Bloomberg Tax

Tax Management Memorandum™

Dawning of a New Era for China's Foreign Investment Law

By Patrick Yip and Lily Ji[*]

The *Foreign Investment Law of the People's Republic of China* ("New FIL"), enacted during the Second Session of the 13th National People's Congress on March 15, 2019, will become effective on January 1, 2020. The New FIL will replace several existing laws (i.e., *Law on Sino-foreign Equity Joint Ventures*, *Law on Wholly Foreign-owned Enterprises*, and *Law on Sino-foreign Cooperative Joint Ventures* (collectively "Old FIE Laws")) and will become China's basic law for regulating foreign investment.

The New FIL introduces sweeping and comprehensive changes to the procedures and rules governing foreign investment. The law contains measures that should make it easier for foreign investors to enter the Chinese market by easing and removing restrictions on investment and granting protections (such as national treatment and putting foreign investors on an equal footing with domestic enterprises), enhancing the protection of intellectual property (IP) and establishing a "complaint mechanism" that can be invoked by foreign investors where they consider that they have been aggrieved by the actions of Chinese administrative bodies.

I. Background and Legislative Process

"Openness brings progress and closure is bound to lag behind"[1] aptly sums up China's strategic perspective based on years of experimentation with economic reform and the opening of its economy. Despite recent economic and geopolitical challenges from abroad, China will not slow down but will accelerate its open-door policy to foreign investment, building on the momentum it has enjoyed from its past efforts. From about 40 years ago when China first experimented with a free-market economy until the end of 2018, close to one million foreign-invested enterprises[2] ("FIEs") have been set up in the country, and the total foreign capital invested in China's economy has exceeded USD 2 trillion.[3] The World Bank's *Doing Business 2019* report shows that China, in the "ease of doing business" ranking, has risen 32 places from 2018, ranking 46th in the world.[4] Undeniably, FIEs have become a mainstay of China's economy and China also recognizes the importance of enhancing its business environment to be more open and friendly to foreign investment.

Against the backdrop of the ongoing China-US trade disputes and the ascendance of protectionism and populism in many western countries, China has been right to revamp its foreign investment laws to better adapt to a new age of globalization, cross-border business models and inter-country competition. An added benefit for creating the New FIL is that hitherto unresolved issues that had been a bane to foreign investors under the Old FIE Laws now may be rectified or clarified.

As early as 2011, China's authorities initiated the drafting process for a new foreign investment law. On January 19, 2015, the Ministry of Commerce issued a

[*] Patrick Yip, M.B.A. (Hons) University of Chicago, MA/BA (Hons) University of Cambridge, MPA/BBA (Hons) University of Texas at Austin, is Vice Chair and International Tax Partner of Deloitte China. Lily Ji, LL.M. University of Columbia, LL.M. in taxation London School of Economics, LLB Peking University, is a counsel of Shanghai Qin Li (Beijing) Law Firm. © 2019. For information, contact Deloitte China.

[1] Excerpted from the opening speech entitled, *"Opening Together, Creating Innovation and Leading the Future"* delivered by China's Chairman Xi Jinping at the opening ceremony of the 2018 Annual Meeting of the Boao Forum for Asia on April 11, 2018.

[2] See "II. Highlights of the Foreign Investment Law, 1. Redefining FIEs" regarding the definition of an FIE.

[3] http://www.mofcom.gov.cn/article/tongjiziliao/.

[4] World Bank Group, *Doing Business 2019*, p5.

draft Foreign Investment Law (''2015 Draft'') for public comments, but that draft did not proceed to the next stage of the legislative process. On December 26, 2018, the Standing Committee of the National People's Congress issued another draft (''1st Review Draft'') for public consultation. On January 28 and 29, 2019, the Standing Committee of the 13th National People's Congress held an extra session to review a Second Review Draft. Then, on March 8, 2019, the Third Review Draft was submitted to the Second Session of the National People's Congress for deliberation and was officially adopted on March 15.

Compared with the 2015 Draft, the New FIL (the Third Review Draft, as adopted) is considerably shorter and sets out primarily foundational rules and principles, as opposed to the more detailed rules in the Third Review Draft. At a high level, the New FIL can be described as aiming at (i) accelerating and broadening the opening of China's economy to foreign investment; (ii) reducing market entry barriers for foreign investors; and (iii) providing a level playing field for both domestic and foreign investors.

II. Highlights of the New FIL

The New FIL contains the following changes that foreign investors likely will find relevant and important:

1. Scope of Coverage Expanded

Under the Old FIE Laws, FIEs generally are grouped into three categories that are governed under the different laws as follows:

1) ''Wholly foreign owned-enterprises'' (''WFOEs''): Enterprises established in China with their capital wholly from foreign investors. Foreign investors include foreign enterprises, organizations, and individuals.[5]

2) ''Sino-foreign equity joint ventures'': Enterprises established in China between foreign companies, enterprises, other organizations, and individuals and Chinese companies, enterprises, or other organizations based on the principle of equality and mutual benefit.[6]

3) ''Sino-foreign cooperative joint ventures'': Cooperative enterprises established in China between foreign enterprises, other organizations, and individuals and Chinese enterprises or other organizations based on the principle of equality and mutual benefit.[7]

The Old FIE Laws regulate the establishment of FIEs (i.e., enterprises that are formed with foreign capital as described above under the three categories), but not merger and acquisition (''M&A'') activities undertaken by foreign investors or FIEs in China.

M&A activities of foreign investors or FIEs currently fall within the scope of various regulations issued by the departments of the State Council, such as the *Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors* (''Circular 10'') issued by the Ministry of Commerce (''MOFCOM''). Circular 10 provides that the acquisition of a Chinese company by a foreign investor will turn the domestic company into an FIE, which will become subject to the foreign investment administration under the relevant Old FIE Laws as described above.[8]

The New FIL, however, will cover FIE investments, M&A activities of foreign investors, as well as non-FIE foreign investments (i.e., investments made by foreign investors without setting up an FIE). Article 2 of the New FIL provides that foreign investment includes direct and indirect foreign investment in the following scenarios:

1) A foreign investor establishes an enterprise in China, either alone or with another investor;

2) A foreign investor acquires equity, shares, property shares, or similar rights and interests of an enterprise within China;

3) A foreign investor invests in a new project in China, either alone or with another investor; and

4) A foreign investor invests in any other way stipulated under laws, administrative regulations, or provisions of the State Council.

As is the case under the Old FIE Laws, ''foreign investors'' in the New FIL refers to foreign individuals, enterprises, and organizations. The definition of an FIE under the New FIL, however, has been simplified and generalized as an ''enterprise formed in China under Chinese law, with all or part of its investment coming from a foreign investor.'' In other words, FIEs no longer will be regulated differently depending on the form of the FIE or the ratio of the foreign investment (i.e., whether wholly or partly invested by foreign investors).

---

[5] Articles 1 and 2 of the *Law of the People's Republic of China on Wholly Foreign-owned Enterprises*.

[6] Article 1 of the *Law of the People's Republic of China on Sino-foreign Equity Joint Ventures*.

[7] Article 1 of the *Law of the People's Republic of China on Sino-foreign Cooperative Joint Ventures*.

[8] It should be noted that regulations governing M&A activities of foreign investors are of a lower legal authority than laws passed by the National People's Congress and its standing committee and administrative regulations issued by the State Council.

ISSN 0148-8295

The term ''foreign investment'' covers green field investment, as well as acquisitions by foreign investors of domestic enterprises, which currently mainly is regulated by Circular 10. Circular 10 is known for its provisions regarding related party M&A transactions. According to Circular 10, the acquisition by an offshore company legally established or controlled by a domestic company or an individual of a related domestic target company must be approved by the MOFCOM. The approval requirement may not be circumvented by way of an FIE re-investment or other means; for example, MOFCOM approval is required if a related ''foreign'' party acquires a domestic company. This provision has presented a major obstacle for many China-based companies seeking to establish ''red-chip'' structures (i.e., using an offshore structure to own a Chinese operating company) for purposes of an offshore public listing. However, the approval requirement may no longer be applicable if the New NIL makes the application of Circular 10 obsolete (given that M&A activities of foreign investors are included within the scope of the New NIL), unless the foreign investment falls under the negative list (see Section 2 below).

In addition, under the New FIL, foreign investment includes both direct and indirect investment, whereas the Old FIE Laws only mention foreign direct investment. Generally, ''indirect investment'' refers to investment in the stocks and securities traded on the host country's stock markets, investment funds, or other securities. If this interpretation is correct, indirect investment would have been covered under scenario (2) above. However, the precise scope of indirect investment is not clear, e.g., whether reinvestment by FIEs in China, ''de facto'' foreign ownership in domestic companies effected via contractual control, trust, etc. is covered.

As mentioned above, non-FIE foreign investment can be made in China without having to set up a legal entity in China, e.g., Sino-foreign cooperation for the exploitation of natural resources is permitted under the Old FIE Laws. However, the New FIL, which should continue to allow this form of non-FIE foreign investment, is silent about how such investment will be regulated or managed or whether the relevant Old FIE Law provisions will be grafted into the New FIL regime for these purposes. Further guidance is expected to clarify this area.

Curiously, the New FIL does not define the term ''Chinese investor.'' This is an important question because under the Old FIE Laws, Chinese individuals are precluded from establishing FIEs with foreign investors (see the definition of FIEs in Section II. 1. above). Interestingly though, a Chinese individual is not prohibited from becoming a shareholder of an FIE because of an M&A transaction. Although the New FIL does not explicitly provide for a definition of a Chinese investor, it introduces the term ''any other investor,'' which seems to denote an expansive meaning. On this basis, unless otherwise provided in future guidance, it is reasonable to assume that Chinese individuals will be able to directly establish FIEs with foreign investors.

2. Pre-establishment National Treatment and the Negative List

The New FIL stipulates that the state will adopt a ''pre-establishment national treatment'' system and a negative list for foreign investment.[9]

Pre-establishment national treatment means that, at the stage of ''investment access'' (i.e., the investigative and planning process leading to an actual investment, including the date the FIE is established), the treatment of ''potential'' foreign investors and their ''potential'' investments will be no less favourable than that granted to domestic investors and their investments. For example, if a domestic investor would not have to obtain approval to set up a domestic company to conduct business in a certain industry, a similarly situated foreign investor should not need approval to set up an FIE to conduct a similar business (provided it is not on the negative list). National treatment usually is used by a sovereign state as a tool to attract foreign investment only after the investment has been approved. However, China has moved this treatment forward to cover the pre-establishment phase, granting expanded national treatment to foreign investors.

The negative list sets out the industries in which foreign investors are prohibited from investing or in which the extent or form of the foreign investment will be restricted. Such restrictions include a limit on the percentage of a foreign shareholding or the form of the FIE (e.g., limited to a Sino-foreign equity or cooperative joint venture). For industries not on the negative list, the government will grant the foreign investment national treatment, i.e., it will be treated in the same way as a domestic enterprise.

The significance of the pre-establishment national treatment, in combination with the negative list, is that pre-investment government approval no longer will be required for a non-negative list foreign investment because a similarly situated domestic enterprise would not be required to obtain such approval. This

[9] Article 4: ''The State adopts the system of pre-establishment national treatment and a negative list for foreign investment. The negative list will be released by or upon approval by the State Council. If more preferential treatment is provided to foreign investors under international treaties or agreements governing foreign investments that the People's Republic of China concludes or accedes, such provisions may apply.''

ISSN 0148-8295

simplified process should be welcome news to foreign investors.

To appreciate why this change is so important, a brief history is warranted. Before 2016 and under the Old FIE Laws, in most cases,[10] the establishment, alteration, and termination of an FIE had to be approved by MOFCOM or the commission of commerce (''COFCOM'') at the provincial or sub-provincial level, regardless of the industry for which the foreign investment was destined.[11] At that time, foreign investments in FIEs were classified as ''encouraged,'' ''prohibited,'' and ''restricted'' under the *Foreign Investment Industrial Guidance Catalogue* (''Catalogue''), which was revised seven times during the period 1995 to 2017.[12] An investment activity or sector not covered by the Catalogue was regarded as ''permitted'' (i.e., not ''encouraged'' but not ''prohibited or restricted'').

In 2013, a negative list system was piloted in the Shanghai Free Trade Zone, which was subsequently expanded to apply in pilot free trade zones in Guangdong, Fujian, and Tianjin. In 2016, the Old FIE Laws were amended such that the negative list system became official and effective throughout the country.[13] The 2017 version of the Catalogue included only two sections, ''encouraged sectors'' and a ''negative list'' covering restricted and prohibited sectors for foreign investments. In 2018, the *Special Administrative Measures (Negative List) for Foreign Investment Access* was issued by the Ministry of Commerce and the National Development and Reform Commission, replacing the negative list section in the 2017 Catalogue. From 2013 to 2018, the entries on the negative list were reduced from 190 to 48, clearly evidencing the government's commitment to further opening up the economy to foreign investment.[14] Further contractions of the negative list are expected. Under the current system, the establishment of FIEs in industries not on the negative list are only subject to a filing requirement, i.e., the foreign investors or FIEs concerned only have to submit the necessary information online with the competent authorities, and approval is not required.

The negative list system represents a major change in China's approach to inbound foreign investment. Prior to the negative list system, the government's byword for approving foreign investments was ''caution,'' and thus the more difficult and lengthy approval procedure. The negative list system, on the other hand, demonstrates openness to foreign investment that is reflective, in large measure, to China's rising confidence in the sustainability and competitiveness of its domestic enterprises and its strong desire to increase investment and business interactions with the international community.

3. Foreign Investment Administrative System

(1) Foreign Investment Information Reporting System

To help implement the negative list system, the MOFCOM issued *Provisional Measures on the Administration of Filing for Establishment and Change of Foreign Investment Enterprises* in October 2016 (''Provisional Filing Measures''), setting out the filing requirements for foreign investment in industries not included on the negative list. The Provisional Filing Measures have been revised three times, most recently in 2018. According to these rules,[15] foreign investors (for setting up an FIE) or existing FIEs (for changing registration) are required to submit the necessary information electronically via the ''enterprise filing system,'' with the competent COFCOM. In addition, since 2015, FIEs have been required to submit annual operating information via the Foreign Investment Enterprise Annual Investment Operation Information Joint Report system (''Joint Report System''),[16] which is separate from the enterprise filing system, but also maintained by the MOFCOM. According to relevant regulations, the information collected is shared with China's commerce, financial, tax, and foreign exchange authorities for statistical and administrative purposes. However, in addition to filing via the Joint Report System, FIEs are required to make other filings, e.g., an annual filing via the National Enterprise Credit Information Publicity System, annual tax filings, etc. Some of the information requests may be considered superfluous or duplicative, and the government departments have not been fully organized or coordinated with respect to information sharing.

---

[10] The major exception is perhaps the establishment of the foreign-invested partnership, for which no government preapproval would be needed. See *Administrative Measures on the Establishment of Partnership Enterprises in China by Foreign Enterprises or Individuals* issued by the State Council on November 25, 2009 and effective as from March 1, 2010.

[11] The local COFCOM generally can approve encouraged and permitted FIEs that make a total investment of less than USD 300 million and restricted FIEs that make a total investment of less than USD 50 million.

[12] The latest version is the *Catalogue of Industries for Guiding Foreign Investment (Revised in 2017)*.

[13] *Decision of the Standing Committee of the National People's Congress on Revision of Four Laws Including the Law of the People's Republic of China on Wholly Foreign-owned Enterprises*.

[14] See *The Special Administrative Measures for Access of Foreign Investment to China (Shanghai) Pilot Free Trade Zone (Negative List) (2013)* and *Special Administrative Measures (Negative List) for Foreign Investment Access (2018 edition)*.

[15] http://wzzxbs.mofcom.gov.cn/WebProBA/app/entp/approve.

[16] http://lhnbgs.mofcom.gov.cn/.

ISSN 0148-8295

Article 34 of the New FIL[17] provides that the government will establish a foreign investment information reporting system through which foreign investors and FIEs will submit investment information to the competent commerce authorities. Only information considered ''necessary'' will be required and the various government departments should not require duplicative information and should share the information submitted among themselves.

The New FIL clearly states that foreign investment in industries not on the negative list will be treated in the same way as domestic enterprises. Thus, after the New FIL becomes effective, it should not be necessary for such foreign investors or FIEs to fulfill the current filing requirements for establishment or alteration because these requirements are not imposed on similarly situated domestic enterprises. Consequently, the Provisional Filing Regulation is expected to be amended to eliminate the filing requirement that otherwise would be applicable to foreign investment in industries not included on the negative list. In addition, as the New FIL emphasizes the information requirement on an ''as-needed'' basis and coordinated information sharing among government departments, the current Joint Report System may need to be amended to streamline the annual filing requirement. However, the scope and the content of the information reporting would need further clarification.

(2) Security Review System

The New FIL also introduces a ''security review system'' for foreign investment, and Article 35 states that a security review will be conducted for any foreign investment that affects or that is likely to affect state security.

Article 59 of the State Security Law stipulates: ''The State shall establish a [security] review mechanism for State security and carry out a State security review of foreign investment. . .that affects or may affect State security. . .in order to effectively prevent and resolve State security risks.'' This provision forms the legal basis for the security review system under the New FIL.

The General Office of the State Council has issued two regulations for the implementation of a national security review of foreign investment: the *Notice of the General Office of the State Council on the Establishment of a Security Review System Pertaining to Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* and the *Notice of the General Office of the State Council on the Promulgation of Trial Measures on a National Security Review of Foreign Investment in Pilot Free Trade Zones*. The former notice is applicable nationwide, but it applies only to M&A involving foreign investors, whereas the latter notice is applicable to all foreign investment, including the establishment of new entities, investment in green field projects, M&A, as well as investments via contractual control, trusts, re-investment, subscription for convertible bonds, etc., but its territorial scope is limited to the pilot free trade zones in Shanghai, Fujian, Guangdong, and Tianjin.

Moreover, in today's digital age and international technology race, it is expected that the security review system would make the protection of IP rights and their transfers a focal point. As demonstrated by the *Notice of the General Office of the State Council on the Promulgation of Measures on Work Relating to the Transfer of Intellectual Property to Overseas Parties (Trial Implementation)*, for purposes of the security review decision, advice and information must be obtained from the relevant government departments on the transfer of IP in the context of M&A transactions involving domestic enterprises and foreign investors.

(3) Legal Form

FIEs and domestic enterprises currently are regulated under different legal regimes which, depending on the circumstances, provide for the prescribed legal form (and the relevant internal organizational structure) for each type of entity. For example, an FIE generally is required to be a limited liability company, whereas a domestic enterprise has the option to set up as a joint stock company. Furthermore, the highest corporate governance body of a Sino-foreign equity joint venture (a form of FIE) is the board of directors, while the Company Law applicable to domestic companies defines the shareholders' meeting as the highest corporate governance body. Other examples of ''divergence'' between FIEs and domestic enterprises include the following: (i) the legal representative of a Sino-foreign equity joint venture is the chairman of the board, while under the Company Law, the general manager or executive director also can act as the legal representative of a company; and (ii) a Sino-foreign equity joint venture must distribute its profits in accordance with the percentage of shareholding of each shareholder, while the shareholders of a domestic company established under the Company Law may mutually decide not to distribute profits in accordance with their contributed capital but instead based on a shareholders' agreement. These differences are pri-

[17] Article 34: ''The State establishes a foreign investment information report system. Foreign investors or foreign-invested enterprises shall submit investment information to the competent department for commerce concerned through the enterprise registration system and the enterprise credit information publicity system. The contents and scope of foreign investment information report shall be determined under the principle of necessity; it is not allowed to require the submission again of any investment information that can be obtained by interdepartmental information sharing.''

ISSN 0148-8295

marily attributable to the fact that the Old FIE Laws were promulgated before the Company Law governing domestic enterprises came into effect.

When the New FIL becomes effective, all FIEs will be subject to the Company Law (or the Partnership Law, where applicable) in the same way as their domestic counterparts—the New FIL does not specify the legal form or internal organizational structure for FIEs. This change should provide more flexibility for FIEs when choosing the appropriate legal form and internal structure through which to conduct their business in China.

(4) Protecting IP and Trade Secrets

The New FIL strengthens the protection of IP rights of foreign investors as follows: (i) IP license fees can be freely repatriated to foreign IP owners; (ii) IP transactions must be conducted in a fair, equal, voluntary, and commercial manner; and (iii) compulsory transfers of technology are prohibited. Specifically, any ''technical cooperation'' between China and a foreign IP owner must be conducted on the ''basis of free will and commercial rules in the process of foreign investment'' and the principle that ''no administrative body or any staff thereof may force the transfer of any technology by administrative means''[18] must be observed.

Article 23 of the New FIL imposes an obligation on administrative authorities and officials to keep confidential any trade secrets belonging to FIEs and their foreign investors that they may have acquired in their interactions with them. Article 39 puts ''teeth'' in the rules by providing for severe penalties, including criminal liability, for noncompliance.

Protection of IP rights and trade secrets has been a critical concern for many foreign investors contemplating investing or doing business in China. The new provisions should help to allay these concerns given that China increasingly recognizes the importance of an open, fair, and legal exchange of IP rights and trade secrets with the international community to the long-term development of China's intellectual and human capital.

Over the past decade, China has been a pioneer in the technology front in many different fields, making it beneficial for the country to have strong IP protection for both foreign investors' IP rights and those of its own citizens. The tougher stance taken to protect IP rights in the New NIL appears to be a reciprocal response to the equally strong protection China demands of other countries for Chinese IP.

Other steps have been taken to enhance IP protection, such as simplification of registration procedures, more effective judicial resolutions to the infringement of proprietary IP, including the establishment of IP courts[19] and a proposed revision to the Patent Law[20] to toughen administrative penalties for patent infringement. The New FIL has made IP protection an indispensable feature of Chinese law that likely will result in more enhancement measures in the future.

(5) Free Flow of Funds

Article 21 of the New FIL provides that foreign investors ''may freely remit'' into or repatriate out of China, in RMB or foreign currency, ''capital contributions, profits, capital gains, income from asset disposal, intellectual property royalties, lawfully acquired compensation, indemnity or liquidation income.''

China operates a foreign exchange control system under which foreign exchange receipts and payments, purchases and sales, settlements, lending and borrowing, exchange rates etc. are managed to maintain the stability of the RMB and the country's balance of payments. The management or control measures that would need to be exerted to avert undesirable fluctuations in the monitored subject matters may, at times, require tighter foreign exchange controls. These controls, when applied to fund flows required of foreign investments (either into or out of China), may create inconvenience and cause for concern for foreign investors about their desire to continue to invest or increase their investments in China.

For example, with respect to liquidation income, under the Old FIE Laws, foreign investors ''may remit'' out of China ''legitimate profits, other legitimate income and funds obtained after liquidation.'' The slight difference in the terminology (''may remit'' vs. ''may freely remit'' between the Old FIE Laws and the New FIL, in practice, may signify a material difference. First, the Old FIE Laws require that any change in the capital structure of an FIE be approved

[18] Article 22: ''. . .The State encourages technical cooperation on the basis of free will and business rules in the process of foreign investment. Technical cooperation conditions shall be determined under the principle of fairness by all investment parties upon equal negotiation, and no administrative organ or any functionary thereof may force the transfer of any technology by administrative means.''

[19] In 2014, Beijing, Shanghai, and Guangzhou set up their own IP courts, and in early 2017, Nanjing, Suzhou, Chengdu, and Wuhan launched specialized IP tribunals.

[20] In 2008, the *Decision of the Standing Committee of the National People's Congress on Revising the Patent Law of the People's Republic of China* was implemented. Article 30 of the decision imposes higher penalties for counterfeiting patent: ''the offender shall, in addition to bearing civil liability pursuant to the law. . .illegal income shall be confiscated, and a fine of not more than four times the amount of the illegal income may also be imposed; where there is no illegal income, a fine of not more than RMB 200,000 may be imposed; where the case constitutes a criminal offence, criminal liability shall be pursued in accordance with the law.'' Subsection 2 of Article 65 imposes a penalty up to RMB 1 million when the actual damages of the IP holder cannot be determined.

ISSN 0148-8295

in advance by the relevant authorities, which may be less inclined to approve requests for capital reductions as they may affect the local statistics on the ''actual amount of foreign investment'' in the region. Second, as stated above, tighter capital controls have tended to make the remittance of liquidation income out of China less than straightforward. For example, since July 2014, China's foreign exchange reserves have been declining and at December 2018, compared to June 2014, the reserves have dropped by approximately 23%. During this period, remittances of capital by FIEs out of China often were challenging, largely due to the tighter capital controls. Therefore, under the Old FIE Laws, while it is true that FIEs ''may remit'' their capital out of China, it also is true that they ''may not,'' depending on the circumstances.

With the new, singularly important word of ''freely'' added to the New FIL, it is anticipated that future guidance may be issued that would grant preferential treatment to capital flows for FIEs, M&A activities, and non-FIE foreign investments, although many existing laws[21] governing this area have not yet been modified.

(6) Equal Treatment of FIEs and Domestic Enterprises

The New FIL stipulates several ''equal treatment'' provisions applicable to FIEs:

- FIEs are entitled to the same policies provided by the state in support of enterprise development as domestic enterprises;[22]
- FIEs can weigh in on the formulation of laws, regulations, and rules affecting foreign investment;[23]
- FIEs are entitled to participate equally in the standard-setting work[24] (vis-à-vis their domestic counterparts);[25]
- FIEs are given the same access to government procurement contracts for products and services as domestic enterprises;[26] and
- FIEs receive equal treatment when applying for administrative permission.

Aside from the fact that FIEs have foreign investors, they are the same as domestic enterprises since FIEs also are established pursuant to Chinese law. However, based on anecdotal evidence, it appears that FIEs have not been granted the same treatment as domestic enterprises as far as government procurement contracts are concerned. Government procurement contracts represent a significant part of China's economy that may dwarf the private sector spending in certain industries or other countries' public sector spending.

Equal treatment of FIEs for purposes of government procurement contracts also can be implied from the Government Procurement Law,[27] which provides that the government should procure ''domestic'' goods, services, and construction, unless these cannot reasonably be procured from within China or are to be used outside China. The procurement law also provides that information on government procurement contracts will be publicly announced in designated media channels on a timely basis, except where commercial confidentiality precludes disclosure. As FIEs also are Chinese enterprises that produce ''domestic'' goods, services, or construction, they should be able to bid on government procurement contracts in the same way as domestic enterprises.

The New FIL confirms and formalizes this treatment ''implied'' in the Law on Public Procurement.

(7) Complaint Mechanism with Administrative Reconsideration and Litigation

Article 26 of the New FIL[28] stipulates that ''if a foreign-invested enterprise or its investor believes that

[21] Related regulations include: *Administrative Regulations on the Foreign Exchange of the People's Republic of China*, *Company Law of the People's Republic of China*, *Law of the People's Republic of China on Sole Proprietorship*, *Provisions of the Supreme People's Court on Issues Relating to Application of the Company Law of the People's Republic of China*.

[22] Article 9: ''The State's various policies in support of enterprise development shall apply equally to foreign-invested enterprises according to the law.''

[23] Article 10: ''Opinions and suggestions of foreign-invested enterprises shall be solicited by appropriate means in the enacting of laws, regulations and rules relating to foreign investment. Normative documents and judgment instruments relating to foreign investments shall be timely promulgated according to Law.''

[24] In China, different industries will set different industry standards to promote higher quality and efficiency usually led by the government, with input from government recognized industry bodies. It generally is perceived that input from FIEs for this purpose has been ''underappreciated.''

[25] Article 15: ''The State protects the right of foreign-invested enterprises to equally participate in the setting of standards and reinforces the information disclosure and social supervision for the setting of standards. The compulsory standards set by the State shall apply equally to foreign-invested enterprises.''

[26] Article 16: ''The State protects foreign-invested enterprises' participation in government procurement activities through fair competition. Products manufactured and services provided by foreign-funded enterprises within the territory of China shall be treated equally in government procurement according to law.''

[27] Issued by Standing Committee of the National People's Congress on August 31, 2014, and effective from that date.

[28] Article 26: ''The State establishes a complaint mechanism for foreign-invested enterprises to timely handle problems encountered by foreign-invested enterprises or their investors, to coordinate and to improve relevant policies and measures. If a foreign-invested enterprise or any of its investors deems that the

ISSN 0148-8295

the administrative actions of an administrative body and its staff thereof infringes on its legitimate rights and interests, in addition to applying for a coordinated resolution through the complaint mechanism for FIEs as prescribed in the preceding paragraph, it also may request administrative reconsideration or file an administrative lawsuit according to the law.''

Based on the *Provisional Measures of the Ministry of Commerce on Handling Complaints Lodged by Foreign-Invested Enterprises*, issued by MOFCOM in 2006, a ''complaint'' refers to a request for action or relief made by an FIE and its investors when they believe their legitimate interests have been harmed by government administrative actions and submitted to the complaint-accepting body(ies) in accordance with the law. The National Complaint Centre for FIEs (''National Complaint Centre'') and the departments charged with handling complaints against local governments are responsible for accepting and addressing such complaints. The National Complaint Centre handles complaints involving multiple provinces, complaints about cases that ''exert a significant influence'' and complaints made directly to the center. A local complaint-accepting body is responsible for handling complaints made within its jurisdiction, and for dealing with complaints transferred from the National Complaint Centre. Although the complaint mechanism has been available for some years, it has not been popular or widely used by FIEs and their foreign investors, perhaps due to the lack of resolve (or motivation) at the level of the local authorities to implement it.

Compared with administrative reconsideration or litigation, the complaint mechanism generally is considered to have at least three advantages: 1) at the pre-establishment phase (before the FIE has been set up), foreign investors would be able to invoke the complaint mechanism, whereas administrative reconsideration or litigation is available only after the FIE has been established; 2) the complaint mechanism would not require a consensus among the foreign investors before a complaint can be filed (i.e., any foreign investor feeling aggrieved can file a complaint on its own (for administrative reconsideration or litigation, it generally is necessary for all of the foreign investors agree to invoke the procedure)); and 3) with respect to 2), the complaint does not have to relate to an issue concerning the FIE, i.e., any complaint at the foreign investor level would be eligible for the mechanism, while administrative reconsideration or litigation typically relates only to complaints raised at the FIE level.

administrative practice of an administrative organ or functionary thereof infringes upon its legitimate rights and interests, it may apply for coordination and resolution through the complaint mechanism. . .''

The New FIL has elevated the status of the complaint mechanism to a system enshrined in the basic law governing foreign investment. Article 26 clarifies that in the event of an administrative dispute, a foreign investor or an FIE can use the complaint mechanism, as well as administrative reconsideration or litigation to protect its interests. The complaint mechanism generally is regarded as a kind of administrative mediation. Therefore, the New FIL specifies that the complaint mechanism is not a prerequisite to initiating administrative reconsideration or filing an administrative lawsuit. In other words, FIEs and foreign investors are given different tools at their disposal depending on their individual preferences and circumstances. The complaint mechanism potentially could become a more flexible, less time consuming and less costly mechanism through which foreign investors can seek to have their grievances addressed. If the system is found to be working to its intended potential, it may enhance investor confidence.

(8) Government Responsibilities

As to the formulation of foreign investment promotion policies by local governments, Article 18 of the New FIL[29] adds a restrictive condition, that is, only the local people's governments *at or above the county level*'' will have the right to formulate foreign investment promotion policies, and such policies must be based on laws, administrative regulations and local legislation.

These rules essentially prohibit local governments below the county level (such as township level governments), from developing local promotion and investment facilitation policies for foreign investment, and emphasize that any such investment promotion policy be consistent with the laws, administrative regulations, and local legislation. According to Articles 7,[30] 56,[31] and 63[32] of China's Legislation Law, laws, administrative regulations, and local legislation can be introduced only by the National People's Congress and its Standing Committee, the State Council, and the People's Congress of a province, autonomous

[29] Article 18: ''A local people's government at or above the county level may, according to laws, administrative regulations and local rules, develop foreign investment promotion and facilitation policies and measures within the limit of its statutory authority.''

[30] Article 7: ''The National People's Congress and Standing Committee thereof shall exercise state legislative power. . .''

[31] Article 56: ''The State Council enacts administrative regulations in accordance with the Constitution and national law. . .''

[32] Article 63: ''In light of the specific situations and actual needs of the jurisdiction, the People's Congress of a province, autonomous region, and municipality directly under the central government and the Standing Committee thereof may enact local legislations provided that they shall not contravene any provision of the Constitution, national law and administrative regulations. . .''

ISSN 0148-8295

region, and municipality directly under the central government and the Standing Committee. As a result, only legislation enacted or promulgated by these specific authorities can be relied on by local governments in formulating their local promotion policies. These rules are designed to prevent unhealthy competition among local governments to lure foreign investment to their locales by offering promotion policies that are beyond their legislative authority or contrary to the legislation of a higher authority. Such ''race to the bottom'' behaviour by local governments would not only aggravate the already precarious finances of some of these governments but also eventually would lead to disappointments to foreign investors when the promises cannot be fulfilled given that the policies are not really ''legal'' to begin with.

The New FIL also mandates that local governments at all levels should honor their commitments to policies provided to, and contracts with, foreign investors and FIEs. If any policy commitments or contractual agreements need to be changed or modified due to state or public interests, statutory procedures should be observed and foreign investors and FIEs should be compensated for any losses suffered.

Undoubtedly, these provisions will serve as an important ''bargaining chip'' in the hands of foreign investors when negotiating with local governments on promotion policies or when unanticipated issues relating to the scope of such policies arise.

III. Unanswered Questions

The New FIL should be applauded for many of its ground-breaking provisions that clearly will benefit foreign investment. However, some unanswered questions remain, which if clarified, would further enhance the effectiveness of the new law in achieving its intended goal of attracting foreign investment.

1. Treatment of Hong Kong, Macao, and Taiwan Investments

The New FIL does not contain specific provisions governing investments from Hong Kong, Macao, and Taiwan investors. Although such investors are not considered investors from foreign countries, they always been treated, for FIE purposes, as ''foreign investors'' under the Old FIE Laws.

According to the statement made by Premier Li Keqiang after the closing of the Second Session of the 13th National People's Congress on March 15, 2019, it is likely that the implementation regulations of the New FIL will confirm that investments made by Hong Kong, Macao, and Taiwan investors will be treated as ''foreign'' for purposes of the New FIL.

2. Impact on Variable Interest Entity (''VIE'') Arrangements

Unlike the 2015 Draft, the New FIL does not address issues relating to the VIE structures.

A VIE structure is a structure where the controlling enterprise (typically an FIE) controls the operating enterprise (typically a domestic enterprise) through a series of agreements rather than through direct equity holding. The VIE structure commonly is used to facilitate the public listing of a Chinese company (which typically is in a restricted or prohibited industry that is off limits to foreign investors in terms of material ownership) outside China. In a way, the VIE structure can be seen as a ''de facto'' FIE structure that is not so categorized since the operating enterprise continues to be a ''standalone'' entity with all of its shareholders of record being Chinese nationals. Thus far, no official laws or regulations have officially endorsed or denied the legality of the VIE structure.

However, Article 2 of the New FIL provides that foreign investment includes ''investment by any other ways stipulated under laws, administrative regulations or provisions of the State Council,'' which appears to provide a possible scope in the law that can be filled with further guidance relating to VIEs. In practice, foreign investors typically use various ownership structures (including foreign trusts and partnerships, as well as contractual control) to acquire interests in domestic enterprises. The extent to which such foreign ownership would need to be ''looked through'' has been a major source of uncertainty for Chinese owners of the domestic enterprise and foreign investors in the structure.

3. Transition and Convergence Issues

As discussed above, under the New FIL, FIEs will be treated in the same way as domestic companies in terms of their legal form and internal organizational structure. With regard to existing FIEs, the New FIL sets out a five-year transitional period during which these FIEs may continue to maintain their current legal form and internal organizational structure. After the transitional period, existing FIEs will have to change or modify these to align with the requirements under the New FIL and the Company Law.

However, it is not clear how existing FIEs established according to the Old FIE Laws can be ''transformed'' to conform to the New NIL at the end of the transitional period. Existing Sino-foreign joint ventures likely will need to revise their joint venture contracts and articles of association to comply with the New FIL and the Company Law, and JV partners likely will need to renegotiate the changes including profit distribution arrangements, governance organization etc.

In addition, during the period between now and January 1, 2020, the effective date of the New FIL, the application of the existing laws governing FIEs may be uncertain. Currently, if foreign investors intend to set up FIEs in China, the relevant provisions

ISSN 0148-8295

of the Old FIE Laws will apply. However, any FIE set up under these rules will have to change or modify its corporate form and internal organizational structure after the New FIL becomes effective (or five years from that date if the transitional period is elected). Time and costs could be saved if an FIE to be set up in the pre-New FIL period could be established in conformity with the New FIL requirements.

Before the New FIL was enacted, a suggestion apparently had been put forward to not require pre-New FIL FIEs to change their legal form and internal organizational structure, i.e., they would be grandfathered. However, this suggestion was not adopted.

IV. Conclusion

The New FIL is now the cornerstone that underpins China's pro-foreign investment philosophy and policy, on the back of 40 years of successful ''opening up,'' with the official endorsement by the highest law-making bodies in China. This new legislation carries with it a significant symbolism, i.e., China clearly is committed to attract foreign investment to disprove detractors that often describe the country as anti-foreign business. The equal treatment of FIEs relative to their domestic counterparts from the pre-establishment phase all the way through to government procurement contracting, development of the relevant rules and regulations, etc. will impose a ''cost'' on China. However, despite these costs, China is willing to focus its attention on the long-term, structurally beneficial aspects of opening the economy to foreign investment, reflecting both its strategic vision and its rising confidence in its international competitiveness. Although detailed guidance is yet to be issued to clarify some of the provisions in the New NIL, the broad principles and approaches in the new law are innovative and transformative. The solid commitment to welcome foreign investment demonstrated by the New FIL is bound to be welcome by foreign investors with open arms.

ISSN 0148-8295