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China Publishes Draft Implementation Regulations on the New Foreign Investment Law; Seeks Comments from Public

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On November 1, 2019, China's Ministry of Justice ("MOJ") released a draft version of the Implementation Regulations on the Foreign Investment Law ("Draft Regulations")[1], aimed at facilitating the new Foreign Investment Law ("FIL"). The Draft Regulations provide much-needed clarity on certain challenging issues in the FIL, such as how to reconcile the corporate structure of foreign investment enterprises (FIEs)[2] during the transition period, but may also leave certain issues for further clarification after enactment.

Transition Period for Existing FIEs

China has promulgated its new FIL as an integrated legal framework to regulate foreign investment, and this will come into effect on January 1, 2020 (please refer to White & Case Client Alert: *China Adopts New Foreign Investment Law*, dated on March 29, 2019, available here). The FIL requires the corporate governance structure of existing FIEs to be modified to align with the requirements under the PRC Company Law. To reconcile such modification process, the Draft Regulations provide in Article 42 a three-phased process, as follows:

- **Phase One – 5-year transition period** (*i.e.*, January 1, 2020 through December 31, 2024): during this period existing FIEs are encouraged to go through a modification process and register with the relevant authorities;
- **Phase Two – 6-month grace period** (*i.e.*, January 1, 2025 through June 30, 2025): during this period any FIE who has not yet modified its entity form is obliged to do so; and
- **Phase Three – Rejection of registration** (i.e., from July 1, 2025): any FIE who has failed to make the required modifications will not be able to register with the relevant authorities.

Nonetheless, challenges may exist for specific FIEs to modify their structures as scheduled, since the reconciliation process requires substantial changes to the corporate structure of Sino-foreign joint ventures and may involve difficult and protracted negotiations between joint venture partners. In practice, the

[1] The Chinese version of the Draft Regulations is available here. The MOJ is currently seeking public comments on the draft, through its online comment portal, via express mail or email, comments to be provided no later than December 1, 2019.

[2] These refer to Sino-foreign equity joint ventures, Sino-foreign cooperative joint ventures, and wholly foreign-owned enterprises.

government registration authority is expected to adopt practical rules to achieve a smooth transition for existing FIEs – especially Sino-foreign joint ventures.

Highlights on Investment Facilitation and Protections

The Draft Regulations also establish specific rules to implement the general guidance of the FIL regarding investment facilitation and protections.

First, the implementation of policies on a public and non-discriminative basis is a core principle in various aspects of the Draft Regulations. For instance,

- the government is requested to treat foreign investment equally as nationals, in terms of investment promotions and incentives, without any discrimination (Article 9);
- unpublished policies shall not be implemented to regulate foreign investment (Article 10);
- the government, when stipulating laws, regulations, rules and policies that may affect foreign investment, shall seek opinions from foreign investors (Article 10) and conduct a review on legitimacy and fair competition aspects (Article 27), and foreign investors may also seek judicial review on a policy through litigation if such policy is found unlawful (Article 27); and
- policy commitment from a local government shall be made in written form and within its legitimate authority (Article 28).

Second, the Draft Regulations provide detailed rules regarding the role of FIEs in the standard stipulation and implementation process, to preserve a fair competition environment for foreign investment. Specifically,

- FIEs are eligible to propose the stipulation of a compulsory national standard, and may provide opinions and undertake relevant roles throughout the process of standard stipulation, technical review or implementation (Article 15); and
- the government shall not impose on FIEs any standards that are stricter than the relevant compulsory standards, or force FIEs to implement non-compulsory standards, unless FIEs themselves opt to adhere to stricter standards (Article 16).

Third, another highlight of the Draft Regulations is to introduce a punitive penalty mechanism to tackle IP infringements (Article 24). However, it is not clear yet from the Draft Regulations how such mechanism would function.

Fourth, the Draft Regulations also reiterate certain principles set forth in the FIL by illustrating specific actions that are prohibited, *e.g.*,

- any government or its officials imposing unlawful restrictions on currency, amount or frequency with regard to a foreign investor's profit remittance (Article 23); and
- any government or its officials imposing unlawful requirements on the foreign investor to perform a technology transfer to any person in the process of registration, project review or filing, permit granting and inspection, or imposing relevant administrative penalties or other measures on such investor (Article 25).

Narrowly Defined "Pierce-through" Ownership Exception

The FIL will replace the current regulatory regime covering three different types of FIEs and regulate all of the foreign investment activities that are defined in Article 2 of the FIL, all of which are subject to the "pre-establishment national treatment and negative list" management system. Foreign investment is either prohibited or subject to specific restrictions in sectors identified in the Negative List. It was not clear under the FIL whether the *variable interest entity* ("VIE"), a special foreign investment instrument tailored to business in restricted sectors, would be subject to FIL regulations.

The Draft Regulations now clarify this by providing for a narrowly defined ownership exception to the VIE structure. As defined in Article 35, a round-trip invested entity may be considered as a domestic entity and thus exempt from the Negative List regulations under the FIL, only if (1) its investor is an offshore entity which is wholly owned by Chinese individuals, entities or other organizations, and (2) such investment is reviewed by a state-level authority and approved by the State Council. Accordingly, such exception, if effective, would be not applicable to a round-trip invested entity where the offshore entity (as foreign investor) is not 100% Chinese-owned, either because it has a foreign investment aspect or goes public in an overseas stock exchange (which is common for most VIEs created for financing purposes). Furthermore, the requirement to obtain state-level authority approval under this exception is likely to lead to practical challenges as well, even if the first prong were satisfied.

This rigid "pierce-through" approach may be a result of the MOJ's cautious but prudent approach of regulating foreign investment at this current stage. Significant uncertainty will still remain after the Draft Regulations take effect, such as how existing and newly established VIE structures under the FIL framework are regulated.

Further Clarification Expected After Enactment

The MOJ will be seeking the public's comments on the Draft Regulations up to December 1, 2019. Considering that the final Regulations are to be enacted on January 1, 2020 when the FIL comes into effect, legislators are only left with a one-month period to study the public's comments. Thus, this may not lead to a significant improvement over the current Draft Regulations, which likely leaves clarification on certain issues after enactment, *e.g.*, how to define local reinvestment by FIEs. Article 2 of the FIL defines the types of foreign investment by providing that "*investment activity directly or indirectly conducted by a foreign natural person, enterprise or other organization*". It appears that such "indirect investment activity" is designed to cover reinvestment by FIEs; however, there is still a lack of practical guidance which regulates such reinvestment activities, *e.g.*, to what extent such reinvestment in China would be still considered as foreign investment and thus subject to the FIL. The need for clarification may become more pressing with the potential boom of FIE reinvestments in the near future, in response to the latest policy announced by the State Administration of Foreign Exchange ("SAFE"), which has opened the door for non-investment nature FIEs to make domestic equity capital investments.[3]

We will continue to monitor any developments on this regime.

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[3] See SAFE's Circular on Further Promoting Cross-border Trade and Investment Facilitation, published as Hui Fa [2019] No.28, dated on October 23, 2019, Chinese version of which is available here.