SWITZERLAND GLOBAL ENTERPRISE

CHINA'S NEW FOREIGN INVESTMENT LAW

Highlights, challenges and concerns for foreign investors

Daisy Cao, Swiss Business Hub China

On the 15th of March 2019, the National People's Congress of China (NPC) adopted the new Foreign Investment Law (FIL). Effective on the 1st of January 2020, the new law will replace the three primary laws regulating foreign-invested enterprises (FIEs) in China: the law on Sino-Foreign Equity Joint Ventures (EJVs), the law on Wholly Foreign-Owned Enterprises (WFOEs), and the law on Sino-Foreign Cooperative Joint Ventures (CJVs) (collectively the "Three FIE Laws") with a transit period of 5 years.

The new FIL has emphasized equal national treatment of foreign investment, putting foreign investors on equal footing with domestic investors in the Chinese market and giving them equal protections. In fact, the new FIL will govern the activities of all individual foreign investors and FIEs, WFOEs and Sino-foreign joint ventures (JVs) within the territory of the People's Republic of China (PRC).

Foreign investment refers to the investment activity directly or indirectly conducted by a foreign natural person, enterprise or other organization (the "foreign investors"), including the following circumstances:

1. A foreign investor establishes a foreign-funded enterprise within the territory of China, independently or jointly with any other investor.
2. A foreign investor acquires shares, equities, property shares or any other similar rights and interests of an enterprise within the territory of China.
3. A foreign investor makes investments to initiate a new project within the territory of China, independently or jointly with any other investor.
4. A foreign investor makes investments in any other way stipulated by laws, administrative regulations or provisions of the State Council.

BACKGROUND

In response to international criticism from the US and others about China's unsatisfying openness to foreign businesses, the Chinese government would like to demonstrate its commitment to a more open and transparent business environment for foreign investment. The on-going US-China Trade War may have influenced the uncommon fast approval of the new law. The NPC approved the new FIL with only two review rounds.

Secondly, China intends to address a number of common complaints from foreign investors including forced technology transfer, IP expropriation and unfair treatment in order to restore the confidence of foreign investors. Furthermore, the existing "Three FIE Laws" can no longer serve the needs of the Chinese economic development. Taking the above factors into consideration, China is in need of a unified legal system for foreign investment, which is the new FIL.

HIGHLIGHTS

There are six chapters in the new FIL covering several important topics from investment promotion to legal obligations. Below are some key articles of note:

- Article 4: Foreign investors will be treated no less favorably than domestic investors in the investment access stage except in areas specified in China's Market Access Negative List.
- Article 16: Guarantees foreign capital enterprises' right to bid for public procurement projects.
- Article 17: Foreign companies can issue stocks, bonds, or other instruments to finance operations.
- Article 22: Prohibits any administrative agency or its personnel from forcing technological transfer from foreign companies operating in China.
- Article 23: All government agencies must protect commercial secrets of foreign companies.
- Article 26: Establishes complaint mechanisms for foreign investors.
- Article 39: The State will punish government employees who abuse their authority, neglect their duties, abuse their power for personal gain, or leak foreign companies' commercial secrets to others. Where criminality is constituted, the government will seek criminal responsibility in accordance with relevant laws.
- Article 40: Any country or region that implements prohibitive or restrictive measures on the PRC, the PRC can take corresponding measures toward that country or region.

In addition to above listed articles, the highlights of the new FIL can be concluded as below.

- **Establishment of "pre-establishment national treatment and negative list" management system.** "Pre-establishment national treatment" refers to the principle that foreign investors and their investments will be granted treatment no less favorable than that granted to Chinese domestic investors at the initial entrance stage of the investment. The Negative List is a list of industries into which foreign investment is either prohibited or restricted.
- **Foreign investment information reporting system.** The new FIL proposes the establishment of a foreign investment information reporting system for the first time. The foreign investors and FIEs will be required to submit relevant information through the enterprise registration system established by the Ministry of Commerce and the enterprise credit information publicity system established by the State Administration of Market Regulation. The content and scope of foreign investment information report shall be determined based on necessity. Authorities will not be allowed to request any investment information that can be obtained by interdepartmental information sharing.
- **Foreign investment national security review system.** The new FIL establishes a national security review system to determine whether a foreign investment may affect national security. It is explicitly stated that any decision that follows a security review will be final. That is to say, once a decision has been made, it cannot be appealed or reviewed again. Subsequent legislation will clarify the scope, content, procedure, time limit and legal consequences of the review process.
- **Corporate governance to follow PRC Company Law.** The organization form, governing structure and operating rules of FIEs will be subject to the provisions of PRC Company Law, the Partnership Enterprise Law and other applicable laws. For FIEs formed prior to the adoption of the new FIL, they are allowed for a five-year transition period to adjust everything accordingly.

- **Enhanced intellectual property protection.** The new FIL clarifies that technical cooperation shall be based on free will and business rules in the process of foreign investment. Foreign cooperation conditions shall be determined by the principle of fairness upon equal negotiation. The government departments and personnel are not allowed to illegally provide the trade secrets learned in the course of performing duties to any other third party. Forced technology transfer in Joint Ventures is expected to be reduced.

CHALLENGES AND CONCERNS

Despite the friendly signal China releases, the new FIL is very general in nature and many details are yet to be addressed.

- **Modification of corporate governance structures.** As indicated in Highlights above, some of the changes implied by the new FIL may result in modifications to FIEs investment contract and articles of association, especially for Cooperative Joint Ventures (CJVs) and Equity Joint Ventures (EJVs). It's possible that foreign and domestic investors cannot reach consensus on certain clauses within the time limit. In this case, the consequences remain unclear.
- **Definition of foreign investment.** The fourth type of "foreign investment" is a catch-all covering any other type of investment into China. It doesn't touch upon variable interest entities (VIE) structure or special purpose vehicle (SPV). VIEs are usually used by foreign investors to access the restricted areas under the Negative List, while SPVs are usually used by domestic investors to raise funding overseas and round-trip an investment back to China in order to take advantage of tax breaks and other benefits available for foreign investments.
- **Compliant mechanism.** The new FIL says if a foreign investor or FIE thinks the administrative practice of a government department or its staff infringes upon its legitimate rights and interests, the foreign investor or FIE can use compliant mechanism to protect themselves. But the new FIL doesn't make it clear how this complaint mechanism will work, which bureau is in charge or what specific procedures to follow.

Possible loopholes due to vague wording

The vague wording could cause loopholes on operational level. It is still a question how the new FIL will be interpreted and implemented in practice. According to the experience over the past several decades, foreign investors have reasons to suspect that they will remain subject to inconsistent implementation by local governments. That is why many analysts are unsure whether foreign investors will really benefit from the new FIL, despite the assurance from government official.

For Swiss investors who are planning to establish new operations in China, they should pay close attention to relevant legislative updates and seek professional advice before making an investment. For existing Swiss investments in China, the new FIL has little impact on WFOEs. It is because WFOEs are generally limited liability companies basically in line with Company Law. For those in the forms of a CJV or EJV, they have to change the governing structure within the five-year transitional period.

CHINA'S NEW FOREIGN INVESTMENT LAW: ANY QUESTIONS?

Do you have questions concerning China's New Foreign Investment Law? Our Consultant China, Daniel Bont, is happy to assist. At Switzerland Global Enterprise, we offer you initial free country consultations, prepare more detailed market and competition analyses according to your needs, support you in your search for the right business partner, and inform you about legal regulations.

LINKS

- Swiss Business Hub China
- Get insights into the Chinese market here!