

# China Adopts New Foreign Investment Law

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On March 15, 2019, China's National People's Congress voted to adopt a new *Foreign Investment Law* (the "FIL"). The FIL will come into effect on January 1, 2020 and may significantly change China's framework for regulating foreign investment. Foreign invested entities ("FIEs") established prior to the FIL's effective date will have five years to amend their constitutive documents to comply with the new law.

The FIL's principal stated aims are to further open China's economy, to attract foreign investment, and to better protect the rights and interests of foreign investors. To these ends, the FIL makes several broad commitments to treat foreign investment consistently with investment by domestic parties—other than with respect to permitting investment in certain "negative list" industries. Whether the FIL will succeed in its stated goals will depend on implementing regulations and how the law is applied in practice.

This alert highlights and analyzes the FIL's material provisions.

## Key Changes Introduced

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### 1. Replacement of Framework for Organizational Documents (Article 31)

- The FIL eliminates three existing foreign investment laws: the *Law on Sino-Foreign Equity Joint Ventures* (the "EJV Law"), the *Law on Sino-Foreign Contractual Joint Ventures* (the "CJV Law"), and the *Law on Wholly Foreign Owned Enterprises*. It provides that the organizational structure and operating rules of FIEs must, like those of domestic invested enterprises, comply with China's *Company Law* or *Partnership Enterprise Law* and other relevant statutes. This will have the greatest impact on Sino-foreign joint ventures (equity joint ventures and cooperative joint ventures), as the EJV Law and the CJV Law vest principal decision making authority in a joint venture's board of directors, whereas the Company Law vests principal decision making authority in a company's shareholders, via the shareholders' meeting. The impact on wholly foreign owned enterprises ("WFOEs") will likely be limited, as WFOEs have been required to comply with the Company Law since 2006.

### 2. Commitment to Treat Foreign Parties Investing in Non-"Negative List" Industries at least as well as Domestic Investors (Articles 4 and 28)

- The FIL provides that foreign investment be considered relative to a "negative list" of industries, published or approved by the State Council, which specifies the sectors into which foreign investment is prohibited or restricted. This does not represent a change in policy, as China published a nationwide negative list on foreign investment in 2017 and revised that list in 2018. It has been reported that a further revised list

will be issued in June 2019 and will be more permissive than the current list. Outside of the negative list industries, the FIL commits that China will treat foreign investors and their investments no less favorably than domestic investors at “the stage of investment access.” The commitment to such “pre-establishment national treatment” differs from the commitment in the second draft of the FIL that was submitted to the Standing Committee of the National People’s Congress to review on January 29, 2019, which called for treating foreign investment no less favorably than domestic investment “during the establishment, acquisition, expansion, and other stages of an enterprise.”

### **3. Other Commitments to Non-Disparate Treatment (Articles 9, 15, 16, 30)**

- The FIL contains other commitments to treat FIEs no less favorably than domestic invested enterprises. Article 9 provides that “policies in support of enterprise development” must apply equally to FIEs. Article 15 provides FIEs may “participate equally” in standards setting and provides that compulsory standards shall apply equally to FIEs. Article 16 provides that FIEs may participate in government procurement activities and that products produced in China and services provided in China by FIEs shall be treated equally in government procurement. These articles do not specify what the treatment of FIEs should be equal to, but we assume it is the treatment of domestic invested enterprises, given the overarching goals of the FIL.
- Article 30 provides that in sectors requiring special licenses, unless otherwise provided by laws or regulations, license applications by FIEs are to be considered under the same “conditions and procedures” as apply to domestic investment.

### **4. Commitments Not to Impair FIEs Without Legal Authorization (Articles 20, 24, and 25)**

- Article 20 provides that the Chinese government may expropriate the investments of foreign investors only “in special circumstances” for public purposes, and that foreign investors will receive fair compensation therefor, in each case, in accordance with law. Article 24 provides that, in the absence of laws or regulations permitting such treatment, government authorities at all levels must not impair FIEs’ “legitimate rights and interests,” increase their obligations, set market access and exit conditions, or intervene in their normal production and operation activities. Similarly, Article 25 requires local governments to keep all policy commitments and to perform all contracts made to or with foreign investors and FIEs, and to compensate such foreign investors for their losses if such policies or contracts must be changed, in each case, in accordance with China’s laws. As with the non-discrimination provisions, these Articles provide that the rights and interests of FIEs will be protected, and that foreign investors will be compensated when they are not, only to the extent provided in China’s laws.

### **5. Support for Flexibility in Cross-Border Payments (Article 21)**

- Article 21 provides that foreign investors may “freely” remit capital contributions, gains, intellectual property (“IP”) royalties, and other compensation and income, into and out of China, in accordance with China’s laws. Given that there are hundreds of foreign exchange and cross-border RMB regulations, which China has strictly enforced for decades, we read this brief statement narrowly, as a restatement of current law, rather than as a commitment to materially relax China’s foreign exchange controls. We expect China’s foreign exchange regulations will continue to be driven by its monetary policy, rather than the FIL.

### **6. Support for Freedom of Contract in Technology Cooperation; Commitments to IP Protection (Articles 22 and 23)**

- Article 22 encourages technology cooperation based on “voluntariness” and provides that the terms of technology cooperation in foreign investment (likely including IP licenses into China) are to be determined based on the “principle of fairness” by the parties’ “equal negotiation.” Article 22 declares that China protects the IP rights of foreign investors and FIEs; it then instructs administrative bodies and their personnel not to “force” technology transfers by administrative means. Article 23 likewise instructs administrative bodies and their personnel to keep confidential, in accordance with law, and not divulge or illegally provide to others, trade secrets of foreign investors or FIEs that they obtain in their official duties.

#### **7. Complaint Mechanism for FIEs (Article 26)**

- Article 26 establishes an FIE “complaint mechanism” by which FIEs and foreign investors may seek “coordination and resolution” if they believe their rights or interests (apparently whether under the FIL or otherwise) have been infringed by administrative bodies or their personnel. Article 26 notes that, notwithstanding the establishment of the complaint mechanism, FIEs or foreign investors may still apply for administrative reconsideration or pursue litigation (if permitted by other laws) in respect of such alleged infringement. The FIL does not provide which government agency or agencies will be in charge of handling the complaints, and it is also silent on the procedure and consequences of the complaint mechanism. Implementation regulations are needed before foreign investors may figure out whether the complaint mechanism will be helpful to them.

#### **8. Information reporting system (Article 34)**

- Article 34 breaks new ground by establishing a “foreign investment information reporting system.” This will comprise, at a minimum, an enterprise registration system and an enterprise credit information system, for which foreign investors or FIEs will be required to submit information via competent commerce authorities. Details regarding the information reporting system, presumably including the scope of information and frequency of submissions required, will be set forth in future regulations.

#### **9. Security review system (Article 35)**

- Article 35 likewise establishes a foreign investment security review system to conduct security reviews of foreign investments that affect or may affect China’s national security. The FIL does not contain any further detail regarding such system—unlike the 2015 draft of the FIL (the “2015 Draft FIL”)—other than that national security review determinations will be final. Additional details will be set forth in future laws and regulations.

#### **10. Exclusion of Financial Industry Rules (Article 41)**

- Article 41 provides that China’s rules regarding foreign investment in the financial sector (including banking, securities, and insurance) or in China’s securities, foreign exchange, and other financial markets should still be followed, presumably even where such rules otherwise conflict with the FIL.

## **Commentary**

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The FIL raises the following issues.

**Expressive purpose of the FIL.** Given the FIL’s broad wording, and the repeated qualification that many of its commitments are to be performed “in accordance with laws,” it is too early to assess what impact the FIL will have on foreign investment in China. Much

will depend upon the implementing laws and regulations and how the FIL and such laws and regulations are applied. For now, the FIL thus largely serves an expressive purpose: to allow China to assert, in the context of its trade negotiations with the United States, that it is committed to treating foreign investment no less favorably than domestic investment (at least outside of permitting investment in negative list industries).

**Distinction between FIEs and domestic invested companies likely to remain.** An alternate approach to the non-discrimination goals promised by the FIL would have been to broaden China's general corporate and partnership laws to cover FIEs, and to handle the negative list and the information reporting and national security requirements through separate measures. Such is the structure of most Western legal regimes. The FIL, in contrast, suggests that FIEs will continue to be distinguished from non-FIEs under Chinese law. This may result in more disparate treatment—by regulators, banks, or counterparties—than if they were formally indistinguishable from domestic invested enterprises.

**No material impact of pre-establishment commitment.** Prior to the FIL, China had already implemented several reforms limiting the discretion of officials over the “investment access” stage of foreign investment. Starting from October 2016, China ceased to require that foreign investments outside of restricted or prohibited industries be approved by the commerce authority, providing instead that such investments be “registered” with the commerce authority and administration for industry and commerce (now the administration of market regulation). And in recent years China “upgraded” its traditional foreign investment “catalogue” to a negative list, which lists only those sectors in which foreign investment is restricted or prohibited. In our experience, establishing an FIE in a non-restricted, non-prohibited sector has become relatively routine. Therefore, the FIL's commitment regarding investments outside of the negative list at the stage of “investment access” does not appear to materially change the current treatment of foreign investment at such stage.

**Amendment to existing entities.** Existing Sino-foreign joint ventures will need to amend their constitutive documents to comply with the Company Law. Existing partners will need to agree on such amendments, potentially creating an opportunity for parties to re-trade on old bargains.

**Status of variable-interest entity (VIE) structures unresolved.** “VIE structures”—contractual arrangements widely-used to channel foreign funds into restricted or prohibited sectors—have not been formally endorsed by Chinese regulations. The 2015 Draft FIL would have defined foreign investment to include the acquisition of control of a domestic invested enterprise by contract, thereby subjecting VIE structures to the rules applicable to typical foreign investments. The FIL, however, does not explicitly include the acquisition of contractual control among the enumerated forms of “foreign investment. But it does define “foreign investment” to include any other form of investment as may be specified by administrative regulations or China's State Council, thus leaving the door open for future regulations that may address VIE structures.

**Cross-border payments to remain subject to China's foreign exchange policy imperatives.** In late 2016 and early 2017, as China's State Administration for Foreign Exchange (“SAFE”) tightened foreign exchange controls, many foreign exchange transactions, e.g., for distributions on equity or royalty payments, experienced substantial delays. The commitment in Article 21 of the FIL to allow FIEs to “freely” remit capital and payments out of China would seem to prohibit such delays in the future. But so long as SAFE acts pursuant to legal authorities—and thus “according to law”—when imposing foreign exchange controls in the future, its actions may be seen as consistent with Article 21.

**Greater freedom of contract for technology licenses, though owing to changes outside of the FIL.** With its broad references to the “principle of fairness” or “equal negotiation,” Article 22 itself provides little clarity as to how free foreign licensors and Chinese licensees will be to negotiate the terms of their technology collaborations. But other recent regulatory changes do suggest that China is increasingly willing to allow parties to negotiate cross-border IP licenses on their own terms. On March 2, 2019, the *Decisions of the State Council to Amend Certain Administrative Regulations* eliminated certain provisions regarding cross-border IP licenses in the *Regulations of the Administration of Import and Export of Technologies* that had long been criticized as overly-burdensome. The eliminated provisions had required, among other things, (i) that foreign licensors be liable for infringement of third-party IP resulting from the licensee’s use of the licensed IP, (ii) that improvements to the licensed IP be owned by the party responsible for the improvements, and (iii) that various pro-licensor covenants be excluded from the licenses. Such requirements have often not been followed in practice, and there has been little publicized enforcement in this area to guide contracting parties. Nonetheless, the existence of these requirements has made it somewhat risky for contracting parties who chose not to strictly follow the requirements in their cross-border license agreements. The elimination of these provisions is thus a welcome development and suggests that China may intend to make real changes in furtherance of the commitments in the FIL.

**No change (yet) to treatment of in-kind capital contributions.** Under the EJV Law, ownership stakes of partners forming a joint venture must be proportional to the value of their respective capital contributions, and the value of in-kind capital contributions is usually considered by the government based upon an asset appraisal report issued by an appraisal firm. It is generally more difficult for such firms to assess the value of IP rights contributed to an entity via a cross-border IP license with standard termination rights, and, on such basis, the government may refuse to allow the registration. This leaves the parties to seek alternative, often costly, ways to achieve their mutually-desired contractual arrangements. The situation may partially change with the passing of the FIL, because the Company Law gives shareholders of limited liability companies the ability to allocate profits not in proportion to their shareholdings.

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We will continue to monitor these developments closely, and we are well-positioned to assist clients in understanding how these developments may affect their potential transactions.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our China Inbound Foreign Investment practice:

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