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## China Rolls Out New Draft Foreign Investment Law

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China has accelerated its foreign investment legislative process, in part as a goodwill gesture before resuming face-to-face trade talks with its U.S. counterparts. The National People's Congress released the [Draft PRC Foreign Investment Law](#) ("Draft Law") on December 26, 2018 for public comment through February 24, 2019. It constitutes a significant departure from the [draft](#) released by the Ministry of Commerce almost four years ago on January 19, 2015. The Draft Law addresses key demands by the U.S. to end the trade war, including protection of foreign investors' intellectual property rights ("IPR"), prohibition of forced technology transfer by administrative means, national treatment of foreign-invested enterprises, and equal treatment in government procurement processes for products produced in China by foreign-invested enterprises. However, the Draft Law's provisions are lacking in detail and leave many areas of longstanding concern unaddressed. It remains to be seen whether the law (if adopted) will lead to the significant changes in practice that the U.S. and several other governments and business communities have long sought.

Principal features of the Draft Law include:

### ***I. Definition of Foreign Investment***

Foreign Investment is defined as investment activity conducted by foreign natural persons, corporations, and other organizations ("Foreign Investors") directly or indirectly in China, including *de novo* projects, the establishment of foreign-invested enterprises and capital increases by Foreign Investors alone or jointly with other Foreign Investors in China; acquisitions of shares, equity, shares of property or other types of interests of enterprises in China by Foreign Investors through mergers and acquisitions; and investments by Foreign Investors in China through such other means as provided by laws, administrative regulations or the State Council (Article 2). The Draft Law would abolish existing statutes governing wholly foreign-owned enterprises, equity joint ventures and cooperative joint ventures, a positive action as joint ventures are difficult to establish anywhere as a corporate form and are inherently prone to technology transfer. The Draft Law does not establish a minimum percentage of foreign ownership to qualify as Foreign Investment. The threshold under current law is 25%.

Foreign-invested enterprises would be given five years to conform their corporate structure to the requirements under the new Law but the date when the clock starts to run remains to be specified. It

is possible that the Company Law would apply, but the requirement for establishment of a Communist Party branch in all companies with three or more Party members under the Company Law may be problematic.

The inclusion of indirect investment within the scope of Foreign Investment encompasses so-called variable interest entities (“VIEs”) in which foreign parties indirectly control domestic companies through contractual means, typically in order to engage in business in industries restricted to Foreign Investors. In practice, VIE structures are common in sectors such as technology, media and telecommunications (TMT) where Foreign Investors are subject to certain restrictions. Such investments by VIEs will need to be restructured to come into full compliance with relevant market access conditions for industries restricted for Foreign Investors, and may be ordered terminated or dissolved if they are unable or fail to do so (Article 35). However, it is unclear how this can be accomplished without disrupting the overseas investment structure employed by many Chinese companies to attract foreign capital.

Treatment of Hong Kong, Macau and Taiwan investors is not addressed in the Draft Law. Typically an article in the closing part of the law will provide that they are covered by reference as the Chinese government regards them as Chinese subject to different economic systems.

## ***II. Promotion of Investment***

To promote Foreign Investment, the Draft Law provides in principle that China will conduct high-level investment liberalization and facilitation policies, develop Foreign Investment promotion mechanisms, create a stable, transparent, and foreseeable investment environment (Article 3), and clarifies five sets of issues:

(1) The Draft Law states that a pre-entry national treatment and negative-list management system will apply to Foreign Investment (Article 4) and will be enforceable against VIEs (Article 35). A [new negative-list](#) was published by the National Development and Reform Commission on June 28, 2018. It is unclear if the new list will prove satisfactory to China’s trading partners as it remains quite broad.

Moreover, China’s predilection for establishing pilot policies and measures as well as special economic zones would be elevated to the level of a statute (Article 13), even though such policies, measures and zones typically operate indefinitely without any systematic evaluation to determine whether and when they should be rolled out nationwide. While Foreign Investors may enjoy some tax and investment preferences under such policies, measures and zones, they often remain indefinitely restricted in their ability to compete on a nationwide basis;

(2) The Draft Law states that government policies supporting enterprise development will apply equally to foreign-invested enterprises; foreign-invested enterprises will be consulted for comments and suggestions in the formulation of foreign-investment-related laws, regulations and rules; regulatory documents and judicial judgments related to Foreign Investment shall be published in a timely manner; the government will develop a Foreign Investment service system to provide consultation and services for Foreign Investors and

foreign-invested enterprises with respect to laws and regulations, policy measures and investment project information (Articles 9-11).

This is broadly consistent with the concept of “competitive neutrality” enunciated by Governor Yi Gang of the People’s Bank of China on October 14, 2018 and embraced by the State Administration for Market Regulation and the State Council more recently. It is moreover questionable whether Foreign Investors and their governments will be persuaded that state-owned and state-influenced enterprises will really be treated equally, in part because the Anti-Monopoly Law legitimizes monopoly conduct by central government state-owned enterprises but perhaps especially because Foreign Investors and foreign-invested enterprises are prohibited from endangering China’s national security or harming China’s social and political interests (Article 6), terms which are vague and open to broad discretion in enforcement;

(3) The Draft Law states that foreign-invested enterprises are to be on an equal footing with respect to participation in standardization work and government procurement activity. Efforts shall be stepped up with respect to information disclosure and public supervision in standards formulation. Mandatory standards apply equally to foreign-invested enterprises. Foreign-invested enterprises shall be treated equally in government procurement for their products produced in China in accordance with law (Articles 15-16). No reference is made to procurement by state-owned enterprises which are officially independent of the government but in practice may be heavily government-influenced.

As foreign-invested enterprises are outnumbered and relatively weak in the standards formulation process, especially in the drafting stage, it is unclear how meaningful the formalization in statute of a right to participate will be if China continues to advocate a strongly nationalistic approach to standards formulation. In addition, the breadth and rigidity of China’s Multi-Level Protection Scheme may still limit the ability of foreign-invested enterprises to cooperate in government procurement and procurement by state-owned enterprises unless they agree to limit their equity and control and/or transfer technology;

(4) The Draft Law states that foreign-invested enterprises may raise funds through public offerings, corporate bonds, and other means (Article 17) in China. With rare exceptions, foreign-invested enterprises presently face significant regulatory and policy hurdles to raise funds through public offerings on Chinese domestic stock exchanges (e.g., A shares) and Article 17 presents a positive development in this connection. However, it is unclear how open China’s securities regulation will be to such offerings given historically high levels of political interference in China’s IPOs and other securities offerings; and

(5) The Draft Law states that local governments may, acting within their statutory authority, formulate Foreign Investment promotion policies, and governments at all levels will further improve their services for Foreign Investment (Articles 18-19).

In addition, the Draft Law would establish a Foreign Investment security review system without right of appeal, which would cover investments, greenfield as well as mergers and

acquisitions, that affect or may affect national security (Article 33). This system presumably would be more elaborate than the existing security review system established in 2011 (click [here](#)). A statutory basis would also be created for retaliation against countries and regions which impose restrictions, prohibitions or other measures against Chinese investors (Article 37).

### ***III. Protection of Investment***

The Draft Law would include provisions to strengthen the protection of Foreign Investors' lawful rights and interests in four aspects:

(1) The Draft Law calls for strengthening IPR protection for foreign-invested enterprises. The State will generally not expropriate Foreign Investments. In the event of expropriation required in accordance with social and public interests, the expropriation will be implemented in accordance with legal procedure and fair and reasonable compensation will be paid (Article 20). The vagueness of the term "social and public interests" presents a risk of unjustifiable expropriation, however. The Draft Law states that capital contributions, profits, and returns on investment of Foreign Investors may be freely transferred outside China in RMB or in foreign currency (Article 21).

The Draft Law states that the State will protect the IPR of Foreign Investors and foreign-invested enterprises in accordance with law and encourage technological cooperation based on voluntariness and commercial norms. The conditions for technology cooperation shall be negotiated and agreed upon by the investment parties; and forced technology transfer through administrative measures is prohibited (Article 22). This liberalization may be of limited impact unless foreign equity caps are lifted from the many industries in which they are maintained, China's currency controls are further relaxed and government licensing requirements are implemented on a timely and non-discriminatory basis;

(2) The Draft Law limits extra-legal restrictions on Foreign Investment. Governments and relevant departments at all levels shall formulate Foreign-Investment-related regulatory documents in accordance with laws and regulations, may not undermine foreign-invested enterprises' lawful rights or impose obligations in violation of law, and shall not set market entry and exit conditions or interfere or influence normal business activities of foreign-invested enterprises in violation of law (Article 23);

(3) The Draft Law calls on local governments to abide by their commitments. Local governments and their relevant departments shall strictly abide by duly-made policy commitments and all contracts concluded according to law. In case of changes to government commitments or contractual agreement due to national interests or social and public interests, the government shall act strictly in compliance with statutory authority and procedures, and compensate Foreign Investors and foreign-invested enterprises for losses suffered therefrom (Article 24); and

(4) The Draft Law calls for improving the mechanisms for complaints and protection of the rights of foreign-invested enterprises. The State will establish a working mechanism for

complaints by foreign-invested enterprises, coordinate and improve major policy measures to respond to complaints by foreign-invested enterprises, provide timely solutions to problems raised by foreign-invested enterprises, and Foreign Investors and foreign-invested enterprises may establish and join on a voluntary basis chambers of commerce and associations to protect their legal rights and interests (Articles 25 and 26). It is unclear how novel or effective this will be, particularly given perennial concerns among Foreign Investors about retribution from the Chinese government.

#### **IV. Conclusion**

The Draft Law promises improvements in market access, IPR protection and equal treatment for Foreign Investors. However, an expression of good intentions will not be sufficient without concrete actions to enforce the law as it is written. In particular, Chinese officials have long denied any “forced” transfer of Foreign Investors’ IPRs and argued that foreign companies do so “voluntarily” in exchange for access to China’s lucrative market. It is unclear how effective the new Foreign Investment Law can be in resolving a problem that the Chinese government has maintained does not exist. Furthermore, the Draft Foreign Investment Law seems to have left unresolved the issues of government subsidies, exemptions for central government-authorized monopolies under the Anti-Monopoly Law, and other preferences granted to domestic state-invested and state-influenced companies, all of which tilt the playing field favoring domestic firms.

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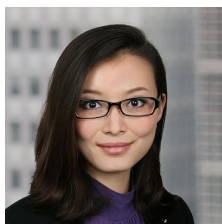


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