

China's New Draft Foreign Investment Law

The State Council presents a near-final draft to the National People's Congress

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Foreign investment; cross-border transactions

On December 26, 2018, the Standing Committee of the National People's Congress ("**NPC**") of the People's Republic of China ("**PRC**")¹ published a new Draft Foreign Investment Law ("**2018 Draft Law**") on its official website. Public opinion is being solicited until February 24, 2019.

The 2018 Draft Law purports to create a level playing field for foreign investments in China. It abolishes three principal foreign investment laws that are currently in force.² The 2018 Draft Law also shifts the government's principal method of regulating foreign investments from "pre-approval" to "post-filing." This new approach consists of regulatory mechanisms like the "negative list," the national security review, and the reporting system.

The annotations to the 2018 Draft Law ("**Annotations**") state that the purpose of this law is to advance accomplishments made by the PRC in the area of foreign investments as it commemorates the 40th anniversary of Chinese economic reform, also known as the "Opening of China." Approximately three years ago a previous Draft Foreign Investment Law ("**2015 Draft Law**") was published for public comment. The 2015 Draft Law contained about four times as many provisions as the 2018 Draft Law but was never enacted. The 2018 Draft Law is more of a guideline for foreign investment, unlike the 2015 Draft Law which also provided many details to be used for implementation.

The 2018 Draft Law will change how foreign investment is regulated in China. This V&T Alert provides an overview of the 2018 Draft Law and examines how best to protect foreign investments in the PRC today.

Scope

The 2018 Draft Law applies to natural persons, enterprises, and other organizations of foreign countries (individually, a "**Foreign Investor**," and collectively, "**Foreign Investors**") when they:

¹ The terms "PRC" and "China" are used interchangeably in this client alert and neither includes Hong Kong, Macau, or Taiwan.

² The Sino-Foreign Equity Joint Venture Law ("**EJV Law**"), the Sino-Foreign Contractual Joint Venture Law ("**CJV Law**"), and the Foreign-Invested Enterprise Law ("**FIE Law**") (collectively, "**Existing Laws**").



- 1) invest individually or jointly in new projects, establish foreign-invested enterprises, or increase investments in China;
- 2) acquire shares of stock, equity interests, property rights, or other similar rights or interests through mergers or acquisitions involving domestic Chinese enterprises; or
- 3) invest in mainland China through other means prescribed by PRC law, administrative regulations, or the State Council.

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- More types of investment now allowed. Under the Existing Laws there are only two basic types of foreign investment in China: limited liability companies and companies limited by shares. Under the 2018 Draft Law, the term “new projects” appears to allow a much broader range of investments. New projects would be allowed as long as they were not prohibited, as is the case with foreign-invested sole proprietorships.
- Indirect investment undefined. The 2018 Draft Law does not define the term “indirect investment.” 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 indirect. But some issues remain unresolved. Does this mean that under the 2018 Draft Law all foreign investments in China will be required to disclose their ultimate controlling shareholder? If so, how much must be disclosed? Will disclosure be to the level of an individual, to a publicly listing company, to a trust, or even to an entity or individual behind a trust? And if the ultimate controlling shareholder of a Foreign Investor is a PRC citizen or a PRC business entity, will this investment qualify as a foreign investment in China? The 2018 Draft Law does not answer these questions. In our experience, either the final law will incorporate certain provisions, or there will be a separate set of implementing rules that address these questions.
- Ambiguous if applicable to investments from Taiwan, Hong Kong, and Macau. Existing Laws and their implementing regulations govern investments from Taiwan, Hong Kong, and Macau. However, the 2018 Draft Law does not explicitly state whether it applies to such investments. If the 2018 Draft Law does not apply, additional legislation will be needed. Of course, it is also possible that the final version of the 2018 Draft Law will follow the Existing Laws and apply to Taiwan, Hong Kong, and Macau as well.

Promotion of foreign investment

The Annotation states that one purpose of the 2018 Draft Law is to create a stable, transparent, and predictable environment for foreign investment in China. Chinese authorities

will now apply the “national treatment” standard to both domestic and foreign investments. It is also possible that preferential policies may be implemented for Foreign Investors.

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- Fundamental change of approach. The Chinese central government has shifted its default approach to foreign investments from “permitted” to “encouraged.” The main function of previous foreign investment legislation was to manage and regulate foreign investments. The 2018 Draft Law not only reduces and streamlines governmental approval formalities, it promises to establish a comprehensive system whose purpose is to assist Foreign Investors by providing for legal and business consultations and the disclosure of information.
- National treatment. Foreign Investors will now enjoy national treatment. Policies that promote the business of Chinese enterprises will now be applied to foreign-invested enterprises as well. Chinese government procurement procedures will also allow foreign-invested enterprises to participate on an equal basis. And products domestically manufactured by foreign-invested enterprises will be treated the same as those made by domestic enterprises.
- Preferential policies for some foreign investments in China. At present, preferential policies are being implemented for Foreign Investors in certain industries located in special economic zones (“**SEZ**”), like the one in Shenzhen, and pilot free trade zones (“**FTZ**”), like the one in Shanghai (collectively, “**Special Zones**”). For example, the Internet and financial industries in the Special Zones currently enjoy preferential policies whose purposes include meeting the current needs of the Chinese economy and enabling China to keep the promises it made when it became a member of the WTO. In the future, the Chinese government will establish additional Special Zones and continue reducing regulations for foreign investments in certain industries found in these Special Zones.

Investment protections

The 2018 Draft Law states that the expropriation of personal property will be permitted only for public use and after fair compensation has been paid. Also, 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. Intellectual property (“**IP**”) transfers and technology transfers of foreign-invested enterprises (collectively, “**Transfers**”) will be negotiated between the parties on an arm’s length basis; government interference or coercion is explicitly prohibited. Additionally, the government and governmental agencies (“**State**”) are allowed to change the terms of State contracts, or to rescind promises made by the State, only in keeping with national interests and after due process has been afforded; foreign-invested enterprises and Foreign Investors must also be paid fair compensation for any



losses they incur. Finally, the 2018 Draft Law will establish an official channel that foreign-invested enterprises adversely affected by State or official conduct may use to appeal to the appropriate authority.

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- Free repatriation. This is 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. Under the Existing Laws, repatriation is (i) limited to legitimate profits, funds that remain after a dissolution, and other legitimate income, and (ii) allowed only after tax clearance. Although the 2018 Draft Law does not mention the tax authority in regards to the repatriation of investments made by Foreign Investors, the government will most likely retain this authority as well as the authority to regulate foreign exchange.
- Government coerced Transfers prohibited. In response to recent criticism by the international community, government coerced Transfers to a Chinese counterpart are now explicitly prohibited. This will be welcome news to US companies that for many years have been vocal critics of such coerced Transfers.
- Additional protections for Foreign Investors that interact with the State. Multinational clients that invest in China have found that local governments in rural areas are more likely than their coastal counterparts to breach State contracts or rescind promises like tax breaks that were made to attract foreign investment. Communications with rural government officials, and even judicial and administrative proceedings whose purpose was to make them live up to their promises, have to date been of limited use, as there has not been adequate legal protection against arbitrary governmental conduct. The 2018 Draft Law for the first time mandates that the State keep promises made to Foreign Investors. More importantly, the 2018 Draft Law also includes a due process clause that better protects the interests of the Foreign Investors when they enter into contracts with the State; the State is also required to pay fair compensation and to act in the best interests of the public.
- A complaint mechanism that protects foreign-invested enterprises. The proposed complaint mechanism will apply to all phases of a foreign investment, from the establishment of a business entity to its dissolution. The 2018 Draft Law does not, however, specify which authority will manage the complaint mechanism or what its procedures will entail. Nor is it known whether decisions rendered by the complaint mechanism can be appealed. It is safe to assume that specific rules will be promulgated to address these issues.

Investment management

The 2018 Draft Law contains three prongs that manage investments: (i) the “negative list,”



through which the government reviews and approves foreign investments; (ii) the reporting system, which requires that Foreign Investors submit certain information to the government authorities; and (iii) the national security review, which requires a separate government review of foreign investments whenever national security concerns have been implicated. Similar provisions were introduced in more detail in the 2015 Draft Law, but the 2018 Draft Law provides only general principles and guidelines.

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- Negative list. The negative list is a list of industries in which foreign investments are 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 2018, the National Development and Reform Commission (“**NDRC**”) released updated negative lists that apply to the FTZ and the rest of China. These negative lists continue the trend of loosening restrictions placed on foreign investments in China. For example, restrictions placed on foreign shareholders are reduced or even eliminated in the TMT, infrastructure, automotive, and aerospace industries. Not only is the Chinese market more accessible to Foreign Investors, government formalities for the foreign investments have been simplified as well.
- Reporting system. The 2018 Draft Law provides that the scope and content of information regarding foreign investments will be collected only when necessary. This information will be disclosed to the general public and will also be shared with various governmental authorities so that foreign investors will no longer be required to prepare duplicate sets of the same application documents for different authorities. Government authorities will also be required to use the same review standards with foreign-invested enterprises as they do with their Chinese counterparts, except as otherwise required by law.
- National security review. The national security review mechanism for foreign investments was first introduced in 2011 by the Ministry of Commerce in the *Circular on Formalizing Security Review System for the Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (“**Circular**”). The 2015 Draft Law contained 26 substantive and procedural provisions regarding the national security review. The 2018 Draft Law, however, merely states the principle that foreign investments are subject to a national security review, and that decisions made by the relevant authorities will be final. As the 2018 Draft Law does not say how the national security review will be conducted, the final law will probably contain a reference to the Circular or to other regulations that have been implemented by that time.

Conclusions and suggestions

The 2018 Draft Law is a concise blueprint for the regulation of foreign investments in the PRC.

Subsequent rules and regulations (“**Accompanying Regulations**”) will need to be promulgated to fully implement the 2018 Draft Law. In any event, there can be no doubt that the 2018 Draft Law and its Accompanying Regulations will create a more friendly and efficient market for Foreign Investors in the PRC.

Based on our interpretation of the 2108 Draft Law in its current form, V&T offers the following suggestions to our international clients:

- 1) Compliance is the foundation of Foreign Investments in China. The government will manage a platform that discloses information about Foreign Investors and their foreign investments in China, including information about noncompliance and penalties that have been imposed on the Foreign Investors. Any unfavorable information will most likely be taken into consideration by government authorities as the Foreign Investors continue to operate their businesses; it will also be taken into consideration by banks when they determine whether or not to grant loans to Foreign Investors.
- 2) Know your own government’s attitude towards Chinese investments. The 2018 Draft Law provides that China retains the right to implement retaliatory measures against Foreign Investors from countries or regions that impose restrictions or bans on Chinese investors.
- 3) Arbitration remains the preferred way to resolve disputes. The 2018 Draft Law provides that court judgements involving foreign investors must be publicly disclosed. There is therefore a risk that confidential information about Foreign Investors and their businesses could be disclosed as well if disputes with Chinese counterparts are litigated in court. Almost all of our foreign clients choose arbitration over litigation because arbitration is more confidential, less costly, and more time efficient. Arbitration is also the preferred way to resolve disputes because it is far less likely to be subject to compelled disclosure by the Chinese government.
- 4) The financial industry will be subject to a separate set of rules. Although China’s financial industry has been opening up to Foreign Investors since China joined the WTO, because the financial industry is so important, it will primarily be regulated by a separate set of rules and regulations (“**Financial Regulations**”). Foreign Investors that wish to invest in the financial sector should therefore seek legal guidance regarding the Financial Regulations before investing.



Contact

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