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CHINA'S NEW DRAFT FOREIGN INVESTMENT LAW – WHAT ARE THE IMPLICATIONS FOR BUSINESSES?

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China has published a draft foreign investment law ("**2018 Draft FIL**") which, if it comes into force, will further encourage foreign investment. If passed into law, the 2018 Draft FIL will replace the Sino-Foreign Equity Joint Venture Law (中外合资企业法), Sino-Foreign Cooperative Joint Venture Law（中外合作企业法）and Foreign Enterprise Law (外资企业法) (the existing main statutes regulating foreign invested entities ("**FIEs**") in China, all initially promulgated during the 1980s). It is commonly perceived that the current law in this area needs to be updated in light of dramatic social and economic changes during the past decades.

This briefing outlines the highlights and what the new law might mean for foreign investors.

Key issues

- The 2018 Draft FIL sends a signal that the Chinese government will continue encouraging foreign investment into China.
- The 2018 Draft FIL could help to remove some uncertainty related to prospect of use of a "variable interest entity" structure.
- It sets out principal rules to further encourage, promote and protect foreign investment.

IMPACT ON VIE STRUCTURE

As early as 19 January 2015, the Ministry of Commerce of the PRC ("**MOFCOM**", being one of the main regulators in charge of FIEs) issued a consultation draft of the Foreign Investment Law (the "**2015 Draft FIL**"), as the first attempt by the Chinese regulator to update the existing statutory framework governing FIEs. The 2015 Draft FIL then contemplated some far-reaching implications for the foreign investment legal regime, and caused heated debates immediately thereafter. Among other changes, the 2015 Draft FIL proposed to amend the approach of defining "control" which in turn determines whether an investor was a "foreign investor" or a "domestic investor".[1]

The 2015 Draft FIL contemplated that a domestic enterprise established in the PRC that is "controlled" by a foreign investor would be deemed to be a "foreign investment". As such, a Chinese domestic corporate entity, though equity owned by Chinese shareholders, would be regulated as a foreign invested enterprise should it be ultimately controlled by a foreign investor. The prevailing

[1] Under the 2015 Draft FIL, "control" is broadly defined to mean: (1) the ownership of no less than 50% of the voting rights; (2) the right to appoint (or the ability to secure) a majority of the board of directors; (3) the ability to otherwise materially influence the decisions of the board or shareholders meeting of a company; or (4) the ability to exercise decisive influence over a company by way of contractual or trust arrangements.

sentiment at that time was that MOFCOM was adopting the "substance over form" philosophy in respect of the "variable interest entity" structure which allows a foreign investor to have effective control over a domestic entity (owned by Chinese shareholders) through a series of contractual arrangements, ("**VIE Structure**", as commonly used in certain restricted business sectors for foreign investment such as telecoms and internet related businesses). Such a change then caused significant concerns about the prospects of the so-called "variable interest entity" structure.[2]

The VIE Structure has been tacitly tolerated by the Chinese government since its emergence in the early 2000s and has been widely adopted by companies seeking offshore financings or an international listing. If the 2015 Draft FIL were to be passed into law as drafted, this would mean that all the foreign investors would need to re-visit the use of a VIE Structure (including those China-based TMT players listed overseas adopting VIE structures).

The 2018 Draft FIL, compared to the 2015 Draft FIL, is much simplified and abandons certain controversial concepts proposed in the 2015 Draft FIL.

The 2018 Draft FIL does not follow the same approach of the "control" concept as proposed in the 2015 Draft FIL. Rather, it remains silent in this aspect (including on the issue whether a domestic entity controlled through a VIE Structure would be deemed as a "foreign investment"). It is commonly perceived that this may be a sign that the Chinese government is inclined to keep the status quo for the VIE Structure for the time being.

However, the door is left open under the 2018 Draft FIL to regulate the VIE Structure in the future as the definition of "foreign investment" now includes "investment by a foreign investor within China through other means provided by law, administrative regulations or the rules of the State Council". If the 2018 Draft FIL is passed into law as is, it remains to be seen whether the other PRC regulators would take any follow-up action to explicitly regulate or scrutinize any domestic entities controlled by foreign investors.[3]

NATIONAL TREATMENT

The 2018 Draft FIL explicitly provides that foreign investors are entitled to "national treatment" at the time of making the investment, though will be subject to the Negative List for Foreign Investment (the "**Foreign Investment Negative List**", jointly promulgated by the National Development and Reform Commission and MOFCOM on 28 June 2018).

In addition to the Foreign Investment Negative List, it is worth noting that, on 21 December 2018, the National Development and Reform Commission of the PRC and MOFCOM jointly promulgated the Negative List for Market Entry (the "**Market Entry Negative List**") which sets out those businesses generally prohibited for investment by any investor (whether Chinese or foreign) and those regulated businesses subject to licensing requirements. Any foreign

2 For more detailed discussions about the issues and concerns introduced by the 2015 Draft FIL, please see our previous client briefing on the MOFCOM Draft FIL available at https://www.cliffordchance.com/briefings/2015/02/china_proposes_newforeigninvestmentlaw.html.

3 It is worth noting that certain PRC governmental agencies started scrutinizing domestic businesses but ultimately controlled by foreign investors through contractual arrangements (including a VIE structure) in certain business sectors. For instance, the PRC State Council explicitly prohibits any listed company from acquiring or otherwise controlling (whether or not through nominee or contractual arrangements) non-profit kindergartens, as stated in its *Certain Opinion on In-depth Reform of the Pre-School Education* (issued and effective as of 7 November 2018).

investor must also comply with this Market Entry Negative List which includes the banning of investment in police training schools, movie imports, post office business and internet news.

PROMOTING AND PROTECTING FOREIGN INVESTMENT

The 2018 Draft FIL sets out several rules which aim to promote foreign investment in China and provide equal treatment for both domestic enterprises and FIEs, including:

- Expanding the application of those rules and policies supporting the development of domestic enterprises to also cover FIEs.
- Permitting FIEs to participate in bidding for government procurement projects.[4]
- Clarifying that FIEs may raise equity or debt financing in China (including pursuing a listing in a Chinese stock exchange and issuing a corporate bond).
- Protecting the intellectual property rights of foreign investors and FIEs.
- Respecting the commercial agreement reached between foreign investors and Chinese partners and prohibiting mandatory technology transfers by governmental officials.
- If a FIE needs to obtain certain operating permits, it will be treated with the same criteria and procedures applicable to a domestic company when applying for such permits.

WHAT IS CLIFFORD CHANCE'S VIEW?

Overall, the 2018 Draft FIL sets an encouraging tone for the future of foreign investment in China and paves the way for the relaxation of regulatory control over foreign investment into non-sensitive sectors. Compared with the 2015 Draft FIL, the 2018 Draft FIL, contains more generic terms and principles, but leaves in flexibility for PRC regulators to promulgate implementing rules in relation to specific issues in the future. While it remains to be seen in what specific form the 2018 Draft FIL will be passed into law, we are confident that the Chinese government is attempting to embrace the long-standing principle of further opening up the market to foreign investment.

4 This could significantly impact FIEs in China, since currently the domestic industrial players are generally given preference compared to their FIE competitors when bidding for governmental procurement orders.

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