Release of New Foreign Investment Law and Its Impacts

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As part of the ongoing reform of China's regulation of foreign investment, the National People's Congress approved a new Foreign Investment Law ("FIL") on 15 March 2019. When it takes effect on 1 January 2020 it will replace existing laws which are "The Law of the People's Republic of China on Sino-Foreign Equity Joint Venture", "The Law of the People's Republic of China on Sino-Foreign Contractual Joint Venture" and "The Law of the People's Republic of China on Foreign-Capital Enterprise" (heroin known as "Three Foreign Investment Laws").

Foreign Investment Law, It's Provisions and How It Affects Foreign Invested Companies

The provisions of FIL are relatively generic, so the impact of FIL will depend on the content of the supporting policies and regulations which we anticipate will be adopted in the coming months. That said, FIL contains several important policies protecting foreign investors as well as changes to how joint ventures are set up and governed. The following sections set look into the main highlights of FIL and our preliminary comments on how it affects foreign investors.

The Main Highlights

New Definition of Foreign Investment

FIL now defines "foreign investment" as investment activity in China "directly or indirectly carried out by foreign persons, enterprises and other organizations". While the determination of foreign investment is still primarily related to the nationality of the shareholders, it recognizes "indirect" ways of investing, suggesting the law will also consider key shareholders. Previously, the nationality of the direct controlling person was the determining factor for the definition of "foreign investment". Chinese domestic enterprises "controlled" through investments by foreign investors were regarded as foreign investment and were subject to foreign investment regulations. Furthermore, companies invested by foreign invested companies ("FIE Re-invested Companies") were regulated similarly to a domestic company (except for businesses that are in regulated industries). Clarification will be needed to see whether FIE Re-invested Companies and their subsidiaries will be treated as foreign invested companies, and also whether or not Chinese domestic companies that are owned through foreign investing vehicles but are really Chinese, are treated as domestic or foreign.

Investment protection and promotion

FIL will replace the current laws and regulations governing the three traditional types of foreign-invested enterprises (equity joint ventures, cooperative joint ventures and wholly-foreign owned enterprises) ("Three Laws"). In doing so, FIL seeks to address long-standing demands of foreign investors for a fairer, more competitive market environment in China, in which foreign investors and their domestic counterparts would be treated similarly. The FIL provides several welcome assurances for foreign investors, including the following:

- No governmental authority may force the transfer of any technology by administrative means;
- Foreign-invested enterprises have an equal right to participate in government procurement activities through fair competition, which aims to address concerns from some foreign invested entities ("FIEs") regarding tender procedures in which domestic companies would be favoured;
- FIL recognizes the right for foreign-invested enterprises to raise funds utilizing a public offering of securities such as shares and corporate bonds or by any other means;
- FIL emphasizes that foreign investors' compensation for violations of contracts or commitments by governmental authorities should be based on "legally made" policy commitments and "legally concluded" contracts;
- Authorities should comply with laws and administrative regulations in formulating normative documents concerning foreign investment;
- Local governments above the county level can develop to promote foreign investment and facilitation measures (a power that was previously substantially limited since the promulgation of the "Notice of the State Council on Reviewing and Regulating Preferential Policies for Taxation and Other Aspects" in 2014).

Full implementation of pre-entry national treatment and Negative List management system

Since 2013, China has launched a Negative List of foreign investment access for foreign investors, and a Negative List of market access for both domestic and foreign investors. The latest version of the Negative List of foreign investment approvals includes the National Special Management Measures for Foreign Investment Access (Negative List, 2018 edition) issued in June 2018 (a total of 48 special management measures were retained) and Special Management Measures for Foreign Investment Access in the Free Trade Zone (Negative List, 2018 edition) only applicable to the Pilot Free Trade Zone (a total of 45 special management measures are retained). Foreign investors in the fields other than the Negative List of foreign investment access are treated equally in market access to Chinese investors (such as state-owned enterprises, private enterprises) who are bonded by the "National List of Market Access (2018 edition)" issued on December 2018.

Foreign Investment Law stipulates that foreign investment is subject to pre-entry national treatment plus the Negative List management system, and gives specific definitions of "pre-entry national treatment" and "Negative List", which indicates that China has cancelled the foreign-funded management model. The cancellation of a case-by-case approval system shows that China's foreign investment legal system is moving in the direction of a more open and flexible reform. This is in line with China's changes in economic globalization and international investment rules. The Negative List of foreign investment access is expected to be further reduced in 2019, which will provide foreign investors with a more excellent choice for investment.

Outside of the national list, there are also zones which have their own reduced lists geared around specific industries, such as the Shanghai Free Trade Zone. The reduction of the Negative List has been on the whole received positively by foreign companies, however, some criteria for industries now not on the list still exist but now at Ministry level, which still by their nature restrict foreign investment in their respective industries.

How Foreign Investment Law Affects Existing Foreign Invested Companies

Arrangement for Transition Period

FIL provides that the FIEs shall follow the Company Law (which applies to domestic companies) and the Partnership Enterprise Law and other applicable laws in terms of form, origination and operating procedures. A five-year transition period is provided in FIL for the changes to be applied to existing entities.

Change of Supreme Authority

After the abolition of the Three Foreign Investment Laws, the biggest and most fundamental change for Sino-foreign joint ventures and Sino-foreign contractual joint ventures are the changes at the highest level from the board of directors to the shareholders' meeting. This change will trigger a series of corresponding adjustments. For example, the term of office of a director of a Sino-foreign joint venture is changed from a fixed term of four years to a term of no more than three years as specified in the Company Law. This move has made the flexibility of the company's personnel set to stretch further. In addition, before the new Foreign Investment Law was issued, as required by the “The Law of the People’s Republic of China on Sino-Foreign Equity Joint Venture” and “The Law of the People’s Republic of China on Sino-Foreign Contractual Joint Venture”, the minimum attendance of the meeting of the supreme authority (i.e. the board of directors or the joint management committee) of the company was two-thirds. After the change of the supreme authority to the shareholders' meeting as required by the "Company Law", the minimum attendance ratio can be freely agreed by the shareholders in the company's articles of association. This will undoubtedly bring greater flexibility to foreign-invested companies.

Fewer Requirements for Equity Transfer

In addition to the changes in the supreme authority, another major change is the restriction on the shareholder's right to transfer shares. “The Law of the People’s Republic of China on Sino-Foreign Equity Joint Venture” requires other shareholders of Sino-foreign joint ventures to agree to transfer the transfer of equity shareholders unanimously. At the same time, although the Sino-foreign contractual joint ventures do not involve equity matters, “The Law of the People’s Republic of China on Sino-Foreign Contractual Joint Venture” requires from the parties to for cooperation to obtain the consent of the other parties before transferring the rights and obligations. The corresponding threshold for the establishment of the Company Law is much lower, that is, unless otherwise stipulated in the company's articles of association, the transfer only needs the consent of the other half shareholders [other shareholders can have the right of first refusal]. This change means that structural adjustment and restructuring will be more flexible for foreign-invested companies and it will change how Articles of Association and Shareholder Agreements are written.

In regards to the interests of Minority Shareholders, per the Foreign Investment Law, the Company Law would regulate the foreign-invested enterprises in all aspects of business operations when the new Foreign Investment Law takes effect in 2020. Therefore, the application of Minority Shareholder rights in foreign invested companies are regulated by the Company Law. In the Company Law, there is no specific information about Minority Shareholders rights since every shareholder enjoys the same rights as stated in the Company Law. However, the extent of influence on the decisions of company's operations that Shareholders have by using their rights are different and based on the number of shares they have in the company. Therefore, unlike in some locations such as Hong Kong, the rights of Minority Shareholders are only as good as those agreed within the Articles of Association.

Changes of Requirements for Resolution on Major Issues

Whether under the "Company Law" or the "The Law of the People's Republic of China on Sino-Foreign Equity Joint Venture" and "The Law of the People's Republic of China on Sino-Foreign Contractual Joint Venture", resolutions concerning major issues of an enterprise (usually include at least: modification of the joint venture's articles of association, increase or decrease of registered capital, merge, dived, termination and dissolve of a joint venture) the law has a requirement for minimum voting right. Compared with the "Company Law", "The Law of the People's Republic of China on Sino-Foreign Equity Joint Venture" and "The Law of the People's Republic of China on Sino-Foreign Contractual Joint Venture" are more demanding that is, the resolution of major matters must be unanimously approved by the directors (or members) present at the meeting. After the "Company Law" regulates foreign-invested enterprises, this standard will be reduced to more than two-thirds of the voting rights of shareholders. This change will also lead to certain changes in the investment structure of newly foreign-invested companies. The former popular structure of JV in Hong Kong plus WFOE in China mainland may be directly replaced by the structure of the JV in China mainland.

Recommendations and implications for foreign investors

While it is intended that eventually the foreign invested enterprises will be regulated in the same way as domestic companies (subject to industry categories in the Negative List), substantial work remains to be done before such a goal is achieved. Before the release and implementation of the new regulations, foreign investors should take the following steps:

1. Review existing joint venture contracts and articles of association for existing joint ventures, and consider how they would need to be amended to become consistent with the Company Law while reflecting the original intention of the investors (or opportunities for renegotiation of terms in light of FIL).
2. Identify potential opportunities for new investment in sectors previously restricted to foreign investors, or the potential to expand the business scope of existing companies. For example, even if the outbound travel agency business does not fall under the Negative List, the current law does not allow such business to be operated by an FIE (unless it is established in the Free Trade Zone). This business may become available for FIEs following the introduction of the FIL.
3. Consider utilizing the existing FIEs, including holding companies, to achieve integrated business goals for foreign investors in China.
4. Consider opportunities for restructuring FIEs, which can be regulated in the same way as purely domestic companies with rules applied to the domestic companies theoretically being applied to the foreign invested companies.
5. Prepare for a possible slowdown or delays in officials handling applications/filings during the transition period (between now and 1 January 2020, as well as a short period thereafter), as there will be inevitable changes to be made to the existing systems in order to implement the simpler and more streamlined foreign investment regulation process announced by FIL.

What to expect in future?

We have illustrated the main contents of the new Foreign Investment Law and its impacts it will bring to foreign investors. We have also given the recommendations and implications accordingly.

Since the provisions of FIL are fairly generic, we expect the impact will depend on the policies and regulations which will be adopted in the coming months. We will give our interpretation the moment the supporting systems and regulations are published.

How LehmanBrown Can Help You?

LehmanBrown International Accountants is a licensed China-focused accounting, taxation and business advisory firm, operating dedicated offices in Beijing, Tianjin, Shanghai, Shenzhen, Guangzhou, Hong Kong and Macau, and with an extensive affiliate network throughout China and in over 100 countries worldwide. LehmanBrown's business advisors can provide advice from pre-conception, when a cross border business strategy is forming, through the setup and implantation of this plan, through change of plan in corporate restructuring, and help in closures and downsizing, where there is a change in structure or strategy, and afterlife, where a company wants to spin off a division or sell.

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Foreign Currency Audit

Royalty Audit

Capital Verification Audit

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Damage Assessment Valuation Intellectual Property Valuation Asset Valuation

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Transaction Advisory

M&A Divesture

M&A Integration

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Company Registration & Maintenance

Cash Flow Management

Chop Custodian Services

Market Entry Advisory

Updating Company Certificates

Annual Inspection & Reporting

Company Secretarial Services

Company Ownership Transferring/Corporate Restructuring Background/Credit Checking

Company Deregistration & Bankruptcy

HR Support Services

China Visa Services for Expatriates

Social Welfare Structures

Outsourcing Services

Accounting & Bookkeeping

Budgeting & Forecasting Financial Statement Preparation Head Office Reporting

Financial Management

Interim Financial Management Finance Manager Function

CFO Function

Treasury Management

Set-up of Bank Account

Payroll Services

Payroll Processing Setup

Expatriate Employees

Local Employees

Secondment & Temping Service

Taxation Services

Individual Tax Planning (IIT)

Tax Immigration & Investment Review

US & Overseas Personal Income Tax Planning & Filing IIT Tax Payment Facilitation

Application for Individual Income Tax Refund

Expatriate Staff Individual Income Tax Staff Filing Local Staff Individual Income Tax

Company Taxation (CIT)

Tax Consulting

Corporate Tax Planning

Business Restructuring

Value Chain Review

Onshore / Offshore Investment

Transfer Pricing

Tax Compliance

Tax Due Diligence

Tax Deregistration

Negotiation of Tax Penalties

Tax Refund Application

Tax Representatives for Tax Audit

VAT & Customs Duty Clearance

PRC Tax Receipt Verification

VAT Application

VAT & Sales Tax Filing

Corporate Income Tax Reporting

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Internal Controls

Systems

Risk Management

Sarbanes - Oxley (SOX 404)

GAAP, SEC & IFRS Compliance

US GAAP

US GAAP Financial Statement Preparation

US GAAP Conversion

Other GAAP

GAAP Conversion

Public Company Compliance

Financial Statement Preparation

IFRS

IFRS Accounting Repackaging

IFRS Financial Statement Preparation

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Labour Legal Advisory

Workforce Downsizing Advisory

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