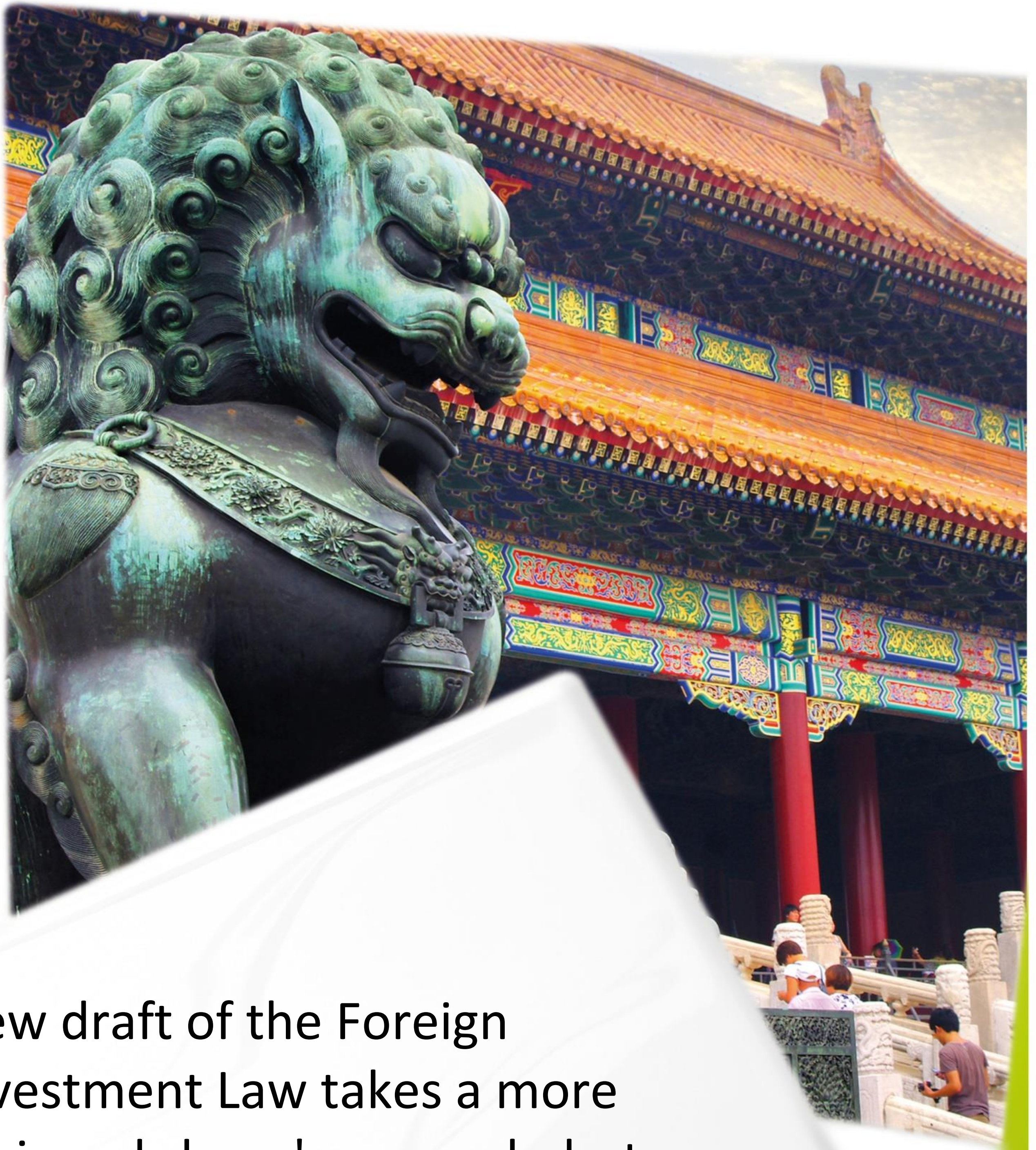

New draft of the Foreign Investment Law takes a more 'stripped-down' approach, but defers discussion on the 'elephant in the room'

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On December 26, 2018, the National People's Congress ("**NPC**") of the People's Republic of China[1] ("**China**" or "**PRC**") issued a revised draft *Foreign Investment Law* (the "**2018 Draft**") for public comments, accompanied by an explanation (the "**Draft Law Explanation**") which outlines some of the reasoning and principles that went into preparing the 2018 Draft. The deadline for the public to submit comments is February 24, 2019. In the Draft Law Explanation, it makes it clear that the Ministry of Commerce ("**MOFCOM**"), the National Development and Reform Commission ("**NDRC**") and (interestingly) the Ministry of Justice ("**MOJ**") took the lead in drafting the 2018 Draft, which was then approved by the State Council of the PRC (the "**State Council**") and reviewed for the first time at the NPC Standing Committee's meeting ending on December 29, 2018[2]. The current draft is not final and may need to go through two more rounds of reviews by the NPC Standing Committee before it can be voted into law[3].

The 2018 Draft is not the first draft of the law whose aim is to unify and replace the existing piecemeal and largely vehicle-specific legal regime on inbound foreign investment ("**FDI**"), consisting of the *Wholly Foreign-Owned Enterprise Law* (the "**WFOE Law**"), the *Sino-Foreign Equity Joint Venture Law* (the "**EJV Law**"), the *Sino-Foreign Cooperative Joint Venture Law* (together with the WFOE Law and the EJV Law, the "**FIE Laws**"), their respective implementing rules and regulations, and applicable provisions scattered across numerous other laws, regulations and rules[4]. Its predecessor, the first draft *Foreign Investment Law* (the "**2015 Draft**") issued by MOFCOM for public comment on 19 January 2015, was highly controversial due to its far-reaching implications if enacted as written. Compared to the 2015 Draft, which contained 11 chapters, 170 articles and detailed provisions on certain newly-established systems for FDI, the 2018 Draft is a much slimmed-down document, comprising 6 chapters and 39 articles, drafted in a far more generic style. As stated in the Draft Law Explanation, the 2018 Draft will act as the fundamental and framework law on FDI, while leaving large open spaces for the promulgation of implementing rules to fill in the gaps in the future.

As the 2018 Draft is very broad-brush in its approach, and retains references to certain systems that also appeared in the 2015 Draft[5], such as the national security review ("**NSR**") system, it seems likely that much of the detail of such systems referred in the 2015 Draft is likely to be forthcoming through future implementing rules.

Overall, the 2018 Draft takes a more permissive and welcoming approach to FDI compared to existing rules and the 2015 Draft. It adds or clarifies several measures or rules on FDI promotion and protection. However in many aspects, the 2018 Draft also imposes new obligations on foreign investors in terms of what types of FDI fall to be regulated and potentially expands the scope of jurisdiction of certain existing rules e.g. in the area of NSR. In

[1] In this note, references to China or the PRC exclude the Hong Kong Special Administrative Region, the Macau Special Administrative Region and Taiwan.
[2] Under the Draft Law Explanation dated December 26, 2018 and announcements on the NPC's website, the 2018 Draft was submitted for review at the Seventh Meeting of the Thirteenth Session of the NPC Standing Committee, which concluded on December 29, 2018.
[3] Under the *PRC Legislation Law*, normally a draft law submitted to the NPC Standing Committee will go through three reviews before voting. So there will likely be two more reviews before the 2018 Draft is submitted for voting and becomes law through a "Presidential Decree".

[4] These other laws, regulations and rules include the *Company Law*, the *Securities Law*, the *Acquisition of Enterprises in China by Foreign Investors Provisions, Changes to the Equity Interests of Investors in Foreign-Invested Enterprises Several Provisions, Investments Made by Foreign-Invested Enterprises in China Tentative Provisions, Foreign Investors' Strategic Investments in Listed Companies Administrative Measures, Interim Measures for the Filing Administration of the Formation and Changes to Foreign-Invested Enterprises and the Special Administrative Measures (Negative List) for the [Market] Access by Foreign Investors (2018),* among others.
[5] For a more detailed analysis of the 2015 Draft, please refer to our Client Note "*China to unify inbound foreign investment laws – But will it create a true level playing field with domestic investors?*" dated January 28, 2015.

addition, it simply provides a generic set of principles and basic rules, but is notably short on detail, leaving the road clear for promulgation of future implementing rules the contents of which are unknown and that could take foreign investors in unpredictable directions. This leaves foreign investors in the dark as to the full implications of the new law for them and their FDI projects. In this note, we analyse some of the new features of the 2018 Draft that may have a substantial impact on FDI, with references to the existing rules and/or the 2015 Draft (where relevant).

Executive summary

In brief, the 2018 Draft:

- Substantially reduces the length of the 2015 Draft and structures it in a more FDI-friendly manner.
- Simplifies the definition of foreign investment compared to the 2015 Draft, but leaves large open space for future expansion of activities that could fall to be regulated as FDI with the use of a catch-all clause.
- Confirms the FDI regulatory approach of "pre -[market] access national treatment plus negative list administrative system" and emphasizes the concept of equal treatment of foreign-invested enterprises ("**FIEs**"), FDI and foreign investors with domestic capital investors, except in 'negative list' sectors.
- Adds or further clarifies certain FDI facilitation and promotion measures, the availability of which is conditional in certain cases.
- Reiterates the broad scope of FDI activities subject to NSR as provided under the 2015 Draft and the *National Security Law* (the "**NSL**"), representing a substantial expansion of the scope as currently provided under the existing national-level implementing rules on NSR.
- Generally provides for the creation of an information reporting system and principles for determining the content and scope of information to be reported, but leaves the questions of who will be responsible for this and how this fits in with existing systems unanswered.
- Provides that although the FIE Laws will cease to have effect from the date it becomes effective, FIEs established before the 2018 Draft becomes effective (the "**Effective Date**") will be given a grace period allowing them to maintain their current corporate structure for five years.
- Existing FIEs may, in fact, be able to gain certain benefits by applying other existing laws from the Effective Date, such as by adopting the more flexible corporate governance regime under the *PRC Company Law* (the "**Company Law**").

Each of these, and other key matters, are analysed in greater detail below, beginning with a comparison of the 2018 Draft and the 2015 Draft.

Comparison with the 2015 Draft

Below is a comparison table between the structures of the 2015 and 2018 drafts, showing the changes in the legislative approach of the Chinese government in relation to FDI over the years.

The 2015 Draft	**The 2018 Draft**
Chapter 1 General Provisions	Chapter 1 General Provisions
Chapter 2 Foreign Investor and Foreign Investment	Revised, simplified, and merged into Chapter 1
Chapter 3 Entry Administration	Simplified and merged into Chapters 1 and 4
Chapter 4	Simplified and merged

The 2015 Draft	The 2018 Draft
National Security Review	into Chapter 4
Chapter 5 Information Reporting	Simplified and merged into Chapter 4
Chapter 6 Investment Facilitation	Chapter 2, adding new FDI facilitation measures
Chapter 7 Investment Protection	Chapter 3, adding new protective provisions
Chapter 8 Complaints Coordination and Settlement	Simplified and merged into Chapter 3
Chapter 9 Supervision and Inspection	Simplified and merged into Chapter 4
Chapter 10 Legal Liabilities	Chapter 5, with revisions
Chapter 11 Supplemental Provisions	Chapter 6, simplified
/	Chapter 4 Investment Administration

Compared to the 2015 Draft, the 2018 Draft is much more generic and simplified. Furthermore, the 2018 Draft deviates from the 2015 Draft in two major aspects – a more FDI-friendly approach, and adopting a simplified but potentially very broad jurisdiction of what constitutes FDI subject to regulation – both of which are analysed further below.

- **A more FDI-friendly drafting approach**

The 2018 Draft has simplified Chapters 3, 4, 5 and 9 of the 2015 Draft, all of which focus on FDI administration, boiling the content down to a couple of articles in one single chapter – Chapter 4 (Investment Administration). It maintains most of the articles on investment promotion and investment protection from the 2015 Draft and emphasizes investment promotion and investment protection by introducing additional measures going beyond the 2015 Draft. Facilitation and protection of, and granting equal treatment with domestic investment to FDI and similar expressions are mentioned repeatedly throughout the 2018 Draft. In addition, the 2018 Draft makes two main changes compared to the 2015 Draft with respect to legal liability for violations by FIEs or foreign investors : (i) it has deleted monetary fines (other than confiscation of income) for violations of the Negative List; and (ii) it has deleted penalties on several other named violations appearing in the 2015 Draft, including violations of NSR provisions, information reporting obligations, and circumvention through any means including trust, rent, contractual controls and so forth. Again this may be more examples of 'kicking the can down the road'.

Based on the above, it seems that the drafting logic of the FDI law has moved from a regulatory and administrative-oriented approach to a more "promoting and protecting" approach[6]. However, it is worth noting that a considerable number of articles of the 2018 Draft, including those on investment administration, leave room for broad interpretation of certain definitions and for promulgation of implementing rules in the future which could take foreign investors in unpredictable directions. Despite the number of articles being significantly reduced, some articles are way too general or broad and their meanings far from clear. For example, Article 31 proposes to establish an FDI information reporting system, without identifying which

[6] The Draft Law Explanation states that the overall objective of the 2018 Draft is further and better opening up and utilization of foreign investment in China, emphasizing FDI promotion and protection. While in the 2015 Explanation, two out of four drafting principles are phrased from an administrative and regulatory angle.

government authority will be in charge of defining the contents and/or the scope of information that can be requested.

- **Simplified, but potentially very broad jurisdiction**

Under Article 2 of the 2018 Draft, "**Foreign Investment**" refers to "investment activities carried out directly or indirectly within the PRC by foreign natural persons, enterprises and other organizations ("**Foreign Investors**"), including circumstances where a Foreign Investor:

(i) Either individually, or together with other investors, invests in new projects, establishes foreign-invested enterprises or subscribes a capital increase of a foreign-invested enterprise;

(ii) Acquires shares, equity interests, asset shares or other similar rights and interests in PRC-based enterprises by way of mergers and acquisitions; and

(iii) 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."

This definition of Foreign Investment removes four other circumstances previously defined as "Foreign Investment" in the 2015 Draft, notably including where a Foreign Investor gains "control through contract" over a Chinese domestic capital enterprise. This was one of the most controversial aspects of the 2015 Draft when it was first made public. All other defined terms appearing in the 2015 Draft relating to FDI, such as "control", "actual controller", "Chinese domestic enterprise" and "Chinese investors" are deleted in the 2018 Draft. These definitions were, at the time, when looked at collectively, seen as an expression of the legislative intent of the Chinese government to expand its jurisdiction over investment activities involving foreign players and their attempt to address the legal status of investments involving "control through contract", of which the most prominent example is the variable interest entity ("**VIE**") structure (for which control through contract is the key mechanism).

- **To VIE or not to VIE, that is the question**

A considerable number of VIEs are either listed overseas or have become sector leaders or national champions (or all of the above) and the wealth of many Chinese captains of industry depends on the continued existence of these. Therefore, in contrast to the limited impact of the unwinding of foreign investment in the predecessor Chinese-Chinese-Foreign structure, any changes to the VIE structure could have a dramatic impact on the market and those individuals. The explanation accompanying the 2015 Draft issued by MOFCOM on the same date ("**2015 Explanation**") proposed three approaches as to how to deal with existing FDIs involving contractual controls. The fact that the 2018 Draft and the Draft Law Explanation are now both thunderingly silent on "control through contract" or other similar terms, suggests that addressing the VIE question was a bridge too far, given that any legislation or draft which tries to subject VIEs to Chinese FDI laws will pose a serious question over the viability of such VIE structures and raise concerns as to the future of such companies, not to mention the fortunes of the influential Chinese entrepreneurs who founded them.

In China, VIEs are typically (but not necessarily) used by companies that wish to attract FDI or go public overseas but operate in sectors that are "restricted" (or even "prohibited") to FDI or to circumvent the restrictions on "round-tripping" investments.[7] Since their first

[7] 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)*

appearance, the Chinese government has essentially turned a blind eye to VIEs. Because of this, many VIEs, particularly in the technology, media and telecommunications sectors and the education sector have been operating in (at best) a grey area of the law (and at worst, constitute an obvious circumvention of the rules on licensing), although China has, to date, studiously avoided any action that might be interpreted as endorsing the VIE structure.

The 2015 Draft attempted to eliminate the grey area by introducing the concept of control into FDI laws and treating VIEs where they were under Chinese control differently from those under foreign control. However given the importance and size of the companies that have deployed VIE structures (Sina, Sohu, Tencent, Baidu, Alibaba, JD, and very recently Meituan and Xiaomi to name but a few) and the tremendous impact such provisions may have on them, MOFCOM took a cautious approach – the three proposals were explained in the 2015 Explanation rather than in the text of the 2015 Draft. In the 2015 Draft, it left a placeholder for a clause on the legal status of existing VIEs. Further, the 2015 Explanation goes on to say that the proposals were only offered to solicit public views and MOFCOM would conduct further research and update proposals after considering public opinions received. After nearly four years, we are not aware of any further official proposals from MOFCOM to address VIEs, except for the 2018 Draft, which has notably removed all articles addressing or making explicit references to VIEs.

This does not, however mean all concerns around the longevity and stability of VIEs have evaporated. It is true that the 2018 Draft shortens the list of situations regulated as FDI, by simplifying the definition of Foreign Investment. At first glance, it would appear that the Chinese government has taken a big step back from its attempt to regulate FDI in its broadest sense and specifically from its attempt to address issues around VIEs. However, after reading the catch-all paragraph (iii) of Article 2, we are inclined to believe that the Chinese government may simply have taken a decision not to address such issues *at this time* or in a document which has the status of a law. Paragraph (iii) potentially allows a broader explanation of the definition of Foreign Investment, by way of either promulgating and/or amending the "laws, administrative regulations", or clarification "by the State Council", thus potentially subjecting other activities not currently covered by paragraphs (i) or (ii) to Chinese FDI laws. So the issue is being parked, not dropped.

Furthermore, the 2015 Draft is not the only attempt by the Chinese government to regulate VIEs. Two implementing rules related to FDI NSR did make it clear that foreign investors may not circumvent the jurisdiction of such rules through 'contractual arrangements' (without specifically citing VIEs)[8]. We have also seen two recent similar attempts in policies and draft legislation in the education sector[9], suggesting that more sector-specific rules may be on the way. Although the provisions are less than clear, under these documents, "control

unscathed or is its very survival threatened?" dated September 2012.

[8] These two rules are: (i) the *Announcement of Provisions of the Ministry of Commerce on the Implementation of Security Review System for Foreign Mergers and Acquisitions of Domestic Enterprises*, taking effect from September 1, 2011 and issued by MOFCOM (the "**MOFCOM Provisions**"). This rule mainly provides the rules on national security review over certain M&A transactions involving foreign investors; and (ii) the FTZ Circular, which provides the rules on NSR in relation to foreign investment in four FTZs.

[9] 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. Article 5 of this draft amendment provides that FIEs and social organizations with foreign actual controllers shall not run, participate in running, or have actual control over, private schools offering compulsory education; and Article 12 provides that non-profit private schools may not be controlled by education groups by means of mergers and acquisitions, franchising, agreement control, and so forth.; 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. Chapter 7, Article 24 of this document provides that social capital shall not control, either a preschool established using state-owned assets or collective assets, or a non-profit preschool, by M&A, entrusted operation, franchising, VIEs, contractual controls or any other means.

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.

Whilst it would be preferable to be able to advise clients to look elsewhere than the VIE structure when investing in sensitive sectors, given the obvious risks associated with the structure and the fact that sooner or later they are likely to be regulated, the problem remains the lack of legally viable or credible alternatives for achieving an equivalent return. The only sure way to ensure that VIEs get unwound would be to liberalize FDI in the underlying sectors.

Pre- [market] access national treatment plus negative list and non-discrimination

The 2018 Draft, for the first time, clarifies and confirms, in legislation with the status of a law, the "pre- [market] access national treatment plus negative list administrative system" for market access and administration of foreign investment and foreign investors in China. However this seems a little behind the curve, as such system has already gradually been transposed into rules and regulations (albeit with lower legal status than a law) issued by departments under the State Council (mainly MOFCOM and NDRC), and has already been implemented nationwide.

In mid-2018, the Chinese government issued the *Market Access by Foreign Investors Special Administrative Measures (Negative List) (2018)* ("**Negative List**")[10], which for the first time no longer listed 'permitted' or 'encouraged' sectors (although the *2017 Guidance Catalogue for Foreign Investment Industry* 'encouraged' sector list still applies). The Negative List specifies sectors which are subject to restrictions or a prohibition with respect to FDI. Around the same time, the Chinese government amended the *Record Filing Administration of the Formation and Amendment of Foreign-Invested Enterprises Interim Measures* ("**Interim Measures**") for the second time; the Interim Measures set up a record filing system for FIEs carrying out business in sectors not listed in the Negative List. Under the record filing system, the establishment of, or changes to, such FIEs no longer need to be approved by MOFCOM (or its local counterparts).This record filing system started to apply nationwide from October 8, 2016 under the Interim Measures, which were subsequently amended twice in July 2017 and June 2018 respectively.

Equal treatment and similar 'feel good' phrases repeatedly appear throughout the 2018 Draft, emphasizing the principle of national treatment in terms of market access and emphasis on post-investment regulation. The following are a few examples:

(a) Chapter 2 (Investment Facilitation), through several articles, provides that FIEs shall be: (i) equally eligible to national supporting policies for development of enterprises (unless otherwise provided in laws or administrative regulations); (ii) equally involved in formulating standards and other standardization works, and national mandatory standards shall apply equally to FIEs; (iii) entitled to raise funds via publicly offerings of shares, corporate bonds, securities and other lawful means; and (iv) entitled to fairly participate in, and FIE products manufactured within the PRC shall be treated equally in, government procurement activities. Item (i) follows the 2015 Draft, but with greater emphasis on equal treatment, while items (ii) to (iv) are new to the 2018 Draft.

[10] The negative list for FDI was first employed in China (Shanghai) Pilot Free Trade Zone in 2013 and five years later, the first Negative List applicable nationwide entered into force on July 28, 2018.

(b) Article 23 of Chapter 3 (Investment Protection) provides that normative documents relating to Foreign Investment as formulated by the governments and their relevant departments at various levels may not unlawfully prejudice FIEs' lawful rights and interests or increase their obligations, or set market entry and exit conditions in violation of the law. In short, it attempts to address issues around local protectionism or hostile industry regulators.

(c) Chapter 4 (Investment Administration), provides in several articles that Foreign Investors, FIEs and/or Foreign Investment are entitled to equal treatment with their Chinese domestic counterparts in terms of: (i) administration of Foreign Investment in sectors not listed in the Negative List; (ii) the conditions and procedures in the review of applications for licenses or permits by Foreign Investors (unless otherwise provided in the law or administrative regulations); and (iii) supervision and inspection of FIEs (unless otherwise provided by law). All of the items are formulated in a way that on the face of it confirms and emphasizes equal treatment, but the carve-outs in (ii) and (iii) allow for unequal treatment to be imposed through legislation, and the existence of the Negative List in (i) is proof positive of unequal treatment.

These articles are an attempt to respond to criticisms and concerns expressed by foreign investors about discrimination against them – in practice and at the policy level, especially in sectors where foreign investors would argue that the regulator has been consistently hostile to foreign investment, such as in the telecommunications sector. However the "unless otherwise provided by law" carve-outs in the above paragraphs essentially undermine the credibility of the approach.

Investment protection

Chapter 4 (Investment Administration) of the 2018 Draft includes a number of provisions on investment protection. Some are new and others are based on the 2015 Draft or existing rules, but have either been made more generic, more specific or clarified. However some of these provisions are not clear. We have set out below a few provisions which are particularly noteworthy.

(a) Expropriation and compensation. The 2018 Draft reiterates the principle governing acts of expropriation in the EJV Law, and the WFOE Law, namely that the State does not expropriate except under special circumstances where required by the social public interest and that expropriation shall be conducted in return for compensation. The 2018 Draft changes the standard of compensation from "relevant compensation" which was used in the EJV Law and the WFOE Law to "fair and reasonable compensation". But "social public interest" is a term open to interpretation and it is still not clear as to what exactly constitutes "fair and reasonable compensation". It would appear the Chinese government has simply borrowed the compensation language from certain bilateral investment treaties it has entered into in recent years.

(b) Funds remittance overseas. Under the FIE Laws, the profits, the funds remaining after liquidation and other lawful income to which foreign investors are entitled can be remitted abroad; but the EJV Law specifies that remittances shall be in the currency as provided in the joint venture contract. The 2018 Draft improves in three ways: (i) it specifically lists certain funds (including capital contributions, profits, capital gains, royalties on intellectual property, compensation or indemnities received in accordance with law) that can be

remitted abroad; (ii) it emphasizes that such funds can be remitted abroad "freely", however it still relies on there being in place foreign exchange policies in the law to turn such remittances into reality to meet the "in accordance with law qualifier"; and (iii) it clarifies that the currency of such remittances can be either Renminbi or foreign currencies.

(c) No mandatory transfers of technology. Forced transfers or quasi-forced transfers of technology by Chinese partners and/or Chinese local governments were common especially in the first years of China's opening up. Due to the lack of transparency in law enforcement and decision-making by some local government authorities, forced transfers of technology remain a common concern of many foreign investors, especially those in high-tech sectors, not to mention the concerns expressed at the policy level by the US. On top of the 2015 Draft, which simply generally states that China protects the intellectual property rights of foreign investors and FIEs, the 2018 Draft adds more details to try and address those concerns. The 2018 Draft makes it clear that (i) China encourages technological collaboration based on voluntariness (of the parties) and commercial rules; (ii) conditions for such collaboration during the course of Foreign Investment shall be discussed and determined by the parties; and (iii) government authorities and officials may not use administrative means to force transfers of technology (e.g. withholding a license unless technology is provided). The parties should be left alone to negotiate terms (without government interference). There is no specific punishment imposed on government officials for forcing a technology transfer in the 2018 Draft, other than where it constitutes abuse of authority.

(d) No discrimination and no interference. As summarized above, the 2018 Draft emphasises that government authorities at various levels shall not discriminate against foreign investment. There is a further clarification on this in Article 23, which expressly forbids governments from unlawfully interfering with, or having a negative impact on, the normal business activities of FIEs.

(e) Fulfilment of government commitments. In practice, it is very common for local governments or their departments to commit to providing favourable policies or conditions to attract FDI, but later to renege on such commitments. Article 24 of the 2018 Draft requires local governments and their departments to strictly fulfil the policy commitments they make to, and contracts entered into with, Foreign Investors and FIEs, provided that such commitments and contracts are made or entered into in accordance with law; where changes are needed in the national or public interest, such changes must be made strictly in accordance with the relevant statutory authorities and procedures; Foreign Investors and FIEs shall be compensated in accordance with law for any losses they incur as a result of such changes.

Possible implications of this article include: (i) there is now a clear legal basis for FIEs and Foreign Investors to demand performance of such commitments or contracts and for claiming compensation for any losses suffered where changes are needed; (ii) it emphasises the condition of lawfulness in entering into, performance, and making changes to, and compensation for failing to keep commitments or contractual obligations by governments, thus unlawful commitments will not be enforceable. The lawfulness point is clearly designed to address the phenomenon of unlawful or *ultra vires* commitments being made by local governments, such as unauthorized tax concessions. However, this article inevitably puts Foreign Investors and

FIEs on notice to do their due diligence when making investment decisions or entering into contracts (or similar) with local government. This may be a heavy burden on them, as Foreign Investors and FIEs have very limited access (if any) to some policies which are only shared internally within government. The provision also does not address what remedies are available to Foreign Investors and FIEs of *ultra vires* granting of government commitments in the event of unenforceability due to the unlawfulness.

Reporting mechanism

Article 31 of the 2018 Draft concerns information reporting in connection with Foreign Investment. This provision provides that China will establish a foreign investment information reporting system, the content and scope of which shall be determined on a "genuine necessity and subject to strict controls" basis; that Foreign Investors or FIEs shall submit such information to the department in charge of commercial matters through an "enterprise registration system" and an "enterprise credit information publicity system"; and that information accessible via sharing among departments shall not be required to be resubmitted.

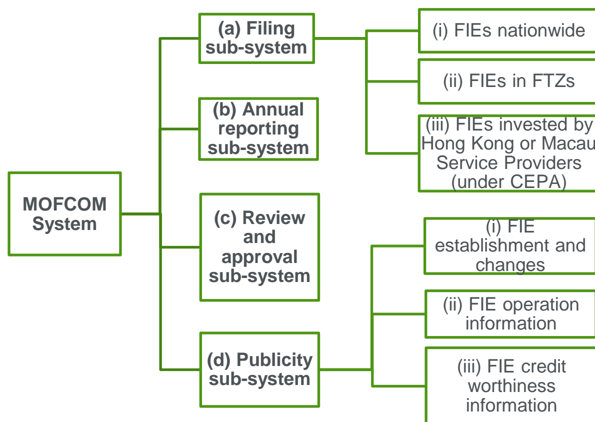
The 2015 Draft set out a very sophisticated reporting system including a very broad proposed scope of disclosure – which raised huge concerns with foreign investors, especially those reluctant to expose their ultimate controller or sensitive business and operational information to either the Chinese government or their Chinese competitors. The 2018 Draft has managed to reduce an entire chapter in the 2015 Draft about information reporting to one single article, removing all the details in the process. However, this single article gives rise to new uncertainties, especially given that in reality, a reporting system encompassing those features proposed in the 2015 Draft has already been established on the ground.

- **Confusion about the various reporting systems**

The two reporting systems mentioned in Article 31 – the "enterprise registration system" and the "enterprise credit information publicity system" – look familiar but do not include the same characters as any of the various existing systems either maintained by MOFCOM or other departments of the Chinese central government. It is also specified in what can only be described as a counsel of perfection article that information shared among departments shall not be required to be resubmitted; however in our experience to date this has not happened in practice.

Currently, the State Administration for Market Regulation ("**SAMR**") runs the National Enterprise Credit Information Publicity System ("**SAMR System**"), which applies to and collects a series of pieces of information from both Chinese domestic capital enterprises and FIEs (please refer to below sub-section "Scope of publicity" for a list of such information). In addition to the SAMR System, FIEs need to resubmit part of the same information to a system run by MOFCOM – the "MOFCOM Operation System Unified Platform/Foreign Investment Integrated Administration Application" ("**MOFCOM System**"), which is still being setup at the time of writing. Further clarification is needed as to whether the systems mentioned in Article 31 are the same as the SAMR System and/or the MOFCOM System. As to the existing systems, the State Council and several departments have issued documents proposing integration and sharing of information collected from the various systems to avoid duplicated requests to business operators for information submission. Such integration is still ongoing, thus currently FIEs still need to submit the same information separately to some existing systems.

The MOFCOM System involves quite a complicated structure with at least two layers of sub-systems (see below for a brief structure at overview).



In the first layer, the MOFCOM System consists of four sub-systems including:

(a) Filing sub-system;

(b) National FIE annual investment operation information joint reporting system ("**Annual Reporting Sub-system**");

(c) Review and approval sub-system; and

(d) Publicity sub-system.

Each of sub-systems (a) and (c) has three lower-level systems. For sub-system (a) – the filing sub-system applies to FIEs in sectors not subject to restrictions or prohibitions on FDI (i.e. non-Negative List). It has three lower-level filing systems, for the information reporting by, respectively, (i) FIEs established nationwide but not subject to record filings under sub-systems (ii) or (iii); (ii) FIEs established in the free trade zones ("**FTZs**") and (iii) FIEs invested by Hong Kong or Macau Service Providers (as defined in the respective agreement on trade in services between the mainland China and Hong Kong or Macau) solely conducting business in certain services sectors (as provided in the respective agreement on trade in services known as the Closer Economic Partnership Arrangement ("**CEPA**")). These sub-systems on record filing were established separately at first and gradually unified into one platform with three portals.[11] Sub-system (d) – the publicity sub-system also consists of three lower-level publicity systems for the publicity of, respectively, (i) information about establishment and changes to FIEs, (ii) FIE operational information to be filed during annual reporting, and (iii) creditworthiness information relating to FIEs and foreign investors.

Currently all the sub-systems except for sub-system (a) have been basically established and put into nationwide operation, while sub-system (c) is now more of a transit site through which FIEs (in sectors subject to restrictions on FDI) can submit information to the online portals of 16 provinces or cities for approval. It is not clear if sub-system (c) will be ultimately be unified into one single platform as well. There are some tricky issues around sub-system (b) – the Annual Reporting Sub-system, which we summarize in more detail below.

- **The Annual Reporting Sub-system**

The current version of the Annual Reporting Sub-system is maintained by MOFCOM together with several other departments of the Chinese central government. This system has evolved from, and gradually moved away from, an old joint annual reporting and examination system officially launched back in 1998 under

[11] The filing system for FIEs established in four FTZs was launched on May 8, 2015, under the *Measures for the Record Filing Administration of Foreign Investment in Free Trade Zones (for Trial Implementation)*. This document was abolished upon the entry into force of the Interim Measures on October 8, 2016, unifying the filing mechanisms (including those on procedures, scope, and so forth.) within and outside FTZs. But FIEs in FTZs continue to use a separate online filing portal and enjoy additional liberalization measures and policies in the FTZs. The record filing systems for FIEs invested by Service Providers from Hong Kong or Macau was launched on June 1, 2016 under the *Measures for the Filing Administration of Investment by Service Providers from Hong Kong and Macau in the Mainland (for Trial Implementation)*. This document stipulates the record filing mechanisms for FIEs solely conducting business in certain services sectors opened to Hong Kong Service Providers under the *Agreement on Trade in Services to the Mainland and Hong Kong Closer Economic Partnership Arrangement*, and opened to Macau Service Providers under the *Agreement on Trade in Services to the Mainland and Macau Closer Economic Partnership Arrangement*.

the *Implementation Plan for Joint Annual Reporting and Examination of FIEs* (the "**1998 Document**") issued by several departments including the predecessors of MOFCOM and SAMR. In 2014, a regulatory revolution was initiated by the State Council in order to improve the business environment for market players. One of the policies at that time was to change the annual "reporting and examination" system to a solely joint annual "reporting" system, removing the examination authority (and discretion) of the relevant government departments during the course of annual reporting. Following the implementation of the policy, a considerable number of laws, regulations and rules were amended, promulgated, drafted or abolished around from 2014 to 2016, including the 2015 Draft which appeared during that time frame. SAMR's predecessor, the SAIC, has since 2014, run the SAMR System by itself, amended its registration rules and made it clear that annual reporting would be subject to its regulatory overlay to the reporting approach.

The tricky part is that, though in practice, the joint annual reporting maintained by MOFCOM has taken a similar annual "reporting" approach since 2014, such change in practice has not been written into law, and the 1998 Document is still in force.

Current practice deviates from the 1998 Document in two more ways. First, under the 1998 Document, FIEs are obligated to file annual reports and go through examination. It is not currently very clear whether FIEs are obligated to submit annual reports in current practice. What we know from various informal notices and Q&As on the MOFCOM website is that in the first years, annual reporting was more an encouraged (but not obligatory) requirement for FIEs and it only started to be taken more seriously from 2017[12]. Second, under the 1998 Document, the scope of information to be reported remains consistent year-on-year, while under current practice, the scope may be amended almost on an annual basis. To make matters worse, since 2017, the scope of information subject to annual reporting is no longer accessible to the public, unless you log into the relevant system as an FIE. The uncertainties caused by the above changes in current practice from the 1998 Document need to be addressed by transposing such changes into formal legislation.

- **Uncertainty of disclosure scope**

Perhaps to mitigate the concerns of foreign investors around potential onerous disclosure obligations, following the strong reaction to the 2015 Draft, Article 31 of the 2018 Draft contains a principle of determining the content and scope of disclosure obligations "genuine necessity and subject to strict controls". However, this does not help much, because this principle is still very general, and gives government authorities considerable discretion to determine what information will be considered "genuinely necessary" and how to define "strict controls". Moreover, it is not clear which government authority will be in charge of determining such contents and scope. If it is MOFCOM that will be in charge in this regard and it continues its existing approach, certain sensitive information, such as the ultimate controller, may be interpreted as falling within such contents and scope. Currently, there are different practices in this regard, even within MOFCOM.

Under the filing sub-system, a [non-Negative List] FIE is required to report its actual controller at the time of its establishment and to report any changes of its actual controller occurring thereafter. But the lists of materials accessible to us via official websites of MOFCOM and some of its local counterparts for their approval to establish, or make changes to, an FIE in *restricted* sectors do not require disclosure of its ultimate controller. This seems illogical, because if FIEs in sectors which are not

[12] A Q&A on MOFCOM website dated April 4, 2014 specifies that from October 1, 2017, an FIE's failure to file on annual report within the specified time period will be recorded into its creditworthiness record.

restricted are required to submit sensitive information, logically the government should be even more motivated to collect the same (if not broader) sensitive information from FIEs in restricted sectors.

The scope of disclosure under annual reporting obligations reinforces such concerns. Under the Annual Reporting Sub-system, the disclosure scope may change year-on-year. Each year MOFCOM (together with other relevant departments) will issue a circular reminding FIEs to conduct annual reporting for the previous year. Based on the forms setting out information to be reported for the years 2014 and 2015 attached to the relevant notices, certain sensitive information has been requested, including the actual controller, financing information (such as paid-in capital, profit distributions, loans from its parent company), employee information (such as the number of employees employed and their basic educational information) and business information (such as whether the FIE has established R&D centres; if it is a high-tech company and so forth). As informed by the MOFCOM hotline, the scope of reporting obligations for the years 2016 and 2017 are not available to the public other than by logging into the annual reporting sub-system as an FIE, and the circular for 2018 reporting will be issued in March 2019.

Though the picture in terms of the scope of disclosure is now somewhat unclear, we are inclined to believe that the ultimate goal of the various reporting systems is to collect certain sensitive information on FIEs in *all* sectors, whether restricted or otherwise. That raises concerns as to why China needs that information and what does it plan to do with it? Its scope goes well beyond that requested in most other more developed jurisdictions.

- **Scope of publicity**

Based on various circulars issued by MOFCOM (together with other relevant departments) reminding FIEs to conduct annual reporting, the scope of publicity of the reported information would be the same as that provided for the SAMR System under the *Enterprise Information Publicity Interim Measures*, including information on an enterprise's:

(i) Contact person;

(ii) Existence and good standing;

(iii) Investments made by establishing sub-enterprises or purchasing equity interests;

(iv) Amounts, time and forms of capital contributions as subscribed to and paid up by its shareholders or sponsors, in case of a limited liability company or a joint stock limited company;

(v) Equity transfers by any shareholder or other changes in equity structure, in case of a limited liability company;

(vi) Website, and the name, website and other information regarding its online stores conducting online business;

(vii) Number of employees, total assets and liabilities, credit guarantees for third parties, total owners' equity, gross income, primary business income, total profits, net profits and total tax payments.

The information as prescribed in above items (i) to (vi) of must be disclosed to the public, while the enterprise has the discretion to decide whether the information as prescribed in item (vii) will be made public (most do not, in our experience).

If MOFCOM continues along this line of disclosure, most of the sensitive information as listed in the reporting forms for 2014 and 2015 may fall under item (vii), thus FIEs may choose not to disclose them to the public. However, it is not clear which category 'actual controller' belongs to. We browsed sample disclosed information of a few FIEs in the publicity sub-

system and did not see any actual controller-related information.

Given that the current information reporting systems are still being established, the 2018 Draft has simply added to the confusion. Implementing rules are urgently needed to clarify the issues, especially on the procedures, platforms, scope of disclosure by FIEs to the authorities and scope of public disclosure.

National security review

In the 2018 Draft, there is only one article (Article 33) relating to NSR in relation to Foreign Investment, which nonetheless deviates from the existing implementing rules in two aspects:

(i) Article 33 makes it clear that the decisions made about NSR cases are final (while the existing rules are silent on this point); and

(ii) it potentially expands the scope of Foreign Investment activities subject to NSR far beyond that under the existing rules. Each of these two aspects is analysed in detail below, while the latter seems particularly worthy of attention, as hypothetically any FDI transaction could potentially fall within such scope.

- **Existing implementation rules on NSR over FDI**

The existing NSR regime in relation to FDI applicable nationwide mainly includes the NSL (which took effect from July 1, 2015) and various implementing rules, including the Office of the State Council's *Notice on the Establishment of the Security Review System for Foreign Mergers and Acquisitions of Domestic Enterprises* (which took effect from March 3, 2011) and two other rules (collectively the "**Existing NSR Rules**")[13]. There is another rule applicable only to four FTZs, i.e. 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* (which took effect from May 8, 2015, the "**FTZ Circular**"). Most of the above rules were issued and entered into force prior to the NSL.

Article 59 of the NSL generally provides that China will establish a NSR and supervision system and mechanisms, but does not provide much by way of implementing detail. Article 59 does specifically identify four categories of activities which will be subject to NSR, including "foreign investments which impact or may impact national security"[14], followed by a catch-all category. However, from the NSL's entry into force until now, no new implementing rules, whether applicable generally to activities across categories or specifically to FDI have been issued, thus for the time being, the Existing NSR Rules and the FTZ Circular are still the main rules governing NSR in relation to FDI.[15]

- **Decisions made about NSR cases are final**

The Existing NSR Rules are silent on whether foreign investors are entitled to appeal decisions made about NSR cases. The 2018 Draft makes it clear that the answer is no, following the approach of, but couched in more direct language than in the 2015 Draft, which goes around the houses and merely states that decisions made about 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 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,

[13] These two rules are: (ii) MOFCOM Provisions; and (ii) the Office of the State Council's *Notice on Issuing the Working Measures for Outbound Transfer of Intellectual Property Rights (for Trial Implementation)*, taking effect from March 18, 2018 and issued by the Office of the State Council.

[14] Article 59 of the NSL specifically identifies four categories of activities and a catch-all category of activities (i.e. category (e): other major items and activities) to be subject to NSR. These four categories include: (a) foreign investments which impact or may impact national security, (b) specific materials and key technologies, (c) network information technology products and services, and (d) construction projects that involve national security.

[15] For a more detailed analysis of the NSL's potential implication on FDI, please refer to our Client Note "*China's new national security law creates more insecurity for foreign business*" dated July 2015.

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 examination and review decisions made by Chinese government authorities, let alone those touching upon national security.

- **Expanded scope of activities subject to NSR**

The 2018 Draft potentially significantly expands the scope of matters which may be subject to NSR. Article 33 of the 2018 Draft provides that "China will establish a national security review system in relation to Foreign Investment and conduct national security review in relation to Foreign Investments which impact or may have an impact on national security." On that basis, on a plain reading, *any* FDI which impacts or may have an impact on China's national security will potentially be subject to NSR, regardless of the sector or transaction type involved or whether control rights are obtained by a foreign investor through such investment activity. This approach stands in contrast to the current regime, especially the Existing NSR Rules applicable nationwide, which are specific to certain sectors (of national security concern), and transactions types, and where investments in certain sectors requires the element of control to trigger NSR.

As to transaction types, the Existing NSR Rules mainly focus on foreign investors "merging with or acquiring Chinese domestic entities", while the 2018 Draft expands the scope beyond this transaction type to also cover greenfield investments. Read together with the broad definition of Foreign Investment provided in the 2018 Draft, a large swathe of activities may be interpreted to fall within such definition and potentially be subject to NSR. The Chinese government has already made one previous attempt to broaden the FDI transaction types subject to NSR in the FTZs to greenfield investments through the FTZ Circular. The NSL, the FTZ Circular and the 2015 Draft were issued about the same time, with the NSL a few months later. Both the NSL and the 2015 Draft were intended to apply nationwide and adopted the wider scope approach. This may reflect the mind-set of the legislator, working up from a local to a nation-wide position bringing all FDI types under the NSR purview.

The 2018 Draft does not include any wording suggesting NSR would be sector-specific. Under the Existing NSR Rules, the sectors (which may of national security concern) include two categories:

(i) military and national defence ("**Category A**"); and

(ii) other sectors ("**Category B**") including agricultural products, energy sources and resources, infrastructure, transportation services, technology, equipment manufacturing and so forth involving important/key/critical products or technologies.

The FTZ Circular adds two more sectors to Category B applicable in the FTZs, namely, culture and information technology. It is worth noting that the NSL has substantially expanded the definition of national security from the core and traditional areas of national defence to a much wider range of geographical, economic, financial, cultural, technological, cyber, political, ideology and religious issues. The FTZ Circular may also be a trial for the sector expansion of NSR implementation in the FTZ, the broad definition of national security provided under the NSL offering a basis for further expansion of the scope of NSR.

Furthermore, the 2018 Draft is also silent on whether gaining "actual control" is still a requirement for an FDI activity to trigger NSR in Category B acquisitions. This can be contrasted with the position under the existing rules, whereby NSR would not apply to transactions involving a Category B sector target if the foreign investor does not acquire "actual

control" over the target. The 2018 Draft seems to follow the approach of the NSL and the 2015 Draft. Absent clarification or new implementing rules, there remains uncertainty as to whether NSR will cover FDI not involving acquisition of "actual control" in a Category B target going forward, though currently they are not.

Reciprocity Rules

The 2018 Draft contains a reciprocity rule (Article 37), which 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 actual situation." This drafting is borrowed from the *PRC Foreign Trade Law,* regulating trade activities, word for word, in which unilateral reciprocity rules are not unusual at all, and in certain circumstances are allowed under world trade rules. The reciprocity rule was included in the 2015 Draft but without providing any specific operative provisions. In the context of an ongoing trade war between China and the US, this article, if enacted in its current form, may provide the legal basis for China to launch investigations and sanctions against US or national champions in other jurisdictions, which is essentially the mirror image of what has happened in the ZTE and Huawei cases. This article may be China's response to the increasingly aggressive use of CFIUS under the Trump Administration where, even if not mentioning China by name, recent US legislation in this area has clearly been drafted with China and Chinese companies in mind.

Impact on existing FIEs (non-VIEs)

Pursuant to Article 39 of the 2018 Draft, from the date it becomes effective, the FIE Laws will cease to be in effect. It provides a 5-year grace period during which existing FIEs established in accordance with the FIE Laws may maintain their enterprise organizational structures. Article 30 suggests (that upon entry into force of the 2018 Draft), matters relating to the registration, taxation, accounting, foreign exchange and so on of FIEs shall be handled in accordance with relevant laws, regulations and rules, though such relevant laws, regulations and rule is not clear. However we think regarding registration and establishment of enterprises (in addition to the FIE Laws), the relevant laws, regulations and rules at that time will include at least the Company Law and its sub-layer regulations and rules such as the *Company Registration Administrative Regulations* (collectively the "**Registration Laws**"). Following this line, these articles seem to require existing FIEs to align their corporate organization structures with the above laws within the 5-year transitional period. What other changes need to be made by existing FIEs during the said transitional period is an open question and requires further clarification. But the alignment in terms of enterprise organization structures alone may impose a significant documentary and management burden on existing FIEs in China.

At the same time, FIEs may realize certain benefits moving from the FIE Laws to the Registration Laws. Technically, some Registration Laws, e.g. the Company Law, currently apply concurrently with the FIE Laws to FIEs, while where there are tailored and FIE-specific provisions (or requirements) provided under the FIE Laws, such provisions in the FIE Laws will prevail in the event of a conflict. Abolishing the FIE Laws means removing such tailored requirements on FIEs provided thereunder, which seems to move us in the positive direction of providing a (more) level playing field for FIEs and Chinese domestic capital enterprises. If so enacted and implemented, FIEs, e.g. Sino-foreign joint venture companies ("**JVs**") established under the EJV Law may enjoy more flexibility in terms

of corporate governance, including the following aspects:

(a) The board of directors is the highest governance authority in a JV (whilst the shareholders' meeting is the supreme authority under the Company Law, and the shareholders shall exercise their voting rights at the shareholders meeting based on their respective percentage of the capital contributions, unless it is otherwise prescribed in the JV's articles of association); having a single system has obvious benefits and would resolve the issues created by the dual track system whereby WFOEs use the Company Law system and JV's still have the board as the supreme authority.

(b) The JV contract (or shareholders' agreement) is required to be registered (vs. no such requirement under the Company Law);

(c) If one party appoints the chairman, the vice chairman shall be appointed by the other party; and if one party appoints the general manager, the deputy general manager shall be appointed by other party (vs. no such requirements under the Company Law); and

(d) The board of directors of a JV shall consist of no less than 3 board members, and the parties shall allocate board seats based on consultations by reference to their ownership ratio (vs. no such requirements under the Company Law, where it is purely a matter of contract).

Conclusion – a 'mixed bag'

Overall, the implications of the 2018 Draft if enacted as written on FIEs, FDI and Foreign Investors appear to be quite mixed, with both positive and negative aspects. Most of the positive signals are around the movement from an administrative and regulatory-oriented drafting approach to a more facilitating and promoting approach, emphasizing equal treatment of FIEs, FDI and Foreign Investors, but this is diluted by some pretty significant carve outs and caveats. The simplification of some provisions in the 2015 Draft, i.e. the definition of Foreign Investment (but with an open-ended sweep-up clause that could be used to expand it), the information reporting system and the NSR, has somewhat backfired, giving rise to confusion and uncertainty.

Above all, we are now left with a 'bare bones' law, where the meat on the bones has yet to be provided, and nobody knows what that meat will look like, leaving the future shape of FDI China hanging in the air. It is also far from clear how much of the current legislation around and based on the FIE Laws will survive the transition, and how much will be recast in implementing regulations. And, of course, China has parked the 'elephant in the room' issue, how to deal with the VIE structure. This may provide temporary respite and relief for foreign investors, but no longer term visibility as to how this business-critical issue will pan out.

For these reasons, we strongly recommend that all interested parties submit comments on the issues raised in this note through the Chambers of Commerce to try and make the final document a better and more helpful document to foreign investors.

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