The Foreign Investment Law gets wings: draft implementation regulations released for public consultation

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Introduction and overview

Following the ground-breaking *PRC Foreign Investment Law* (the "**FIL**") being voted into law on 15 March 2019 to unify and replace the main existing rules governing foreign invested enterprises ("**FIEs**") and their activities, namely the *Sino-Foreign Equity Joint Venture Law* (the "**EJV Law**"), the *Sino-Foreign Cooperative Joint Venture Law* (the "**CJV Law**"), and the *Wholly Foreign-Owned Enterprise Law* (the "**WFOE Law**")(collectively the "**FIE Laws**"), the Ministry of Justice recently released the long-awaited draft *PRC Foreign Investment Law Implementation Regulations* (the "**Draft Implementation Regulations**", full text in Chinese, in-house English translation available[1] upon request) to seek public comments. Interestingly, the full text of the Draft Implementation Regulations was first released to various Chambers of Commerce in China to solicit their opinions (the "**Internal Version**"), followed by the official release to the general public on 1 November 2019 (the "**Public Version**"). Despite there being only a short interval between the two releases, we note that the relevant regulators have made some further changes in the Public Version.

Given that, in stark contrast to the prescriptive approach seen in the FIE Laws, the FIL takes a very generic, vehicle-neutral approach to regulating foreign investment, it had been widely anticipated that its implementing rules would contain detailed provisions and clause-by-clause operative guidance on how to apply the FIL in practice. However, the Draft Implementation Regulations emerged as a surprisingly short document, comprising only 5 chapters and 45 articles. In an even shorter explanatory letter accompanying the Draft Implementation Regulations, it was said that the Ministry of Justice, the Ministry of Commerce ("**MOFCOM**") and the National Development and Reform Commission ("**NDRC**") were co-leading the efforts on drafting this significant piece of legislation, bringing an interesting, but contrasting set of skills to the drafting table.

This note aims to summarize and highlight what we consider to be the most notable provisions included in the Draft Implementation Regulations. We will not seek to repeat what has already been discussed in great detail in our earlier Client Notes "*The Foreign Investment Law: A New Chapter Opens for Foreign Direct Investment in China*" dated April 2019, "*New draft of the Foreign Investment Law takes a more 'stripped-down' approach, but defers discussion on the 'elephant in the room'*" dated February 2019, and "*China breaks new ground with Foreign Investment Law-related Intellectual Property ("IP") reform*" dated April 2019.

Key provisions of the Draft Implementation Regulations

Further clarifying the definition of "Foreign Investment"

Under Article 2 of the FIL, "**Foreign Investment**" is defined as "investment activities carried out directly or indirectly within the PRC by foreign natural persons, enterprises or other organizations ("**Foreign Investors**"), including circumstances where a Foreign Investor:

- Either individually, or together with **other investors**, establishes foreign-invested enterprises;
- Obtains shares, equity interests, asset shares or other similar rights and interests in PRC-based enterprises;
- Either individually, or together with **other investors**, **invests in new projects within China**; and

[1] Given the amount of time and effort expended in making this, availability will be limited to existing and potential clients of the firm.

- Invests in the PRC by other means specified by laws, administrative regulations or the State Council.

A foreign-invested enterprise (FIE) referred to hereunder means an enterprise invested in whole or in part by Foreign Investor(s) and **registered** and established in the PRC in accordance with PRC laws."

Who can be an investor in an FIE?

The Draft Implementation Regulations have now made it clear that "**other investors**" include Chinese individuals. Article 3 of the Draft Implementation Regulations expressly allows Foreign Investors to make investments in China jointly with Chinese individuals. Under current FIE Laws, Foreign Investors are not allowed to partner with Chinese individuals to set up new joint ventures in China, except in two scenarios. The first exception was made available under the *Merger with and Acquisition of Enterprises in China by Foreign Investors Provisions* ("**M&A Provisions**") allowing existing shareholders of an acquired enterprise who are Chinese individuals, subject to MOFCOM approval (now record-filing in most cases), to remain as the shareholders of such enterprise after being acquired by Foreign Investors. There used to be a minimum holding period requirement under the *Circular on Issues related to Strengthening the Administration of the Approval, Registration, Foreign Exchange and Taxation pertaining to Foreign-Invested Enterprises* (the "**Approval and Registration Circular**") that such Chinese individual shareholders must have been holding the interests in the acquired enterprise for more than one year prior to the acquisition. However, such requirement was presumably lifted by the M&A Provisions which, as a relatively newer piece of legislation, override the conflicting provisions in the Approval and Registration Circular.

The second exception was made available under the specific regulations adopted by the local governments of certain places including Shanghai Pudong New Area, Beijing, Chongqing, Xiamen, Shenzhen and so forth, which have territorial applicability as well as limitations[2]. Therefore, Article 3 of the Draft Implementation Regulations, if eventually adopted as written, will be a legislative breakthrough allowing, for the first time ever, Foreign Investors to set up new joint ventures with Chinese individuals anywhere in China, providing a historical levelling of the playing field for Chinese individual investors, who were previously not allowed to invest unlike their foreign individual counterparts.

The Draft Implementation Regulations also clarifies that:

- "**invests in new projects within China**" as referred to in paragraph (c) means investments made by Foreign Investors in the construction of specific projects within the PRC without establishing FIEs or acquiring the shares, equity interests, property shares or other similar rights and interests in a Chinese domestic enterprise; and

- the State Administration for Market Regulation ("**SAMR**") or its authorized local counterparts will be responsible for the **registration** of FIEs, which is consistent with the current practice.

Carving out round-tripping investment

For decades, Chinese individuals and entities have been making round-tripping investments, i.e. setting up an offshore holding vehicle in another jurisdiction and using such holding vehicle to make direct investment back into China ("**Round-tripping Investment**"), for various reasons, including attempting to receive preferential treatment as an FIE, partnering

[2] Please note that the local regulations promulgated by the governments of Shanghai Pudong New Area and Xiamen have been repealed. We have also seen examples where the rule has not been strictly enforced.

with a Foreign Investor in a less restricted economic and legal environment, raising funds offshore from foreign currency denominated funds, creating an offshore income stream in a fully-convertible currency and so forth. A large portion of such Round-tripping Investment was, strictly speaking, not foreign investment at all, as it was not investment made by genuine Foreign Investors into China. However, because foreign investment has historically been distinguished from domestic investment based on the place of establishment of the investor, rather than the source of funds, such Round-tripping Investment was still treated as foreign investment for FIE Laws purposes. In practice the State Administration of Foreign Exchange ("**SAFE**") requires that if the ultimate investor of an FIE is a Chinese resident, such fact must be disclosed to SAFE when completing SAFE registration in relation to such FIE, unless the circumstances fitted into the narrow box where a Chinese investor making a Round-Tripping Investment could be registered with SAFE (e.g. founders in a Series A-D type venture capital-type offshore financing where the structure is being moved offshore with a view to an offshore listing) failing which dividends could not be remitted out and the proceeds of sale of the shares held by the ultimate Chinese investor could not be repatriated to China and converted into RMB.

While the FIL is silent on this point, the Draft Implementation Regulations has, somewhat unexpectedly, proposed a carve-out for Round-tripping Investment. Article 35 provides that **wholly-owned** enterprises established overseas ("**Offshore Investment Vehicle**s") by Chinese natural persons, legal persons or other organizations (excluding FIEs, which makes sense) which invest within the PRC may, subject to a review by the relevant competent departments under the State Council and approval by the State Council, be exempt from complying with the restrictions under the *Market Access by Foreign Investors Special Administrative Measures (Negative List)* (the "**Negative List**"). This seems to be a logical carve-out for the reasons given above. It also takes us back to the highly controversial first draft of the FIL, where, amongst other things, it was proposed to draw a distinction in terms of regulatory treatment between Chinese controlled foreign investors and foreign-controlled foreign investors. However, the requirement that only Offshore Investment Vehicles that are wholly-owned by Chinese investors can be exempted will significantly narrow the scope of applicability of this carve-out provision, as many Offshore Investment Vehicles, such as red-chip companies and Chinese start-ups raising offshore funds, will have minority Foreign Investors, even if they are ultimately controlled by their Chinese founders.

It is also unclear which department under the State Council will be responsible for reviewing the application, but presumably it would be one of MOFCOM and NDRC or both. The fact that the approval will be granted by the State Council, which is the highest level within the Chinese government, suggests that it might actually be difficult to obtain such approval in practice. It also blurs the lines between Chinese Investors and Foreign Investors, although many of the differences such as historical tax breaks have disappeared over the years. Would, for example, a Chinese company be happy knowing that the FIE it chose because it wanted, for whatever reason, a 'foreign brand', be pleased to find out it actually is 100% Chinese owned? Could, for example, such an Offshore Investment Vehicle access tax breaks intended for Foreign Investors?

That said, this Article 35 could potentially become a game-changer and reshape the landscape of many Chinese businesses structured under the variable interest entity ("**VIE**") arrangement, if the "wholly-owned" requirement could be changed to a "controlled" test to capture most of the Chinese ventures using an offshore vehicle to raise funds overseas.

If such offshore vehicles were no longer treated as Foreign Investors for the purpose of the FIL and therefore not subject to the restrictions in the Negative List, then in many cases there would be no need to keep the VIE structure in place, the main purpose of which is to circumvent foreign ownership restrictions under the Negative List. This could have a material, and largely positive, impact on thousands of market players in the sectors which remain restricted such as TMT and education. Query, however, whether China would allow minority Foreign Investors to effectively circumvent Negative List restrictions by hanging on the coat-tails of a majority Chinese investor. It would start to get complex, for example, if you had to analyse whether the offshore attributable foreign equity interests fell within the prescribed shareholding ratios under the Negative List.

Removing MOFCOM approval requirement

Under current FIE Laws, Foreign Investors wishing to make an investment in a restricted sector under the Negative List need to first obtain approval from MOFCOM. The Draft Implementation Regulations proposes to lift such approval requirement by vesting such authority in SAMR. Article 38 states that where a Foreign Investor invests in sectors in which investment is restricted under the Negative List, the competent SAMR will, at the time of registration, conduct a review to ascertain whether the Foreign Investor satisfies the restrictive requirements under the Negative List concerning shareholding ratios, senior management personnel and so forth; where the relevant competent department has already conducted the review when performing the relevant procedures in accordance with law, SAMR will not conduct a second review.

It is worth noting that the Internal Version still requires SAMR or the relevant competent department to solicit the opinions of the competent MOFCOM at the same level. However, such requirement was deleted in the Public Version. No timeline is stipulated in the Draft Implementation Regulations, so it is unclear how long the SAMR registration process will take, and whether such process will be prolonged as a result of the integration of the approval and registration process. It is also unclear how SAMR's review will be conducted for foreign investment made in a manner that does not require registration, such as an asset acquisition within China by an existing FIE. The Internal Version of the Draft Implementation Regulations is silent on whether a foreign investment not otherwise subject to the Negative List would still need to make record-filings with MOFCOM as is currently required under the post-reform FIE regime, in particular the *Record-filing of the Establishment of, and Changes to, Foreign Invested Enterprises Interim Administrative Measures* (the "**FIE Record-filing Measures**") promulgated by MOFCOM. However, a new Article 36 was added to the Public Version, stating that where a foreign investment project needs to be approved or record-filed, such approval or record-filing process shall be undertaken in accordance with the relevant provisions stipulated by the State Council and NDRC. Since the FIE Record-filing Measures were promulgated by MOFCOM rather than NDRC, it is our understanding that the MOFCOM record-filing system will likely be repealed in its entirety and replaced by the information reporting system proposed to be established under the FIL, or, perhaps less likely, by a new record-filing system established by NDRC. It also raises interesting questions about the diminishing role of MOFCOM as the main, general-purpose regulator for FIEs, with several of its key functions being transferred to SAMR and NDRC.

Clarifying what will happen within and after the Transitional Period

Article 31 of the FIL provides that the FIE Laws shall cease to be in force from its effective date (i.e. 1 January 2020), and from such date onwards, the *PRC Company Law* ("**Company Law**") or the *PRC Partnership Law* ("**Partnership Law**") will regulate and govern the organizational structures, organizational bodies and rules governing activities by FIEs. Not surprisingly, it clarifies and fills in the gap left by the FIL by stating that the *PRC Sino-Foreign Equity Joint Venture Enterprise Law Implementing Regulations*, the *Operating Terms of Sino-Foreign Equity Joint Venture Enterprises Interim Provisions*, the *PRC Foreign-Invested Enterprise Law Implementing Rules* and the *PRC Sino-Foreign Cooperative Joint Venture Enterprise Law Implementing Rules* will be repealed at the same time. However, it remains unclear what will happen to the vast number of departmental rules, measures and rules promulgated by MOFCOM, NDRC, SAMR, SAFE and the other *de facto* regulators governing and regulating every single aspect of an FIE's life, including, for example, the M&A Provisions and the Approval and Registration Notice.

Article 42 of the FIL further provides that existing FIEs may maintain their original governance structures for five years after the FIL takes effect (the "**Transitional Period**"). Many have been wondering, in the absence of detailed guidance, how such transition should be managed (if you act now, will your Chinese joint venture partner seek a wider renegotiation of terms, but if you wait too long, will you end up backed up against the deadline for the expiry of the Transitional Period and lose any negotiating leverage you might otherwise have had) and what would happen to FIEs which failed to make the switch within the Transitional Period. Now Article 42 of the Draft Implementation Regulations makes the 'carrot and stick' elements clear: it states that the State 'encourages' all FIEs to make changes in accordance with law within the Transitional Period. If an FIE that should have made the change fails to do so within the Transitional Period, then it will have another grace period of six months to complete the change procedures, failing which the competent SAMR will not accept its applications subsequently made for other changes and may disclose such non-compliance in the enterprise information publicity system. This means that attacking the transition early enough while you have time on your side seems to be the better strategy and will help to avoid a damaging impasse and business interruption down the line.

On the other hand, the specific measures by means of which existing FIEs are to change their organizational form, institutional framework and so forth will be formulated by SAMR together with other relevant departments under the State Council, so the wait is not over yet. We expect that such specific measures will be rolled out around the time of commencement of the Transitional Period.

Carving out proceeds distribution methods

Article 43 of the Draft Implementation Regulations has also proposed an interesting agreement-over-statute carve-out from the general application of the Company Law and the Partnership Law. It states that following the implementation of the FIL, the distribution of profits method, the residual property distribution method and so forth as set forth in the relevant contracts by the parties to an existing Sino-foreign equity joint venture ("**EJV**") or Sino-foreign cooperative joint venture ("**CJV**") may continue to be valid during the term of the joint venture. Presumably this means that such agreement reached by the parties to a joint venture, to the extent that it is conflicting with the statutory provisions under the Company Law or the Partnership Law, can override the statutory provisions if the parties so wish.

The rationale behind this may be as follows: the Company Law allows the shareholders of a company to agree on a method of dividend distribution in the articles of association

("**AOA**") of the company that is different from the default position under the Company Law that distribution must be made in proportion to capital contributions. However, the Company Law does not allow the shareholders to agree otherwise on the method of distribution of liquidation proceeds. By way of contrast, the EJV Law does not permit dividend distributions which are not made strictly in proportion to capital contributions and equity interests held, but its implementation regulations allow liquidation proceeds to be distributed by agreement as set out in the joint venture contract ("**JVC**") and AOA. The CJV Law is much more flexible and allows both methods to be determined by agreement between the parties. Therefore, if a JVC between the parties contains provisions that are different than the statutory provisions under the Company Law, which could have been heavily negotiated by the parties at the time of entering into the contract, such agreement ought to be respected.

Change of power dynamics

Of course the way that this is phrased, using the word "may" makes it clear that there is no compulsion to maintain the current structures. The FIL does, of course, change the power dynamic within an existing EJV or CJV, where previously you had Board of Directors – driven governance, and entrenched minority protections that allowed a small minority with say the right to appoint one director to the Board of Directors to veto key corporate actions such as changes to the AOA, increases or decreases of capital, merger and demerger or termination and dissolution. Under the FIL, with the shift to shareholder-driven governance, and with the removal of the veto rights in favour of shareholder resolutions requiring only a two-thirds majority of votes cast by shareholders to pass these same corporate actions, the position of minorities such as in a 70:30 EJV becomes more precarious (as 66% becomes a 'magic number' conferring absolute control absent contractual carve-outs). Those minorities will be keen to ensure that veto rights to changes in profit distributions (as noted above the Company Law uses the model based on equity interests held as a default but allows contracting out if all shareholders agree in the AOA) will be maintained, particularly if they agree to lose previous minority protection veto rights. In short, minorities will want to stick to the status quo on distributions of profit and it may be difficult to persuade a minority in an EJV to change profit distribution ratios away from the default, even if the law now allows it. Similarly those minorities may seek to replicate their entrenched minority protections contractually after any FIL-driven renegotiation of JVC terms. That is not an issue that will blight FIEs established post 1 January 2020, as they can agree the mechanism from the outset, free from the rigid structures of the EJV Law. It may prove to be easier to start afresh than try and shoehorn reluctant shareholders from a legacy EJV/CJV into a new structure that takes full advantage of the inherent flexibility of the Company Law, which allows the parties to contract out of many of the default positions.

Further clarifying investment protection provisions

The FIL has an entire chapter (Chapter 3) addressing the issue of protecting Foreign Investors' investments in China. Article 7 of the Draft Implementation Regulations provides that the State will protect Foreign Investors' investment, proceeds and other lawful rights and interests in China in accordance with laws and regulations [of the PRC] and the international conventions and treaties that have been entered into by China. This is the first time that international conventions and treaties have been listed as the legal basis for the source of protective measures with respect to foreign investment, as compared to the WFOE Law which only provides for PRC laws and the EJV Law and CJV Law which are both silent on this point. We are of the view that this emphasizes the importance of the some 104[3] bilateral investment treaties that China has entered into with other countries around the globe, many of which may have been completely overlooked by Foreign Investors when making their investments into China, not to mention international conventions such as the New York Convention which are key to successfully resolving disputes in China by allowing a *prima facie* path for enforcement of an arbitration award rendered in any given adhering state in any other, to which China has adhered and has effectively extended to Hong Kong.

Chapter 3 of the Draft Implementation Regulations speaks to investment protection. It contains the following notable provisions:

- **Expropriation**. Article 22 reiterates that the specific circumstances under which expropriation of Foreign Investors' investment is permitted must be expressly stipulated in laws, which refers to laws in their narrow sense, i.e. those that have been adopted by the full National People's Congress or its standing committee pursuant to the *PRC Legislation Law*. No expropriation may be carried out on any basis other than in accordance with laws. This means that administrative regulations and measures adopted by the State Council and its ministries and departments and by local governments at various levels cannot serve as the basis for an act of expropriation targeting a Foreign Investor's investment in China. This gives comfort to Foreign Investors that they will not fall victim to expropriations triggered by local rules or power games.

- **Remittance of funds**. Article 23 repeats what has been said in the FIL on 'free' remittance abroad of capital contributions, profits, capital gains, proceeds from disposal of assets, royalties on intellectual property, compensation or indemnities received in accordance with law and liquidation proceeds. However, it goes on to provide that no organizations or individuals may **unlawfully** impose restrictions on the currency, amount and frequency of such remittance made in both directions. Presumably banks in China, to which a large swathe of the authority to review and process cross-border payments has been delegated by SAFE are also caught by this ban. However, in practice, banks still receive window guidance from SAFE and their attitude towards cross-border payments is largely influenced by the foreign exchange policy that changes from time to time, often in a fairly opaque manner. Given that Article 23 has an "unlawfully" qualifier, it may be difficult in practice to argue or produce evidence that a bank following non-public domain window guidance is actually in violation of this article by placing restrictions on remittances of funds.

- **Protection of intellectual property rights**. Article 24 provides that a punitive damages system will be established to address infringements of intellectual property rights. It also says that the State will strengthen the protection of intellectual property rights of Foreign Investors and FIEs by driving to establish an intellectual property quick coordination protection system, and improving the intellectual property alternative dispute resolution system and the intellectual property rights protection and aid system. This is consistent with developments in intellectual property law in China in recent years aimed at strengthening protection for domestic and foreign intellectual property owners alike in China, including the amendments to the *PRC Trademark Law* and the *PRC Anti-Unfair Competition Law* (primary legislation on trade secret protection) in 2019, which allow the courts to award punitive damages up to five times the actual

[3] At time of writing. Source: http://tfs.mofcom.gov.cn/article/Nocategory/201111/20111107819474.shtml

damages for serious infringement conducted in bad faith. Article 25 and Article 26 of the Draft Implementing Regulations provide similar assurances on the protection of intellectual property rights, reiterating what has been set out in the FIL. Article 25 prohibits administrative authorities from forcing Foreign Investors or FIEs to transfer technology, explicitly or in a disguised form, during the administrative licensing process. Article 26 requires administrative authorities to adopt effective measures to protect the confidentiality and restrict the disclosure of trade secrets obtained from Foreign Investors or FIEs during the administrative licensing process. These provisions address some of the key and longstanding concerns of Foreign Investors in relation to bringing technology over to China, but the question remains as to how they will be enforced, once enacted, at the local level.

- **Lawfulness of normative documents**. Article 24 of the FIL addresses local protectionism in legislation by providing that normative documents relating to foreign investment as formulated by government and its relevant departments at various levels may not prejudice FIEs' lawful rights and interests or increase their obligations, set market entry and exit conditions or interfere with the normal business activities of FIEs without a legal basis provided under laws and administrative regulations. To this end, Article 27 of the Draft Implementation Regulations further provides for a remedy allowing Foreign Investors or FIEs to challenge the lawfulness of such normative documents by requesting a judicial review when they bring an administrative suit on the specific administrative act in accordance with the *PRC Administrative Procedure Law*. This is technically not a new remedy, as such right to request a judicial review has been made universally and equally available to all persons and entities having a cause of action under the *PRC Administrative Procedure Law* or the *PRC Administrative Review Law*. The question here is how many Foreign Investors will be willing to challenge the local authorities that are responsible for the future longevity of their FIE, which may be seen as 'biting the hand that feeds you', knowing that they have say a critical operating permit coming up for renewal.

- **Fulfilment of commitments**. Article 25 of the FIL requires local governments and their respective departments to strictly fulfil the policy commitments they make to, and the contracts entered into with, Foreign Investors and FIEs, provided that such policy commitments and contracts are made or entered into in accordance with law. Article 28 of the Draft Implementation Regulations clarifies that "policy commitments" as set forth under Article 25 of the FIL refers to commitments made by local governments at all levels, and the relevant departments thereof, with respect to the preferential measures or facilitating conditions applicable to the investments by Foreign Investors or FIEs in their respective areas under administration. It also provides that local governments at all levels and the relevant departments thereof must not go beyond the four corners of their statutory authority when making policy commitments to Foreign Investors and/or FIEs. Quite interestingly, it further provides that policy commitments must be reduced to writing, and the contents thereof must comply with laws, regulations and the relevant policies of the State. This is presumably to prevent the local governments from promising what they have no right or ability to deliver (e.g. rebates of national as opposed to local taxes) and from reneging on their commitments. However, this might push local government officials acting more discreetly and conservatively in making policy commitments for fear of any written documents potentially being used as evidence against them at a later stage, threatening their career progression prospects, given that Article 29 of the Draft Implementation Regulations expressly forbids local governments and the relevant departments thereof from breaching or reneging on such contracts or commitments on the grounds of administrative divisions being readjusted, changes in government leadership, institutional or functional adjustments, changes of the relevant persons in charge and so forth. In short, policy commitments risk becoming a permanent millstone around an officials neck, even after leaving the locality, which may argue against bold initiatives in this regard. It also means Foreign Investors will have to carefully scrutinize the lawfulness of any commitments given.

- **Complaint mechanism**. Article 26 of the FIL provides that the State will establish a working mechanism through which FIEs can lodge complaints, to promptly resolve the problems reported by FIEs and their investors, and coordinate and improve the relevant policies and measures. Article 30 of the Draft Implementation Regulations has now made it clear that MOFCOM will take the lead on establishing a national working mechanism together with other relevant departments under the State Council. It is, however, worth noting that Article 30 seems to have narrowed the scope of the complaints that will be processed under such working mechanism, which is now limited to issues that have a nationwide material impact and other material or complex issues. The materiality qualifier, which is not clearly defined, will likely make it difficult for Foreign Investors and FIEs to take advantage of, and to benefit from, such national working mechanism. Article 30 also provides that local governments at the county level or above may, subject to actual needs, establish a local complaint working mechanism to resolve the problems reported by FIEs and their investors within the applicable region. Most likely most Foreign Investors and FIEs will have to make their complaints through such local working mechanisms should they ever be established.

Other clarifications and new changes

The Draft Implementation Regulations further clarifies the meaning of certain provisions of the FIL, including the following:

- Article 4 of the FIL states that the Negative List will be promulgated by, or be authorized to be promulgated by, the State Council. Article 6 of the Draft Implementation Regulations further clarifies that the Negative List may be amended by the State from time to time and NDRC and MOFCOM will be responsible for proposing the Negative List and its amendments to the State Council for promulgation or authorization for promulgation. This is consistent with current practice on formulating and promulgating the Negative List;

- Article 13 of the FIL provides that the State will establish special economic areas to promote foreign investment. Article 12 of the Draft Implementation Regulations clarifies that such special economic areas refers to specific areas approved to be established by the State where more liberal policies and measures will be adopted with respect to foreign investment. This provides for the legal basis for further opening up the domestic market to Foreign Investors and implementing pilot programs on a trial-run basis in designated areas such as the Shanghai Free Trade Zone;

- Article 13 of the Draft Implementation Regulations authorizes the State to formulate a catalogue of business sectors in which foreign investment is encouraged and

NDRC, MOFCOM and other relevant departments and local governments will be responsible for formulating such catalogue and presenting the same to the State Council for approval. Foreign Investors making investment in such encouraged sectors will be entitled to enjoy preferential treatment in terms of governmental funding support, taxation, finance-related support, use of land and so forth. Such a catalogue already exists in any event. Interestingly, Article 14 goes on to say that Foreign Investors will also be entitled to preferential treatment if they use their investment returns in China to make further investments in China, but it remains to be seen what preferential treatment will be made available to Foreign Investors in such scenario other than the current rules on facilitating fund flows in using Foreign Investors' RMB profits originated from China to make re-investments in China and deferring such Foreign Investors' payment of withholding tax;

- Article 17 of the Draft Implementation Regulations forbids all organizations and individuals from obstructing or restricting FIEs from by whatever means entering into the local government procurement markets or discriminating against FIEs in the procurement process; this is clearly taking aim at scorecard-type systems which discriminate against FIEs and favour local or State-owned tenderors.

- Article 34 of the Draft Implementation Regulations aims to close a loophole that was left open in the FIL and the Negative List. It provides that where the Negative List contains restrictive provisions concerning the shareholding ratios of Foreign Investors in relevant sectors which are technically applicable to FIEs established in the form of a limited liability company or company limited by shares only, and a Foreign Investor invests in such sector by way of establishing a partnership, the proportion of voting rights of such Foreign Investor under the partnership agreement must comply with the restrictive provisions of the Negative List concerning shareholding ratios. This is inconsistent with the 2019 version of the Negative List, which expressly forbids Foreign Investors from investing in such restricted sectors by way of setting up a foreign invested partnership enterprise. If Article 34 is eventually adopted, then presumably the next version of the Negative List will have to be amended so as to be made consistent with this Article; in a sense this removes one functional alternative to the VIE structure from consideration in restricted sectors;

- The FIL has proposed to establish an information reporting mechanism and the content and scope of the information to be reported shall be determined on a "genuine necessity" basis. Article 40 of the Draft Implementation Regulations clarifies that the contents and scope of foreign investment information reports, as well as the frequency of reporting, will be determined by MOFCOM, SAMR and other relevant departments under the State Council. We expect that MOFCOM and SAMR will further formulate and promulgate rules in this regard. The hope is that these will not be overly intrusive or resource-intensive to produce, and will provide for even-handed treatment of domestic investors and Foreign Investors[4].

- The Internal Version of the Draft Implementation Regulations has an article providing that the administrative measures for the investment by FIEs in the PRC will be prescribed separately by the relevant competent departments under the State Council in accordance with the principles under the FIL and the Draft Implementation

[4] Please see further our article published on Practical Law

Regulations. This suggests that the *Investments Made by Foreign-Invested Enterprises in China Interim Provisions* will likely be repealed and replaced in the near future. However, this article was deleted in its entirety in the Public Version, leaving this an open issue to be further clarified at a later stage. A related major development to note in this regard is that SAFE issued the *Circular on Further Improving the Facilitation of Cross-border Trading and Investment* on 25 October 2019, completely relaxing the restrictions on the use of registered capital by ordinary (non-investment-type) FIEs for reinvestment within China, providing a major boost to the M&A market within China.

Further clarifying applicability and replacement arrangement

The applicability of the FIL and the Draft Implementation Regulations to investors from Hong Kong and Macau Special Administrative Regions is different from that to investors from Taiwan. Article 44 provides that except where laws, administrative regulations or the State Council provide otherwise, investment in mainland China by investors from the Hong Kong or Macau Special Administrative Regions will be subject to the FIL and the Draft Implementation Regulations. On the other hand, however, investment in mainland China by investors from Taiwan will be subject to the *People's Republic of China Taiwan Compatriot Investment Protection Law* and the *People's Republic of China Taiwan Compatriot Investment Protection Law Implementing Rules*; and matters not specified under the aforesaid rules will be subject to the FIL and the Draft Implementation Regulations. In addition, investment in mainland China by Chinese citizens residing overseas is also subject to the FIL and the Draft Implementation Regulations.

Conclusion

The Draft Implementation Regulations, if adopted, will come into force on 1 January 2020, simultaneously with the FIL. The most striking thing about the Draft Implementation Regulations is how they are still pitched at a very generic, vehicle-neutral, detail-lite level. Unless the next batch of implementing rules go in a different direction, it would appear that we are indeed entering a different paradigm for the modern FIE where China is no longer seeking to micro-manage how you run every aspect of your FIE, but whose role is now more like providing the four corners of the 'playpen' and saying that as long as you do not stray outside those boundaries which apply across the board to domestic capital entities and FIEs alike (e.g. the Company Law and the shareholder as the supreme authority), you are more or less free to determine what you do within them. This new approach in itself is quite liberating and refreshing. What we have now may not be enough to ensure that FIEs have enough to take flight, as we still do not know whether, for example, the previous restrictions on debt financing will apply to FIEs under the FIL: it would appear not, but we have not seen an express repeal of the very 'vintage' rules in this regard. But it is a good start.

For those with existing FIEs, the challenges are clear: the FIL redirect to the Company Law as the base set of default rules would, if applied literally, create winners and losers, in something of a zero sum game, with small minorities who previously enjoyed entrenched veto rights on certain board resolutions the big losers under the shareholder-driven governance under the Company Law, particularly those who would fall below the 33% blocking threshold for certain key resolutions. But they are unlikely to roll over and accept this in any FIL-driven JVC/AOA renegotiation and, we think, will fight tooth and nail to retain, on a purely contractual basis by way of 'reserved matters' their veto rights under the old pre-FIL regime. This may, in some cases, mean that contractually you end up in the same place and unable to truly benefit from the greater flexibility that is one of the key attractions of the FIL and the Company Law regime. It remains to be seen whether parties to these legacy FIEs are able to agree a new *modus operandi* that meets somewhere in the middle, with some of the previous entrenched rights maintained contractually but others being abandoned, or whether an impasse will be reached leading to the parties deciding to cut their losses, liquidate, and start with new parties and a clean sheet of paper or have one party buy out the other (where legally permitted). The combination of the FIL and the Draft Implementation Regulations do take us overall to a better place from just about every angle you look at it, but the benefits are more obvious for the greenfield operations starting after 1 January 2020, and less obvious for legacy EJV/CJV. No-one ever said that the biggest change to the FDI regime in China since the 1980s was going to be a walk in the park or would not leave any victims in its jet trails, but the Draft Implementation Regulations do drive home the point that the clock will start ticking on 1 January 2020 for those legacy EJV/CJV to start making the changes needed to comply with the new FIL regime.

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