The foreign investment law: A new chapter opens for foreign direct investment in China

April 2019

Hogan Lovells

1. Introduction and Overview

As had been widely anticipated, the *Foreign Investment Law* (the "**FIL**", full text in Chinese here, in-house English translation available[1] upon request) was voted into law by China's highest legislative body, the National People's Congress ("**NPC**") of the People's Republic of China[2] ("**China**" or "**PRC**") on March 15, 2019.

The FIL will form the backbone of legislation regulating and governing foreign direct investment ("**FDI**") in China going forwards. Against the backdrop of trade tensions with the United States and the EU, the official purposes of the FIL are (leaving out the more political ones) to expand the opening up policy, promote FDI into China and protect lawful the rights and interests of foreign investors, and to regulate the administration of foreign investment. How it opens up a new chapter in FDI regulation in China is by replacing the main existing rules governing foreign invested enterprises ("**FIEs**"), namely the *Sino-Foreign Equity Joint Venture Law* (the "**EJV Law**") the *Sino-Foreign Cooperative Joint Venture Law, and the Wholly Foreign-Owned Enterprise Law* (the "**WFOE Law**")(collectively the "**FIE Laws**").

The FIL will take effect from January 1, 2020. The final version was largely based on a draft law issued by the NPC in December 2018 for public comment (the "**2018 Draft**"). There have not been many significant changes in the newly-promulgated FIL compared to its 2018 Draft, so much of our recent analysis of the 2018 Draft still applies. Please see our Client Note "*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 for further details (the "**Earlier Note**").

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

[2] In this note, references to China exclude the Hong Kong Special Administrative Region, the Macau Special Administrative Region and Taiwan.

This note will not cover old ground, particularly the now of largely only historical interest comparison between the 2018 Draft and the earlier draft of the FIL issued by the Ministry of Commerce ("**MOFCOM**") in 2015 ("**2015 Draft**"), except where particularly pertinent to the analysis. Instead, in this note we will try to highlight changes in the substance of the FIL that have taken place since December 2018, as well as analysing some of the more important implications of the FIL, such as in relation to foreign investment involving: (a) Sino-foreign joint ventures ("**JVs**"); (b) variable interest entity ("**VIE**") structures; and (c) national security review ("**NSR**").

For the intellectual property rights-related implications, please see our separate Client Note "*China breaks new ground with Foreign Investment Law-related Intellectual Property ("IP") reform*".

2. Key Changes Compared to the 2018 Draft

Further expanded definition of "Foreign Investment"

In Article 2, "**Foreign Investment**" refers to "investment activities carried out directly or indirectly within the PRC by foreign natural persons, enterprises ~~and~~ or other organizations ("**Foreign Investors**"), including circumstances where a Foreign Investor: (**Changes kept to show differences**)

a. Either individually, or together with other investors, ~~invest in new projects,~~ establishes foreign-invested enterprises ~~or increase investment in the PRC~~;

b. Obtains shares, equity interests, asset shares or other similar rights and interests in PRC-based enterprises ~~by way of mergers acquisitions~~;

c. Either individually, or together with other investors, invests in new projects within China ; and

~~b.~~d. 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."

The above changes, as marked against the 2018 Draft, seem to give more space for interpretation regarding the VIE structure. In particular, the changes in paragraph (b) above could potentially capture newly-created VIE structures by a foreign investor or an FIE. Please see further discussion on the implications for the VIE structure in section 4 below.

Further clarification of certain terms and articles

The FIL further clarifies the wording and expression of certain, including the following:

a. In Article 4, explaining the meaning of "pre - [market] access national treatment", i.e., at the market access stage, giving foreign investors and their investments treatment that is no less favourable than that granted to Chinese investors and their investments;

b. In Articles 3, 9, 16, among other things, placing greater emphasis on fair competition and equal treatment between foreign investors and Chinese domestic investors;

c. In Article 16, adding services (on top of products) into the scope of government procurement activities in relation to which foreign investors are equally eligible to participate on the basis of fair competition;

d. In Article 20, specifying that compensation for expropriation shall be paid "in a timely manner" and adding that the state shall also only engage in "requisitioning" as well as "expropriation" in special circumstances; Foreign Investors may need to look at any applicable bilateral investment protection treaty which trumps domestic law like the FIL to determine whether it provides additional safeguards or protections against expropriation;

e. In Article 21, adding asset disposal and liquidation proceeds (in addition to capital contributions, profits, capital gains, intellectual property licensing fees, compensation or indemnification obtained in accordance with law) which foreign investors are allowed to transfer freely in or out of the PRC in accordance with law;

f. In Articles 23 and 39, requiring governmental authorities and officials to keep trade secrets of foreign investors and FIEs confidential, failing which administrative penalties and even criminal liability will be imposed;

g. In Article 31, clarifying that in terms of organizational form, institutional framework and standards for activities of FIEs they shall apply the *PRC Company Law* (the "**Company Law**") or the *PRC Partnership Law* (the "**Partnership Law**") as appropriate, thus confirming the legislative link to the main rules regulating domestic capital entities ("**Domestic Capital Entities**"); and

h. In Article 42, clarifying that it will be the State Council that will promulgate implementing rules regarding the transition from the organizational form of existing FIEs' to that under the Company Law or the Partnership Law during the 5-year transitional period.

Local incentives

In Article 18, it is further specified that only "governmental authorities at the county level or above" have the authority to promulgate

promotional and/or facilitation measures for Foreign Investment "in accordance with laws, administrative regulations or local regulations”. This means such preferential investment measures must have a legal basis, and cannot be issued by lower-level governmental authorities. This Article aims to prevent unlawful or *ultra vires* policies being issued by local governments. However, as mentioned in our Earlier Note, when read together with Article 25 which requires local governments to perform their policy commitments and/or contractual agreements, Article 18 may, on the other hand, increase the due diligence burden on foreign investors and FIEs in distinguishing lawful and authorized commitments from unlawful or *ultra vires* ones prior to making investment decisions or entering into contracts. On the positive side, the FIL does give foreign investors a baseline: if a government authority below county level offers an incentive, it can be ignored.

Link to AML

The FIL incorporates an article (Article 33) to link to the existing merger filing and anti-monopoly regime under the *PRC Anti-monopoly Law* effective 1 August 2008, specifying that foreign investors carrying out mergers and acquisitions of Chinese Domestic Capital Entities or otherwise participating in concentrations of businesses must go through merger control review. Merger control filing remains a concern in terms of timing of establishment of joint ventures and/or M&A transactions involving concentrations, in that where a case is accepted for simple case treatment it may need 1-2 months for clearance, but if not cases can take between 3-5 months to process. Given that the law prohibits implementation of the concentration before clearance is granted, a merger filing in China (not to mention in other jurisdictions) has the potential to push out closing timelines significantly.

Legal liability for violation of Negative List

a. Article 36 adds that in the event of violation of restrictions or prohibitions under the Negative List, foreign investors must assume the corresponding legal liability in addition to those already specified under the FIL, such as cessation of investment, disposing of shares or assets and returning to the pre-investment *status quo*.

b. The FIL also adds a separate penalty provision (Article 37) on violation of information reporting rules by foreign investors or FIEs, and specifies that MOFCOM is the competent authority to impose such penalties, which may range from RMB 100,000 to 500,000. For a more detailed discussion of the current information reporting system run by MOFCOM, please refer to our Earlier Note.

The new paradigm

Overall, the FIL has established a revamped multi-pronged framework for Foreign Investment, based around the following core concepts:

a. pre- [market] access national treatment plus negative list administrative system;

b. FIE general or sector-specific regulation by corresponding governmental departments such as the Ministry of Industry and Information Technology for Internet, telecoms and certain manufacture sector FIEs and so forth;

c. project-level regulation by NDRC;

d. merger control review for concentrations;

e. national security review;

f. information reporting;

g. governance rules and registration rules for changes in senior management (such as directors, general manager or legal

representative), members of governance bodies and so forth; and

h. general ongoing regulation of FIE operational activities, such as labor protection, tax, foreign exchange, and so forth.

Most, if not all of these concepts are not new, but the FIL brings them together in a single piece of legislation that is 'vehicle agnostic', in contrast to the previous approach. (a) to (e) are applicable at the point of investment, while (f) to (h) are ongoing in nature.

3. What Will Happen to Existing JVs?

This is one of the "million dollar questions" raised by the FIL. Article 31 of the FIL provides that the FIE Laws shall cease to be in force from its effective date (i.e. January 1, 2020), and from such date onwards, the PRC Company Law or the Partnership Law will regulate and govern the organizational structures, organizational bodies and rules governing activities by FIEs. Since a wholly foreign-owned enterprise ("**WFOE**") is already in the form of a limited liability company with its shareholders meeting as the supreme governance body as stipulated under the Company Law, the changes will mostly affect JVs, i.e., equity joint ventures ("**EJV**") and cooperative joint ventures ("**CJV**").

Corporate governance under the Company Law vs. EJV Law and CJV Law

As briefly set out in our Earlier Note, FIEs may actually benefit (e.g. enjoy more flexibility in terms of corporate governance) from moving from the FIE Laws to the Company Law or the Partnership Law. The FIE Laws were written at a time when the relationships between foreign investors and Chinese investors were very different, with the emphasis on protecting a perceived weaker Chinese party, as opposed to now, where the parties may have roughly equal or similar bargaining power, so included things like entrenched minority protections for Chinese investors in key areas like changes to Articles of Association ("**AOA**"), capital increase or decrease, termination and dissolution, merger and demerger and mortgages of assets or change of corporate form (the latter two for CJVs only). On the other hand, such alignment may impose a significant documentary and management burden on existing FIEs in China. There are various 'flavours' of equity FIEs under current FIE Laws, including WFOEs, EJVs, and CJVs, the latter either with or without separate legal personality from investors, which resemble a partnership but are quite rare not to mention a few joint stock foreign-invested limited liability companies (foreign-invested companies limited by shares). The most impacted vehicles will be EJVs and CJVs. We have summarized in the table below the main differences in governance structure and rules governing certain corporate actions (e.g. profit distributions) under the Company Law compared to those provided under the EJV Law and/or CJV Law.

Matters	The Company Law	The EJV Law	The CJV Law
Supreme governance body	Shareholder/shareholder(s) meeting.	Board of directors ("**Board**").	Board joint management committee[3] ("**JMC**").
Minimum number of board/committee members	1	3	3
Term of directors	≤ 3 years.	4 years.	≤ 3 years.
Restrictions on allocation of board/committee seats	None.	Based on consultations by reference to each investor's ownership ratio.	Based on consultations by reference to the ownership ratio of/cooperation conditions provided by each investor.
Restrictions on appointment of chairman/general manager	None.	If one party appoints the chairman/general manager, the vice chairman/deputy general manager shall be appointed by the other party.	If one party appoints the chairman/committee head, the vice chairman/head shall be appointed by the other party.
Board/committee member	Nominated by shareholders and appointed by shareholder(s) resolution.	Appointed by shareholders.	Appointed by shareholders/parties.
Quorum requirement for meetings of the supreme governance body	None. Normally provided in AOA.	2/3 of the Board members.	2/3 of the Board/JMC members.
Voting requirement for statutory reserved matters matters	Votes in favour representing 2/3 of shareholding rights for amendment of AOA, increase/decrease capital, mergers or splits, change of corporate form.	Unanimous approval of the board for amendment of AOA, increase/decrease capital, mergers or splits, termination and dissolution.	Unanimous approval of the Board/JMC members for same matters as for EJVs plus mortgage of assets of CJV or change of corporate form.
Profit distributions	Based on percentage of paid-in capital, except where all shareholders agree otherwise.	Based on the ownership ratio of the shareholders.	As agreed by the parties in the CJV contract, and allows early recovery of investment by foreign investors. In-kind distributions expressly permitted.
Mandatory after-tax fund contributions prior to profit distribution	Statutory funds (and discretionary funds, as decided by the shareholder(s)). 10%	Statutory reserve fund, expansion fund and employee bonus and welfare fund. Percentages	None.

[3] Under the CJV Law, a CJV can be established with no separate legal personality from its investors. The highest internal governance body of such CJV is the "joint management committee", corresponding to the board of directors of a CJV with separate legal personality.

Matters	The Company Law	The EJV Law	The CJV Law
	minimum allocation until cumulative amount equals 50% of registered capital.	determined by Board.	
PRC individual as an initial shareholder	Allowed.	Not expressly specified (read not allowed in practice for a greenfield EJV).	Not expressly specified (read not allowed in practice for a greenfield CJV).
Share/interest transfer restrictions	Consent of non-transferring shareholders representing the majority of the non-transferring shares.	Consent of all the other shareholder(s) who also have pre-emptive right to buy on the same terms as a third party.	Consent of all the other shareholder(s)/party(ies) who also have pre-emptive right to buy on the same terms as a third party.
Available organization form	Limited liability company with undivided shareholding rights and separate legal personality from investors ("**LLC**"); or limited liability company with divisible shares (or joint stock company).	LLC.	LLC; or partnership type contractual joint enterprise, with no separate legal personality but unlimited liability for parties.
Governance document(s)	AOA to be filed with registration authority; shareholders may choose to have a separate shareholders agreement, which is not required to be submitted to registration authority or MOFCOM local branch.	AOA to be submitted to registration authority; and joint venture contract (“**JVC**”), to be submitted to the respective MOFCOM local branch together with AOA if the EJV is engaged in business in a restricted sector.	AOA to be submitted to registration authority; and JVC, to be submitted to the respective MOFCOM local branch together with AOA if the CJV is engaged in business in a restricted sector.

Main issues FIEs should expect to encounter within the transitional period

Article 42 of the FIL provides that existing FIEs may maintain their original governance structures for five years after the FIL takes effect (January 1, 2020). Implementation rules will be promulgated by the State Council during this transitional period. Currently, the issue is that there is insufficient detail to guide either existing FIEs, or FIEs which will be established in the period prior to the FIL becoming effective through the transitional period.

a. Absent legislation on the implementation of Article 42, past practice by the Chinese government suggests that foreign investors and FIEs may need to complete their alignment with the Company Law or Partnership Law within the transitional period. There was a governance structure transition for FIEs in 2005 and 2006, triggered by a major amendment to the Company Law in 2005 (the "**2005 Amendment**"), where WFOEs went down the Company Law 'track' with the shareholders meeting becoming the supreme organ, whilst EJVs and CJVs continued with the Board/JMC as supreme authority. Two subordinate rules issued in 2006 clarify the implementing mechanisms for that transition, one of which was jointly issued by five ministries including MOFCOM and the then company registration authority – the State Administration for Industry and Commerce ("**SAIC**", now part of the restructured 'super regulator' the "State Administration for Market Regulation" or "**SAMR**" for short), and the other issued by SAIC itself. The latter provides that FIEs established prior to the entry into force of the 2005 Amendment may decide whether to adopt the new governance structure and amend their AOAs accordingly. However in practice, in our experience, WFOEs were often required by local branches of SAIC to amend their AOAs to be in line with the new governance structure requirements when they tried to register or file other changes (e.g. to business scope or legal representative) with local branches of SAIC. Gradually over the years, most WFOEs have aligned their organizational structure with these requirements, although there may still be some outliers where they have not needed to make any changes or enforcement at the local level has been lax.

b. It is clear from the comparison table in section 0 that EJVs and CJVs and their investors will be faced with significant changes, although some will result in more favourable outcomes than under existing FIE Laws. Any attempt to align FIE governance with the Company Law will inevitably reopen negotiations among the investors in EJVs and CJVs, and investor consent will be needed to amend the AOA and JVC. This in itself can be a source of uncertainty, particularly if one party sees this as an opportunity to reallocate rights and benefits or a chance to walk away from a bad deal or partner. Under the Company Law, except for a few statutory reserved matters requiring shareholder super-majority (two-thirds) approval, all other matters can be subject to majority rule and may be subject to renegotiation, including: how to allocate rights and obligations among shareholders, the rights to appoint the members of the Board and general manager; the voting requirements on each matter at the shareholders meeting and/or Board meeting level; additional mechanisms to protect minority shareholders at the shareholder level to replace the statutory reserved matters under the EJV Law/CJV Law (although such mechanism may increase the risk of deadlock), and so forth.

c. There are various other uncertainties associated with the transition to the FIL regime, including:

i. Upon the CJV Law being repealed, CJVs with no separate legal personality will lose the legal basis for their current organisational form. What forms (e.g. partnerships) are available needs to be clarified in the implementing rules;

ii. Under the Company Law, a company does not need to file its shareholders agreement (if any) with SAMR. However, it is not clear as to whether JVCs for FIEs in restricted sectors set out in the Negative List are still subject to MOFCOM examination and approval; and

iii. There are now only eight months to go before the FIL becomes effective, from 1 January 2020, but it is not clear what organizational form FIEs proposed to be established during this interim period should adopt, what governance structures should they create, and how they should carry out certain corporate activities. Is there a choice to be made in terms of which rules to apply (e.g. can an EJV, from 1 January 2020 make a dividend that no longer corresponds to shareholding interests assuming the shareholders have agreed to this)? FIEs currently under negotiation may have to either: (a) apply existing FIE laws and align themselves with the new rules after the FIL becomes effective (which will involve extra cost to investors); or (b) apply the FIL before it has come into force (which feels inappropriate); or (c) wait until the FIL takes effect to establish (which will delay the launch of business operations).

The above uncertainties need to be addressed in the implementing rules, which are expected to be issued in the coming months. Foreign investors and FIEs will need to take note and plan accordingly: in fact it is possible that the uncertainty may lead to a drop in FIE formation in the period prior to the implementing rules being promulgated.

4. Implications on VIE structure

The VIE structure in a nutshell

A VIE structure is a control structure consisting of a set of contractual arrangements, through which an offshore parent (or foreign investor), normally through its owned FIE (typically a WFOE), is able to obtain *de facto* control over one or more Domestic Capital Entities registered and operating in the PRC (usually referred to as the "**OpCo**"). Under the VIE structure, the WFOE is normally granted power of attorney by the nominee shareholder(s) of the OpCo to exercise shareholder rights, and profits/cash flows generated by the OpCo are flowed back to the WFOE in the name of technical services fees (or similar) and/or be remitted to the offshore parent as dividends. By means of this structure, the finances of the OpCo can normally be consolidated by the offshore parent. [4]

This structure was initially used by Chinese Internet companies (requiring a permit that could only be held by a Domestic Capital Entity or where they needed a WFOE for the overseas financing aspects, but the permit could only be obtained by an EJV) to raise capital on overseas capital markets and/or through venture capital and private equity investments that are made offshore. A considerable number of such companies have now either been listed overseas or have become sector leaders or national champions (or all of the above), such as Sina, Sohu, Tencent, Baidu, Alibaba, JD, and very recently Meituan and Xiaomi to name but a few. Over the years, the VIE Structure has been widely deployed in certain sectors such as

[4] For a more detailed explanation of VIEs, please refer to our Client Note "*China VIE structure for foreign investment under attack from multiple directions: Will it emerge (relatively) unscathed or is its very survival threatened*?" dated September 2012.

telecommunications, education, media and so forth.

The Chinese government has studiously avoided any action that might be interpreted as either endorsing or banning the VIE structure since its first appearance almost twenty years ago, not least because the personal fortunes of some of China's captains of industry are tied up in such structures. But in recent years, we have seen several attempts by the Chinese government to regulate VIEs, as set out in widely seen as Section 0 below.

FIL's potential jurisdiction over foreign investments incorporate a VIE structure

The 2018 Draft was widely seen as a compromise document to address the tension between the Chinese government's attempt to expand jurisdiction over VIEs and the negative impact this might have on the above mentioned national champions and high-tech industry players with a VIE structure already set up or in process who were seeking overseas financing.[5]

With the very broadly worded sub-clause (2) of Article 2, the FIL seems to have moved one step further by bringing certain FDI forms once enumerated under the 2015 Draft but deleted in the 2018 Draft back within the scope of regulated FDI. By reading sub-clause (2) together with the paragraph defining "Foreign Investment", you can arrive at the following conclusion "Foreign Investment" includes the obtaining of shares, equities, property shares or any other similar rights and interests in an enterprise in China by foreign investors directly or indirectly. This sub-clause neither enumerates nor does it carve out any specific means whereby such interests were obtained (e.g. via capital contribution or contract). Thus on the face of sub-article (2), even without the help of the catch-all sub-article (4)[6] (which would require the type of investment to be specified in legislation to count), VIEs could be interpreted as falling within the wording, thus becoming Foreign Investments subject to regulation under the FIL.

Potential information reporting requirement on ultimate controller

Under the FIL, Foreign Investment includes both direct and indirect investment activities, and again, without defining the scope of "indirect" or enumeration of any structures that are (or are not) deemed "indirect" investment activities. Thus, there is a potential risk from this broad definition that the ultimate shareholder or beneficial owner of an FIE (which might indirectly hold an interest in such FIE through several intermediate holding vehicles) might still be viewed as a foreign investor under the FIL and thus become subject to various obligations, including information reporting. The current record-filing system run by MOFCOM requires FIEs to submit information on their ultimate controller (though as noted in the Earlier Note, curiously this has not yet been extended to FIEs conducting business in restricted sectors under the Negative List), which echoes our concern. Considering the fact that the FIL potentially covers VIEs, the information relating to the ultimate controller of a VIE might fall under the scope of information reporting, if future implementing regulations go in this direction. Ultimate shareholder/controller was previously the core concept under the 2015 Draft to

---

5 The 2018 Draft simplified the definition of foreign investment in the 2015 Draft by, among others, deleting detailed descriptions of several FDI forms, including "obtaining control over or interests in domestic enterprises through contract", and deleting the definition of "control" which includes "control through contract" – this was one of the most controversial aspects of the 2015 Draft when it was first made public. The 2018 Draft adopted a catch-all FDI definition, leaving space for future legislation expressly providing jurisdiction over VIEs.

6 The catch-all sub-article (4) stipulates that Foreign Investment includes investment activities by other means specified by laws, administrative regulations or the State Council, leaving space for future legislation to expand the scope of Foreign Investment and thereby broaden the jurisdiction regulated by the FIL.

distinguish between "true foreign investment" and "true domestic investment" (e.g. the so-called "round-tripping" invested companies, controlled by, say PRC individuals, indirectly through such individuals' overseas entities or individual shareholdings). If future legislation takes the approach of the 2015 Draft in terms of this point (as has happened with respect to certain other aspects), such "round-tripping" companies may be deemed to be domestic investment and thus not subject to some or all of the restrictions or prohibitions under the Negative List, but conversely, VIEs invested/controlled by foreign investors may be viewed as Foreign Investment and thus governed by the Negative List. Taking this one step furthermore, absent a material liberalisation of sectors like telecoms or the Internet, such OpCos and/or associated WFOEs may be seen as having circumvented the rules on obtaining permits in the sector in question and therefore to be in violation of restrictions or prohibitions under the Negative List. The basic remedy in such circumstances would be restructuring to return to a compliant state, e.g. stripping out all direct or indirect foreign investment or elements giving rise to foreign control in relation to an OpCo conducting business in one or more prohibited sectors. It might be possible to restructure a VIE into a JV if it only runs say a single business which is a 'restricted' sector activity subject to foreign investment equity caps, and the shareholders meet the conditions for obtaining the permits needed for running that business as a JV, but this is the exception rather than the rule. Most of the larger VIE-based operators have "fingers in many pies", some of which are 'restricted' and some "prohibited" to foreign investment, making this type of restructuring impractical and unachievable.

Other new trends on VIE regulation

a. In the education sector, we have seen two attempts in policies and draft legislation in 2018[7] that suggest that more sector-specific rules may be on the way. Although the provisions are less than clear, under these documents, "control through contract" and/or "VIEs" are specifically mentioned (but not defined) and subject to regulation. The education sector may, therefore, become a pilot sector for imposing VIE regulation.

b. In the PRC capital markets, the China Securities Regulatory Commission ("**CSRC**"), China's stock markets regulator, indicated in early 2018 that the Chinese government will encourage technology and innovation companies which are listed overseas or intend to seek overseas IPOs to return to the PRC stock markets, including "red-chip companies" (this usually refers to overseas companies seeking an overseas listing while its main business operations are in China, many of which have incorporated a VIE structure). On March 1, 2019, CSRC issued the registration measures for the "Science and Technology Innovation Board" ("**STI Board**"), a newly-established board of the Shanghai Stock Exchange ("**SHSE**"), and on the same day, the SHSE issued the listing rules for the STI Board. These rules expressly provides that red-chip companies (including those with a contractual control structure) are eligible for apply for listing on the STI Board, if they have met the listing requirements and made full and detailed disclosures about such structure, especially on the associated risks and corporate governance aspects.

c. Information from a non-public source indicates that the Antimonopoly Bureau of SAMR has reviewed and unconditionally approved a joint venture in which one

---

7 These two documents are: (i) the *Amendment to the Regulations on the Implementation of the PRC Private Education Promotion Law*, issued by MOJ on August 10, 2018 for public comments.; and (ii) *Several Opinions of the CPC Central Committee and the State Council on Further Reform and Well-regulated Development of Preschool Education*, issued on November 7, 2018.

partner had adopted a VIE structure. If verified, this can be viewed as an important shift in terms of the attitude of Chinese government authorities towards VIEs. Previously, MOFCOM (when it was in charge of merger filings) had refrained from reviewing merger filings containing a VIE element for more than a decade by 'sitting' on them, to avoid being interpreted as endorsing the VIE structure or had caveated its approval (such as in the Walmart acquisition of Yihaodian from PingAn).

d. National security review (NSR) over foreign investment is another area where more implementing rules and expanded jurisdiction are expected in the next few years (please see further analysis below in part 5). Under existing implementing rules on NSR in relating to foreign investment, it has already been made clear that foreign investors may not circumvent the jurisdiction of such rules through "contractual arrangements" (i.e. VIEs).

5. Implications for NSR of foreign investments

Article 33 of FIL provides that Foreign Investment that has or may have national security implications shall be subject to NSR and that decisions made in relation to NSR cases are final and cannot be challenged. In defining the scope of coverage of NSR over foreign investment, this article takes the same general approach as Article 59 of the *National Security Law* (the "**NSL**"), i.e. all foreign investment activities, regardless of sector, vehicle/means of investment, direct or indirect, or transaction type (minority or control deals), and so forth. This scope is much broader than the existing implementing rules. We have analysed the existing NSR regime in relating to foreign investment and the implications of the new law in our Earlier Note, however as this topic is of general concern of clients across-sectors, we have briefly recapped the key issues below.

Expected expansion of jurisdiction

The existing implementing rules[8] applicable nationwide took effect in 2011, only covering certain sectors (of national security concern), and transaction types ("merging with or acquiring Chinese Domestic Capital Entities"), and where investments in certain sectors automatically triggered NSR and in others required the element of acquiring control to trigger NSR. Another implementing rule[9] applicable in four free trade zones on a pilot basis taking effect in 2015, a few months prior to the NSL, expanded sector coverage and covered greenfield investments in terms of transaction types, but still required the element of acquiring control to trigger NSR over foreign investments in such sectors.

Now, by reiterating the broad coverage under the FIL, it seems the Chinese government is ready to roll out the pilot nationwide and to even go one step further – to impose NSR over FDI activities in the broadest possible sense.

Decisions made about NSR cases are final

The FIL makes it clear that the decisions made about NSR cases are final (while existing implementing rules are silent on this point). This means that NSR cases are exempted from both administrative review and administrative litigation. We think this change may not be of great practical significance to foreign investors

[8] The existing rules include: (ii) the *Announcement of Provisions of the Ministry of Commerce on the Implementation of Security Review System for Foreign Mergers and Acquisitions of Domestic Enterprises* issued by MOFCOM; and (ii) the Office of the State Council's *Notice on the Establishment of the Security Review System for Foreign Mergers and Acquisitions of Domestic Enterprises*.

[9] The Office of the State Council's *Circular on Issuing the Measures for the Pilot Program of National Security Review of Foreign Investments in Pilot Free Trade Zones*.

in China. For one thing, it follows the precedent set by NSR legislation in other jurisdictions, such as US CFIUS review. This may, therefore, be something investors and MNCs worldwide conducting business worldwide have grown to accept. For another, even absent such provision, there have been very few cases (if any) where foreign investors have made formal challenges through administrative review or administrative litigation to general examination and review decisions made by Chinese government authorities, let alone those touching upon national security.

6. The reciprocity rule and trade tensions

China provides itself with a legal basis for trade retaliation

Article 40 of the FIL provides that "if any country or territory adopts discriminatory measures against China in respect of investment matters, such as prohibitions, restrictions or other similar measures, China may adopt corresponding measures against such country or territory based on the actual circumstances." In the context of an ongoing trade war between China and the US and growing trade tensions with the EU leading to a raft of NSR-type legislation in Europe, this Article provides the legal basis for China to launch investigations and sanctions against companies based in US or possibly Europe, similar to the steps taken by the Trump Administration in the ZTE and Huawei cases.

The implication of this Article is that China may also seek to use tools similar to CFIUS, the use of which has become increasingly aggressive under the Trump Administration (e.g. expanding coverage to minority investments, adding a number of high-tech sectors into areas of national security concern); the reference to "discriminatory treatment" in this Article presumably reflects the fact that while not mentioning China by name, recent cases and US legislation in this area have clearly been drafted with China and Chinese investors in mind, with a view to preventing certain types of transactions in perceived sensitive sectors. What it could mean is that if China follows through on its implied threat to take retaliatory action above and beyond the tit-for-tat tariffs game, and depending on the outcome of current trade negotiations, we may see further policy restrictions on acquisitions by certain foreign investors in certain sectors which China views as sensitive, e.g. Chinese-owned semiconductor manufacturers or possibly, and more controversially, VIEs in the telecoms, Internet and media sectors.

7. Conclusions

The FIL is probably the most significant overhaul of the Chinese FDI regime since it was put in place in the 1980s and 1990s. It clearly represents a step in the right direction in terms of moving away from the outdated model of having different sets of rules for different vehicles, rather than one set of rules for all vehicles. However in many ways the new regime under the FIL raises more questions than it provides answers, foremost of which are:

a. when will there be sufficient guidance from implementing rules to tell foreign investors:
   i. what kind of a legal structure to use from now until 1 January 2020 and which rules to follow between now and then when setting up an FIE in the next few months;
   ii. what parts of the previous FIE rules e.g. on debt equity ratios not set out in the laws being repealed or their implementing regulations will still apply going forward, or will these automatically fall away under the "equal treatment" principle (as no such restrictions apply to Domestic Capital Entities under the Company Law)?

It surely cannot be healthy or conducive to FDI to have a hole in the legislative framework such as has been left by the FIL for too long.

b. what is going to happen to VIEs? To what extent are they going to be regulated under the FIL? Do foreign investors in these need to think about restructuring if they operate in Negative List sectors?

c. how will information disclosure obligations work and just how far up the chain does information reporting go? How does "actual needs-based" disclosure work in practice? Who decides?

d. when are we going to get detailed implementing rules on when NSR does and does not apply to FDI or M&A: leaving it open ended is likely to leave Foreign Investors frustrated and struggling to work out when a filing is needed (while NSR tends to be quite "black box" anywhere in the world, the US, for example, does have some guidance on when CFIUS filings are required) or lead to an avalanche of defensive filings.

e. will legacy JVs be forced to more over to the new FIL organisation structures in the same way as previously happened to WFOEs in 2006 i.e. when they first make a change to their AOA or other registered particulars? Is the five year grace period for legacy JVs real, or just a backstop period by which time any outliers will be forced to align with the FIL? Should such legacy JVs "bite the bullet" and start changing their structures now? What happens if no consensus can be reached between the shareholders in JVs that have been running well for say 20 years needed to make the changes to comply with the FIL regime? Will we see a wave of sales and exits on the back of disruptive change brought about by the FIL?

f. Will the Foreign Investor complaint mechanism work? How can this operate in a way that does not mean Foreign Investors end up reporting to another part of the same local government that gave rise to the complaint in the first place, raising issues of local protectionism.

Only time will tell whether the FIL is an improvement on the "clunky" but "road tested" prior regime. Officials trying to implement the FIL may also struggle with "regime change" and this could lead to the confusion and processing delays we saw in 2016 with the introduction of record filing instead of approval as the default process for establishing a new FIE. Above all, has China really chosen an opportune time to foist this game-changing reform on Foreign Investors, when it has just recorded its slowest year of growth since 1990, and is starting to feel the pain of the trade wars in its exporting manufacturing sector and therefore needs every last dollar of FDI it can get to create jobs and support the increasingly difficult domestic economic growth narrative?

Contacts

Andrew McGinty
Partner, Shanghai
andrew.mcginty@hoganlovells.com

Liang Xu
Partner, Beijing
liang.xu@hoganlovells.com

Jessica Li
Associate, Beijing
jessica.li@hoganlovells.com

Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest*
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta*
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Moscow
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Riyadh*
Rome
San Francisco
São Paulo
Shanghai
Shanghai FTZ*
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar*
Warsaw
Washington, D.C.
Zagreb*

*Our associated offices

www.hoganlovells.com

"Hogan Lovells" or the "firm" is an international legal practice that includes Hogan Lovells International LLP, Hogan Lovells US LLP and their affiliated businesses.

The word "partner" is used to describe a partner or member of Hogan Lovells International LLP, Hogan Lovells US LLP or any of their affiliated entities or any employee or consultant with equivalent standing. Certain individuals, who are designated as partners, but who are not members of Hogan Lovells International LLP, do not hold qualifications equivalent to members.

For more information about Hogan Lovells, the partners and their qualifications, see www.hoganlovells.com.

Where case studies are included, results achieved do not guarantee similar outcomes for other clients. Attorney advertising. Images of people may feature current or former lawyers and employees at Hogan Lovells or models not connected with the firm.

©Hogan Lovells 2019. All rights reserved.