

China welcomes investors with new Foreign Investment Law

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In brief

The commencement of China's new Foreign Investment Law ("FIL") on 1 January 2020, presents significant opportunities for foreign investors, including more flexibility on joint venture terms and streamlined entity establishment procedures. This alert provides an overview of the key provisions of the FIL and the long-awaited implementation regulation published on 26 December 2019, as well as the matters foreign investors should consider under the new regime. Those changes, including a new information collection regime, continue the recent trend of affording foreign investors better access to the China market while subjecting them to continued regulatory scrutiny.

Key takeaways

-  Unification of corporate forms, structures, and operating rules will lead to a reshuffling of power among JV partners and opportunities to renegotiate 
-  The opening-up and promotion of foreign investment coupled with liberalisation measures will prompt opportunities of restructuring and re-investment 
-  Concrete steps to protect intellectual property rights opens up the possibilities of rearranging existing and future intellectual property rights 
-  A more convenient, efficient, and transparent administration of foreign investment equals more certainty and more manageable processes with less unexpected hiccups 

Background – the FIL

The FIL was approved by the PRC National People's Congress and officially took effect on 1 January 2020. The FIL replaces the current laws and regulations governing the three traditional types of foreign-invested enterprises (equity joint ventures, cooperative joint ventures and wholly-foreign owned enterprises) ("**Three Laws**"). In doing so, the FIL seeks to address long-standing demands of foreign investors for a fairer, competitive market environment in China, in which foreign investors and their domestic counterparts would be treated in a similar manner. In particular, the FIL

provides that the foreign-invested enterprises (“**FIEs**”) should follow the PRC Company Law (which applies to domestic companies), the PRC Partnership Enterprise Law and other applicable laws in terms of form, organs and operating procedures.

That means that legally, wholly-foreign enterprises and sino-foreign joint ventures will be generally regulated in the same manner. The PRC authorities are already replacing previous systems and application forms with new arrangements, although foreign investors will not immediately see significant differences. For example, online filings still need to be supplemented by hard copy submission of countless original documents (including a notarised and legalised incorporation certificate for their overseas parent company). While foreign investors must still specify an amount of registered capital to contribute, the Articles of Association can provide for this to be contributed over a lengthy period and the authorities appear more relaxed about the particular quantum specified.

For existing FIEs established under the Three Laws to be compliant with the PRC Company Law and other applicable laws, a 5-year transition period is provided in the FIL in order to adopt the changes to be applied to existing entities. A detailed comparison of the PRC Company Law and the Equity Joint Venture Law in terms of requirements on company organs and governing structure can be found in our previous alert at <https://www.tiangandpartners.com/en/publications/china-spectacular-foreign-investment-transformation.html>. Some of the key differences that may provide an opportunity for foreign investors to renegotiate certain terms of joint ventures are summarised below:

Item	Equity Joint Venture Law	Company Law
Highest authority	Board of directors	Shareholders' meeting
Majority rule for certain major items	Directors - All directors presented at the board meeting	Shareholders - 2/3 votes
Profit distribution	Distribution shall be in accordance with the registered capital ratio	Distribution shall be in accordance with the actual contribution ratio between shareholders or as otherwise agreed by all shareholders
Equity transfer	Consent by all other shareholders	More than 1/2 votes from the remaining shareholder, plus pre-emptive rights, unless articles of association provide otherwise

The FIL also changes the previous governing regime for foreign investment. The responsibility of particular regulators under China's new foreign investment regime can be depicted as follows:

Area	Regulator
Formulating and publicising Negative List and Catalogue of Industries Encouraged for Foreign Investment	National Development and Reform Commission (' NDRC ') and Ministry of Commerce (' MOFCOM ')
Reviewing whether foreign investment is compliant with the foreign investment negative list (' Negative List ')	Governing authorities for the relevant industries, Administration for Market Regulation (' AMR ') and NDRC
Issuing industry specific licences	Governing authorities for the relevant industries
Registering FIEs	SAMR
Maintaining foreign investment reports and handling complaints raised by FIEs	MOFCOM
Approving and recording fixed assets investment projects	NDRC

Highlights of the Implementation Regulation

The regulation implementing the FIL (《中华人民共和国外商投资法实施条例》 (“Implementation Regulation”) adopted on 26 December 2019 addresses and further elaborates on some key issues under the FIL. In this section, we have set out some of the highlights of the Implementation Regulation that may be of interest to foreign investors.

Streamlined procedure for approval of foreign investments and company registration

Under the previous foreign investment approval regime, MOFCOM and its local level counterparts were responsible for reviewing and approving foreign investment that fall under the Negative List. If an investment was classified under the Negative List, foreign investors could only register their companies with the relevant AMR after obtaining MOFCOM's approval. However, this MOFCOM approval power was abolished on 1 January 2020.

The Implementation Regulation has now adopted a new approach by providing that “*relevant administrative departments in charge*” will not issue licences, process company establishment registration and others or grant fixed assets investment approvals if the relevant foreign investment is not in compliance with the Negative List. In other words, the review regarding whether the foreign investment is in compliance with the Negative List will be conducted in conjunction with the examination of the relevant application for industry specific licences, company establishment registration or fixed assets investment approvals.

With regard to foreign investment falling outside the Negative List, previously a filing still needed to be made with MOFCOM before or after registering the establishment or any change of an FIE with AMR. Under the new FIL regime, a filing with MOFCOM is no longer required.

As such, foreign investors can register the establishment and changes of their FIEs with AMR directly without the need to obtain an approval (for FIEs falling under the Negative List) or a filing record (for FIEs falling outside the Negative List) from MOFCOM.

New information collection system

Under the previous system, information about FIEs was mainly collected by SAMR and MOFCOM individually through their respective systems (*Foreign Investment Comprehensive Management System* managed by MOFCOM and *Enterprise Registration System and Enterprise Credibility Information Publication System* managed by the SAMR).

To simplify the previous information collection system, the FIL and its Implementation Regulation propose to merge the system managed by the MOFCOM into the AMR system, so that foreign investment information will be collected from the Enterprise Registration System and Enterprise Credibility Information Publication System managed by the SAMR and shared with MOFCOM.

On 31 December 2019, MOFCOM and SAMR jointly issued the Information Reporting Measures of Foreign Investment Information (《外商投资信息报告办法》) (“**Reporting Measures**”) which provided the following details of the information reporting system:

- MOFCOM will oversee and guide the information reporting work nationwide and SAMR will guide the implementation of the Enterprise Registration System and Enterprise Credibility Information Publication System. Further details regarding the division of responsibilities will become clearer as the FIL is implemented by the authorities;
- Foreign investors and FIEs must report their information via Enterprise Registration System and Enterprise Credibility Information Publication System and AMR will forward the information collected to MOFCOM;
- The information reporting includes four types of reporting, namely, (I) initiation reporting in relation to company establishment, (II) change reporting, (III) de-registration reporting and (IV) annual reporting, with the first three types of reporting to be made through Enterprise Registration System and the last reporting to be made on Enterprise Credibility Information Publication System; and
- The information of the enterprises invested by FIEs (including multi-levels) will also be forwarded to the MOFCOM: this last point is an endorsement of article 47 of the Implementation Regulations confirming that enterprises invested by FIEs may still be subject to foreign investment regulations.

Most authorities across China are still in the process of introducing the new information collection system under the FIL and its Implementation Regulation (as at the date of this alert). In Shanghai, we understand that the new systems is already in place. Foreign investors will need to further monitor developments of relevant legislations and be ready to complete online reporting in accordance with the new requirements once the relevant online systems are made available by the authorities in the place where their businesses are located.

Treatment of VIE structure

The FIL and its Implementation Regulation are silent on the issue of legality of foreign investments using a so-called variable interest entity (“VIE”) structure. It is likely that different regulators may adopt different approaches to the use of VIEs in their sector, noting that the Ministry of Education is one regulator already adopting an approach to regulate VIEs.

Different regulators are also likely to adopt a different approach to the treatment of foreign investment more generally. For example, the authority regulating telecommunication industry takes the view that whether a company should be viewed as an FIE and thus subject to the Negative List depends on the identity of the ultimate shareholder of such company, while some other authorities consider that only the identity of the direct shareholder of such company should be looked at when determining whether the relevant company is an FIE.

5-year transitional period: clarification

The FIL provides that all FIEs established under the regime prior to the FIL coming into force can keep their existing structure for five years after the FIL comes into effect (“**Transitional Period**”) but lacks further details on how this 5-year rule will be implemented. The Implementation Regulation only specifies that the registration authority will not allow FIEs failing to complete corporate changes required under the FIL by the end of the six month grace period after the five year Transitional Period (i.e. by 30 June 2025) to register any other changes and the registration authority will report companies that have failed to do so in the national enterprise information publication system.

However, the Implementation Regulation further clarifies that existing sino-foreign joint ventures established under the previous regime can retain the following specific arrangements previously agreed upon, after the Transitional Period (so the revised Articles of Association can continue to contain these negotiated terms, even where they are inconsistent with the PRC Company Law):

- Share or equity interest transfer mechanisms;
- Profit distribution arrangements (for example, special early investment recoupment clauses in a cooperative joint venture agreement); and
- Asset distribution arrangements in case of liquidation.

Points that remain unclear

Both FIL and Implementing Regulation aim to lay down a new legal regime in respect of the foreign investment. However, given the complexity of the existing legal regime and previous rules regulating the foreign investment in the past three decades, it is expected that many foreign investment related issues left unanswered yet will have to be clarified by further measures, guidance, practice notes and interpretations in the next few months. We have set forth below a couple of topics of such nature:

(a) Reinvestments by FIEs

Article 2 of the FIL stipulates that the term “foreign investment” refers to any direct or indirect investment made by any foreign investor. Article 47 of the Implementation Regulation further provides that reinvestment by FIEs will be regulated under FIL and Implementation Regulations. As such, any reinvestment made by an existing FIE in China should be captured by the FIL as well.

However, in practice, we understand that SAMR will only treat enterprises invested by foreign investors as FIEs and designates direct subsidiary of FIEs as “invested by FIEs”. Any subsidiaries from that level downward are treated the same as domestic companies. Whether such practice will be changed following the implementation of FIL will have to be further clarified.

(b) Total Investment and Registered Capital ratio

Total investment is a legal concept created under the corresponding implementation rules of the Three Laws with the main purpose to calculate the amount of foreign capital that a foreign investor will bring into China and also the amount of foreign debt that an FIE can have.

However, given the Three Laws were abolished on 1 January 2020, it appears that the legal validity of the concept of total investment is questionable.

It is noted that China has been making efforts to introduce a new foreign debt regime where both domestic companies and FIEs can be regulated in the same manner since 2017 following the promulgation of Notice of People’s Bank of China on Matters Concerning Macro-prudential Management on All-round Cross-border Financing (中国人民银行关于全口径跨境融资宏观审慎管理有关事宜的通知). An FIE has since then been permitted to select a model where the maximum of its foreign loan amount can be calculated based on the net asset value of such FIE. Accordingly, the grounds for keeping the concept of total investment are substantially weakened.

While we note that based on recent practice, the information of total investment amount is still required to be reported as a part of reporting procedure, we surmise that this is mainly due to the reason that the majority of the FIEs are still using/or more familiar with using the total investment amount for its borrowing room purposes. However, it is fair to say that this model will become less favored by the authorities, and the concept of total investment will eventually be abolished.

Enhanced investment protection

The FIL introduces a complaint system and the Implementation Regulation further details the complaint mechanism and the authority responsible for handling complaints. Under the Implementation Regulation, MOFCOM will work with the relevant departments of the State Council to implement an FIE complaint working mechanism and to supervise and oversee the complaint resolution works by the local governments. Local level (above the county) governments must also implement local complaint working mechanisms to deal with issues reported by FIEs or their investors in the region.

Further, the Implementation Regulation also points out that government authorities should not change their policy concerning preferential treatment provided to FIEs. If the authorities need to change their commitments because of national or public interests, they should compensate FIEs for their losses on a fair and reasonable basis. While the authorities may still have the discretion to determine what level of compensation should be deemed as “fair and reasonable”, the Implementation Regulation at least provides comfort to FIEs that there is a basis to claim compensation in the event that certain policy commitments provided by government authorities are cancelled or changed.

Evolving framework

As result of the FIL and its Implementation Regulation, a series of regulations have been repealed recently, and we expect more to be amended or cancelled in the coming months, as the PRC authorities continue to review the previous legal framework applicable to FIEs and streamline the regulatory framework. For example, MOFCOM published a notice on 28 December 2019 which abolished 6 regulations including the Change of Equities Interests of the Foreign Investors in the FIE (外商投资企业投资者股权变更的若干规定) promulgated on 28 May 1997 and the FIE Equities Contribution Provincial Regulations (商务部关于涉及外商投资企业股权出资的暂行规定) promulgated on 21 September 2012, reflecting a reduced role of MOFCOM in regulating the foreign investment.

The FIL also sets forth that foreign investors can, in accordance with the laws, freely transfer into and outside China their contributions, profits, capital gains, income from asset disposal, royalties of intellectual property rights, legitimate compensation or indemnity, derived from liquidation, etc. within the territory of China in CNY or foreign currency. This provides legal protection on foreign investors' repatriation from China. It is worth noting that foreign investors still need to fulfil the obligations with tax authorities, banks or administration of foreign exchange when remitting funds outside China - though the procedural requirement of remittance is being simplified, it does not eliminate such responsibilities or tax uncertainty.

Recommendations and implications

As local authorities across China progressively implement the changes introduced by the FIL, foreign investors will start to see new procedures introduced for the establishment of FIEs. Those with existing investments in China now have 5 years to update their existing constitutional documents. The agreements underpinning joint ventures are now also open to review in light of the FIL.

In particular, we suggest that foreign investors consider taking the following steps:

- ❖ Review joint venture contracts, articles of association and organisation structure of their existing joint ventures established under the Three Laws, and consider how they would need to be amended to become consistent with the PRC Company Law whilst reflecting the original intention of the investors, or consider opportunities for renegotiation of terms in light of the FIL.
- ❖ Ensure that the articles of association and organisation structure of existing WFOEs are still compliant with the PRC Company Law (which we understand should be the case for all WFOEs established after 2006), and determine the minimal changes that might still need to be made.
- ❖ Review agreements concluded with local governments. In case of any conflicts or gaps with the FIL, we recommend approaching government authorities to explore potential protection or remedy.

- ❖ Prepare for changes in procedures during the transition period (at least, for the next few months in 2020), while authorities implement the simpler and more streamlined foreign investment regulation process announced by the FIL.
- ❖ Keep monitoring the process of amendment of other legislation that conflict with the FIL. The relevant departments are working on removing the existing regulations conflicting with the FIL.
- ❖ Explore opportunities arising from restructuring and reinvestment in China. The FIL sends a positive message from the authorities about opening-up the Chinese economy and facilitating foreign investment. We suggest closely monitoring developments to identify whether the current restrictions on foreign investment in certain sectors will be lifted. We also expect more flexibility on corporate restructuring, for example, share swap, or reinvestment in China. It is also critical to take potential tax impact into consideration when developing restructuring strategies and to explore the possibility of achieving tax deferral or minimizing tax cost.

Let's talk

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