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WFOE Compliance Issues during the Transition Period under the new FIL

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On 1 January 2020, the *Foreign Investment Law of the People's Republic of China* ("**FIL**") came into force, and at the same time, the three-decades-old-plus *Wholly Foreign-owned Enterprises Law of the People's Republic of China* ("**WFOE Law**") and its relevant regulations were simultaneously repealed. With respect to the existing c.375,000 WFOEs already established in accordance with the previous WFOE Law and regulations, the new FIL and its Implementation Regulations provide a 5-year transition period ("**Transition Period**") for them to make the necessary adjustments and conversion to ensure compliance by the end of 2024. The *Company Law of the People's Republic of China* ("**Company Law**") shall universally govern the WFOEs in the same way as it does domestic Chinese companies.

In order to help existing WFOEs and their foreign shareholders better understand the impact of the new FIL and its relevant regulations, we hereby set out the main compliance issues to be attended to in the Transition Period, mainly in respect of the corporate governance, foreign exchange and foreign investment reporting obligations etc.

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1. Corporate Governance

In order to quickly identify the to-be-complied issues, we have conducted an overhaul of all the corporate governance aspects under the old WFOE Law regime and the new FIL regime. Accordingly we have prepared the below detailed table which sets out the main issues.

Issue	Old WFOE Law	New FIL	Comment
Legal basis for the establishment and operation of WFOEs	WFOE Law, its relevant implementation regulations, rules, orders, measures, notices and circulars etc.	FIL and its relevant implementation regulations, rules, measures, notices and circulars etc. which are currently under rapid development to substantiate in practical terms the new FIL regime. Upon repeal of the WFOE Law, **the Company Law** shall govern all the corporate issues of WFOEs.	The relevant wordings in the articles of association shall be amended.
Articles of Associations	The articles of association of a WFOE shall include the following: (1) name and address; (2) **purpose**, business scope; (3) **total investment amount**, registered capital, subscribed capital contribution amount, capital contribution method, capital contribution timing; (4) organizational form; (5) internal organizational authorities and duties and powers, and rules of procedures, and **the duties and powers of the legal representative, general manager, chief engineer, chief accountant, etc.**;	The articles of association of a company shall state the following: (1) name and address; (2) business scope; (3) registered capital; (4) name(s) of the shareholder(s); (5) method, amount and timing of capital contribution; (6) organizational authorities, composition, duties and powers, and rules of procedures; (7) legal representative of the company; and (8) other matters resolved by the shareholders' meeting to be stipulated in the articles.	Most, if not all, existing corporate governance practices and the organisational structure of WFOEs stipulated by the articles of association are more or less inconsistent with some mandatory provisions of the Company Law, therefore, WFOEs shall amend their articles of association in due course and adjust their corporate governance accordingly.

	(6) **financial, accounting and audit principles and systems**; (7) **labour management**; (8) **term of operation, termination** and **liquidation**; and (9) **procedures for the amendment of the articles of association**.		
Post-tax profit reserve	A WFOE shall, upon payment of income tax on its profits pursuant to the relevant tax law, make apportionment to its reserve fund as well as employees' bonus and welfare fund (a.k.a. "**FIE three funds**").	Under the new FIL, the Company Law's relevant provisions shall govern the reserve fund issue. A company shall contribute 10% of the post-tax profits into its **statutory reserve** which may be capped at 50% of its registered capital. Apart from the statutory reserve, any other reserve, provident fund(s) as well as retained earnings are subject to company's own discretion.	As a matter of fact, in practice, the "FIE three funds" rule has already been widely relaxed in recent years and a lot of WFOEs have stopped providing after-tax funds into the FIE three funds. The relevant outdated and obsolete provisions in relation to the "FIE three funds" contained in the articles of association shall be amended.
Liquidation	The liquidation committee shall comprise the legal representative of the WFOE, creditor representatives, and representatives of the competent authorities, and shall engage Chinese certified public accountants and lawyers.	The liquidation committee of a limited liability company shall be formed by the **shareholders** according to the law**.**	The relevant provisions in the articles of association shall be amended to give the shareholder the right to constitute the liquidation committee. If a WFOE considers liquidation during the Transition Period, the liquidation shall comply with the Company Law.

2. Foreign Debt Management

Under China's foreign exchange regulatory regime, the foreign debt management system involving the total investment ("投资总额") and the stipulated gap between the registered capital and the total investment

(“投注差”) have been in place for many years. A WFOE is allowed, not obliged, to take out loans and incur foreign debt within such a gap. In 2017, the *Notice of the People's Bank of China on Full-coverage Macro-prudent Management of Cross-border Financing* specified a new alternative foreign debt management system.

Technically speaking, the total investment and the stipulated gap between the registered capital and the total investment are no longer mentioned in either the new FIL or the Company Law. However, the competent authorities have not yet promulgated new regulations formally repealing the old foreign debt management system, i.e. the old and new foreign debt management systems co-exist for the time being. Practically speaking, the total investment provisions in the articles of association may not need any immediate change where a WFOE prefers at present not to switch to the new system.

There has recently been some kind of transitional regulatory practice. For example, pursuant to a notice issued by SAFE[1] Beijing Bureau in March 2020, non-financial enterprises/companies in Beijing may choose to change their current foreign debt regime where the gap between the registered capital and the total investment is essential, to the more flexible Macro-prudent Management of Cross-border Financing System[2] which may offer an easier approval/registration process and a higher permitted amount of foreign debt raised. It is advisable to pay continuous close attention to the subsequent updates of regulations in this regard.

3. Foreign Investment Report

Since 2016, while the “restricted” foreign investment within the scope of the relevant negative lists continues to be subject to approval of the relevant authorities, “encouraged” and “permitted” foreign investment has been subject to filing requirements.

Effective from 1 January 2020, the *Measures on Reporting of Foreign Investment Information* (“**Reporting Measures**”) established a new foreign investment information reporting system, under which the WFOEs shall submit investment information reports (incl. initial report, change report, deregistration report, annual report, etc.) through the online Enterprise Registration System and the Enterprise Credit Information Publicity System.

Pursuant to the Reporting Measures, where there is a registerable change such as the name, address, legal representative, shareholder(s), scope of business, registered capital etc., a WFOE shall report the same via the Enterprise Registration System at the same time as processing the relevant change(s) registration. Where the change does not involve any registerable item but is subject to the relevant filing requirement, a WFOE shall report the same via the Enterprise Registration System within twenty (20) working days from the occurrence of the changed matter (e.g. the date of the related resolutions).

1 State Administration for Foreign Exchange
2 http://www.safe.gov.cn/beijing/2020/0310/1194.html

The annual report for the preceding year should be submitted before **30 June** annually through the National Enterprise Credit Information Publicity System, which may include WFOE's basic corporate information, the investors and their actual controllers, business conditions, assets and liabilities, etc. Please note in accordance with the Company Law, a company shall have its annual financial statements audited; however for the time being the reporting obligation might not explicitly require the audited financial statements to be uploaded via the reporting system.

4. Timing Considerations

It is worth noting that

(1) the FIL is new and Chinese authorities are still in the process of ramping up the necessary implementing rules and measures, practice needs to be time tested;

(2) although the 5-year Transition Period seems to be plenty of time, a timely compliance conversion has been encouraged by the Chinese authorities;

(3) 31 December 2024 is a hard deadline; from 1 January 2025 if a WFOE has not fully complied with the new FIL, the registration window will be closed thus jeopardizing the foreign investor's investment in that WFOE and a public notice listing incompliant companies will be published.

Undoubtedly with due care penalties for the delay should be avoided.

If you would like to know more information about the subjects covered in this publication, please contact:

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