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China's New Foreign Investment Law: What's New and What's Next

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IN DEPTH

A Series of Basic Legal Systems for Foreign Investment

The Foreign Investment Law establishes a series of basic legal systems for foreign investment, including the following:

- *Pre-establishment national treatment and negative list system*. “Pre-establishment national treatment” means that foreign investors and their investments will be granted treatment no less favourable than that granted to Chinese domestic investors and their investments at the initial entrance stage of the investment. Foreign investors may not invest in fields where a “negative list” prohibits foreign investment, unless the investor meets certain conditions stipulated in the list.
- *Foreign investment information reporting system*. The Foreign Investment Law proposes the establishment of a foreign investment information reporting system for the first time. Foreign investors or foreign-invested enterprises must submit investment information to the competent department of commerce through the enterprise registration system and the enterprise social credit information publicity system. The contents and scope of foreign investment information reporting is determined by necessity, and requests for re-submission are not permitted for investment information that can be obtained through interdepartmental information-sharing.
- *Foreign investment national security review system*. The Foreign Investment Law establishes a national security review system to determine whether a foreign investment may affect national security. Subsequent legislation will clarify the scope, content, procedure, time limit and legal consequences of the review process.

Unified Law for Organisational Structure and Governance Structure

Article 31 of the Foreign Investment Law stipulates that the organisational structure and activities of foreign-invested enterprises will be governed by the Company Law of the People’s Republic of China or the Law of the Partnership Enterprise of the People’s Republic of China (Partnership Law), as applicable. Foreign-invested enterprises established pursuant to the three previous foreign investment laws may retain their original organisational structure for five years starting from 1

January 2020 according to Article 42 of the Foreign Investment Law. This implies that the corporate organisational structures stipulated by the previous foreign investment laws (especially Sino-foreign joint ventures) will gradually be phased out. At the same time, foreign-invested enterprises (especially Sino-foreign joint ventures) will need to make substantial adjustments to their corporate governance structures to meet the requirements of the Company Law or the Partnership Law.

The three previous foreign investment laws were promulgated in the early days of China's economic reform. At the time, China's legal system was not yet established, and the Company Law and the Partnership Law had yet to be promulgated. There were significant differences between the provisions of the three previous foreign investment laws and the subsequent Company Law regarding corporate governance structures, particularly with respect to shareholder meetings and the authority of the board of directors for Sino-foreign equity joint ventures and Sino-foreign cooperative joint ventures. After the Company Law was revised in 2005, the relevant government agencies issued executive opinions to coordinate their efforts and require joint foreign-owned limited companies, solely foreign-owned limited companies and foreign-invested joint-stock companies to establish shareholder meetings as their governing authorities (while the authority of a solely foreign-owned company is its shareholder) and install a board of directors (or executive director) in accordance with the provisions of the Company Law. However, Sino-foreign equity joint ventures and Sino-foreign cooperative joint ventures have continued to use the board of directors as the highest authority in their corporate governance structure and have not set up shareholder meetings since 2005 because of the restrictions of the Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures and the Law of the People's Republic of China on Sino-Foreign Cooperative Joint Ventures.

After the Foreign Investment Law goes into effect, many Sino-foreign joint ventures will face requirements to revise the relevant provisions of their articles of association (and/or joint venture contracts). While revising, Chinese and foreign parties are likely to face a new round of negotiation. As for the specific timeframe for carrying out these revisions, the registration authorities generally require foreign-invested enterprises to revise the relevant provisions according to the Company Law while registering any routine changes (such as increasing the registered capital or changing the registered address of the company) to meet the requirements of the Foreign Investment Law. Foreign-invested enterprises and their Chinese and foreign shareholders should begin preparing for this process.

Emphasis on Free Transfer of Monetary Funds

Article 21 of the Foreign Investment Law stipulates that foreign investors may freely remit into or out of China their capital contributions, profits, capital gains, income from asset disposal, intellectual property royalties, lawfully acquired compensation, and indemnity or liquidation income in renminbi or any foreign currency within the territory of China. Under China's current legal system, this provision is subject to foreign exchange regulations. However, against the backdrop of the national treatment of foreign investors and the principle of equal protection, various regulatory measures for foreign exchange supervision should not be an obstacle to the normal commercial arrangements of foreign investors in investment activities. In past cross-border transactions, foreign investors often found that certain internationally common deal arrangements (such as purchase price adjustments, earn-outs, etc.) were difficult to implement in China. This is in stark contrast to the flexible arrangements available for purely domestic transactions in China. It remains to be seen whether the Foreign Investment Law and its implementation rules will provide more flexibility for foreign investors to conduct cross-border transactions involving China, especially for cross-border M&A activities.

Intellectual Property Protection and Technology Transfer

Intellectual property protection has always been a key focus for foreign investors in China. In recent Sino-US economic and trade negotiations, intellectual property rights and compulsory technology transfers were primary points of contention. This topic was also likely a focal point for PRC legislators while preparing and deliberating the Foreign Investment Law. Article 22 stipulates that the State protects the intellectual property of foreign investors and foreign-invested enterprises, as well as legitimate rights and interests in intellectual property and other relevant obligations. Under that same article, any intellectual property infringement will be investigated for legal liability, and the State will encourage technical cooperation in the process of foreign investment on the basis of free will and business rules. It also provides that conditions for cooperation between Chinese and foreign investors concerning technology shall be negotiated by following the principle of fairness for all investment parties. The principles of voluntariness and commerce established by the Foreign Investment Law provide a flexible space for cross-border technology licensing and transfer arrangements. Foreign investors as licensors also will have more avenues to protect their technology, which should help ease the concerns of foreign investors.

Article 22 of the Foreign Investment Law also clarifies that administrative agencies and their staff members may not use administrative means to force the transfer of technology. The provisions of the current regulations on cross-border technology transfer and licensing are likely to require corresponding amendments. For example, Article 27 of the Regulations of the People's Republic of China on the Administration of the Import and Export of Technology, promulgated by the State Council, requires that the results of any improvements in the technology belong to the party that makes the improvements. Article 29 of the same regulations provides that the following restrictive clauses are prohibited in a technology import contract:

or

- Clauses requiring that the assignee accept incidental provisions that are not essential to the importation of technology, including the purchase of unnecessary technology, raw materials, products, equipment or services
- Clauses that require the assignee to pay fees or take on related obligations for the use of technology where the patent rights have expired or have been declared invalid
- Clauses that restrict the assignee from improving the technology provided by the assignor, or that restrict the assignee from using the improved technology
- Clauses that restrict the assignee from obtaining from other sources technology similar to, or that competes with, the technology provided by the assign
- Clauses that unreasonably restrict the channels or sources from which the assignee may procure raw materials, parts, products or equipment
- Clauses that unreasonably restrict the quantity, type or sale price of the assignee's products
- Clauses that unreasonably restrict the assignee's export channels for products that are produced using the imported technology

Subject to anti-monopoly laws and regulations, the above restrictions may also need to be amended or relaxed in accordance with the principles set out in the Foreign Investment Law.

Other Issues to Be Clarified

The Foreign Investment Law establishes basic macro principles and systems. There are still issues to be clarified with respect to the specific system design and requirements, including the following

topics.

Definition of Foreign Investment in Specific Situations

Article 2 of the Foreign Investment Law defines “foreign investment” as direct or indirect investment in China by foreign natural persons, enterprises and other organisations (foreign investors). This includes:

- A foreign investor establishing a foreign-invested enterprise within the territory of China, either alone or together with any other investor
- A foreign investor acquiring shares, equities, property shares, or any other similar rights and interests of an enterprise within the territory of China
- A foreign investor investing in any new project within the territory of China, either alone or together with any other investor
- A foreign investor investing in any other way stipulated under laws, administrative regulations or provisions of the State Council

The last provision catches various forms of foreign investment that are not listed. In China’s current practice, however, when laws and regulations are not clearly defined, it often leads to a failure to operate in practice because there is no clear legal foundation. Therefore, some issues concerning how to define foreign capital in practice are still subject to clarification by subsequent implementing regulations or interpretations.

Questions requiring clarification include:

- Is investment made by foreign investors in a VIE structure formally recognised?
- How does one determine “direct” and “indirect” investment, particularly where the explosive growth of global M&A and investment by Chinese investors in recent years means that some shareholders (including controlling shareholders) of foreign investors engaged in investing in China are actually from China?
- If Chinese citizens transfer to a foreign nationality, will their investment in China be recognised as foreign investment?

Review and Approval of Affiliated Mergers and Acquisitions

Under the current legal system, domestic companies, enterprises or natural persons must report to the Ministry of Commerce for approval to acquire or merge with domestic companies that are affiliated with companies legally established or controlled abroad. After the Foreign Investment Law implements the “pre-establishment national treatment and negative list” system, approval requirements will focus on foreign investment in specific areas on the negative list. The question of whether affiliated mergers and acquisitions would be included in the scope of approval by the Ministry of Commerce, and the legal basis for such approval, deserves further attention and exploration.

A Few Additional Special Concepts

In the current foreign investment legal system, foreign-invested enterprises have certain special features in accordance with provisions of the three previous foreign investment laws. For example, foreign-invested enterprises have “total investment”, and they can borrow foreign debts within the amount of the difference between the total investment and the registered capital without obtaining additional approval from relevant PRC authorities. When establishing Sino-foreign joint ventures, joint

ventures partners need to sign joint venture contracts. After the three previous foreign investment laws have been abolished, further clarification will be necessary as to whether the above concepts and corresponding practices will continue to exist or whether they will be adjusted.

Since the three previous foreign investment laws were promulgated in 1979, decades of development and foreign investment have resulted in complicated laws, regulations and rules, as well as a judicial interpretation system. Some of these laws and regulations involve special types of foreign-invested enterprises (such as the Provisions of the Ministry of Commerce on the Establishment of Foreign-Invested Investment Companies), some involve specific forms of investment (such as the Provisions on Merger and Acquisition of Domestic Enterprises by Foreign Investors), and some involve foreign investment activities in specific industries (such as the Administrative Provisions on Foreign-Invested Telecommunications Enterprises). In conjunction with the promulgation of the Foreign Investment Law, the relevant authorities are expected to summarise, amend and update current foreign investment rules in accordance with the requirements of the new law, and successively promulgate laws, regulations and regulatory documents that implement and enforce rules that accord with the Foreign Investment Law. We will pay close attention to this progress to ensure timely, accurate and effective services to our clients.

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