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China Issues Market-Entry Negative List And Publishes Draft Foreign Investment Law for Public Comment

Since late 2017, in the context of the escalating trade war between the United States and Chinese governments, Chinese political leaders have signaled that they are willing to address some of the issues that the U.S. and other governments had complained about. Their statements promised better protection of foreign investors' intellectual property rights, an easing of market access restriction, equal access to government procurement and, generally, the creation of a level playing field. In late December 2018, the Chinese authorities took significant steps in this direction in advance of the bilateral Chinese-American trade talks in Beijing during the week of January 7, 2019.

On December 26, 2018, the National People's Congress ("NPC"), China's top legislature, published the long-awaited second draft of the Foreign Investment Law (the "2018 Draft"). The draft is open for public comments until February 24, 2019, and the Foreign Investment Law is expected to be adopted at the next NPC session in March 2019 after the Standing Committee's approval, assuming no complications arise. The outcome of the legislative process may depend in particular on the progress of trade negotiations with the United States.

On December 24, 2018, the National Development and Reform Commission ("NDRC") and the Ministry of Commerce ("MOFCOM") of the People's Republic of China ("PRC" or "China") jointly issued the Market Entry Negative List (2018 version) (the "General Negative List"). The General Negative List, effective upon its adoption, applies to all market participants in China, both domestic and foreign investors alike. It will exist in parallel with the Special Administrative Measures on Access to Foreign Investment (2018 version) (the "Foreign Investment Negative List") issued on June 28, 2018.

In this update, we discuss the practical consequences of these legislative actions for foreign investors in China.

The 2018 Draft of the Foreign Investment Law

Foreign Investment Protection Enshrined in Law

The 2018 Draft includes sweeping statements of broad principles that protect foreign investment. The key aspects of national treatment contained in the 2018 Draft are:

- All supportive government policies that apply to domestic entities shall equally apply to foreign invested enterprises ("FIEs") (except otherwise provided by laws or regulations).

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- FIEs will be treated equally and fairly in government procurement with respect to products produced in the PRC.
 - FIEs may participate in the formulation of standards on an equal basis.
 - FIEs are allowed to raise capital by issuing shares or bonds to the public or through other similar means.

The 2018 Draft also aims to protect foreign investment through the following principles:

- Government authorities will not expropriate foreign investment, except in the public interest under special circumstances where it will provide fair and reasonable compensation.
- Foreign investors may freely remit their capital contributions, profits, capital gains, royalties under intellectual property licenses and legally obtained compensation or indemnity payments out of China either in local or foreign currency.
- Conditions to technological cooperation in connection with foreign investment should be decided by all parties involved through good-faith negotiation, and government authorities and officials shall not take administrative measures to force any transfer of technology by foreign investors.
- Local governments are strictly required to fulfill their policy commitments made to foreign investors and FIEs, and perform any contracts that they have duly entered into with foreign investors and FIEs.

In this list, the grant of fair access to public procurement procedures is the most significant novelty. The other principles, on the other hand, are already contained in existing laws or regulations. Reiterating them in the Foreign Investment Law emphasizes their importance, but does not significantly increase the protections for foreign investors in practice. In fact, the rights laid out in the 2018 Draft do not constitute absolute guarantees. The Foreign Investment Law will only protect rights and benefits of foreign investors obtained “according to law”. Thus, restrictions (e.g., on the repatriation of dividends or the protection of intellectual property rights) can be contained in other legislation.

The 2018 Draft also introduces important caveats to the principle of national treatment:

- Foreign investment is subject to national security review under separate legislation. The 2018 Draft adds that decisions made in a national security review are final. There is concern expressed in the market as to whether this implies that no administrative or judicial review is permitted
- China may retaliate against foreign countries if they discriminate against China through prohibitions, restrictions or similar measures.

- Regulations governing investment in securities, forex and other financial markets and foreign investment in financial services industries (banking, securities and insurance) prevail over the provisions of the Foreign Investment Law, so that even the general principles enshrined in the 2018 Draft may be negated in specific legislation.

VIE Structures Not Addressed

In January 2015, MOFCOM released a first draft of the Foreign Investment Law (the “2015 Draft”) for public comment. We had briefed you about this development (see our previous [update](#) on January 22, 2015). The 2018 Draft avoids regulating some facets of foreign investment on which the 2015 Draft had focused.

Most importantly, the scope of “foreign investment” as defined in the 2018 Draft is less specific than that in the 2015 Draft. Any indirect control of a domestic entity by foreign entities or individuals, either through contractual arrangement or trust, was deemed to be foreign investment in the 2015 Draft. The 2015 Draft thus explicitly aimed to regulate the contractual control of domestic operating entities in restricted industries through variable interest entity (“VIE”) structures as foreign investment. This had potentially far reaching consequences. The 2015 Draft also contained a chapter on the proposed overhaul of the VIE regime, including three alternative options for public comment: (i) legitimization through self-declaration; (ii) legitimization through self-declaration and verification by the regulatory authorities; and (iii) legitimization through self-declaration and approval by the regulatory authorities. This was a controversial topic in the market. There was also much concern over the impact on existing VIEs and what any grandfathering arrangement would be.

The 2018 Draft remains silent on this issue. Until further regulatory developments, it appears that the current status and legal treatment of VIE structures will not be affected by the Foreign Investment Law. However, as the 2018 Draft defines foreign investment generically as “activities in mainland China conducted directly or indirectly by natural persons, enterprises or other organization of foreign countries, including ... when foreign investors invest in mainland China through other means prescribed by laws, administrative obligations or the State Council”, the generic and catch-all references still leave open the possibility for subsequent regulation of VIEs as a form of foreign investment should the PRC government choose to do so.

Negative List Approach Confirmed

The 2018 Draft stipulates that foreign investment will be managed through a combination of national treatment and a negative list of industries to which such national treatment will not apply.

Thus, the Foreign Investment Law will formally enact the existing negative list regime under which foreign investors are barred from investing in prohibited industries and must comply with restrictions (e.g., foreign ownership caps) when investing in restricted industries. On the other hand, except to the extent provided

in the Foreign Investment Negative List promulgated by the State Council, foreign investors will enjoy equal treatment under the protective principles described above, and all central and local government authorities must abide by them.

The 2018 Draft stipulates the consequences for violating the market access restrictions under the Foreign Investment Negative List :

- If a foreign investor invests in a prohibited industry, the competent regulatory authority shall order it to stop the investment activities and restore the pre-investment status by disposing of its shares or assets as well as taking other necessary measures within a prescribed time limit. Any illegal gains will be confiscated.
- If a foreign investor invests in a restricted industry without complying with the applicable restriction, the competent regulatory authority shall order it to take necessary remedial measures. If the investor refuses to do so, the authority may order the investor to dispose of its investment and confiscate illegal gains.

It is notable that foreign investors will be guaranteed an opportunity to rectify a violation of the market access rules for restricted industries. For instance, if a foreign investor acquired a majority shareholding in a company in an industry where foreign ownership is capped at 50%, the terms of the 2018 Draft would allow the investor to reduce its shareholding to 50% and remain a shareholder at the permitted level of ownership.

Practical Changes Specified

In addition to the main principles of foreign investment, the 2018 Draft also addresses a few questions of more specific concern.

Once adopted, the 2018 Draft will replace three existing laws governing foreign investment, namely the Law on Chinese-foreign Equity Joint Ventures, the Law on Chinese-foreign Cooperative Joint Ventures and the Law on Wholly Foreign-owned Enterprises (collectively, the “Existing FIE Laws”). As such, the 2018 Draft removes the distinction in corporate form between foreign and domestic invested corporate entities. The 2018 Draft prescribes that the existing FIEs that are established in accordance with the Existing FIE Laws will have five years after adoption of the Foreign Investment Law to transition from their existing corporate form to other forms under PRC laws and regulations.

A number of issues will need to be dealt with in this transition. In particular, shareholders in equity and cooperative joint ventures may have to reconfirm or renegotiate the terms of their joint venture contracts to ensure that they comply with the new legal regime. Consequential changes to the corporate governance regime and capital structure will need to be considered.

An information reporting mechanism for foreign investment will be established. Foreign investors or FIEs shall report investment-related information to MOFCOM and its local counterparts through the National Credit Information Disclosure System for Enterprises and Enterprise Registration System. If any information can be obtained from other government authorities, foreign investors or FIEs should not be required to submit such information again.

The 2018 Draft also stipulates that, where several government authorities are involved in approving a foreign investment, one of them should take the lead and act as the single point of contact for the applicant under a “one shop stop” principle. This approach, which some local PRC authorities already adopt, is another welcome development.

The General Negative List

A New Regulatory Tool

While the Foreign Investment Negative List is only the latest in a long history of negative lists and guidance catalogues for foreign investment, the General Negative List is the first of its kind on a nationwide basis. The PRC State Council had mandated the preparation of this list in 2015. An experimental version, which applied to Tianjin, Shanghai, Fujian and Guangdong only, was issued in March 2016. In 2017, the experimental version was expanded to cover a total of 15 provinces.

The stated legislative objective of the General Negative List is to consolidate existing prohibitions and approval requirements into a single list, separate access restrictions from other requirements and limit the power of government departments and local authorities to prepare their own lists, in order to make the regulatory framework more rigorous and transparent.

In addition to local investors, foreign investors will also be able to rely on the provisions of the General Negative List to insist on national treatment for all industries that are not treated differently under the Foreign Investment Negative List.

The Negative List applies to all market players including state-owned firms, private companies, mixed-ownership enterprises and foreign investors despite their entity form, size or other differences, which demonstrates China’s desire to further open up the economy and provide a level playing field for foreign and domestic investors.

Restrictions and Clarifications

The General Negative List contains two categories: (i) the “prohibited” category of industries in which investment is completely prohibited; and (ii) the “approval-required” category of industries in which

investment will be subject to market access approval. Industries not on the list are open for investment to all and require no access approval.

The General Negative List has four “prohibited” categories, namely (i) business activities explicitly prohibited by laws, regulations, or other rules made by State Council in connection with market access; (ii) projects prohibited or restricted under the Catalogue for Guiding Industrial Restructuring; (iii) unlawful finance-related business activities; and (iv) unlawful internet-related business activities.

The General Negative List has 147 “approval-required” categories, mostly in the manufacturing industry (26), financial industry (11), and culture, sports and entertainment industry (11). The General Negative List specifies, with regard to each industry in the “approval-based” category, the access approvals that investors must obtain in order to conduct business in this industry. For certain categories, investors may also need to obtain access approval at the provincial level.

The General Negative List is not only a transparent and limiting list of existing restrictions. It also abolishes restrictions in some industries, albeit to a limited extent. For example, access restrictions to certain resource-related industries like coal and nonferrous metals have been relaxed.

On the other hand, the General Negative List also emphasizes priority areas for government control, in particular in the finance and the Internet sectors. Activities that have attracted government intervention in recent years, such as illegal or risky peer-to-peer online lending, are highlighted in the General Negative List.

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On the whole, both the 2018 Draft and the General Negative List further protect foreign investment in China by loosening market-access control, streamlining approval processes, and granting national treatment. However, the 2018 Draft and the Negative List, in their current forms, also raise new issues that need to be clarified in order to avoid unintentional consequences for foreign and domestic investors investing in China.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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