your reference.

Although FIEs have five years to change their organization to comply with the legal requirements of PRC Company Law after the Effective Date, it is advisable for FIEs to identify the difference and start to contemplate necessary internal adjustments to be made in a timely manner.

IV. Conclusion

As a landmark legislation, FIL aims to improve the transparency of foreign investment policies and ensure that FIEs participate in market competition on an equal basis.

As FIL only provides the most basic principles for the regulation of foreign investments, detailed provisions are yet to be issued with further implementing rules and regulations.

Asiallians will pay close attention to the potential formalized and refined rules and regulations.

(1) See: http://www.xinhuanet.com/english/2019-03/11/c_137886753.htm

(2) Three FIEs Laws refers to the three foreign-invested enterprises laws governing foreign investors since 1979, namely PRC Sino-Foreign Equity Joint Ventures Law, PRC Wholly Foreign-owned Enterprises Law and PRC Sino-Foreign Cooperative Joint Ventures Law.

(3) 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 sensitive sectors (particularly in technology, media and telecommunications, and education sectors which foreign investors cannot freely access). VIE structures allow the foreign investor to control the company by using a series of agreements, instead of holding the company's shares. Since Sina completed its listing by adopting a VIE structure in 2000, VIE structure has been widely used by many Chinese sector leaders such as Alibaba, Tencent, Baidu, JD, and very recently Xiaomi.

(4) According to a speech made by spokesman during the second session of the 13th National People's Congress, FIL also includes investors originating from Hong Kong, Macau, and Taiwan; however, this point is not on paper yet.

(5) The nationwide Negative List refers to Special Administrative Measures on Access of Foreign Investment, which has been getting shorter over the past few years and the most updated version is promulgated in 2018. It is expected that items of the negative list will be further reduced.

(6) It is noteworthy that article 15 and article 30 of PRC Anti-Unfair Competition Law has already regulated the confidential obligations, which read "The supervision and inspection authorities and their staff members shall keep confidential any commercial secrets known to them during the investigations. Where any staff member of a supervision and inspection authority reveals any commercial secrets known during the investigations, such staff member shall be subject to punishment in accordance with the law."

(7) Chinese individual cannot normally be a shareholder in an EJV except in some special circumstances, for example, in a JV incorporated in the Beijing Zhongguancun High-Tech park.

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