

China Promulgates New Foreign Investment Law

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On March 15, 2019, China's top legislature, the National People's Congress, passed the long-anticipated new Foreign Investment Law (the "FIL"). Promulgation of this legislation is widely held to have been accelerated in response to changes in China's economic conditions, in particular cross-border trade tensions and increasing pressure on China's domestic economy in recent years.

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The FIL, which will become effective on January 1, 2020, will replace the primary laws that have been governing foreign-invested enterprises ("FIEs") in China for the last four decades: the Sino-foreign Equity Joint Venture Law, the Sino-foreign Cooperative Joint Venture Law and the Foreign Enterprise Law (the "FIE Laws"). However, unlike the FIE Laws, which provided in detail the requirements on establishment, governance and operation of FIEs, the FIL contains only 42 provisions stipulating overall guidance on regulation and protection of foreign investment in China (which covers foreign investments as well as those from Hong Kong, Macau and Taiwan).

Negative list approach. The FIL confirms that foreign investment in China will be regulated under the negative list approach, which has been applied nationwide since late 2016, after having been tested in pilot free-trade zones. Under the previous regime, prior approval from regulators was required for the establishment and subsequent changes of any FIEs. Under the FIL, establishing FIEs in sectors not on the negative list for foreign investment will only require record-filing with the relevant governmental authorities.

The latest negative list, which was issued by the Ministry of Commerce and National Development and Reform Commission in June 2018, includes 48 industries in which foreign investment is either restricted or prohibited. Investments in restricted industries (such as life insurance, securities and nuclear power) are typically subject to foreign ownership restrictions, while prohibited industries (such as operations of news agencies and radio/television networks) are off-limits for foreign investment.

Subject to the negative list restrictions, the FIL provides for a "national treatment system" whereby foreign investors and domestic investors in China will be treated equally in terms of market entry. The FIL also provides that any existing or future

regulations governing foreign investment in banking, securities, insurance and other financial industries remain and will be valid, which implies that China is still cautious about further opening up in these industries and any such opening-up will take place under different legislation. In that regard, Chinese Premier Li Keqiang has stated on March 15 that additional supplemental rules will be issued to implement the FIL.

Unified corporate governance requirements. Historically, FIEs have been subject to a mixed set of corporate governance requirements under the FIE Laws and the laws primarily applicable to domestic companies, including the PRC Company Law. These sets of laws differ from each other in many respects. For example, under the Sino-foreign Equity Joint Venture Law, the board of directors is a company's highest governing authority, while the PRC Company Law provides that shareholders' meeting is the highest governing authority of a company. These differences or conflicts often caused confusion for investors and even regulatory authorities, both in terms of interpreting and implementing legislation.

With the promulgation of the FIL, a unified set of corporate governance requirements will apply to all companies in China, whether foreign-invested or domestic. This eventually will require many existing FIEs to reorganize, which may lead to difficult negotiations with joint venture and other partners. The FIL provides existing FIEs with a five-year grace period to reorganize their current corporate structure.

Protection of Intellectual Property Rights. In response to concerns voiced by some foreign investors and governments about protection of intellectual property rights in China, the FIL specifically provides that the Chinese government will protect the intellectual property of foreign investors and legitimate interests of intellectual property owners. The FIL also provides that the terms of technology cooperation shall be negotiated and determined by the investors under the principle of fairness, and the administrative authorities and government officials may not force technology transfer by administrative means. It remains to be seen how the Chinese government will strengthen enforcement actions in practice to protect intellectual property rights, which we believe is more important than the general guidance under the FIL.

VIE structure. The variable interest entity ("VIE") structure commonly refers to an investment structure in China that relies on contractual arrangements to enable foreign investors to control—but not directly own—operating companies in China. VIE structures are used by both foreign investors in certain inbound investment transactions and Chinese companies seeking overseas financing or listing. The structure, which has been widely used in transactions across a range of industries, has never been officially endorsed by the Chinese government.

The original draft FIL, published in early 2015, expanded the scope of regulated foreign investment activities to cover contractual control arrangements. The draft caused some observers to speculate that the law would result in the end of the VIE structure in China. However, the final FIL does not include such a contractual control concept from the 2015 draft, and so the government's view of VIE structures remains unclear.

Outlook. The FIL marks a milestone in China's reform of its foreign investment regime. It is expected that the national treatment plus negative list approach will further facilitate foreign investment, as well as foreign investor access, to China. Although it remains to be seen how the FIL will be implemented in practice, the general trend over the past few years suggests that China is continuing its efforts to ease foreign investment restrictions. With the recent messaging around full liberalization of the life insurance industry by 2021, for example, we expect further updates to the negative list over the course of this year.

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We will continue to monitor developments in this area. If you have any questions about the FIL or foreign investment regulations in China generally, please do not hesitate to reach out to your regular Debevoise contacts.

Debevoise & Plimpton LLP, as all other foreign firms in China, is not admitted to practice PRC law. This update is based on our review of the relevant laws and on our general experience dealing with similar matters. We would be pleased to arrange for assistance from licensed Chinese counsel should you require a formal opinion on any of the matters referred to herein.

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