China's new Foreign Investment Law

An effort to reform Chinese investment regime in favor of foreign investors

Patrick Heimann
Manager – Swiss Desk
Fidinam (Hong Kong) Limited
Hong Kong SAR

Roger Bischof
Managing Director
BIRT | International Restructuring
Shanghai PRC

Since the early '80s, when China started to open up its doors to international trade under the leadership of Deng Xiaoping, foreign investors have been facing obstacles with respects to business establishment and investment treatment. Recently, in an effort to restore foreign investors' confidence by providing equal privileges to all countries trading with China and reaffirm its administrative integrity, China has passed a new Foreign Investment Law (FIL), which came into force on 1st of January 2020. The FIL, which has been positively welcomed by the global public opinion, aims at addressing investors' concerns such as (i) forced technology transfers; (ii) protection of intellectual property rights and (iii) equal competition and fair market access. While the new law is encouraging, foreign investors are well advised to take a close look at the major changes, benefits and obligations that the new Law brings in the Chinese corporate landscape and consider which concrete steps are necessary in order to take advantage of upcoming investment opportunities in China. This article provides an overview of the FIL by placing it into current global context and by examining its most salient clauses and related consequences for investors.

I. Introduction

Since the beginning of 2020, China and the rest of the world have been facing what is probably considered the biggest social and business challenge for decades. As a result of the COVID-19 virus outbreak, governments around the globe have been busy trying to contain the pandemic and implementing a wide range of economic and social measures in an attempt to reduce repercussions on businesses and public health. However, apart from that, the commencement of the new year also brought some good news for companies looking to invest in China. In an effort to restore foreign investor confidence, China passed a new Foreign Investment Law (FIL) which came into force on January 1, 2020.

The FIL reshapes the legal framework governing (*i*) access, (*ii*) promotion, (*iii*) protection and (*iv*) management of foreign investment in mainland China aiming for an upgrade of its image as an international business hub.

With this article the authors intend to provide an overview of the new Chinese Foreign Investment Law by putting it into global context and by analyzing its most relevant provisions.

II. The Law

China's first attempt to reform its foreign investment regime dates back to January 2015, when the draft bill was circulated for public consultation under a Chinese name slightly different from the final version of the FIL – 《中华人民共和国外国投资法（草案征求意见稿）》("Draft 2015"). Following a substantial overhaul of the latter, on March 15, 2019, the National People's Congress, China's main legislative body, promulgated a new Law on Foreign Investment of the People's Republic of China ("FIL",《中华人民共和国外商 投资法》), which together with the corresponding Regulation on the Implementation of the

Foreign Investment Law of the People's Republic of China ("FIL ROI", 《中华人民共和国外商投资法实施条例》), entered into force on January 1, 2020.

The FIL now constitutes the only unified guidance document for regulating foreign investment into China. It replaced the three laws that so far have dealt with investments of foreign companies in China: (*i*) the Law on Wholly foreign-owned enterprises ("WFOE Law", 《中华人民共和国外资企业法》), (*ii*) the Law on Sino-foreign Equity Joint ventures ("EJV Law", 《中华人民共和国中外合资经营企业法》) and (*iii*) the Law on Sino-foreign Cooperative Joint Ventures ("CJV Law", 《中华人民共和国中外合作经营企业法》). These three PRC texts governing foreign-invested enterprises ("FIEs") ("FIE Laws") which were passed between the early eighties and late nineties of the last century have been revoked with the recent entry into force of the FIL.

The FIL consists of only 42 articles (Draft 2015: 170 articles) and is divided into the following six chapters: (*i*) general principles, (*ii*) investment promotion, (*iii*) investment protection, (*iv*) investment management, (*v*) legal responsibility and (*vi*) final provisions. Generally, the new rules are characterized by the recurrence of relatively broad and vague language.

The FIL sets out the general principles for promoting foreign investment in China by improving protection for the benefit of foreign investors and addressing concerns about unbalanced market access, weak safeguard of intellectual property and forced technology transfers. In addition, foreign-invested companies are now governed by the Chinese Company Law and/or Partnership Enterprise Law. In other words, the previous distinction between FIEs and domestically owned companies has been abolished. Hence, the common legal form of the WFOE does no longer exist. Instead, all Chinese companies, no matter if foreign-owned or domestically-owned, are now subject to identical regulatory regime.

III. 2018/2019: The global context prior and after Law approval

According to the World Investment Report 2019 issued by the United Nations Conference on Trade and Development (UNCTAD), in 2018 mainland China was the second largest recipient of FDI after the US, attracting $139 billion, which represents a 4% increase in comparison to the previous year (*i.e.* $134 billion in year 2017).

During year 2018, China continued to absorb increasing investment flows from Asian economies such as Hong Kong SAR, South Korea and Singapore. Inflows from other developed Western economies also rose significantly, mostly due to the increase in the number of M&A megadeals. For example, German company BMW invested an additional $4 billion in its Chinese joint venture in October 2018 while UK company Diageo acquired a majority stake in Sichuan Swellfun, a Chinese spirit brand for $9 billion.

However, despite the positive numbers reported in terms of FDI Inflows, according to another study focusing on global competitiveness published by the World Economic Forum ("The Global Competitiveness Report 2019"), China surprisingly ranks 28th, unchanged from the previous edition and right after Malaysia. The Global Competitiveness Index analyses 141 economies and measures national competitiveness and ease of doing business defined as the set of (*i*) institutional, (*ii*) political and (*iii*) economic factors.

Pursuant to the report, China's strengths obviously include the size of its domestic market, Information Communication Technology (ICT) adoption, infrastructure development and innovation capability. However, the report also highlights how the country's innovation ecosystem could definitively benefit from a more efficient, open and fairer domestic market that would foster competition and guarantee better allocation of resources.

Interestingly, according to the same report, the weakest area for China is "Institutions", which is the pillar rating (*i*) the efficiency of laws and regulations, (*ii*) the efficiency of the legal framework in settling disputes, (*iii*) property rights, (*iv*) intellectual property protection and (*v*) conflict of interest regulation. Therefore, the report implies that the great technology adoption rate in China and the ability to foster innovation (China is indeed exceeding 25 OECD countries on the ICT Adoption pillar) may not be enough to assure a bright future for the country.

This information supports the hypothesis that the foreign investment regime in China is now more than ever in need of a substantial revision. Announced between 1979 and 1990, a period in which China was just about to open up towards the Western world under the leadership of Deng Xiaoping, the existing investment rules need to be aligned with a new and modern business landscape.

During 2018 and 2019, China was also facing severe international criticism in relation to the treatment of foreign direct investments and the alleged relatively slow opening of the domestic market to foreign investors. While the United States voiced the most criticism, other governments and corporate leaders from Asia and the European Union have also expressed similar concerns regarding the absence of a true level playing field regarding investments. As a result, the United States initiated a trade war to counter China's alleged unfair trade and investment practices through a drastic tariff increase on China imported goods.

In light of these events, manufacturers received a further push to adjust their supply chain by considering to move production to other growing economies in the Southern Asian hemisphere given the availability of cheaper labor force and growing purchase power of a fast-developing middle class. ASEAN countries (Vietnam, Cambodia, the Philippines) started to slowly gain attractiveness to the eyes of international investors who started to seriously consider a supply chain shift of labor-intensive operations (garment and footwear production in the first position) from China to other countries in the region.

Only on January 15th 2020, after more than two years of rising tension, U.S. President Donald Trump and China's Vice Premier Liu He signed in Washington DC the so called "US-China Phase One Trade Deal" aimed at mitigating frictions between the two superpowers.

Against this background, it seems plausible why China needed a law to demonstrate a concrete commitment towards the creation of a more transparent legal and corporate framework which protects the rights of foreign investors. Chinese policymakers came to the conclusion that the country was in need of a much more welcoming investment climate to remain competitive on a global scale.

IV. Content analysis

Foreign companies already operating in China or investors intending to enter the Chinese market are well advised to closely review the new bill and understand how it may affect their projects and initiatives.

In the following paragraph, the key clauses of the new law will be outlined and analyzed. In summary, the identified highlights of the FIL are the following:

A. Extended Scope of foreign investment;
B. National pre-investment treatment and negative list;
C. IP protection and Prevention of compulsory technology transfers;
D. Governmental commitment;
E. Free remittance of profits and liquidation proceeds abroad;
F. Complaint mechanism;
G. Information reporting and national security review;
H. More flexible corporate governance based on PRC Company Law.

A. Extended Scope of foreign investment (Art. 2 FIL)

In Article 2 of the FIL, foreign investment is defined as *"any direct or indirect investment activity carried out by natural persons, enterprises or other foreign organizations in China"*. Specifically, Article 2 FIL defines four different circumstances that are considered as investment under the new regulatory regime:

1) a foreign investor establishes a foreign-invested enterprise within the territory of China, alone or together with any other investor (so called "Greenfield investments");
2) a foreign investor acquires stock shares, stock equity, property shares or other similar rights and interests in mainland Chinese enterprises ("M&A");
3) a foreign investor invests in any new project within the territory of China, either alone or together with other investors ("New Projects");
4) a foreign investor invests in any other way provided for by law, administrative regulations or provisions of the Chinese State Council ("Other ways").

However, it is to be noted that investments in the banking and insurance sector will continue to be regulated by separate laws (see Art. 41 FIL).

Article 2 (4) FIL serves as a catch-all provision which will need to be further clarified by future additional implementation regulations. The same is true for the definition of indirect investments[1] and investments in new projects[2].

Art. 44 FIL ROI clarifies that investments into China by investors from Hong Kong, Macau or Taiwan will be subject to the new law and thus are treated as foreign investors and investments.

However, at this point it remains unclear whether Variable Interest Entities (VIE) will still be allowed going forward. While this open issue might be addressed by the promulgation of future implementation rules, neither the FIL nor the FIL ROI do explicitly allow or forbid them. VIE structures are contractual arrangements used by foreign investors to invest in restricted sectors and they are also widely adopted by Chinese domestic companies to obtain an offshore listing or raise finance in the capital markets outside China. The 2015 draft prohibited the use of such structure which were deemed as circumventions of the foreign investment restrictions. Hence, foreign investors should stay up to date and carefully monitor the development in this area.

B. National pre-investment treatment and Negative List (Art. 4, 9, 15, 16, 28, 30 FIL)

The National treatment regime and negative list articles state that in regard to market access, foreign investment will be regulated in the same way as investment by Chinese investors. In other words, the law refers to the principle that foreign investors are granted access to the market on terms no less favorable than those granted to domestic investors.

However, only foreign investments in sectors not included in the so-called Negative List are granted equal treatment by the Chinese government. The negative list specifies those sectors that are fully or partly closed to foreign investment.

The mechanism of the "Negative List" was tested in 2013 within the Shanghai Free Trade Area and was then extended nationwide in 2018. The FIL is the first bill in which the concept of a Negative List is anchored in the form of a law. In June 2020, the State Council released an updated version of China's Negative List for foreign investment. The number of items on the list, which sets restrictions or completely bans foreign investors from certain industries, has been steadily decreased over the last few years.

In industries which are not prohibited or restricted according to the negative list (so called non-regulated industries), international investors are not subject to prior approval form Chinese authorities.

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[1] For example, what happens with an investment made by a foreign entity whose ultimate controlling shareholder is a Chinese entity or individual or how shall the scenario be treated where the ultimate controlling shareholder is a foreign investor but the investing entity is a Chinese company.

[2] The term could include investments that foreign investors carry out through contractual arrangement such as natural resource exploration and exploitation concession agreement, infrastructure construction etc.

Art. 9 FIL ROI stipulates that the governments at all levels and their relevant departments shall treat equally and not discriminate against FIEs in the development, implementation of policies and measures for the development of enterprises and the examination of applications under such policies.

C. IP protection and prevention of compulsory technology transfers (Art. 22 FIL)

The FIL also addresses major foreign concerns with respect to intellectual property protection, access to government procurement and the principle of no expropriation without compensation. The bill explicitly bans forced transfers of technology or disclosures of trade secrets. Art. 25 FIL ROI also prohibits disguised forms of forced technology transfer during registration, recordation, administrative licensing or other administrative acts. Such transfers, if any, must be voluntarily negotiated between the parties on an arm's length basis. Government officials involved in forced transfers can be made criminally liable. Therefore, the new law should prevent government officials from using administrative measures to force technology transfers. Acts of infringement of intellectual property rights will be severely prosecuted in accordance with the law. Art. 24 FIL ROI provides for the establishment of a punitive compensation system for IP rights infringements, developing a fast-track coordinated protection mechanism for IP rights and improving dispute resolution mechanisms.

However, the definition, circumstances and legal consequences of a "forced technology transfer", which is a particularly sensitive issue for a number of foreign investors, will need to be further clarified in practice.

D. Governmental commitment (Art. 24, 25 FIL)

According to Art. 25 FIL, local People's governments at all levels shall adhere to policy commitments lawfully made towards foreign investors and shall perform all contracts concluded according to PRC law. If any policy commitment or contract needs to be changed for the sake of national or public interests, such change shall be implemented by the competent authority having the statutory power to do so in accordance with the procedures stipulated by PRC law. The concerned foreign investor or foreign-invested enterprise shall be compensated for losses incurred by such change according to PRC law.

E. Free remittance of profits and liquidation proceeds abroad (Art. 21 FIL)

Art. 21 FIL foresees that foreign investors may freely remit RMB or any other foreign currency into or out of China, *e.g.* capital contributions, profits, capital gains, income from a sale of assets, intellectual property royalties, lawfully acquired compensation, indemnity or liquidation income sourced within the territory of China in accordance with PRC law. The freedom of foreign exchange is new for China aimed at making international capital flows more efficient. The concrete implementation of such free foreign exchange also remains to be seen.

F. Complaint mechanism (Art. 26 FIL)

According to Art. 26 FIL, if a foreign-invested enterprise or any of its investors deems that the practices of an administrative organ or functionary thereof infringe its legitimate rights and interests, it may apply for the remedy of such infringement through a complaint mechanism. In such a case, the foreign-invested enterprise or its investor may also apply for the so-called "administrative review" or file for administrative litigation.

The said provision adds a new method for foreign-invested enterprises to safeguard their rights and interests in China. The details of the operation of the complaint mechanism are contained in Art. 32-30 FIL ROI.

G. Information reporting (Art. 34 FIL) and national security review (Art. 35 FIL)

The Chinese government is directed to establish a foreign investment information reporting system. Foreign investors or FIEs shall submit investment information to the Ministry of Commerce (MOFCOM) through the enterprise registration system and the enterprise credit information disclosure system.

In addition, the FIL establishes a foreign investment security review system to review foreign investments which impact or may impact China's national security. Unfortunately, the FIL ROI does not elaborate on how this sensitive matter will be handled; questions as to which types of investments and investors will need to undergo such specific review and what the exact procedures remain unanswered for the time being and will need to be determined by government practice.

H. More flexible corporate governance based on PRC Company Law (Art. 31 FIL)

The new regime generally provides for more flexibility regarding the company corporate governance.

Furthermore, a crucial point to understand is that the FIL has significant impacts not only on future foreign invested enterprises in all industries but also on existing ones. In fact, Art. 42 of the law provides for a 5-year transitional period during which all existing FIEs must be restructured in accordance with the new law. According to FIL ROI, FIEs which fail to restructure until January 1st, 2025, will be provided with a further 6-months grace period to implement the necessary changes. If they are unable to restructure even after the grace period, the enterprise registration authority (State Administration for Market Regulation, SAMR) will not process their other registration matters and may announce the relevant circumstance in the enterprise information publicity system. It can be anticipated that the Chinese authorities will publish further guidelines regarding the conduct of these modifications and the sanctions in the case of their absence.

Moreover, a big step forward is the fact that the highest authority of EJVs will now be the shareholders' meeting and no longer the board of directors. Another important point is the voting mechanism for major issues. Previously, a unanimous vote of the EJV's board was required. Under the new law, the amendment of the articles of association (AOA), an increase or decrease of registered capital, merger and dissolution are no longer matters subject to unanimous resolutions of the board of directors but rather an affirmative vote of shareholders representing no less than 2/3 of the total voting power participating in a Shareholders' meeting.

Another significant change is related to the distribution of profits. Previously, the distribution within EJVs had to be based on the registered capital. Now the profits distributed shall be in proportion to its paid-in capital contribution, unless otherwise agreed by all shareholders.

As a consequence, existing FIEs should – with the help of legal advisors – urgently review their key documents such as shareholder agreement, JV contract, AOA, technology license agreement, and corporate governance structure and consider which parts need to be revised in order to conform with the applicable new FIL and the company law.

V. Concluding remarks

The new FIL combines and integrates previous legislation into one unified law which addresses topics such as equal treatment, market access, corporate governance as well as protection of intellectual property rights.

Even though many provisions stipulated in the law are formulated as broad general principles which will need to be further detailed in practice, subject to the recovery of the global economy post COVID-19, the authors expect the FIL to generally have a positive impact on existing and future foreign investments into China.

This can be expected especially for Swiss investments in China given the longstanding favorable political and economic relationship between Switzerland and China. During 2020 the two countries celebrate indeed 70 years of diplomatic relations. The free trade agreement (FTA) between Switzerland and China which entered into force on July 1, 2014, was the first of its kind that China concluded with a continental European state. In April 2019, Swiss President Mr. Ueli Maurer and Chinese President Mr. Xi Jingping signed a Memorandum of Understanding (MoU) aimed at increasing co-operation between the countries involved in projects under China's Belt and Road Initiative (BRI), hence generating an even stronger economic tie between the two countries.

Swiss investors who are not yet in China are advised to first familiarize themselves with the unrestricted trade sectors according to the latest Negative List. The new provisions are indeed of particular importance for Swiss investors who wish to acquire shares in Chinese companies in the future.

On the other hand, EJVs established before January 1, 2020 must make a series of important adjustments in their company organization within a relatively short five-year transitional period. The time and costs required to restructure the company, to amend the AoA, to renegotiate the JV contract with all JV parties, to transform the JV contract into a Shareholders' Agreement as well as to register these changes with the MSA should definitely not be underestimated.

The concerned EJVs need to plan the implementation of the required amendments as soon as possible to secure their operations in China in the long term. By following the suggestions, the principles explained in this article and further advice from legal advisors, the necessary transformation of EJVs not only bears challenges and risks but also holds opportunities for foreign investors to protect their investments in China.

The number of companies established in China has increased tremendously in the past couple of years. With the implementation of the new FIL, which is a welcome step forward in China's political agenda to reform and open up to the Western world, the Chinese economy will most likely recover speedily from the pandemic and boost further in the years to come.