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CHINA'S NEW FOREIGN INVESTMENT LAW – WHAT DOES THIS MEAN FOR FOREIGN INVESTORS IN CHINA?

On 15 March 2019, the National People's Congress ("**NPC**"), China's legislature, promulgated the long-awaited Foreign Investment Law ("**FIL**") which will come into force on 1 January 2020.

The FIL will bring China's foreign investment regime into a new era by replacing and repealing 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 laws regulating foreign invested entities ("**FIEs**") in China which have been in force for decades, (collectively the "**FIE Laws**") with a single unified law as from 1 January 2020. Foreign investors will welcome the rules laid down in the FIL for the promotion and protection of foreign investment in China, but some uncertainties remain.

Key issues

- The FIL sends a signal that the Chinese government will continue encouraging foreign investment into China.
- It sets out rules to further encourage, promote and protect foreign investment.
- The status quo of the "variable interest entity" structure appears to be tacitly accepted, at least for the time being.
- The FIL replaces the existing FIE laws. Foreign investors with existing joint ventures in China should prepare for changes to the corporate governance structure of their ventures to conform with PRC Company Law.

BACKGROUND

A new unified Foreign Investment Law was contemplated as early as 19 January 2015 when the Ministry of Commerce ("**MOFCOM**", the main regulator in charge of FIEs) issued a consultation draft of the proposed law (the "**2015 Draft FIL**").[1] China published a further consultation draft on 26 December 2018 and the FIL was finally passed following deliberations at the annual sessions of the NPC in March 2019. The 2015 Draft FIL, with 11 chapters and 170 articles, contemplated some far-reaching implications for China's foreign investment regime. The FIL, as adopted, has been significantly simplified, with 6 chapters and 42 articles. Given its brevity, some commentators have observed that the FIL lacks a certain level of detail, and it is expected that further implementing regulations will be adopted to provide clarity.

[1] For more detailed discussion about the issues and potential implications 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.

NATIONAL TREATMENT AND NEGATIVE LIST REGIME

The FIL confirms that foreign investors which invest in sectors falling outside the "negative list" will be entitled to "national treatment" at the time of making the investment. The FIL also reinforces China's implementation of the "negative list" regime nationwide, which was initially implemented in a number of free trade zones from 2013 and then rolled out nationwide in 2017. The latest Negative List for Foreign Investment, jointly promulgated by the National Development and Reform Commission ("**NDRC**") and MOFCOM on 28 June 2018, sets out a list of sectors for which foreign investment is prohibited or restricted (i.e. foreign investment in restricted sectors will be subject to approval and certain restrictions such as a cap on foreign ownership percentage). With respect to the "national treatment" for sectors not covered by the "negative list", the FIL further clarifies that the market access requirements applicable to foreign investors will be no less favourable than those applied to domestic investors.

PROMOTING AND PROTECTING FOREIGN INVESTMENT

The FIL provides that China will continue with the national policy of opening-up and sets out a number of rules that are designed to promote and protect foreign investment in China, including:

- All national policies for supporting the development of enterprises shall apply equally to FIEs in accordance with law.
- When formulating laws, regulations and rules relating to foreign investment, appropriate methods shall be used to seek the views of FIEs.
- FIEs shall be permitted to participate in government procurement projects through fair competition.
- FIEs may raise financing in China through the public offering of shares or issuance of corporate bonds.
- Foreign investors may freely remit profits, capital gains, royalties from intellectual property rights, lawfully obtained compensation and the proceeds of liquidation, out of China.
- The State protects the intellectual property rights of foreign investors and FIEs.
- The State respects the commercial agreement reached between foreign investors and Chinese partners on technology cooperation, and prohibits government authorities or officials from mandating technology transfer by administrative means.
- An FIE or foreign investor which is of the view that its legitimate rights and interests have been infringed by a government authority or official may submit its complaint to a central system for handling complaints from FIEs. In addition, an FIE or foreign investor may apply for administrative review or commence administrative litigation in accordance with law.
- If an FIE needs certain operating permits, its application for such permits will be handled according to the same criteria and procedures applicable to a domestic company.

- Local governments should abide by any policy-related undertakings made to foreign investors or FIEs and honour any contracts lawfully entered into with foreign investors or FIEs.

NATIONAL SECURITY

While foreign investors will welcome the above rules which encourage and protect foreign investment, at the same time, the FIL reiterates that foreign investment "which affects or may affect national security" will be subject to review under a national security review system. It is unclear whether the system referred to under the FIL is the same as, or is intended to replace, the existing one which was implemented in 2011 when both State Council and MOFCOM promulgated regulations to establish a national security review system. It is noteworthy that the 2015 Draft FIL had devoted an entire chapter to a new national security regime, while the FIL covers this with a single article. It remains to be seen whether there will be any further clarity on the exact meaning or scope of the term"national security".

INFORMATION REPORTING

The FIL contemplates that a foreign investment information reporting system will be established which will require FIEs to submit certain investment information through the "enterprise registration system" and the "enterprise credit information publicity system". This initially may alarm foreign investors as the scope of disclosure remains unclear with only one article in the FIL addressing the issue. However, there is a qualification that the content and scope of investment information to be reported will be determined based on the principle of "genuine necessity". In contrast, the 2015 Draft FIL had an entire chapter dealing with information reporting, setting out a comprehensive system and extensive reporting obligations for FIEs, but this has been pared back for now following strong reaction from the foreign investment community to the 2015 Draft FIL. It is currently unclear as to whether the foreign investment information reporting system under the FIL fits in with the existing "enterprise credit information publicity system" operated by the State Administration for Market Regulation (which applies to both domestic companies and FIEs) and the foreign investment information reporting system managed by MOFCOM.

IMPACT ON VIE STRUCTURE

The 2015 Draft FIL proposed to introduce a concept of "control"[2] to determine whether an investor was a "foreign investor" or a "domestic investor" and contemplated that a domestic enterprise established in the PRC that is "controlled" by a foreign investor would be deemed to be a "foreign investor". As such, a domestic enterprise, even though all of its equity interest is held by Chinese shareholders, would be regulated as a "foreign investment" where the ultimate controller was a foreign investor. Such a move, as envisaged by the 2015 Draft FIL, would have had complicated ramifications for the use of the "variable interest entity" structure which allows a foreign investor to have effective control over a domestic enterprise (owned by Chinese shareholders) through a series of contractual arrangements ("**VIE Structure**"), which is

[2] 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.

commonly used in certain restricted business sectors for foreign investment such as telecoms and internet related businesses.

The VIE Structure has been tacitly tolerated by the Chinese government since its emergence in the early 2000s and has been widely adopted by Chinese companies seeking offshore financings or an international listing. If the 2015 Draft FIL had been passed into law as drafted, this would have meant that these companies (including those China-based TMT players listed overseas which have adopted VIE Structures), and their foreign controllers, would have had to re-visit the use of the VIE Structure.

In contrast, the FIL does not adopt the "control" concept as proposed in the 2015 Draft FIL. Rather, it remains silent in this respect (including on the issue whether a domestic enterprise controlled through a VIE Structure would be deemed as a "foreign investment"). This is perceived by some commentators as a positive sign that the Chinese government is inclined to keep the status quo for the VIE Structure, at least for the time being.

On the other hand, the door is left open under the FIL to regulate VIE Structures in the future. The definition of "foreign investment" in the FIL now includes a catch-all provision extending to "investment by a foreign investor within China through other means provided by law, administrative regulations or the rules of the State Council". Further, it remains open whether other PRC government authorities would take action to explicitly regulate or challenge domestic enterprises which are controlled by foreign investors via the VIE Structure or through other means.[3]

IMPACT ON EXISTING FIES AND NEW FIES TO BE ESTABLISHED

The FIL will repeal the FIE Laws once it comes into effect on 1 January 2020. As a result, the organisation structure, governance structure and operating rules of FIEs which are corporate entities will be governed by the PRC Company Law. The FIL provides that FIEs established under the existing FIE Laws will be "grandfathered" (i.e. without any need for change) for a period of five years. However, the FIL does not specify how FIEs established under the existing FIE Laws should be transformed so as to be in compliance with the FIL during such five-year period, nor does it specify the consequences for failure to do so at the end of such period. The FIL generally provides that detailed regulations will be promulgated by the State Council.

Existing joint ventures

Foreign investors who have existing joint ventures in China will need to understand what this will mean for the corporate governance structure of their joint ventures. For example, under the PRC Company Law, the highest governing body of a company will be the shareholders meeting, whereas for an existing joint venture established under the Sino-Foreign Equity Joint Venture Law (中外合资企业法) or Sino-Foreign Cooperative Joint Venture Law（中外合作企业法）, the highest governing body is the board of directors. Therefore, existing partners in a joint venture will need to amend the articles of association and the joint venture contract to accommodate the corporate governance

[3] It is worth noting that some PRC government authorities have been scrutinizing the use of VIE structures in certain business sectors. For instance, the PRC State Council issued the *Certain Opinion on In-depth Reform of the Pre-School Education* on 7 November 2018 explicitly prohibiting any listed company from acquiring or otherwise controlling (whether or not through nominee or contractual arrangements) non-profit kindergartens.

structure under the PRC Company Law. This may require the joint venture partners to come back to the negotiation table and potentially reopen the discussion over corporate governance terms and potentially other terms for the joint venture.

We have set out in the table at the end of this note a summary of some key differences for a joint venture in the form of a limited liability company ("**LLC**") under the PRC Company Law as compared to an equity joint venture ("**EJV**") established under the Sino-Foreign Equity Joint Venture Law, which is by far the most common form of joint venture with foreign investment.

New joint ventures

If a foreign investor intends to form a new joint venture with a Chinese partner or acquire equity interests in a domestic enterprise to form a joint venture before 1 January 2020, in the absence of implementing rules for the transitional period before 1 January 2020, it would appear (at least theoretically) that the joint venture will be subject to the existing FIE Laws. Foreign investors in this predicament will be well advised to discuss upfront with their partners the impending changes to the corporate governance structure that would be brought about by the implementation of the FIL, rather than risk having to re-negotiate terms in the future.

WHAT SHOULD INVESTORS EXPECT?

Although detractors may observe that the FIL has been simplified and moved swiftly through the legislative process, on balance, the FIL is a positive development as it demonstrates the Chinese government's continuing commitment to attract foreign investment and promises equal market access for business sectors which are outside the "negative list". On the other hand, much will depend on the more detailed rules which are expected to follow. In particular, further clarity is required around the scope of the national security regime and the information reporting obligations, the absence of which may bring unease to foreign investors. Foreign investors with existing joint ventures in China will need to prepare for the impending changes to the corporate governance structure as a result of the repeal of the existing FIE Laws.

Key Differences Between Limited Liability Company (under PRC Company Law) and Equity Joint Venture (under Sino-Foreign EJV Law)[4]

	LLC (under PRC Company Law)	EJV (under Sino-Foreign EJV Law)
Corporate governance	Highest authority is the shareholders meeting	Highest authority is the board of directors
Number of shareholders	Not more than 50 shareholders	2-50 shareholders
Number of directors	3-13 members	Not less than 3 members
Appointment of directors	Allocation of the number of directors to be appointed by each shareholder can be stipulated in AoA	The number of directors to be appointed by each shareholder through consultation with reference to the proportion to each shareholder's capital contribution
Statutory quorum for board meetings	As stipulated in AoA	2/3 of all directors
Matters subject to super-majority approval	Approval of shareholders holding 2/3 voting power: • Amendments to AoA • Increase or decrease of registered capital • Merger, division or dissolution • Change of company's form	Unanimous approval of directors present: • Amendments to AoA • Increase or decrease of registered capital • Termination or dissolution • Merger or division
Distribution of dividends	Dividends shall be distributed in proportion to each shareholder's capital contribution, unless shareholders unanimously agree otherwise	Dividends shall be distributed in proportion to each shareholder's capital contribution
Pre-emptive right for transfer of equity	If a shareholder transfers its equity interest to a third party, it shall obtain the consent of more than half of the other shareholders. The transferring shareholder shall give written notice to the other shareholders. If a shareholder fails to give its consent within 30 days, it shall be deemed to have given its consent. If more than half of the other shareholders refuse to give consent to such transfer, the dissenting shareholders shall have an obligation to purchase the equity interest from the transferring shareholder; if such dissenting shareholders refuse to purchase, they shall be deemed to have given their consent to the transfer. Subject to the consent of the shareholders, if a shareholder transfers its equity interest to a third party, the other shareholders shall have a pre-emptive right on the same terms. The shareholders may contract out of shareholders' consent and statutory pre-emptive right by providing otherwise in the AoA.	If a shareholder intends to transfer its equity transfer to a third party, it shall obtain the consent of the other joint venture parties. If a shareholder transfers its equity transfer to a third party, the other joint venture parties shall have a pre-emptive right.[5]

[4] Please note that this is not intended to be an exhaustive comparison of the differences between LLCs and EJVs.

[5] The PRC Supreme Court issued a judicial interpretation in 2010 concerning adjudication of disputes involving FIEs, which provides that a shareholder of a FIE may transfer its equity interest to a third party even if consents of other shareholders are not obtained, provided that (1) the transferring shareholder has given written notice to the other shareholders, and the other shareholders fail to respond within 30 days, or (2) if the other shareholders do not give their consents and fail to buy the equity interest from the transferring shareholder.

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