LATHAM&WATKINS

Client Alert
White Paper

Latham & Watkins Mergers & Acquisitions Practice | August 2, 2019 | Number 2531

China Introduces New Foreign Investment Law, Negative Lists, and Encouraged Industries Catalogue

What do multinational corporations, private equity funds, and other foreign investors need to know?[1]

On March 15, 2019, the National People's Congress of China approved The People's Republic of China Foreign Investment Law (FIL) which will come into force on January 1, 2020, replacing and updating China's various existing laws regulating foreign direct investment and foreign invested entities (FIEs)[2] with a single unified law. In promulgating the FIL the Chinese government aims to promote foreign investment by better protecting the rights and interests of foreign investors and standardizing management of foreign investment. As discussed below, the FIL offers welcome and long-awaited improvements to existing laws and regulations governing foreign direct investment and FIEs, but as is often the case with new legislation in China, a number of areas will need to be addressed through amendments to existing legislation, in detailed implementing regulations and in practice.

New Opportunities for Foreign Investment

Since the FIL was approved, the Chinese government has continued to emphasize its commitment to further opening China's economy to foreign investment in previously restricted sectors, including value-added telecommunications, medical services, education, and culture industries.[3] Meanwhile the National People's Congress has approved a number of amendments to existing legislation, all of which have now taken effect or will take effect prior to January 1, 2020 when the FIL comes into force.[4] At the same time, China's principal agencies regulating foreign direct investment, the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM), have been busy formulating updates to regulations that will guide implementation of the FIL and encourage foreign direct investment. On June 30, 2019, with the approval of China's State Council, the NDRC and MOFCOM jointly issued a new version of the *Special Administrative Measures for the Access of Foreign Investment (Negative List)* (Negative List), further reducing the sectors in which foreign investment continues to be restricted or prohibited.[5] The same day, the two agencies also jointly issued an updated *Catalogue of Encouraged Industries for Foreign Investment* listing industries in which foreign investors are eligible to enjoy certain preferential policies and treatment (Encouraged Industry Catalogue).[6] These new regulations demonstrate the Chinese government's resolve to attract increased foreign investment and spur economic growth.

Despite its relative brevity and lack of detail in certain areas, the FIL will bring significant changes for existing and new foreign investors alike. These important changes will include:

- Extending national treatment to foreign investments in sectors not expressly restricted by the Negative List
- Offering preferential treatment for foreign investments in sectors and regions provided for in the Encouraged Industry Catalogue
- Providing protection for foreign investment and access for FIEs to domestic capital markets and Chinese government contracts
- Conforming the law governing FIEs with existing corporate and other legislation (with a five-year transition period for existing FIEs)

This *Client Alert* provides an overview of the FIL, the abovementioned key changes to come under the FIL, and companion legislation and regulations as well as transition matters for existing FIEs.

Overview of the FIL

The FIL is not an outright break from China's existing laws, nor is it an unexpected development. Rather the FIL is a crucial and long-awaited step to streamlining China's foreign investment regulation under the framework of the *Company Law of the People's Republic of China* (Company Law). Since initiating its policy of "Reform and Opening" 40 years ago under Deng Xiaoping, China has gradually developed a comprehensive body of civil and corporate laws and regulations, including the Company Law first adopted in 1994 (subsequently amended in 2018), the Antimonopoly Law adopted in 2008, and the body of implementing regulations that has been developed over the past 11 years as relevant government agencies have applied these laws in practice. Interested parties have widely recognized that even as the FIE laws have been amended from time to time, they have not kept up with the development of other legislation, in particular the Company Law. For a number of years, the inconsistencies and conflicts between the existing laws governing FIEs and the Company Law have caused confusion and have presented legal and practical issues to foreign investors and government regulators alike. In order to promote inbound foreign investment, to protect the rights of foreign investors, and to maintain the average 15% year-on-year increase in inbound foreign direct investment that China has enjoyed from 2005 through 2018,[7] the Chinese government has promulgated a unified foreign investment law that is consistent with its existing corporate laws and regulations.

MOFCOM first published a consultation draft of the FIL in January 2015, a long document encompassing 11 chapters with 170 articles, which the foreign business community and the local bar commented on extensively. The FIL as promulgated is a much-abbreviated document with only six chapters and 42 articles. It emphasizes certain topics that were less relevant in 2015, such as the prohibition of compulsory technology transfer and the protection of trade secrets, which drew much attention amid the trade talks between the US and China from 2017 to 2019.

Article 2 of the FIL defines foreign investment as "investment activities directly or indirectly conducted in China by foreign individuals, enterprises or other organizations (collectively foreign investors)" within one of the following four categories:

- Establishment of a foreign invested enterprise in China, independently or jointly with other investors

- Mergers with and acquisitions of domestic Chinese enterprises

- Independent or joint investment in a new project

- Any investment in any other manner as stipulated by a law or administrative regulation or provision issued by the State Council

The definition of foreign investment is notably silent on whether variable interest entities (VIEs) constitute foreign investment. A VIE is an investment structure whereby a Chinese operating company — either wholly owned by domestic shareholders or a joint venture FIE in which the Chinese partner holds the majority equity interest — is controlled by an offshore entity through a series of agreements (share pledges, directors proxies, and management or operating agreements). The VIE has been used for the past 20 years to facilitate investment in restricted sectors (such as internet, value-added telecommunications, education, media, real estate, and financial sectors). In contrast to the 2015 draft of the FIL — which specifically referenced VIEs in the definition of "foreign investment" and adopted the standard of "actual control" to determine whether an investment is indeed "foreign" — the FIL as promulgated does not address VIEs. The catch-all in the definition of foreign investment, however, "investment in any other manner as specified by laws or administrative regulations or provisions by the State Council," reflects drafting that is typical in Chinese legislation, and leaves open the possibility for the government to address VIEs in the future. Accordingly, foreign investors seeking to use VIE structures to invest in sectors that remain restricted under the Negative List will need to evaluate carefully the risks involved.

National Treatment for Foreign Investment in Sectors Outside the Negative List

The FIL provides that foreign investors investing in sectors not specifically included on the Negative List will be entitled to enjoy national treatment from the point of investment.

National treatment affords foreign investors and their investments in China rights and autonomy no less favorable than the rights and autonomy granted to domestic Chinese investors and their investments, including:

- Equal access to the market in the initial establishment of the investment[8]
- Equal entitlement to national policies supporting enterprise development[9]
- Autonomy in carrying out technology cooperation[10]
- Equal participation in setting standards[11]
- Fair competition when participating in Chinese government procurement projects[12]

By contrast, foreign investments in sectors specified on the Negative List are not entitled to enjoy national treatment. The 2019 Negative List, which came into effect on July 30, 2019, will effectively open additional sectors to foreign investment by reducing the number of restricted sectors from 45 to 37 sectors for investments in one of the pilot free trade zones (FTZ) and from 48 to 40 for foreign investments outside of the FTZ.

The 2019 Negative List (applicable nationwide, outside of the FTZ) included the following changes:

- **Oil and gas**: Foreign investment in the exploration and development of oil and gas resources (including coal-bed methane, but excluding oil shale, oil sands, and shale gas) is no longer restricted to Sino-foreign joint ventures; wholly owned investment is permitted.[13]
- **Mining**: Foreign investment in the exploration or mining of molybdenum, tin, antimony, or fluorite is now permitted.

- **Manufacturing**: Foreign investment in the manufacturing of Xuan paper or ink sticks is now permitted.
- **Infrastructure**: A Chinese party is no longer required to have a controlling stake in the construction or operation of an urban gas and heat facility for a city with a population of no less than 500,000.
- **Transportation**: A Chinese party is no longer required to have a controlling stake in a domestic marine shipping agency company.
- **Telecommunication**: Lifting restrictions on certain value-added telecommunications services: domestic multi-party communication, store and forward, and call center services are now open to foreign investment without restrictions on foreign ownership.
- **Agriculture**: Foreign investment in the development of wild fauna and flora resources originating in China under national protection is now permitted.
- **Entertainment**: A Chinese party is no longer required to have a controlling stake in a performance management agency, the construction of a movie theater, or the operation of a movie theater

The 2019 Negative List also provides that certain restrictions on the maximum percentage of foreign ownership or on the number of joint ventures a foreign investor may invest in within certain industries are set to be phased out after a transition period (same as the 2018 version and the FTZ list):

- The restriction on foreign shareholding in automobile manufacturing other than special-purpose vehicles and new energy vehicles will be phased out in 2020.
- The restriction on the number of equity joint ventures manufacturing the same line of automobiles will be phased out in 2022.
- The restriction on foreign shareholding in securities, futures, or life insurance industries will be phased out in 2021.

The Chinese government typically tests new policies on a pilot basis. If such policies are deemed successful, the government then implements them more broadly. Beginning in the late 1980s and through the 1990s, the government tested new policies in Special Economic Zones such as Shenzhen. More recently, the Chinese government has used the FTZ as a testing ground. The Negative List is no exception to this common practice. Restrictions previously lifted for foreign investment in the FTZ in the 2018 version of the Negative List have now been lifted for the rest of the country.[14]

The 2019 Negative List also includes important changes for investments in the FTZ. These changes are noteworthy in and of themselves, signaling changes that could be implemented more broadly in the next update of the nationwide Negative List, including:

- **Fishery**: Foreign investment in harvesting of aquatic products in the territorial waters or inland waters of China is now permitted in the FTZ.
- **Publishing**: The requirement that a Chinese party hold a controlling stake in the printing of publications has now been eliminated in the FTZ.

Notably, only two sectors are open to foreign investment in the FTZ but restricted nationwide. The gap between the two lists is narrowing, further highlighting the extent of the changes to the nationwide list over the past several years.

Promotion and Protection of the Foreign Investment

The FIL aims to put foreign investors and entities on an equal footing with their domestic counterparts. The new law provides for policies that promote foreign investment and builds a more foreign investment-friendly environment. The promoting measures and policies include:

- Establishing special economic zones and implementing pilot policies and measures for foreign investment in particular regions[15]
- Allowing public offerings of securities, including stocks and bonds, as financing tools for FIEs
- Guaranteeing fair market competition for FIEs participating in Chinese government procurement activities and bidding for Chinese government contracts

In addition to the policies set forth in the FIL, the Encouraged Industries Catalogue provides important guidance for foreign investors and offers tax and other incentives as a means to promote foreign investment in encouraged sectors and underdeveloped regions. The first half of the catalogue sets out 13 broad sectors in which foreign investment is encouraged countrywide. The second half sets out separate lists covering 22 different less-developed regions across central, western, and northeastern China. Compared with the 2017 catalogue, the 2019 nationwide catalogue includes 67 new sectors in which foreign investment is encouraged, while the regional catalogue includes 54 new sectors. More than 80% of the newly added sectors are in the manufacturing industry, with an emphasis on new and high technology industries such as artificial intelligence, clean production, carbon capture, and storage sub-sectors. The catalogue for the western regions leans toward a combination of labor-intensive, technological, and supporting facilities industries to encourage development in those underdeveloped regions.

In particular, the Encouraged Industries Catalogue aims to promote investment in 5G core components, etching machines for integrated circuits, chip packaging equipment, and cloud computing equipment, presumably with a view to supporting the rollout of 5G services in many Chinese cities.

In a press conference held on June 30, 2019, an NDRC official clarified the supporting policies that apply to the catalogue:[16]

- For foreign invested projects in the catalogue, any tariff is exempted for imported self-use equipment capped at the total investment.[17]
- For qualified foreign invested enterprises in encouraged industries in the western region, the corporate income tax rate is 15%.[18]
- Foreign-invested industrial projects that engage in intensive land use receive priority in land supply. Depending on the specific land grade, the base price for land transfer shall be no less than 70% of the minimum price set forth in the National Standards for the Minimum Prices for Assignment of Land for Industrial Purposes.[19]

As discussed above, the FIL addresses compulsory technology transfers and the protection of trade secrets. The FIL sends a strong signal of China's commitment to protecting the rights of foreign investors. Some key provisions include:

- No expropriation of foreign investment; if necessary to serve the national interest or the public interest in special circumstances, expropriation will be effected through a legal process and with fair and reasonable compensation that will be paid in a timely manner.

- Technology transfer to be negotiated by parties freely with no forced transfer via administrative measures by government authorities.

- Governmental authorities and officials will keep confidential any trade secrets obtained from foreign investors and FIEs in the course of performing their official duties.

- Free cross-border flow of capital, profits, capital gains, proceeds from assets disposal or liquidation, royalty payments, and other lawfully obtained compensation in either Chinese yuan (Renminbi) or in foreign currency.

While the FIL lays the groundwork for an improved environment for foreign investment with greater certainty, there will need to be further administrative regulations, provisions, and documents to implement the FIL's broad policy objectives. This process is already in progress with the Negative List and the Encouraged Catalogue. On July 2, 2019, in his speech at the World Economic Forum, China's Premier Li Keqiang stated that the implementing regulations and policies for the FIL are under consideration and will come into force together with FIL on January 1, 2020.[20] He also announced that China would accelerate the opening of the securities and life insurance sectors with majority foreign ownership of securities companies to be permitted by 2020. On July 20, 2019, the Financial Stability and Development Committee under the State Council announced that the restrictions on foreign shareholding in securities, futures, and life insurance industries will be lifted in 2020, a year earlier than the time stipulated in the Negative List. The notice also announces further opening of financial sector to foreign investment including pension funds, insurance, wealth management, and credit ratings among others.[21]

Navigating the Transition Period

Currently, the existing laws governing FIEs prevail over the Company Law to the extent of discrepancies in their application to FIEs. Once the FIL comes into force it will supersede the existing FIE laws, and all FIEs, like domestic enterprises, will need to comply with the Company Law. To achieve compliance, existing FIEs will need to implement certain changes in their corporate organization and governance within a five-year transition period.[22] Some of the key changes include:

- **Form of Organization**: Currently, an FIE may be set up as an "equity joint venture" (EJV), a "cooperative joint venture" (CJV), or a "wholly foreign-owned enterprise" under different governing FIE laws. After January 1, 2020, any new FIE will be established as a limited liability company (LLC) under the Company Law (or another form of legal person permitted by the Company Law). Existing FIEs will have a five-year transition period before the end of which they must convert into an LLC or other corporate form as permitted under the Company Law.

- **Corporate Governance**: For an LLC, the highest corporate authority is its members meeting. Under the Company Law, certain fundamental matters (such as amending the articles of association, changing the registered capital, mergers, or dissolutions) require the approval of more than two-thirds majority of the member voting rights. The board of directors however acts through a simple majority, and the allocation of board seats does not have to follow the members' respective shareholding percentage. Conversely, under the existing FIE laws, an EJV (the most common form of Sino-foreign joint venture) does not have "members meetings." Instead the EJV's board of directors functions as its highest authority with board seats allocated in proportion to each joint venture partner's capital contribution and certain fundamental matters requiring unanimous board approval. Therefore, as a result of transition from an EJV to an LLC, the members will have more flexibility in corporate structuring and governance. To the extent contractually agreed, the supermajority shareholder(s) can also enjoy a higher level of control than permitted under the default rules of the existing FIE laws.

- **Thin Capital Rules**: The concept of "total investment amount" as unique to FIEs under the existing FIE laws does not exist under the Company Law. Therefore the FIL will abolish the relevant "thin capital" rules applicable to FIEs, which prevent a FIE from borrowing debt exceeding a certain percentage of its registered capital. Foreign investors would gain more flexibility in using shareholder loans rather than capital contribution to fund the capital needs of their portfolio FIEs.

- **Transfer Restrictions**: Under the existing FIE laws, any proposed transfer of registered capital of an EJV is subject to the consent of the non-transferring party.[23] By contrast under the Company Law, although the transfer by a shareholder of an LLC would be subject to the other shareholders' statutory right of first refusal, the shareholders may agree to certain transfers of registered capital in the articles of association .[24]

Given the significant difference between the Company Law and the existing FIE laws, foreign investors with existing FIEs should consider revising their articles of association, and for EJVs and CJVs, their joint venture contracts as well. These EJVs and CJVs may need to renegotiate agreed joint venture terms between the joint venture partners.

Together with the 2019 updates to the Negative List and the Encouraged Industries Catalogue, the FIL marks an important milestone in the development of China's foreign investment laws that should give foreign investors and their Chinese counterparts greater certainty. Over the last 18 years since acceding to the World Trade Organization, China has successfully implemented wide-ranging legal and regulatory reforms to meet its obligations under its protocol of accession, reforms that have substantially improved the legal environment for domestic and foreign investors alike. The FIL, the Negative List, and the Encouraged Industries Catalogue — as well as ongoing regulatory updates and initiatives to improve intellectual property protection and to further open the country's financial sector — continue these reforms and demonstrate the Chinese government's determination to promote foreign investment and economic development based on a well-developed and effective legal system.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

David M. Blumental
david.blumental@lw.com
+852.2912.2686
Hong Kong

Frank Sun
frank.sun@lw.com
+852.2912.2512
Hong Kong

Rowland Cheng
rowland.cheng@lw.com
+86.21.6101.6123
Shanghai

Cheng-Ling Chen
cheng-ling.chen@lw.com
+1.415.395.8048
San Francisco

You Might Also Be Interested In

Navigating Cross-Border M&A Transactions

CFIUS and Chinese Investments in the United States — A Closed Door?

China: New Measures for Deregulating and Promoting Foreign Direct Investment

Endnotes

[1] Please note that the legal information contained in this *Client Alert* and the analysis thereof are based on publicly available versions of PRC legislation and regulations, secondary sources such as commentaries, conversations with PRC officials and practitioners of PRC law, and the authors' reasoned reflection in light of experience with similar matters and transactions, in each case as of the date of this *Client Alert*. Please also note that the PRC Ministry of Justice does not permit foreign law firms to practice PRC law, and nothing contained herein should be interpreted as rendering a legal opinion on PRC law.

[2] Previous laws include: Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures (first passed on July 1, 1979), Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures (first passed on April 13, 1988) and Law of the People's Republic of China on Wholly Foreign-Owned Enterprises (first passed on April 12, 1986).

[3] In a keynote speech at the Bo'ao Forum for Asia Annual Conference in late March 2019, Premier Li Keqiang confirmed that China will open its economy wider to the world, especially the service sector including value-added telecommunications, medical services, education and culture industries. He also addressed that the transportation, infrastructure, energy and resources sectors will also see new opportunities. https://www.fmprc.gov.cn/mfa_eng/wjdt_665385/wshd_665389/t1650537.shtml

[4] The laws amended include among others the Anti-Unfair Competition Law, the Trademark Law, and the Administrative License Law.

[5] The Special Administrative Measures for the Access of Foreign Investment (Negative List) jointly issued by the NDRC and MOFCOM on June 30, 2019, sets out a list of sectors in which foreign investment is restricted or prohibited. The Negative List can be downloaded at: http://www.ndrc.gov.cn/zcfb/zcfbl/201906/W020190628615780569680.pdf.

[6] The Catalogue of Encouraged Industries for Foreign Investment jointly issued by the NDRC and MOFCOM on June 30, 2019, expands the sectors and regions in which foreign investments are eligible to enjoy preferential treatment. The Encouraged Industry Catalogue supersedes the Catalogue of Industries for Guiding Foreign Investment (2017 revision) and the Catalogue of Priority Industries for Foreign Investment in Central-Western Regions (2017 revision). The Catalogue can be downloaded at: http://www.ndrc.gov.cn/zcfb/zcfbl/201906/W020190628622707054403.pdf.

[7] OECD (2019), FDI flows (indicator). doi: 10.1787/99f6e393-en (accessed on 16 July 2019). Financial flows consist of equity transactions, reinvestment of earnings, and intercompany debt transactions.

[8] Article 4 of the FIL.

[9] Article 9 of the FIL.

[10] Article 22 of the FIL.

[11] Article 15 of the FIL.

[12] Article 16 of the FIL.

[13] Note that existing regulations governing foreign investment in upstream oil and gas will need to be amended accordingly. These include the Regulations of the People's Republic of China on Sino-Foreign Cooperation in Exploitation of Onshore Petroleum Resources (Revised July 18, 2013) and Regulations of the People's Republic of China on Sino-Foreign Cooperation in Exploitation of Offshore Petroleum Resources (Revised September 30, 2011). The proposed Administrative Measures on the Mineral Rights Transfer (Draft) (矿业权出让管理办法（征求意见稿）) a draft of which was published by the Ministry of Natural Resources of the People's Republic of China for comment addresses foreign ownership of mineral rights. See: http://www.mnr.gov.cn/dt/ywbb/201903/t20190319_2402103.html.

[14] The previous examples observed are: restrictions regarding exploration and development of oil and gas and performance management agency were lifted in the 2018 version of the Negative List for the FTZ and are now lifted in the 2019 version of the nationwide Negative List.

[15] The Chinese government has begun implementing this policy aim through the Negative List and the Encouraged Catalogue, discussed in this *Client Alert*.

[16] Besides favorable treatment mentioned below, other supporting policies for the Catalogue of Industries for Guiding Foreign Investment and the Catalogue of Priority Industries for Foreign Investment in the Central-Western Regions still apply.

[17] Article 2 of Notice of the Ministry of Finance, the General Administration of Customs and the State Administration of Taxation on Tax Policy Issues concerning Further Implementing the Western China Development Strategy (No. 58 [2011] of the Ministry of Finance) (财政部·海关总署·国家税务总局关于深入实施西部大开发战略有关税收政策的通知) (财税[2011]58号), http://www.chinatax.gov.cn/n810341/n810765/n812156/n812474/c1186395/content.html.

[18] Article 1 of Announcement on Issues concerning Enterprise Income Tax in Implementing the "Catalogue of Industries Encouraged to Develop in the Western Region."(Announcement No. 14 [2015] of the State Administration of Taxation) (关于执行《西部地区鼓励类产业目录》有关企业所得税问题的公告) (国家税务总局公告2015年第40号), http://www.chinatax.gov.cn/n810341/n810765/n1465977/n1466052/c1677549/content.html.

[19] Article 17 of Notice of the State Council on Several Measures for Expanding Opening Up and Vigorously Using Foreign Capital (No. 5 [2017] of the State Council) (国务院关于扩大对外开放积极利用外资若干措施的通知) (国发[2017]5号), http://www.gov.cn/zhengce/content/2017-01/17/content_5160624.htm.

[20] The full transcript of the speech is available at http://www.gov.cn/premier/2019-07/03/content_5405783.htm.

[21] http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3863019/index.html.

[22] Article 42 of the FIL.

[23] Article 4 of Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures.

[24] Article 71 of the Company Law.