

New Implementing Regulations Partially Clarify China's Foreign Investment Law

February 11, 2020

Foreign investment; cross-border transactions

Introduction

China's State Council just passed new Foreign Investment Law Implementing Regulations (**2019 FILIR**) that partially clarify how foreign investment is regulated in China.¹ The Chinese authorities rarely finalize implementing regulations this quickly: The 2019 FILIR was passed less than two months after the 2019 Draft Foreign Investment Law Implementing Regulations were published (**2019 Draft FILIR**).

The 2019 FILIR adds substantial detail to the Foreign Investment Law (**2019 FIL**, and together with the 2019 FILIR, "**New FIE Law**") that was passed on March 15, 2019.² When the 2019 FIL was passed, V&T noted that it could be regarded as a guideline that required substantial implementing legislation.³ Many foreign business organizations also said that although the 2019 FIL was a step in the right direction, it was too general, lacked detail, and was incomplete.⁴

The 2019 FILIR addresses many of these concerns. In its annotations to the 2019 FILIR, China's Ministry of Justice says that the purpose of the new regulations is to "clarify and refine the relevant provisions of laws and regulations of foreign investment, to enhance the feasibility of the foreign investment system, and to ensure the effective implementation of the Foreign Investment Law."⁵

The 2019 FILIR adds much needed detail to the 2019 FIL. The 2019 FILIR purports to treat

¹ Waishang Touzi Fa Shishi Tiaoli (外商投资法实施条例) [Foreign Investment Law Implementing Regulations] (promulgated by the National People's Congress, December 26, 2019, effective January 1, 2020). The terms "PRC" and "China" are used interchangeably in this client alert and neither includes Hong Kong, Macau, or Taiwan.

² Waishang Touzi Fa (外商投资法) [Foreign Investment Law] (promulgated by the National People's Congress, March 15, 2019, effective January 1, 2020).

³ Lyon Dong and Charles Stone, "China Passes New Foreign Investment Law," *V&T Client Alert*, April 16, 2019, <http://vtlaw.cn/ueditor/php/upload/file/20190417/1555464300564828.pdf>.

⁴ American Chamber of Commerce in China, "AmCham China Statement on Foreign Investment Law," *AmCham China Statements*, March 13, 2019, <https://www.amchamchina.org/about/press-center/amcham-statement/amcham-china-statement-on-foreign-investment-law>; Keith Bradsher, "China Law Responds to U.S. Investment Demands. Critics Say It's Not Enough," *New York Times*, March 4, 2019, <https://www.nytimes.com/2019/03/04/business/china-foreign-investment.html>.

⁵ The annotations to the 2019 FILIR were issued on November 1, 2019, http://www.moj.gov.cn/news/content/2019-11/01/zlk_3235066.html.

Foreign Investors and Chinese nationals equally and to provide incentives without regard to national origin. It also addresses an issue that has been of concern to Foreign Investors for decades: the forced transfer of technology. The 2019 FILIR strengthens provisions contained in the 2019 FIL that prohibit the coerced transfer of foreign technology and which protect foreign trade secrets.⁶

In any event, the New FIE Law officially ends the regulatory regime that has governed foreign investment in China for decades.⁷ This V&T Alert provides an overview of the major provisions of the 2019 FILIR and examines many facets of the new regulatory regime.

Major changes

1. Scope of foreign investment expanded

The scope of investments contemplated by the 2019 FIL is greater than that addressed by the previous foreign investment regulatory regime. The 2019 FIL applies to natural persons, enterprises, and other organizations from foreign countries (**Foreign Investors**) when they:

- (a) establish foreign-invested enterprises in China, either individually or jointly (**Greenfield Investments**);
- (b) acquire shares of stock, equity interests, property rights, or other similar rights or interests involving domestic Chinese enterprises (**M&A**);
- (c) invest in new projects, either individually or jointly with other investors; or
- (d) invest in mainland China through other means prescribed by PRC law, administrative regulations, or the State Council.⁸

The 2019 FILIR also clarifies that Chinese natural persons are included in the category “other investors” who invest in the new projects contained in item (c) above. This is the first time that the Chinese government has explicitly allowed Chinese natural persons to be shareholders or partners in foreign-invested business entities.⁹ In fact, the Shanghai Administration of Market Regulation Bureau has just issued the first business license for a foreign-invested enterprise in which a Chinese natural person was a shareholder.

2. Functions of the regulatory authorities

⁶ Waishang Touzi Fa Shishi Tiaoli, articles 24 and 25.

⁷ The 2019 FIL and 2019 FILIR replace the following laws and implementing regulations that used to regulate foreign investment in China: Law of the People’s Republic of China on Sino-foreign Equity Joint Ventures, Law of the People’s Republic of China on Sino-foreign Cooperative Enterprises, and Law of the People’s Republic of China on Wholly Foreign-Owned Enterprises.

⁸ Waishang Touzi Fa, article 2.

⁹ Waishang Touzi Xinxin Baogao Banfa (外商投资信息报告办法) [Foreign Investment Information Reporting Measures] (promulgated by MOFCOM and SAMR, December 30, 2019, effective January 1, 2020), article 3.

While a main purpose of previous foreign investment legislation was to regulate foreign investment in China, the New FIE Law instead focuses on the reduction of regulations and the streamlining of government approval formalities. The New FIE Law also calls for the establishment of a comprehensive “investment service system” whose purpose is to assist foreign entities that invest in China by providing information about laws, regulations, policies, and investment project information.

Foreign Investors will now register their business entities with the State Administration of Market Regulation (**SAMR**). The National Development and Reform Commission (**NDRC**) will continue to review foreign-invested projects as required by PRC law. The Ministry of Commerce (**MOFCOM**) and other regulatory authorities will no longer man the “front desk” that reviews foreign-invested business entities, as it will now monitor business entities after they have been established. The new regulations will probably eliminate a problem that used to plague foreign-invested enterprises: Different authorities could issue contradictory guidance regarding the same application.

3. Investment guidance list

The negative list enumerates the industries in which foreign investment is either prohibited or restricted (**Regulated Industries**). If an investment is made in an industry not found in the list of Regulated Industries, prior governmental approval is not required. In June of 2019, the NDRC and MOFCOM released updated negative lists (**2019 Negative List**).¹⁰ The 2019 Negative List continues to loosen restrictions placed on foreign investments. For example, restrictions placed on foreign shareholders are reduced and sometimes eliminated in the TMT, infrastructure, automotive, and aerospace industries.

The NDRC and MOFCOM also published a list of industries in which foreign investors are encouraged to invest (**2019 Positive List**, and together with 2019 Negative List, “**Investment Guidance Lists**”).¹¹ Central and local governments often offer incentives like tax cuts and subsidies to foreign investors willing to invest in the areas included in the 2019 Positive List.

The 2019 Negative List and 2019 Positive List offer valuable guidance to foreign investors deciding which industry in which to invest.

4. Increased involvement of foreign investors in the following areas:

(a) Legislative processes

This is the first time that PRC law requires that Foreign Investors be given the

¹⁰ The 2019 negative list issued by the NDRC and MOFCOM is available at: <http://tfs.mofcom.gov.cn/article/bc/201911/20191102916059.shtml>.

¹¹ The 2019 positive list issued by the NDRC and MOFCOM is available at: http://www.gov.cn/xinwen/2019-06/30/content_5404702.htm.

opportunity to consult with Chinese officials when new legislation, rules, and regulations that affect foreign investment are being drafted. Foreign Investors are also now allowed to participate in the process of setting standards in a wide variety of industries.

(b) Government procurement

Foreign Investors are supposed to be treated equally when they participate in government procurement activities. However, as currently written, the New FIE Law says that equal treatment extends only to products produced and services provided by Foreign Investors within the territory of China. In other words, it appears that the equal treatment might not extend to products not produced in China.

5. Corporate governance structure

The New FIE Law now requires that the corporate governance structure of foreign-invested enterprises comply with China's Company Law and Partnership Law.

Because most foreign-invested enterprises in China were established according to the Law of PRC Sino-foreign Equity Joint Ventures or the Law of PRC Sino-foreign Cooperative Joint Ventures (**PRC Joint Venture Laws**), the board of directors is the highest authority. But under China's Company Law, the shareholders are the highest authority. The corporate governance structures of joint ventures formed prior to the Foreign Investment Law will therefore have to be updated. During the grace period this will be the subject of much negotiation between foreign parties and their Chinese counterparts, as after five years compliance with the New FIE Law will be mandatory.

Potential improvements for Foreign Investors

The following features of the 2019 FILIR may benefit Foreign Investors:

1. Strengthened IP protection

(a) No coerced transfers of intellectual property (**IP**)

Government coerced transfers of intellectual property and technology owned by foreign-invested enterprises are now explicitly forbidden. Such transfers are to be voluntarily negotiated between the parties on an arm's length basis. Government agencies are also instructed to protect IP owned by Foreign Investors and foreign-invested enterprises.

(b) Protection of trade secrets

Chinese officials are required to keep proprietary information and trade secrets of foreign-invested enterprises and Foreign Investors secret. Administrative sanctions

and criminal prosecutions may be imposed to ensure that this provision is enforced.¹²

2. A more level playing field

The 2019 FILIR purports to level the playing field between foreign and domestic investors by providing (a) national treatment and (b) equal treatment in government procurement activities.

(a) National treatment

Foreign Investors are supposed to be treated the same as their local counterparts when Chinese authorities review applications for licenses, certificates, and qualifications for industries that are not found in the Negative List.

(b) Government procurement

Foreign-invested enterprises will participate on an equal basis in Chinese government procurement activities as long as the products have been manufactured in China and the services are provided within China. This is not true national treatment because it does not treat the products and services of foreign-invested enterprises equally if they are not produced in China, but the 2019 FIL does provide a slightly more level playing field than Existing Laws.

3. Free repatriation

The free repatriation of the capital contributions, profits, capital gains, royalties, and other compensation of Foreign Investors will be allowed in RMB or a foreign currency. This appears to be the first time that the word “free” has been used in connection with the repatriation of gains derived from investments made by Foreign Investors in China. In the past, repatriation was (i) limited to legitimate profits, funds that remained after a dissolution, and other legitimate income, and was (ii) allowed only after tax clearance.

Earnings of employees from Hong Kong, Macau, Taiwan, and other foreign countries may also be repatriated freely. “Free” means there will be no restrictions on the currency, amount, or frequency of repatriation.

Free repatriation under the New FIL Law must still comply with tax clearance and relevant PRC laws, regulations, and foreign exchange controls.

4. Legal responsibilities

The 2019 FILIR contains a section that enumerates the legal responsibilities of Chinese

¹² Waishang Touzi Fa Shishi Tiaoli, article 43.

government officials.¹³ The 2019 FIL also describes the legal responsibilities of Foreign Investors.

(a) Chinese government officials

Government officials who abuse their power, are derelict of duty, engage in favoritism, or disseminate trade secrets in the course of performing their official duties may be subject to administrative sanctions or even be prosecuted criminally.

Specifically, the 2019 FILIR says that government officials may be held legally liable for conduct that:

- (i) delays a response to a complaint made by a Foreign Investor;
- (ii) unlawfully restricts a Foreign Investor from remitting or repatriating funds; or
- (iii) breaches a contract or promise made to a Foreign Investor.

(b) Foreign Investors

Foreign Investors who violate the provisions of the Investment Guidance List could be subject to preliminary injunctions, be forced to pay restitution, and have to disgorge profits earned from unapproved investments. Foreign Investors who fail to comply with the reporting system will first receive a warning from the local authorities, and may be subject to a fine from ten thousand to fifty thousand RMB if the noncompliance is not remedied in a timely fashion.

5. Additional protections

(a) Expropriation by the state

Investments made in China by Foreign Investors may be expropriated by the state only for public use and only after fair compensation has been paid. This compensation must also be paid in a timely fashion and be calculated on an arm's length basis. The New FIE Law includes a due process clause that better protects the interests of Foreign Investors, and procedures for administrative reconsideration and administrative lawsuits allow Foreign Investors to challenge a state expropriation.¹⁴

(b) More freedom of association

Foreign-invested enterprises may now choose whether to form business associations, something not previously allowed by PRC law. They may now also choose whether to join a business association, which will come as a relief to multinational corporations

¹³ Waishang Touzi Fa Shishi Tiaoli, articles 41, 42, and 43.

¹⁴ Waishang Touzi Fa Shishi Tiaoli, article 21.



who have long protested being coerced into joining local quasi-governmental associations that provide minimal services but which still require the payment of membership fees. For the first time, the 2019 FIL guarantees the freedom of association of foreign-invested enterprises, and the 2019 FILIR strengthens this right of association, even though in recent years it has become increasingly difficult for foreigners to establish certain kinds of associations. For example, foreign non-governmental organizations have been strictly scrutinized since a new NGO law was passed in 2016.¹⁵

Substantial ambiguity remains

Although the 2019 FILIR is a step in the right direction, many major issues that have been discussed for years remain ambiguous.

1. Variable interest entities

A variable interest entity (**VIE**) is controlled by contractual arrangements instead of majority voting rights. VIEs are an important issue in China because they can enable a foreign investor to invest in a sector that would otherwise prohibit foreign investment, like the internet sector. The 2015 Draft Law and its official annotations said that VIEs would be regarded as foreign investments, but both the 2019 FIL and the 2019 FILIR are silent on this issue. We suspect that the New FIE Law will eventually apply to VIEs because the law contains a “catch-all” provision that says it applies to foreign investments by “other means allowed by PRC law.” In any event, subsequent regulations or judicial interpretations will have to clarify whether the New FIL Law applies to VIEs.

2. Indirect investments

Implementation rules yet to be written need to clarify what the term “indirect investment” means. An indirect investment will probably be subject to the 2019 FIL if it is made by a foreign entity whose ultimate controlling shareholder is a Chinese entity or a Chinese individual. One way to determine whether an investment is direct or indirect is to examine if the ultimate controlling shareholder is a Foreign Investor. If the ultimate controlling shareholder is a Foreign Investor, but the investing entity is a Chinese enterprise, then the investment is an indirect foreign investment, regardless of how many affiliated entities are between the ultimate controlling shareholder and the investing entity. However, some practical issues remain unresolved since Foreign Investors, unlike their domestic counterparts, will remain subject to the Negative List when they invest in China.

We do not yet know if the 2019 FIL will require the disclosure of the ultimate controlling shareholder when determining if an investment is a foreign investment. Nor do we know how much needs to be disclosed. It could be to the level of an individual, to a publicly

¹⁵ Edward Wong, “Clampdown in China Restricts 7,000 Foreign Organizations,” *New York Times*, April 28, 2016, <https://www.nytimes.com/2016/04/29/world/asia/china-foreign-ngo-law.html>.

listed company, to a trust, or even to an entity or individual behind a trust. Nor do we know if an investment will be considered a foreign investment if the ultimate controlling shareholder is a PRC citizen or business entity. These questions will need to be clarified by practical guidance that will be issued by various government authorities in the near future.

3. New projects

Foreign Investors may now invest in a much broader range of “new projects.” New projects are allowed as long as they are not prohibited, like foreign-invested sole proprietorships that used to be prohibited but which will now probably be allowed by the New FIE Law. The scope of “new projects,” however, is defined in the 2019 FIL as an investment in a specific project other than a Greenfield Investment or M&A project, but there is no further explanation.

We suspect that China’s Supreme Court will issue judicial interpretations on a case-by-case basis to clarify what types of transactions are to be considered new projects. In the meantime, the 2015 Draft Foreign Investment Law (**2015 Draft FIL**) could provide practical guidance on the scope of new project investments. For example, the 2015 Draft FIL considers the following to be new projects: cross-border financing for a term longer than one year, projects related to the exploration for and use of natural resources, build-operate-transfer infrastructure projects, and real estate projects.¹⁶

4. Round-trip investments

The State Administration of Foreign Exchange (**SAFE**) defines a round-trip investment as “a direct domestic investment activity, conducted by a domestic resident directly or indirectly through a special purpose vehicle, made by setting up a foreign invested enterprise or project through a greenfield investment, merger and acquisition, or other means, in order to obtain ownership, right of control, or right of management or administration.”¹⁷

However, SAFE does not say whether a round-trip investment will be considered a domestic investment. This is important because domestic investments are not subject to the Negative List and other provisions of the New FIE Law.

¹⁶ Waishang Touzi Fa Caoan (外商投资法草案) [Draft Foreign Investment Law] (published on February 17, 2015 for public comment, never enacted), article 15 (3) (4) and (5).

¹⁷ Guojia Waihui Guanliju Guanyu Jingnei Jumin Tongguo Teshu Mudi Gongsiji Jingwai Tourongzi Jiwai Fancheng Touzi Waihui Guanli Youguan Wenti De Tongzhi (国家外汇管理局关于境内居民通过特殊目的公司境外投融资及返程投资外汇管理有关问题的通知) [Notice of the State Administration of Foreign Exchange on Issues concerning Foreign Exchange Administration of the Overseas Investment and Financing and the Round-Trip Investments Made by Domestic Residents through Special-Purpose Companies] (promulgated by the State Administration of Foreign Exchange, April 7, 2014, effective April 7, 2014), <http://www.safe.gov.cn/safe/2014/0714/5546.html>.



The Draft 2019 FILIR may provide some guidance: Article 35 says that a round-trip investment will be considered a domestic investment only if: (1) the investor is an offshore entity that is wholly owned by Chinese individuals, entities, or organizations; and (2) a state-level authority has reviewed the investment and it has been approved by the State Council.¹⁸ This provision is not, however, contained in the 2019 FILIR.

If MOFCOM considers a round-trip investment be to a “related acquisition” according to the “Regulations Concerning the Merger and Acquisition of Domestic Enterprises by Foreign Investors” (**M&A Rules**),¹⁹ MOFCOM will strictly scrutinize the acquisition. To date, MOFCOM has not approved a related acquisition, so in practice related acquisitions continue to be subject to MOFCOM review on a case-by-case basis. We suspect that the status of the M&A Rules will be clarified by future regulations.

5. Governing law for foreign investment contracts

PRC Joint Venture Law and PRC Contract Law both state that PRC law must govern the joint venture agreements and shareholders’ agreements of foreign-invested enterprises (**Foreign Investment Agreements**). China’s Supreme Court did not address this issue in its latest judicial interpretation of the New FIL Law.²⁰ We therefore suspect that PRC law will continue to be the mandatory governing law for Foreign Investment Agreements.

Conclusions and suggestions

The 2019 FIL is a concise blueprint for the regulation of foreign investments in the PRC. The 2019 FILIR added much needed detail, but much work remains to be done. Various Chinese government authorities like the Supreme Court, Ministry of Justice, and State Council will continue to issue guidance, rules, and measures to implement the New FIL. As Chinese Premier Li Keqiang noted: “I have said many times that China’s opening-up measures are often not launched as one package; they come out every year and even every quarter ... Then you turn around and realize they’ve cumulatively had an unimaginable effect.”²¹

As the New FIE Law continues to evolve, V&T offers the following advice to our international

¹⁸ Waishang Touzi Fa Caoan, article 35.

¹⁹ Guanyu Waiguo Touzizhe Binggou Jingnei Qiye De Guiding (关于外国投资者并购境内企业的规定) [Provisions on the Acquisition of Domestic Enterprises by Foreign Investors] (promulgated by the Ministry of Commerce, August 8, 2006, effective September 8, 2006, revised June 22, 2009), article 11, http://www.moj.gov.cn/ Department/content/2006-08/11/594_205057.html.

²⁰ Zuigao Renmin Fayuan Guanyu Shiyong Zhonghua Renmin Gongheguo Waishang Touzi Fa Ruogan Wenti De Jieshi (最高人民法院关于适用《中华人民共和国外商投资法》若干问题的解释) [Interpretation of the Supreme People’s Court on Several Issues concerning the Application of the Foreign Investment Law of the People’s Republic of China] (promulgated by China’s Supreme Court, December 26, 2019, effective January 1, 2020), <http://www.court.gov.cn/zixun-xiangqing-212921.html>.

²¹ Gerry Shih, “Amid Skepticism, China Fast-Tracks Foreign Investment Law to Show Goodwill to Washington,” *Washington Post*, March 15, 2019, https://www.washingtonpost.com/world/asia_pacific/amid-skepticism-china-fast-tracks-foreign-investment-law-to-show-goodwill-to-washington/2019/03/15/9506b31e-4701-11e9-9726-50f151ab44b9_story.html?utm_term=.b2b094013636.

clients:

1. Adapt to the New FIE Law during the transition period

Foreign-invested enterprises that existed before the New FIE Law was enacted have five years to change their business and governance structures. However, existing agreements regarding (a) transferring shares and equity interests; (b) sharing profits; and (c) distributing liquidated assets will remain effective regardless of changes made to the structure of the business. After the five-year grace period has elapsed, administrative penalties can be assessed against foreign-invested enterprises that have failed to update their business structures. SAMR could also refuse to accept any filing submitted by noncompliant Foreign Investors, and any such noncompliance would be disclosed to the public.

2. Protect your interests

The 2019 FIL says that an official complaint mechanism will be established for foreign-invested enterprises whose investments in China have been adversely affected by government conduct. There will be a right to appeal to the appropriate authority, and it will apply to all phases of a foreign investment: from the establishment of a business entity to its dissolution. The 2019 FIL also provides two mechanisms for resolving disputes with government entities: administrative reconsideration and administrative lawsuits. The 2019 FILIR also explicitly prohibits the government from retaliating against Foreign Investors who file complaints.

The 2019 FILIR does not, however, specify what procedures will comprise the complaint mechanism. Nor is it known if decisions resulting from the complaint mechanism can be appealed. As the 2019 FILIR notes, rules to address these issues will be promulgated by the Joint Committee for Foreign Enterprise Complaints, an authority that will be formed by MOFCOM and other departments of the State Council.²²

3. Use the new reporting system

The 2019 FIL requires that foreign-invested enterprises upload annual reports and information about their investments to a single government-managed platform managed by SAMR. All of this information will be shared with MOFCOM and other governmental authorities.²³ This new reporting system will replace an inefficient system that required submitting the same documents to different authorities.

4. Determine which investments are covered by the New FIE Law

²² Waishang Touzi Fa Shishi Tiaoli, article 29.

²³ Waishang Touzi Xinxin Baogao Banfa (外商投资信息报告办法) [Foreign Investment Information Reporting Measures] (promulgated by MOFCOM and SAMR, December 30, 2019, effective January 1, 2020), articles 4, 5, and 6.

(a) Investments from Taiwan, Hong Kong, and Macau

Investments from Taiwan, Hong Kong, and Macau are governed by the 2019 FILIR. The 2019 FIL did not address this issue, although during a press conference a Chinese official said that foreign investment regulations would apply to these investments.²⁴

(b) Investments by Chinese citizens who have established permanent residence in a foreign country (**Foreign Permanent Residents**)

The 2019 FILIR says that it applies to Chinese citizens who are “Foreign Permanent Residents,” but it does not define this term. The draft version of this law instead said that it applied to “overseas Chinese,” a term defined in the Rules on Defining the Status of Overseas Chinese and Their Families (**Overseas Chinese Rules**).²⁵ The Overseas Chinese Rules say that a Chinese citizen who has resided in a foreign country for at least 18 months during two consecutive years, and who has obtained the right to reside there long-term or permanently, is considered a permanent resident of a foreign country. We suspect that the 2019 FILIR will use this definition of Foreign Permanent Resident.

Chinese investors who live abroad and who wish to invest in China will therefore have to determine if they have established permanent residency in a foreign country. If they have, the New FIE Law will apply to them, and provisions like the Negative List will apply to them as well.

5. Monitor continuing developments

Many rules and regulations regarding the New FIE Law are yet to be written. We will continue to inform you of new developments.

²⁴ Yesui Zhang, press conference during the 13th National People’s Congress of the PRC, *Xinhua Net*, March 4, 2019, http://www.gov.cn/xinwen/2019-03/04/content_5370547.htm.

²⁵ Guanyu Jieding Huaqiao Wajji Huaren Guiqiao Qiaojuan Shenfen De Guiding (关于界定华侨外籍华人归侨侨眷身份的规定) [Rules on Defining the Status of Overseas Chinese and Their Families] (issued by the PRC Overseas Chinese Affairs Office, April 24, 2009), article 1.



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