

Memo regarding Legal Update on PRC Foreign Investment Law

On March 15, 2019, China's national legislature, the PRC National People's Congress ("NPC"), adopted the PRC Foreign Investment Law, a landmark legislation that will bring fundamental changes to the PRC foreign investment regulation regime. The PRC Foreign Investment Law will take effect as of January 1, 2020. This memo intends to provide a summary of the new law for your information. This memo has three parts, starting with a brief introduction of the existing foreign investment regulation regime, followed by a brief summary of the new law and ends with the new law's possible practical impact on foreign investment deals.

A. The Existing Foreign Investment Regulation Regime

1. The Approval Based Regime Prior to October 1, 2016

The existing regulatory regime was established with the promulgation of the Sino-foreign Equity Joint Venture Enterprise Law in 1979. In 1986 and 1988, respectively, the Foreign Owned Enterprise Law and the Sino-foreign Cooperation Joint Venture Enterprise Law were promulgated, thereby completing the trio of the so called "Three FIE Laws", which constitute the three pillars of the foreign investment regulatory regime that governed foreign investment matters for the past three decades. The abbreviation "FIE" stands for foreign invested enterprises.

Under the Three FIE Laws, all foreign investments into China and their subsequent changes require prior, case-by-case approval from MOFCOM or its local branches. In its deliberation of each case submitted for approval, MOFCOM would review not only the background of the foreign investor, the industry and project that the foreign investor intends to engage in, but also the corporate governance terms of the FIEs to be established. Joint venture contracts and articles of associations of FIEs are to become effective only after MOFCOM approval is granted. As a result, FIEs have been subject to a parallel series of regulations in addition to the PRC Company Law (which was promulgated in 1993).

The Approval Based Regime, which played a pivotal role in the initial opening up of China to the external world and in bringing in foreign capital and technologies into the Chinese market, had long seemed excessive and inefficient. It prolonged the approval process, increased regulatory costs for foreign investors and to some extent, impeded free competition and liquidity flow.

2. The Current Record Filing System

The PRC government had acutely realized the restrictions of the old approval based

regulatory regime and had explored ways of reformation and after testing on a pilot basis in several specified regions, adopted the currently effective nationwide record filing system effective as of October 1, 2016. The currently effective recording filing system takes a modest approach that involves minimum changes to the existing set of laws and regulations but still effectively grants a pre-establishment national treatment to foreign investors in most of their foreign investment activities in China. This is achieved by the following three steps:

- **Amendment to the Three FIE Laws:** On September 3, 2016, the Standing Committee of NPC passed amendments to the Three FIE Laws. Each law is amended by adding an article which provides that, with respect to matters involving FIEs that are not captured by the special administrative measures specified by the State, a record-filing requirement, instead of the approval requirement otherwise provided in the laws, will be applicable. These amendments took effect on October 1, 2016. These amendments laid the legislative basis for the record filing system and also authorized the State Council to promulgate "special administrative measures", a.k.a. the "negative list".
- **Filing Measures Promulgated by MOFCOM:** On October 8, 2016, MOFCOM published Provisional Measures for Filing Administration of Establishment and Changes of Foreign-invested Enterprises, setting forth detailed guidance with respect to the scope of application of the filing system, the timing, process, and information requirement of the filing, authorities in charge of the filing, and etc.
- **Negative List:** As of October 8, 2016 and as approved by the State Council, NDRC and MOFCOM have adopted a "negative list" and have updated such list for a couple of times, with the currently effective one promulgated in June, 2018.

In general, the current record filing system has fulfilled its purpose of simplifying foreign investment process and granting "pre-establishment national treatment" to foreign investors. However, the expectation for a unified foreign investment law is still very high for reasons including: (i) FIEs are still subject to the Three FIE Laws in addition to the Company Law, leading to potential conflicts between the two sets of laws; (ii) demands from foreign investors for more transparency and certainty in foreign investment regulation, facilitation and protection are still high. And after several years' deliberation, the PRC Foreign Investment Law finally comes into stage.

B. The PRC Foreign Investment Law

Upon its effectiveness as of January 1, 2020, the PRC Foreign Investment Law will replace the Three FIE Laws and become the unified and fundamental law on foreign investment matters.

The goal of the new law, as provided in Article 1 of the law, is to further expand opening-up, vigorously promote foreign investment, protect the legitimate rights and interests of foreign investors, and standardize the management of foreign investment.

As commented by vice chairman of the NPC Standing Committee, the new law shows China's will and determination to follow through with reform and opening up in a new historical context.

The new law in total has 42 articles provided in 6 chapters. Main contents and highlights of the new law are summarized as below. We also include in the last part of this section our observation regarding the future implementation of the new law.

1. Equal Treatment between Domestic and Foreign Investors

- **Pre-establishment National Treatment plus Negative List System.** The new law provides that the state shall manage foreign investment according to the system of pre-establishment national treatment plus a negative list. The pre-establishment national treatment requires that treatment given to foreign investors and their investment during the investment access stage shall not be inferior to treatment afforded to PRC domestic investors and their investment except where a foreign investment is captured by the negative list. The negative list refers to special administrative measures for foreign investment access in specific fields to be promulgated, or authorized to be promulgated by the State Council.
- **Equal Treatment post-establishment?** The new law provides from various angles that FIEs should be treated equally with pure domestic enterprises. According to the new law, FIEs will equally enjoy government policies supporting enterprise development, and be able to participate in standard-setting on an equal footing and in government procurement through fair competition.

2. Foreign Investment Protection

The new law dedicates a full chapter to investment protection. Notable mechanisms include:

1) **Non-expropriation.** The State shall not expropriate foreign investors' investment in general, and if under special circumstances an expropriate or requisition is necessary as per the requirement of public interests, it should be taken according to statutory procedures with a timely, fair and reasonable compensation. This is a continuation of the basic position taken by the Three FIE Laws.

2) **Free Cross-border Fund Flow.** The contribution, profit, investment returns, compensation and indemnity made or obtained by foreign investors can be remitted outside or inside China in renminbi or foreign currency freely according to law.

3) **Intellectual Property Protection.** The State protects intellectual property rights of foreign investors and FIEs and the government shall not force technology transfers.

4) **Governmental Official's Confidentiality Obligations.** Governmental departments and

their officials shall keep confidential the trade secrets of FIEs they learn about in the course of performing their duties.

5) Restrictions on the government's power. The governments at all levels shall not formulate any rules that may impair FIEs' legitimate rights and interests or increase their obligations, set any market access or exit conditions or otherwise intervene their ordinary operation. The new law also stipulates that local governments shall fulfill their policy promises and all types of legal contracts with FIEs, otherwise, FIEs shall be compensated for their losses.

6) FIEs complaints mechanism. The State shall establish a complaint mechanism for FIEs and timely handle problems encountered by FIEs or their investors.

It is worth noting that 3, 4, 5 and 6 above are new elements that were not found in the Three FIE Laws. While this does not necessarily mean that such protection was non-existent currently (for example, the various PRC intellectual property laws do provide protection to FIEs), having these codified into a fundamental law does send a strong signal of the PRC government's commitment to providing enhanced protections to foreign investors in these regards.

3. Investment Management

With Pre-establishment National Treatment plus Negative List System as the basis, the new law adopts the following investment management principles for foreign investment:

- **Organizational governance.** Depending on the organizational form, the PRC Company Law or the PRC Partnership Law shall apply with respect to an FIE's organization. This will put an end to the confusion caused by the discrepancies between the Three FIE Laws and the Company Law.
- **Information report system.** The State shall establish a foreign investment information report system. Foreign investors or FIEs shall submit investment information to the competent department for commerce through the enterprise registration system and the enterprise credit information publicity system. The content and scope of information subject to the reporting obligations shall be determined under the principle of necessity.
- **National security review system.** The State shall establish a security review system for foreign investment, under which a security review shall be conducted for any foreign investment affecting or having the possibility to affect the state security.
- **Others.** In addition to the above, FIEs shall also be subject to the laws and regulations relating to anti-trust, taxation, accounting, foreign exchange, employee protection, social insurance contribution, etc.. These laws and regulations are in general applied

equally to FIEs and pure domestic enterprises.

4. Implementation of the New Law

It shall be certain that with unified provisions for the entry, promotion, protection, and management of foreign investment, the new law will provide stronger protection and a better business environment for foreign investors. However, as the new law only provides for the most basic principles for the regulation of foreign investment, and its implementation would involve the actions from various governmental agencies, many matters and issues are still pending clarification and more detailed guidance to be given by the State Council, the MOFCOM, and other relevant governmental agencies by way of implementation rules. Such matters and issues include, for example, what will trigger national security review and how will such review be conducted, what's the relationship between the current record filing system and the information report system, the transition arrangement between now and the effective date of the new law, and etc.. We expect more detailed regulations and rules regarding the implementation of the new law to be promulgated in the near future.

C. Possible Practical Impact on Foreign Investment Deals

In addition to the general expectation that the new law will provide a stronger protection and a better business environment for foreign investment in China, below are several practical points regarding existing and/or future foreign investment in China:

- **Transaction documents.** Previously, in addition to other deal specific documents, every transaction would have the following three transaction documents as per the requirement of the FIE Laws: an equity purchase agreement (if the foreign investment is not a green field one), a joint venture contract (similar to a shareholders agreement) and an articles of association. Under the new law, the joint venture contract will no longer be a statutorily required document. But the parties may still choose to have a shareholders agreement.
- **Corporate governance.** As noted above, prior to the new law, the FIEs are subject to the Three FIE Laws in addition to the Company Law, and where there are discrepancies, the general principle is that the Three FIE Laws shall prevail as they are special rules applicable to FIEs. For an Sino-foreign joint venture, the key differences between the Three FIE Laws and the Company Law include (i) the highest internal authority for a Sino-foreign joint venture is the FIE's board of directors while under the Company Law the highest internal authority is the shareholders' meeting; (ii) under the Three FIE Laws, certain matters are subject to the unanimous approval while under the Company Law the highest statutory threshold for a shareholders resolution is a supermajority approval (2/3 of the total voting rights) and the parties' voting rights do not need to be in proportion to their respective capital contribution if the JV takes the form of a limited liability company. The new law grants a five years transition period for the

existing FIEs to change their organizational structure in accordance with the new law.

- Dividend distribution. Under the Three FIE Laws, for a Sino-foreign joint venture the dividend distribution shall be made in proportion to the JV parties' capital contribution, causing frustrations to the parties who intend to adopt a more flexible dividend distribution mechanism. Under the Company Law, however, dividend distribution does not need to be in proportion to the shareholders' capital contribution for a limited liability company if the shareholders provide so in the AOA. Therefore, under the new law regime, there is more flexibility regarding dividend distribution arrangement if the parties intend to do so.
- Information Report System. It remains to be clarified by more detailed implementation rules, but we would expect that the requirements shall not be more onerous than the current record filing system.

Ending Note: as said above, this memo intends to give you a brief update regarding the new PRC Foreign Investment Law. Also noted above, many matters and issues regarding the implementation of the new law are still pending clarification and more detailed guidance from the State Council, the MOFCOM, and other relevant governmental agencies. Therefore, this memo does not intend to provide a full and exclusive guidance regarding the new law and we will keep you posted regarding any updates.

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