FOREIGN INVESTMENT LAW IN CHINA

BEITEN BURKHARDT

After years of deliberation, the PRC National People's Congress issued the PRC Foreign Investment Law ("**FI Law**") on 15 March 2019. Thereafter, the State Council promulgated the Implementing Regulations of the Foreign Investment Law of the PRC ("**Implementing Regulations**") on 26 December 2019. The FI Law and the Implementing Regulations both entered into effect on 1 January 2020 and constitute the comprehensive laws governing foreign investment activities and apply – among others – to all foreign investment enterprises ("**FIEs**") within the territory of the PRC.

With the coming into force of the FI Law and the Implementing Regulations, the PRC Wholly Foreign-Owned Enterprise Law ("**WFOE Law**"), the PRC Sino-Foreign Equity Joint Venture Enterprise Law ("**EJV Law**") and the PRC Sino-Foreign Cooperative Joint Venture Enterprise Law ("**CJV Law**") and their respective implementation rules have been abolished. In case of any discrepancy between the FI Law and the Implementing Regulations and relevant provisions on foreign investment formulated prior to 1 January 2020, the FI Law and the Regulations prevail.

The issuance of the FI Law and the Implementing Regulations corroborates the trend of unifying the legislation for domestic and foreign investments in China.

The FI Law and the Implementing Regulations adjust the corporate legal framework governing FIEs in many aspects, some of which materially impact the operation of the existing FIEs and some of which impact the strategy applied by foreign investors to enter into the PRC market.

For existing FIEs a five-year transition period (counted as of 1 January 2020 and hence lapsing on 31 December 2024) is granted to adjust their corporate governance to the new system of the FI Law.

Since the FI Law and the Implementing Regulations are rather general provisions concerning foreign investment, many aspects of the actual application will be subject to specific administrative regulations and local policies and practices. This publication is hence designed to summarise the key points of the FI Law and the Implementing Regulations. We recommend to closely monitor the issuance of the FI Law related administrative regulations, rules and normative documents and specific local implementing measures and practices.

1. Definition of "Foreign Investment"

Prior to the FI Law, no PRC law actually defined what shall be considered "foreign investment". The FI Law defines "foreign investment" as investment activities carried out (in-)directly by foreign natural persons, foreign enterprises and other foreign organisations in China, including the following investment models:

(1) Foreign investors, independently or jointly with other investors, setting up FIEs in China;

(2) Foreign investors obtaining shares, equity, property shares **or other similar rights and interests** in Chinese domestic enterprises;

(3) Foreign investors, independently or jointly with other investors, investing in new projects in China;

(4) **Investment through other means** stipulated in laws, administrative regulations or provisions of the State Council

The Implementing Regulations define the term "other investors" mentioned above under items (1) and (3), unlike previously under the EJV Law, to also include Chinese natural persons.

Thus far, the WFOE Law, EJV Law and CJV Law mainly focus on foreign investments in the form of direct corporate investments. Additionally, certain other foreign investment schemes were governed by other (non-law-ranking) legislation, such as e. g. the "Provisions on Foreign Investors' Merger with and Acquisition of Domestic Enterprises".

Compared with the existing legislation, the FI Law applies a seemingly much more comprehensive definition of what constitutes "foreign investment". In part, such definition appears to be open to a substantial degree of interpretation as to what does and what does not qualify as "foreign investment".

Terms such as "foreign investors obtain **other similar rights** of Chinese domestic enterprises" or "**investment through other means**" (likely intentionally) lend themselves to wide interpretation. They could e. g. be used to reign in investment forms that are designed to circumvent the many still existing restrictions for foreign investment in China (e. g. in internet, telecoms and other restricted industry sectors). Hence, any such circumventive structures that thus far seemed to fly somewhat under the radar of governmental scrutiny (such as e. g. variable interest entity structures ("**VIEs**") may want to re-assess if the corporate set-up may require modification under the new FI Law in order to minimise compliance risks.

In addition, the Implementing Regulations clarify that investments from the Hong Kong and Macao Special Administrative Regions, investments from Taiwan (to the extent not covered by the "Law on Protecting the Investment of Taiwan Compatriots" and its implementation rules) and investments of Chinese citizens residing overseas shall be governed by reference to the FI Law and the Implementing Regulations, unless otherwise prescribed by laws, administrative regulations and provisions of the State Council.

2. Pre-entry National Treatment Plus Negative List Mode

According to the FI Law, "pre-entry national treatment" means that at market-access level, the conditions offered to foreign investors and their investments in China shall not be less favorable than the conditions granted to Chinese investors.

In addition to such a general provision of the FI Law, the so-called "negative list for market access" ("**Negative List**") applies. Such Negative List refers to the special administrative measures stipulated by the State for foreign investment access to specific areas, the latest version of which was released jointly by the National Development and Reform Commission ("**NDRC**") and the Ministry of Commerce ("**MOFCOM**") on 30 June 2019. The Negative List categorises industries as either "prohibited" or "with investment restrictions". Sectors that are not explicitly mentioned in the negative list are considered "permitted", meaning that they do not have special requirements for investment.

Foreign investors are not allowed to invest in fields prohibited in the Negative List for foreign investment.

Foreign investors intending to invest in the fields of the restricted industries shall satisfy the conditions stipulated in the Negative List, e. g. foreign investment shall not exceed a certain percentage of shareholding ratio.

Compliance with the market access measures is monitored by the competent market supervision and management administrations ("**MSAs**") during the establishment and change registrations process of FIEs. The MSAs do not accept an enterprise registration application if the intended business activities fall under the "prohibited" category or if any specific shareholding requirement for "restricted" foreign investment is not met.

3. Corporate Governance of FIEs

Corporate governance structures of FIEs were previously governed by specific laws such as the WFOE Law and the JV Laws. Where such specific laws lack provisions, the PRC Company Law applies.

With effect as of 1 January 2020, the specific corporate governance rules of the WFOE and JV Laws have been abolished and henceforth only the PRC Company Law (and for partnerships the PRC Partnership Law) shall apply .

While for WFOEs the resultant changes will be in most cases rather limited (because the corporate governance structure under the WFOE Law generally corroborates with the PRC Company Law), the changes for Joint Ventures will be more profound. Under the JV Law an EJV had no formalised Shareholders' Meeting, but this shall now become its highest organ and the thus far highest organ Board of Directors (or Executive Director) shall become a subordinate organ to the Shareholders' Meeting.

Also, the EJV Law required certain decisions to be unanimously consented by all members of the Board of Directors (irrespective of the majority/minority ratio of the shareholders) while under the PRC Company Law (provided the articles of associations of the company do not provide otherwise) a majority of two-thirds of the votes is sufficient to resolve any matter subject to approval by the Shareholders' Meeting.

Another major change concerns the equity transfer transactions of EJVs. According to the EJV Law, where an EJV shareholder intends to transfer any equity interest in the EJV to a third party, all other EJV shareholders must agree. In practice, this often led to substantial disputes and deadlocks. Under the PRC Company Law, a proposed transfer of equity by a shareholder to a third party is subject to consent of more than half of the votes of the other shareholders (unless otherwise stipulated in the articles of associations of such company). Where more than half of the other shareholders object the transfer, such non-consenting shareholders must acquire the to-be-transferred equity interest, failing which they shall be deemed to have consented to the transfer to the third party.

For many EJVs the new FI Law and the Implementing Regulations will trigger re-negotiations of existing agreements. All FIEs existing before 1 January 2020 will have time until 31 December 2024 to implement the necessary changes and adjust their organisational forms, organisational structures, etc.. With effect as of 1 January 2025, the MSAs will reject any applications for other registration matters made by EJVs that failed to adjust their organisational forms, organisational structures, etc. and go through change registration procedures and will further make public relevant circumstances. However, MSAs have so far not issued implementing guidelines for EJVs to proceed with this matter. EJVs are advised to put this matter on agenda and negotiate with their partners how to handle this change.

4. Total Amount Investment / Foreign Debt Threshold of FIEs

The "total amount of investment" is a concept that only applies in such form to FIEs. It refers to the sum of funds for operating the enterprise, i.e. the sum total of registered capital funds and working capital necessary for reaching the operation needs of the FIE.

The registered capital of an FIE refers to the total amount of capital registered with the enterprise registration authorities, i.e. all the capital subscribed by the shareholder(s).

FIEs have been required to observe the following "debt-equity ratio" between total investment and registered capital:

Total Investment (TI)	Minimum Registered Capital
≤ USD 3 million	70% of the TI
USD 3 – 10 million (inclusive)	50% of the TI (if the TI is < USD 4.2 million, at least USD 2.1 million)
USD 10 – 30 million (inclusive)	40% of the TI (if the TI is < USD 12.5 million, at least USD 5 million)
> USD 30 million	33.3% of the TI (if the TI is < USD 36 million, at least USD 12 million)

So far, the total amount of investment set the threshold for foreign debt that can be assumed by an FIE. This means FIEs may take out foreign exchange debt (e. g. foreign exchange loans (including shareholder loans)) up to a maximum amount of the difference between their total amount of investment and the registered capital. In 2017, the People's Bank of China has introduced a so-called "full-coverage macro-prudent management" regime to set the foreign debt threshold of a PRC enterprise whereby FIEs may – according to their own capital and operational status – choose whether to have their foreign/cross border financing regulated by such "full-coverage macro-prudent management" regime or by the aforesaid debt-equity ratio model, even though most FIEs chose the "debt-equity ratio" regime.

With the abolishment of the FIE specific laws, the concept of the "total investment amount" shall lose its legal basis. Although for the time being, FIEs at many localities may still register cross-border financing based on the "debt-equity ratio" regime with the local foreign exchange administration authorities, one may presume that in the near future the "full-coverage macro-prudent management" regime shall become the only applicable regime for cross-

border financing by FIEs.

5. Prohibition of Forced Technology Transfer

Foreign investors have long feared the forced technology transfers often connected to their investment activities in the PRC. In that context, the FI Law stipulates that technical cooperation matters shall be negotiated and determined by the parties concerned based on the principles of voluntariness, equality and fairness. It goes on to say that forced transfers using administrative measures by the administrative organs and their staff members are prohibited. The Implementing Regulations further stress the protection of intellectual property rights of foreign investors and prohibit administrative organs and staff members from overtly or covertly forcing foreign investors and FIEs to transfer technology by virtue of implementing administrative licensing, conducting administrative inspection, meting out administrative punishments, or taking administrative enforcement or other administrative actions. How much impact such clauses will have in practice in the future remains to be seen, but at least these provisions grant a certain leverage to argue against such forced transfers where they would be encountered in the future.

6. Profit Distribution

Under the EJV Law, dividends shall be allotted to the shareholders in proportion to their registered capital ratio. With the abolishment of such law, the general provisions of the PRC Company Law apply also to dividend distribution. According thereto, the shareholders can agree on the profit distribution plan as they deem fit and are not bound by the registered capital ratio if they wish to deviate therefrom.

The FI Law also provides that dividends may be transferred out of China in RMB or foreign exchange in accordance with the law. Hence, the foreign exchange control restrictions will still have to be adhered to.

7. Governmental Reporting and Supervision Systems for FIEs

Prior to October 2016, all FIE projects required at least approval by the MOFCOM (or its subordinate authorities) and registration by the State Administration of Industry and Commerce (the predecessor of the State level MSA) (or its subordinate authorities).

With the first introduction of the Negative List, many FIEs no longer required MOFCOM ap-

proval but only SAIC registration. Still they had to record their FIE projects through the MOFCOM online platforms.

The FI Law now provides that a unified "foreign investment information reporting system" shall be established, taking into account also the existing administrative management regimes for FIEs, e.g. NDRC investment projects approval/recordal, operating license management, anti-monopoly review, etc.. Since 1 January 2020, the information reporting regime officially replaced the previous MOFCOM approval and MOFCOM online recordal regime.

Finally, the FI Law affirms that a security review system shall apply to review foreign investment projects that (may) affect national security.

The detailed implementation for such an information reporting regime including content, scope, frequency and process of the information and security review remains to be interpreted and monitored in practice according to local practices.

8. Outlook

The promulgation of the FI Law and its Implementing Regulations is a significant legal development for FIEs in China. Compared with a much more detailed draft of the FI Law circulated in 2015 (which contained over 170 articles), the finally promulgated version now only contains a mere 42 articles.

This alone exemplifies that the FI Law on its own is a very high-level outline of certain core principles, and even the Implementing Regulations left quite a few questions open for further interpretations and guidelines. Nevertheless, the FI Law and the Implementing Regulations ascertain in many important respects national treatment of foreign investment, which shed a light on various authorities to further implement the regime.

Foreign investors and FIEs are advised to closely monitor how the future interpretations and guidelines will impact their investments in China.

Susanne Rademacher
German Attorney-at-law | Partner
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Beijing

Dr. iur. Jenna Wang-Metzner
Legal Consultant | Partner
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Beijing

Simon Henke
German Attorney-at-law | LL.M.
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Beijing

Corinna Li
Legal Consultant | LL.B. | LL.M.
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Beijing

Kata Liu
Legal Consultant | LL.B. | LL.M.
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Beijing

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