



A New Foreign Investment Regime is Arising: Comments on the Draft PRC Foreign Investment Law

On January 19, 2015, the PRC Ministry of Commerce (“MOFCOM”) issued the draft PRC Foreign Investment Law (the “Draft Law”) for public comments. The Draft Law, if and when enacted, would repeal and replace the three existing laws on foreign investment: (i) the Chinese-Foreign Equity Joint Ventures Law, (ii) the Chinese-Foreign Contractual Joint Ventures Law, and (iii) the Wholly Foreign-Owned Enterprises Law (collectively, “Current FIE Laws”), thereby forming a new legal regime that is to govern all current and future foreign investments in China.

Significant Changes Expected to Shape a New FIE Regulatory Framework

The Draft Law is Intended to Unify the Current FIE Laws and Regulations to be Consistent with the PRC Company Law. The Current FIE laws and their implementing regulations and rules set forth different requirements for different forms of foreign invested enterprises (“FIEs”) and sometimes are not consistent with the principles set forth in the PRC Company Law (the “Company Law”). The Draft Law, however, by unifying the Current FIE Laws, aims to adopt a unified regulatory system with systematic and consistent provisions regulating all types of foreign investments. The

Draft Law would regulate policies on foreign investors and their investments in China, market access, national security, information reporting, investment promotion and protection, and legal liability, which would invariably apply to all forms of FIEs. Further, once the Draft Law is enacted, all entities (both domestic and foreign) would have to apply the Company Law to their corporate governance. Therefore, this “Draft Law and Company Law” system will basically set up a regulatory regime in which the Draft Law provides for specific policies on foreign investment, leaving the corporate governance and business operation matters under the Company Law.

The Draft Law Replaces the Project-by-Project Approval for FIE Establishment with a “Negative List” Management Approach. Under this new regime, FIEs would not be subject to market access review and approval for their establishment, except for those in the industries that appear on the negative list to be issued by the State Council. In other words, FIEs not falling under this negative list would not have to apply for any regulatory approval and can directly file for company establishment. Thus, repealing market access approvals on presumably most foreign investments in China will substantially remove the major

hurdles that have tightly regulated all foreign investment projects over the years. This significant change seems in line with the legislative intent to loosen the market access regulation and focus on regulation and compliance during and after a company's business operation.

Comments on Suggested Revisions to the Draft Law

National Treatment on Reporting Obligations. The Draft Law requires all foreign investors and FIEs to comply with information reporting obligations, no matter whether the corresponding foreign investment falls within or outside the negative list. As currently proposed under the Draft Law, the information required to be reported is fairly broad, including certain financial, accounting, and operational information on the FIE (similar to that required of a PRC listed company), and information on the foreign investor, including the ultimate controlling shareholders. When compared to the information reporting requirements of a domestic nonlisted company, the scope of information to be reported by FIEs is substantially broader and more intrusive. Thus, the Draft Law does not offer FIEs national treatment in terms of their reporting obligations. We believe that giving FIEs national treatment with respect to their reporting obligations under the Draft Law would be in line with the legislative intent and spirit of the Draft Law. Since both FIEs and domestic companies are operating in China, there is no reason why the reporting requirements applicable to them should differ. Additionally, the Draft Law is unclear as to which government agency the FIEs will report to in order to meet their information reporting obligations. Since all domestic and foreign companies are already required to report certain mandatory information to an information disclosure platform administered by the Administration of Industry and Commerce, we suggest that the same platform be utilized in connection with the reporting obligations under the Draft Law so as to avoid repetitive reporting obligations to more than one government agency.

Concentration of Legislative Power in the Regulatory Authorities. The Draft Law introduces a negative list management regime whereby only FIEs operating or investing in industries appearing on the negative list will need to seek regulatory approval for establishment. What this means

is that the regulatory authorities charged with formulating, amending, and administering this "negative list" will have tremendous power with formulating China's foreign investment policies and the execution of such policies. These agencies will have the power to decide what industries appear on the list and thus face a more rigorous regulatory approval process compared to those not on the list. Considering the significant impact such list will have on the interests of foreign investors, we suggest that the formulation of the negative list and its amendments from time to time should undergo a more rigorous and transparent legislative process, rather than being issued and often amended under administrative orders.

Limited Liability Protection for Foreign Investors. The Draft Law imposes various legal liabilities not only on FIEs but also on their investors or shareholders. This creates, we believe, an unintentional effect of denying limited liability protection for foreign investors with respect to their capital investment in China. Even under the PRC Company Law, an equity holder's liability would be limited to the amount of such investor's equity investment. The company, as a separate legal entity, should bear its own legal liabilities, and its investors or shareholders should be shielded personally (including their personal assets) from the company's liabilities. However, under the Draft Law, government agencies would have recourse against both the FIEs as well as their investors. We believe that penalizing foreign investors for the acts or omissions of the FIE in which they invested would be at odds with the limited liability principle under the PRC Company Law and the spirit of encouraging foreign investments. Instead of the current language, the drafters of the Draft Law may want to consider incorporating the concept of "piercing the corporate veil," which will serve the same purpose without denying the limited liability protection.

Requirements under National Security Review. Under the Draft Law, foreign investors *may* apply for national security review if the proposed foreign investment "endangers or is likely to endanger national security." No specific scope or definition of "national security" or "endangerment of national security" is provided under the Draft Law. Thus, the foreign investor is left to decide for itself whether the proposed investment "will endanger or is likely to endanger national security." Given the abstract nature of what may constitute

national security, it would seem unrealistic and unreasonable to require foreign investors to make such determination without guidance under the Draft Law. Furthermore, considering the negative list regime discussed above, foreign investments will already be subject to regulatory scrutiny if they are investing in an industry on the negative list (the assumption being that if it is an industry that relates to national security, such industry would either be prohibited or restricted from foreign investment). As such, the more rational approach would seem to be incorporating national security review as part of the market access approval by identifying certain industries as being critical or relevant to national security and flagging foreign investments in such industries as requiring national security review. This would eliminate any ambiguity and reduce foreign investors' anxiety in making investments in China.

Although the Draft Law would likely take many months to go through the legislative process before its enactment, multinational companies investing or doing business in China should be fully prepared in advance in order to adjust to the significant changes under the forthcoming new foreign investment regime in China. We believe that those who are well positioned with a workable strategy going forward should be able to deal with the new changes more effectively.

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