COLLANA DEL DIPARTIMENTO DI GIURISPRUDENZA
UNIVERSITÀ DEGLI STUDI DI BRESCIA

PRODUCTION AND CIRCULATION OF WHEALTH PROBLEMS, PRINCIPLES AND MODELS

Summer school, Brescia 8-12 luglio 2019

Edited by

Maurizio Onza e Antonio Saccoccio

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NEW RULES ON FOREIGN INVESTMENT IN CHINA

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1. *Introduction*

The start of the strategy for the reform of the foreign investment system in China finds its basis in the *Decision* adopted at the Third Plenary Session of the 18th Central Committee of the Communist Party of China on November 12, 2013. Through a repeated reference to the instrument of the law, in order to define a balance between the role of the government and that of the market, it had set the goal of providing a generally unified system of laws and regulations on both Chinese and foreign investment and to create an environment for foreign investments characterized by stability, transparency and predictability, indicating 2020 as the deadline to achieve decisive results in the reform of important areas and crucial segments. [1]

On January 19, 2015, Ministry of Commerce (MOFCOM) brought out Foreign Investment Law of the People's Republic of China (Exposure Draft) to solicit opinions from the general public. [2]

In a text of 170 articles, the Chinese government affirmed the current inadequacy of a management mode *"case-by-case examination and approval system"* established by the Three Foreign Investment Laws [3] for

[1] About the *Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform*, *see* http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31212602.htm.

[2] See *Mofcom Spokesman Sun Jiwen Comments on Foreign Investment Law (Exposure Draft) Issued for Soliciting Public Opinions*, http://english.mofcom.gov.cn/article/policyrelease/Cocoon/201501/20150100875221.shtml.

[3] See, M. TIMOTEO, *La Costituzione di Equity Joint Venture in Cina. L'Investitore Occiden-*

construction of a new open economic system, activation of the market and transformation of governmental functions; the necessity to provide as general reference the Chinese Company law and the importance to include a security review system in fundamental laws on foreign investment.

On the basis of these forecasts, the work of the Ministry of Commerce to amend the *Law on Chinese-Foreign Equity Joint Ventures*, the *Law on Wholly Foreign Owned Enterprises* and the *Law on Chinese-Foreign Contractual Joint Ventures* began at that time, meanwhile highlighting as strengthening governmental functions in facilitating foreign investment is a new tendency in foreign investment legislations and policies of the countries all over the world.

It was not until three years later that, on December 26, 2018, the official website of the National People's Congress (NPC) released a draft of *Foreign Investment Law*, consisting of six chapters and 39 articles, and sought for the public's comments. The draft, despite through provisions of principle at the most, focused on promotion and protection of investment, as 20 of 39 articles which were concerning about them. It confirmed, for foreign investments, the system first implemented by the Shanghai Pilot Free Trade Zone in 2013 as a pilot policy (the pre-establishment national treatment plus negative list management system) and provided a complain system for foreign-funded enterprises. [4]

The second draft of the Foreign investment law was published on January, 2019 [5] to be then approved two months later at the annual meeting of the National People's Congress.

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tale a confronto con il diritto cinese, in *Dir. comm. Internazionale*, 12, 1, 1988; P. BUCKLEY, *Foreign Direct Investment, China and the World Economy*, Springer, Berlin, 2010; T. MAHONY, *Foreign Investment Law in China: Regulation, Practice and Context*, Tsinghua University Press, Beijing, 2015, 4-12.

[4] HUANG, D.C.-VAN, V.T.-HOSSAIN, MD.E.-HE, Z.Q. (2017) *Shanghai Pilot Free Trade Zone and Its Effect on Economic Growth: A Counter-Factual Approach*. *Open Journal of Social Sciences*, 5, 73-91. https://doi.org/10.4236/jss.2017.59006.

[5] The second draft did not differ significantly from the first one. Some changes were related to: a) the scope of foreign investment where "foreign investment" no longer covered capital increases by foreign investors, either individually or jointly. Any acquisition by foreign investors of "shares, equity, property shares, or other similar rights in mainland Chinese enterprises" was considered "foreign investment" under the second draft with no restriction to mergers and acquisitions; b) the definition of "pre-establishment national treatment", to be explicitly understood as "affording foreign investors and their investments treatment no less favorable than that afforded to Chinese domestic investors and their investments, during the establishment, acquisition, expansion, and such other stages of an enterprise"; c) requisition that, in addition to expropriation, was authorized by government for public interest; d) anti-monopoly review to which must be submitted any foreign investors that "merge with or acquire mainland Chinese enterprises" or otherwise participate in concentration of undertakings.

2. *Preliminary steps of change for foreign invested enterprises*

Since foreign investment in PRC companies became permitted in 1979, the Ministry of Commerce (MOFCOM), the National Development and Reform Commission (NDRC) and the State Administration of Industry and Commerce (SAIC) were the frontline regulators in approving the establishment of foreign-invested enterprises (FIEs).[6] This regime, characterized by a complete separation of discipline from the one reserved for domestic enterprises, was built from the beginning according two specific pillars, relevant for the establishment and modification of these forms of foreign presence in China: the delimitation of areas in which allow such enterprises to enter the market, in full or limited form where not prohibited (*see paragraph 3 below*), and a system of a case-by-case evaluation and approval of the corresponding forms of investment, involving the Ministry of Commerce and the State Administration for Industry and Commerce, at central and local levels, depending on the size of the proposed investment and further, different, parameters.

However, in the period of time between the publication of the first draft of the Foreign Investment Law and its approval, the Chinese government has taken important steps to reform the above regime, working towards harmonization between rules for domestic and foreign subjects, starting from the *Decision on Revising Four Laws, Including the «PRC Wholly Foreign-owned Enterprise Law»* adopted by the Standing Committee of the People's National Congress on September 3, 2016.[7]

Since the NPC Decision came into effect on October 1, 2016, a FIE engaged in a business that was not subject to restrictions or "special administrative measures for access" changed from being subject to administration by way of examination and approval, to administration by way of record filing. This development has consistently reduced time and complexity of establishing a non-restricted FIE.

The NPC Decision only amended a single article in each of the laws governing the three traditional types of FIE – the wholly foreign-owned enterprises, the equity joint venture and the cooperative joint venture – which changed the approval regime to a filing regime.

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[6] *See*, T. MAHONY, *Foreign Investment Law in China: Regulation, Practice and Context*, Tsinghua University Press, Beijing, 2015, 19, where these entities and their respective provincial and municipal sub-entities involved in the foreign investment approval process, are indicated as representatives of three separate stages of one process, beginning with the "planning approval" from the NDRC, followed by the "foreign investment approval" from Mofcom and concluding with the "business establishment approval" (the issuance of the business license) from the Saic.

[7] E.J. DE BRUIJN-X. JIA, *Joint Ventures in China Face New Rules of the Game*, *Research technology management*, Vol. 61(3), 2018.

To implement the new process, MOFCOM adopted and released, jointly with the National Development and Reform Commission, also the *Tentative Measures for the Administration of the Record Filing of the Establishment of, and Changes to, Foreign-invested Enterprises* (Filing Measures),[8] describing businesses subject to special access administration as being those listed in the "restricted" or "prohibited" categories of the Foreign Investment Industrial Guidance Catalogue and those listed in the "encouraged" category but subject to foreign shareholding limits or requirements for senior management.[9]

This change has meant, first time, that the pre-access national treatment and negative list administration model for foreign investment (better described below) would no longer be limited to the pilot free trade zones[10] but would be implemented nationwide, shaping some general rules later contained in the Foreign Investment Law.

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[8] The Filing Measures have been promulgated on October 8, 2016 and entered in force on the same date. Announcement of the Ministry of Commerce [2016] No. 3.

[9] Under the Filing Measures, filing with a local authority under Mofcom was required for specified matters in relation to Wholly Foreign Owned Enterprises (WFOE), Equity Joint Ventures (EJV) and Cooperative (or contractual) Joint ventures (CJV) as well as foreign-invested companies limited by shares, foreign-invested investment type companies (holding companies), and foreign-invested venture capital investment and "equity investment" enterprises. Equity investment enterprises refer to onshore private equity and venture capital funds, which are often organized as foreign-invested limited partnerships. Although Mofcom had no authority over the establishment of partnerships, which only needed to be registered with the local counterparts of the State Administration for Industry and Commerce, the Filing Measures apparently extended Mofcom's powers to cover partnerships as well.

The matters that only required Mofcom filing were: the establishment of a non-restricted FIE; a change in basic company particulars of a non-restricted FIE (name, registered capital, form of organization, term of operation, category of business, business scope, total investment, legal representative, ultimate controlling shareholder, etc.); a change in basic information regarding the investors of a non-restricted FIE (name, nationality, subscribed capital contribution, country of origin of funds, etc.); transfer of equity interest in a non-restricted FIE (other than a transfer that represents a less than five percentage point change in the aggregate holding of foreign investors in a non-restricted FIE that is a listed company); merger, division or dissolution of a non-restricted FIE; creation and enforcement of security interests over assets of a WFOE; early recovery of investment by the foreign investor of a CJV; and the entrustment management of a CJV.

The filing for the establishment of a new non-restricted FIE could be made either during the period between the date the company name is reserved with the SAIC and the date the business license is issued or within 30 days after the business license is issued. A change in the registered particulars of a non-restricted FIE or its shareholders should be filed within 30 days after the change.

[10] See *Decision on Authorising the State Council to Provisionally Adjust the Administrative Examination and Approval Specified in Relevant Laws in the China* (Shanghai) *Pilot Free Trade Zone*, adopted by the Standing Committee of the National People's Congress, on August 30, 2013 and effective on October 1, 2014. The Decision has authorised the State Council to provisionally change the administrative examination and approval relating to foreign investment, except where the State specifies the implementation of special administrative measures for access, to administration by way of record filing in the Shanghai Free

3. *Guidance Catalogues for foreign investment and Negative List*

The People's Republic of China, after Mao Zedong's death in 1976, embarked on radical economic reforms. Deng Xiaoping, who succeeded him in 1978, understood the necessity to open the doors to foreign investors. In the 1980s, the "open door policy" (*gaige kaifang*) marked the gradual transition from a planned economy to a socialist market economy.

In order to ensure better stability in foreign investment and within a careful macroeconomic planning framework, the central government launched, in 1995, the Catalogue of Foreign Investments (*Waishang touzi chanye zhidao mulu*) jointly issued by the National Development and Reforms Commission and by the Ministry of Commerce of the PRC.

The Catalogue was structured schematically into three macro-categories: encouraged investments; restricted investments; prohibited investments. The types of investments not expressly contemplated were to be considered permitted.

The belonging of an investment to one of these macro-categories affects factors such as the level of the government authority competent to approve the project (usually at the central government level for restricted projects), the participation of the sector government agency in the project approval phase as well as the necessity or otherwise of a Chinese partner.

This document has been subject of several amendments and updates over the years (1997, 2002, 2004, 2007, 2011, 2015, 2017). On June 28, 2017, following the adoption of the Filing Measures, China's National Development and Reform Commission and Ministry of Commerce released the 2017 edition of the Catalogue for the Guidance of Foreign Investment Industries, which came into effect one month later and, changing the traditional structure of the Guidance Catalogue, has introduced a nationwide negative list system for market access of foreign investment.

Compared to the previous division into three categories, the Catalogue version updated to 2017 keeps the encouraged category and provides a "Negative list" for the Special Administrative Measures that contains the restricted and prohibited categories as well as restrictions, such as equity ratio and senior executive requirements, for certain types of foreign investment industries. Additional investment restriction measures that ap-

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Trade Zone established on the basis of the Shanghai Waigaoqiao Free Trade Zone, Shanghai Waigaoqiao Bonded Logistics Zone, Yangshan Free Trade Port Area and Shanghai Pudong Airport Free Trade Zone.

In September 2019, the State Council established 6 new pilot free trade zones in the provinces of Shangdong, Jiangxu, Guangxi, Hebei, Yunnan, Heilongjiang. For the first time, FTZs have been established in border areas to facilitate cooperation with neighboring countries, and are characterized by different policies and reform experiments.

ply to both foreign and domestic investments and those not related to market access are not included in this Negative list. [11]

Under the new system, in principle, no restrictive measures should be applied to foreign investment access in areas of investment other than those included in the negative list, and setting up projects and enterprises with foreign investment in such areas will be subject just to record-filing requirements, but not pre-approvals, from the authorities.

The national Negative list, deleted from the Catalogue of Industries for Guiding Foreign Investment in 2017 and presented under the name of *Special Administrative Measures on Access to Foreign Investment* was published in 2018 and revised in 2019 and 2020. On 23 June 2020, the State Development and Reform Commission and the Ministry of Commerce jointly issued two "negative lists", both of which entered into force on July 23, 2020 to further ease market access for foreign investments. [12]

With regard to the Catalogue of Encouraged Industries for Foreign Investment and in terms of investment policies, Chinese government has continued to use it to facilitate and guide foreign investment in specific industries, fields and regions in China.

In order to further promote opening-up, to accelerate the construction of a new open economy and to improve foreign investment policies, on July 30, 2019 the State Development and Reform Commission and the Ministry of Commerce issued the *Catalogue of Industries for Encouraged Foreign Investment* (2019 edition). On the same date, the encouraged fields detailed in the Catalogue of Industries for Guiding Foreign Investment (Amended in 2017) and the *Catalogue of Priority Industries for Foreign Investment in Central and Western China* (Amended in 2017) have been abolished. [13]

On this basis, Chinese government announced that it would continue to expand the scope of encouraged industry sectors. Against such background, a Catalogue of Encouraged Industries for Foreign Investment (2020 version) was announced on 31 July 2020, [14] keeping the same struc-

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[11] The National Development and Reform Commission and the Ministry of Commerce released for the last time on December 16, 2020 the Market Access Negative List that standardizes market entry rules for domestic and foreign players.

[12] The two Negative Lists refer to the Special Administrative Measures on Access to Foreign Investment (2020 National Negative List) and the Free Trade Zone Special Administrative Measures on Access to Foreign Investment (2020 FTZ Negative list) which will replace their respective 2019 versions.

See, C. CHEN, *The Negative List in China – Causation, Content and Implication. In International Conference on Humanities and Social Science 2016*, Atlantis Press, 2016.

[13] The General Administration of Customs issued an Announcement on Issues Concerning the Implementation of the Catalogue of Industries for Encouraged Foreign Investment. See, GAC Announcement [2019] No. 125.

[14] The revised parts of the Catalogue encourage foreign investors to participate in the

ture of the latest model so by combining the National Catalogue of Encouraged Industries for Foreign Investment and the Catalogue of Advantageous Industries for Foreign Investment in the Central and Western Regions" together. [15]

China's Negative lists (at national and local level) and Encouraged Catalogue are used as a tool for foreign direct investment attraction and their industrial and geographical composition while free trade zones are used as a testing ground for new policies later to be applied in the whole country.

Both of them are instruments to realize a deepen reform of the administrative system aimed at an administrative simplification and power decentralization, purpose of the Third Plenary Session of the 18th CPC Central Committee.

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high-quality development of the manufacturing industries, invest in the production service industry, further invest in the central and western regions of China.

[15] The first version of the *Catalogue of Advantageous Industries for foreign Investment in Central and West China* (*Zhong xibu diqu waishang touzi youshi chanye mulu*) was adopted in 2000 by the National Development and Reform Commission and the Ministry of Commerce and then amended in 2004, 2008, 2013. This Catalogue, limited to the central-western area of mainland China, constituted a further intervention of the Chinese Government for the realization of the objectives set under the Twelfth Five-Year Plan.

Through this new Catalogue, the Government aimed to continue the policy of economic and administrative decentralization, giving each province an autonomous economic plan, putting the provinces in competition with each other in order to stimulate the development of the national economy. Leveraging the opportunities offered to foreign investors in these new areas, it aimed to maintain a competitive advantage and prevent foreign investment from moving to areas bordering China. The purpose of this Catalogue was threefold: 1) to create districts and specialized areas for the production of different types of products; 2) to standardize the level of development of China's inland areas to that of the more developed areas on the east coast; 3) to encourage the development of environmentally sustainable technologies and industrial plants. This text is structured on a provincial and municipal basis and uses as a reference 22 areas (including provinces and municipalities) in which the following are encouraged: i) industrial sectors affected by crisis; ii) those sectors that play a fundamental role in the development of the local and national economy.

The development policy of central-western areas actually began in March 1999 with the publication of the first Development Strategy for Western areas, where the Chinese government had established the main criteria of the strategy which included: the development of infrastructure, the exploitation of local natural resources, greater attention to environmental protection aiming, among other things, to redistribute sources of pollution in different areas of the territory to avoid the accumulation of pollution only in certain areas.

The first phase of this strategy ended in 2008 with only apparently encouraging results. The second phase of the plan opened with the creation of three development plans for the following special economic zones in the western area: Chongqing-Chengdu; Guangxi-Gulf of Beibu; Guanzhong-Tianshui. This development policy paved the way for an economic development policy also for the central regions with the aim of developing four major industrial sectors: grain production; transport; development of energy sources and exploitation of raw materials; production of high-tech equipment. This plan was integrated in May 2010 by the Ministry of Commerce with the Central China Foreign Investment Promotion Plan, and six provincial plans.

4. *The Foreign Investment Law: scope of application*

On January 1, 2020, the *Foreign Investment Law* of the People's Republic of China came into force. On the same date, the related *Implementing Regulations for the Foreign Investment Law of the People's Republic of China*, issued by the State Council [16] and the *Interpretation of the Supreme People's Court on Several Issues Concerning the Application of the Foreign Investment Law of the People's Republic of China* became effective as well. [17]

The Foreign Investment Law contains general principles to consolidate provisions of various laws and regulations on foreign investments in China, to promote and provide a fairer treatment of them, to safeguard foreign investors by strengthening the protection of intellectual property rights, to establish a national security review system and other provisions.

The Law enacted is extremely shorter than the draft submitted for public comment in 2015: within 42 articles compared to 170 of the original draft, it embodies the implementation of obligations undertaken two decades ago upon accession to the World Trade Organization, particularly the duty of transparency and prohibition of discrimination. [18]

In six chapters (general provisions, investment promotion, investment protection, investment management, legal liability and supplementary provisions), as better described below, the Foreign Investment Law affirms promotion and protection of foreign investment concerning investment safety and further market liberalization and emphasizes the protection of intellectual property.

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[16] Approved by the 74th Executive Session of the State Council on December 12, 2019 and in force since January 1, 2020, the text consists of 49 articles and reproduces the same structure as the Law to which it refers. For an Italian translation, *see*, *Leggi tradotte della Repubblica Popolare cinese*, vol. XII, *La normativa in materia di investimenti esteri*, translation and notes by L. FORMICHELLA-E. TOTI, Wolters Kluwer, Milan, 2021, 38-81.

[17] Adopted by the 1.787th Session of the Judicial Committee of the Supreme People's Court on December 16, 2019, and effective as of January 1, 2020, the text consists in 7 articles governing issues related to the law applicable to investment contract dispute cases between equal parties before the Chinese People's courts, in order to ensure the proper implementation of the Foreign Investment Law of the People's Republic of China, the fair protection of the legitimate rights and interests of Chinese and foreign investors under the law and the establishment of a stable, impartial and transparent business environment governed by law in concert with judicial practice. Among areas regulated by the Law and the Implementing Regulations, the Interpretation of the Supreme People's Court exclusively and partially addresses the one related to market access requirements.

[18] A.S ALEXANDROFF-S. OSTRY-R. GOMEZ (a cura di), *China and the Long March to Global Trade. The Accession of China to the World Trade Organization*, London-New York, Routledge, 2003; R. CAVALIERI, *L'adesione della Cina alla Wto. Implicazioni giuridiche*, Argo, 2003; C.G. CHOW, *The Impact of Joining Wto on China's Economic, Legal and Political Institutions*, in *Pacific Economic Review*, 1, 9, 2003, n. 2, 105-115.

In the general provisions (art. 2) the Law defines the scope of application of the legal framework, [19] further specified by the Implementing Regulations (art. 3) and sets out some clear indications on it, leaving other issues open, while hinting at the solution it intends to adopt.

The first disclosure is provided by the first paragraph of art. 2, which refers the application of the new discipline to investments made in the territory of the People's Republic of China, so-called Mainland China. It is confirmed in the Implementing Regulation (art. 48) where investments in Mainland China by investors from Hong Kong Special Administrative Region and Macau Special Administrative Region are subject to the new rules on foreign investments, unless laws, administrative regulations or the State Council stipulate otherwise; differently, to investments in Mainland China by investors from Taiwan, shall apply provisions of the *Law of the People's Republic of China on the Protection of Investment by Taiwanese Compatriots* and its Implementation Regulations and, merely matters not governed by these Law and Regulations shall be handled with reference to the Foreign Investment Law and the Implementation Regulations.

A second issue, of the utmost concern, relates to what can be considered foreign investment.

Through a formulation that explicitly includes direct and indirect investments conducted by foreign individuals, enterprises or other organizations, by means of a three-point list specifying the types of investment and a final open clause, the Law does not clearly resolve the question of whether an individual Chinese citizen may be part of an investment with a foreign investor, as was the case in the draft prepared by the Ministry of Commerce in 2015.

The interpreter will be able to find an answer in art. 3 of the Implementing Regulations where it is provided that other investors referred to in item (1) and item (3) of the second paragraph of Article 2 of the Foreign Investment Law shall include Chinese natural persons. So, under the new regime, a previous restriction has been abolished and Chinese individuals no longer need to set up a legal entity to establish a Sino-foreign joint venture for legal reason. [20]

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[19] For the purposes of the Law, "foreign investment" means the investing activities within China directly or indirectly conducted by foreign natural persons, enterprises, and other organizations including the following circumstances: 1) a foreign investor forms a foreign-funded enterprise within China alone or jointly with any other investor; 2) a foreign investor acquires any shares, equities, portion of property, or other similar interest in an enterprise within China; 3) a foreign investor invests in any new construction project within China alone or jointly with any other investor; 4) investment in any other manner as specified by a law or administrative regulation or the State Council. "Foreign-funded enterprise" means an enterprise formed and registered within China under the laws of China in which all or part of investment is made by a foreign investor.

[20] Under the previous laws, it was not allowed them to be part of investment with foreign

Compared with the previous regulatory context, in which laws on foreign investment were silent on indirect investment (set forth in the *Interim Provisions on Investment Inside China by Foreign Investment Enterprises* which only addressed issues in connection with investments made but with no legal prescriptions about further investment made by foreign investment enterprises or their subsidiaries), the current Law explicitly states that "foreign investment" includes direct and indirect ones while leaving without a clear prescription about what may fall under the latter category, re-proposing so uncertainty, through a catch-call clause, with respect to those "contractual arrangements", commonly used by foreign investors to enter in China industry sectors (prohibited or restricted) where Chinese government exercises the greatest control and deferring to the future the regulation of such eventualities.

In particular, according to art. 2, paragraph 2, under 4), doubts have been raised by all sides that so called Variable Interest Entities (VIEs) may fall within the scope of application of the general rules governing foreign investments. VIEs, also known as contractual control or contractual arrangements, represent legal structures in which an entity, owned by a Chinese legal person or Chinese natural person is in fact controlled by a foreign investor, possibly achieving a penetration of those areas banned, in whole or in part, by the government.

The provision by the Chinese government of areas in which foreign investments are prohibited or limited is obviously connected to the will to exclude any hypothesis in which, through structures that do not fall within the types of investment specifically listed in art. 2, the foreign investor may attempt to circumvent the regulatory framework.

The 2015 Draft of the Law, for the first time, clearly referred to VIE as a way to create a foreign investment. [21] The final version of the Law, by inserting the catch-call clause, including "investments made by foreign investors in China through other means", temporarily shelves many contro-

investor unless such Chinese individuals had been shareholders of the target company for at least one year before the acquisition of such target by foreign investors.

[21] Art. 15 of the Draft stipulated that foreign investment referred to, among others, "control" of a domestic enterprise or the holding of an interest in a domestic enterprise by foreign investors through contracts, trusts, etc., which shall be governed by investment access management provisions, security reviews, information reporting on foreign investment under the foreign investment law; art. 11 of the Draft stipulated that foreign investors also included domestic enterprises that are "controlled" by non-PRC nationals, overseas registered entities and other organizations; with regard to the definition of "control", article 18 further clearly provided three means of control, specifically: (1) by acquiring more than 50% of the equity, voting rights or similar rights of the controlled enterprise; (2) in the absence of 50% equity ownership, (i) be entitled to decide the appointment of more than half of the board members of the controlled enterprise; (ii) have a significant impact on the shareholders' meeting or the board of directors of the controlled enterprise; or (3) be able to exert decisive influence on the business, finance, personnel or technology of the controlled enterprise through contracts, trusts, etc.

versial issues leaving them for later legislative response, case by case analysis or consider VIEs to be implemented as a pilot program in certain sensitive industries.

5. *Market access and impact on the governance of companies with foreign capital*

The new rules on foreign investment have had a large impact on the business forms and structures of foreign investment enterprises (FIEs) they have taken since the late 1970s on the basis of the special regulations contained in the Sino-foreign Equity Joint Ventures Law,[22] the Wholly Foreign Owned Enterprises Law,[23] the Sino-foreign Contractual Joint Ventures Law[24] and related legislation.

With regard to the three forms considered above, it should be noted that joint ventures have always been the most frequently used structure by foreign investors to enter the Chinese market. This is due both to the restrictions imposed by the government, which in specific areas has necessarily required it (*see above* paragraph 3), to the evaluations of opportunity that have made it preferable to involve Chinese partners for a better market access and, finally, to the obvious preference of the administrative authorities.

With reference to the business structure of the contractual joint venture, it should be pointed out, as far as the Law on foreign investments is concerned, that it has been set up with or without the Chinese legal personhood status and that the choice for this more flexible structure has often been determined by the different criteria for sharing the profits deriving from its activity.

The Law on Foreign Investments has, at one stroke, replaced the special legislation which for about 40 years governed the special statutory regime of these business forms, bringing them, in the new terms and guaranteeing a transition period of five years, into the sphere of application of the PRC Company Law,[25] like domestic companies, with a specified scope of application and conflicting with the special laws in many parts.

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[22] The Law, adopted in 1979, was amended in 1990, 2007 and 2016.

[23] The Wholly Foreign Owned Enterprises, adopted in 1986, was amended in 2000 and 2016.

[24] The Law was adopted in 1988 and amended in 2000 and 2016.

[25] The Company Law of the People's Republic of China came into force on 1994 and has been amended in 1999, 2004, 2005, 2013 and last time at the 6th Session of the Standing Committee of the 13th National People's Congress, and effective as of, October 26, 2018. For an Italian translation of it *see*, *Leggi tradotte della Repubblica Popolare cinese*, vol. X. *Legge sulle società*, (ristampa aggiornata), translation and notes by L. FORMICHELLA-E. TOTI, Wolters Kluwer, Milano, 2018, X-140.

The main aspects affected by the change in legislation concern the scope and the procedure for setting up FIEs, the relevant types of companies that the legislation will make available for foreign investors and their organizational structure.

With regard to the former, art. 4 of the Law on Foreign Investment establishes in terms of general principle the application of a pre-access national treatment, namely a treatment no less favorable than that granted to Chinese investors and their investments, with the exception of those included in the Negative list sectors. In order to ensure high-level investments liberalization and facilitation, Chinese government shall implement at pre-establishment stage a principle of equality and a general administration of foreign investment activities in line with the principle of equal treatment between domestic and foreign investment (art. 22, paragraph 3). Under specific circumstances, government could provide to foreigners even preferential treatment if it is required for the development of the national economy and society at national level (art. 14 FIL) as well as at local level (art. 18, FIL).

This principle is confirmed in several other provisions of the Law and Implementing Regulation where it is provided that policies of the State supporting the development of enterprises shall apply equally to FIEs in accordance with the law (art. 9, FIL), the possibility to participate in accordance with the law in the formulation of standards on an equal footing and the equal application to FIEs of mandatory standards formulated by the State (art. 15 and art. 13, Implementing Rules). Same principle is also shared with regard to government procurement activities to ensure a fair competition (art. 16).

In order to attract and encourage foreign investments, the Implementing Regulations involve, within the scope of investment promotion, an equal treatment in terms of government funding, land supply, tax reduction and exemption, qualification licensing, formulation of standards, project declaration, human resource policies (art. 6). Relevant policies to support enterprise development must be available pursuant to the law as well as applications terms and conditions.

More, to the application of national treatment with reference to the pre-establishment phase, the Foreign Investment Regulation, after having abolished the previous special legislation with the exception of the sectors included in the Negative List, confirms the change for handling applications by foreign investors, removing the governmental approval and requiring only the registration with the government authority of the place where foreign investment is made and filing for record. The latter fulfilment is once required to newly established FIEs and later imposed by the government authority for certain changes made to the FIEs as in total investment, registered capital, equity or cooperative rights, mergers or divisions, business scope, operating terms, early termination, methods and

terms of capital contributions, return in advance of investment of foreign partner of a contractual joint venture or cross-region migration of enterprises.

The application of the Company Law to foreign investment enterprises is wide-ranging and entails several changes, not only in the incorporation stage but also in the very governance of the companies which, according to the Law, must adapt their decision-making and management structure and may retain their original organizational form for a period of five years since the Law became effective (art. 42).

Moreover, where a foreign investor acquires an enterprise in China or otherwise participates in a concentration of business operators, they will be subject to a review of the concentration of business operators in accordance with the *PRC Anti-Monopoly Law*.

Reference is also made to the scope of application of the Company Law covering the two different forms of limited liability company and company limited by shares (or stock company), both of them identified as legal person and it seems to exclude the possibility that contractual joint ventures may fall within the scope of this discipline.

Compared to the previous discipline of foreign investment enterprises, the Company law differs significantly, in particular with respect to the structure of joint ventures. With reference to the highest authoritative body, joint ventures will need to establish a new shareholders meeting system and a new voting mechanism. Shareholders meeting shall become the highest authority and share rights and responsibilities with the board of directors in accordance with the Company law. This issue will require the start of a new season of negotiations between the parties that may not always be easy to finalize.

For the voting mechanism, changes will affect the quorum required for the approval of the main resolutions, in the area of amendment of the company's articles of association, increase or decrease of the registered capital, merger division dissolution or change of the company's form, for which Company Law requires the consent of a number of shareholder representing more than two-thirds of the voting rights and the Law on Chinese-foreign Equity joint ventures required the unanimous approval by directors present at the meeting. The repealed legislation and the Company law also differ with reference to the number of the board members, the term of office, the appointment of directors.

A further important difference concerns the rules relating to the distribution of profits which, under the rules no longer in force, indicated for joint ventures a distribution criterion based on registered capital contribution; differently the Company Law relies it on proportion of paid-in capital, unless otherwise agreed by all shareholders. In this sense, the application of the new legislation could provide more room for joint-venture members to regulate.

Finally, the allocation of a company's remaining assets differs significantly among the disciplines: Company law requires consent of more than half of the other shareholders if shares are to be sold to a non-shareholder; the previous joint ventures' regime required consent from all the other shareholders, regardless the shares purchaser or the subject to whom shares will be allocated.

6. *Intellectual property protection and technology transfer*

Within the scope of Chapter III of the Law on foreign investment relating to the protection of investments, articles 22 and 23 expressly refer to the subjects of intellectual property protection (art. 22, paragraph 1),[26] prohibition of technology transfer (art. 22, paragraph 2)[27] and duty of confidentiality by the administrative bodies and their officials with regard to trade secrets (art. 23).[28] The same issues can be found, with more specific reference to the procedures for settling disputes and the system of sanctions, in the Implementing Regulations (articles 23, 24 and 25).

Following the entry into force of the Law and the Implementing regulations, these provisions have found multiple forms of concrete expression in specific documents of regulatory nature.

It is enough here to mention the *Revision of the Patent Law*,[29] the *Revision of the Supreme People's Court Interpretation on Several Issues Concerning the Application of the Law in the Trial of Patent Infringement Disputes*,[30] the *Decision on Amending the PRC Copyright Law*,[31] the *Revision of the*

[26] The state protects the intellectual property of Foreign Investors and FIEs, and protects the lawful rights and interests of intellectual property rights holders and neigh boring rights holders; and pursues legal liability for infringement of intellectual property rights in strict accordance with the law (art. 22, paragraph 1).

[27] The state encourages technical cooperation in the course of foreign investment based on the principle of free will and business rules. The conditions of technical cooperation shall be determined by the parties to the investment through consultations conducted on the basis of equality in accordance with the principle of fairness. Administrative authorities and their working personnel may not use administrative means to compel technology transfer (art. 22, paragraph 2).

[28] Administrative authorities and their working personnel shall keep confidential, in accordance with the law, the trade secrets of Foreign Investors and FIEs to which they are privy in the course of performing their duties, and may not disclose or illegally provide the same to third parties (art. 23).

[29] Adopted at the 22nd Session of the Standing Committee of the 13th National People's Congress on October 17, 2020 and effective as of June 1, 2021.

[30] Promulgated on December 29, 2020 and effective as of January 1, 2021.

[31] Adopted at the 23rd Session of the Standing Committee of the 13th National People's Congress and in force on June 1, 2021.

Trademark Law,[32] the latter in particular including provisions against bad faith registration.

With specific regard to technology transfer, it should be noted that the transfer of the most advanced technologies to China represents one of the pillars on which the country's current development towards an economy based on innovation has rested on.

The Chinese government stimulates innovation by providing incentives for companies to import and absorb cutting-edge foreign technologies. The aim of this policy is to increase high value-added production in China and build an innovation-centered economy.

The approach of Chinese policy here, as in other fields, is characterized by a utilitarian way of thinking: access to the Chinese market in return for access to new technologies. The long-term objective is to strengthen domestic market players and increase the domestic industry's share of the high-tech market.

Chinese enterprises have an extraordinary ability to absorb inventions and technologies already on the global market. Enterprise returns are generated by process innovation (improved factory and distribution systems) and product innovation (adaptation of existing goods for specific Chinese needs).

Since the issue of the first special regulations on market access for foreign investors, these dynamics resulted in the opportunity to exploit their own technologies in the Chinese market. On the other hand, the main risk for foreign companies has always been the loss of control and ownership of technology (with particular reference to those intellectual property titles, patents and trademarks, whose ownership is entitled, in the Chinese system, under the first registration and not under the first use).

Therefore, against the facilitation of access to the Chinese market, subsidies, tax and financial incentives, on the negative side of the balance have always impacted the exploitation of the technology by the Chinese recipient beyond the scope agreed in the contract on transfer, the disclosure of the technology to third parties, the illegal reproduction of the contents of the transferred technology, up to the possibility, for the transferor, of being permanently cut off from the Chinese market.

In this regard, the provision of art. 22, paragraph 2 of the Law on Foreign Investment, takes on particular relevance, both with reference to the amendments introduced almost at the same time in the special legislation on technology transfer, both in relation to the most recent provisions of the *Chinese Civil Code* (Book III, Chapter XX)[33] regulating the so-called techno-

[32] Adopted at the 10th Session of the Standing Committee of the 13th National People's Congress on April 23, 2019 and effective as of November 1, 2019.

[33] The Chinese Civil Code was approved on May 28, 2020, and went into effect on January 1, 2021. For an extensive and detailed analysis of the process of drafting the Chinese

logical contracts, previously covered by the *PRC Contract Law* (1999). [34]

With regard to the prohibition of forced technology transfer by administrative authorities and their officials, the Law on Foreign Investment reverses a long-standing trend expressed by the Chinese government where it provided for technology transfer to Sino-foreign joint-ventures as a precondition for market access (business license) and access to state support (public procurement and other financial resources) in traditional high interest industries of the Chinese market; or other foreign investment restrictions as the establishment of R&D center in China as a precondition for entering a joint-venture in industries in which it was the requisite mode in entry, or data servers localization in China as a precondition by law for receiving and maintaining certain business licenses. [35]

Art. 22 introduces another significant provision, that allows technological cooperation to be based on principle of voluntariness and commercial norms in the process of foreign investment. This means, among others, there is room for the parties to regulate their own contractual relationship involving a transfer of technology by seeking to strike a balance between the interests of the parties, where regulatory provisions that prevented the pursuit of it have disappeared.

This remarkable rule, must be read in connection with a valuable regulatory change introduced shortly before, of which art. 22, while expressing the essence, raises to a general rule.

On March 2, 2019, State Council issued a *Decree* to amend the *Technology Import and Export Regulations* (TIER), applicable to contracts that realize an entry or exit of technology from the territory of the PRC, and therefore in the first instance to contracts in which one of the parties is a foreign entity. [36]

Over time, the regulations set by the Technology Import and Export

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Civil Code, its structure, the civil law tradition and traditional Chinese law to which it refers, see R. CARDILLI-S. PORCELLI, *Introduction to Chinese Law*, Giappichelli, Torino, 2020.

[34] For an Italian translation of it see, *Leggi tradotte della Repubblica Popolare cinese, Legge sui contratti*, translation by L. FORMICHELLA-E. TOTI, Giappichelli, Torino, 2000.

[35] See DAN PRUD'HOMME, *Reform of China's "forced" technology transfer policies,* University of Oxford, Oxford, 2019 (*https://www.law.ox.ac.uk/business-law-blog/blog/2019/07/reform-chinas-forced-technology-transfer-policies)*.

[36] "Import and export of technology" is defined as any act involving the transfer of technology from abroad to the territory of the PRC and vice versa through the modes of "trade" (technology transfer contracts), "investment" (contribution to the capital of companies through the contribution of technology) or "economic and technical cooperation" (Article 2 TIER). With particular reference to importation, a distinction must be made between unrestricted and restricted (or prohibited) technologies. Depending on whether the technology qualifies as restricted or unrestricted, specific licenses will be required and different procedures to be followed for the transfer (Art. 8 TIER). For restricted import technologies, there is an "administrative license" regime (Art. 10 TIER). For unrestricted import technologies, on the other hand, a more streamlined and rapid "filing" system is in force.

Regulations was likely to dissuade foreign companies to export their own technologies to China and, in a context of strong tensions and pressures at international level, the need to rebalance the positions of the parties has been the reason of the amendment of the aforesaid rules, then confirmed both in terms of general provision, by the Law on Foreign Investments, and in terms of specific provisions, by the Chinese Civil Code (articles 862-877).

In particular, the Chinese government has granted greater freedom to the parties as regards the allocation of liability towards third parties, by repealing paragraph 3 of article 24, which provided "if the assignee of a technology import contract had used the technology covered by the agreement causing damage to the rights or interests of third parties, the liability would be borne by the assignor"; likewise, article 27 has been repealed: it provided that any right raising from improvements and modifications made to the technology transferred was due to the author of the modification.

However, the most significant response is undoubtedly represented by the repeal of article 29, the provisions of which effectively laid down the clearly disadvantageous treatment reserved for the transferor.

In the pre-reform context, a party transferring technology to a Chinese counterparty was not permitted to include conditions in the agreement that were not essential or closely related to the importation of the technology, including the purchase of technology unrelated to the contracted technology, raw materials, products, equipment or additional services; in other words, all the ancillary services that are frequently included in sales, supply, administration or licensing contracts and that in economic language are defined as "tie-in".

In addition, the ban on including in the agreement clauses in order to oblige the beneficiary to pay royalties relating to technologies whose patent has expired or has been declared null and void (art. 29 paragraph 2, previous text) has been formally dropped, as has the prohibition on preventing the assignee from modifying the technology or limiting its use (art. 29 paragraph 3, previous text).

Greater room for the autonomy of the parties has then been recognized with regard to the limitation of competition and exploitation (quantitative and qualitative) of the technology. More specifically, the provisions of paragraph 4 of the previous text of article 29, which prohibited the transferor from preventing the beneficiary from obtaining similar or competing technologies from third parties during the period of validity of the contract, have been removed.

Finally, the prohibitions on unreasonably restricting the channels of trade through which the transferee obtains raw materials, components, products or equipment; on unreasonably restricting the quantity or quality of production, as well as the selling price of products; and on unreasonably restricting the export of products made by the transferee through the use of imported technology have been formally dropped.

These provisions, if read in conjunction with the relevant chapters of the Civil Code, mark out a considerable space for negotiation between the parties for the achievement of a more balanced structure, on condition that the relevant contractual provisions are included in the negotiated agreements.

7. *Security review system*

After provided for the prohibition of endangering China's national security in the implementation of investment activities, as a general principle (art. 6), the Law on foreign investments establishes a system for verifying the safety of foreign investments with respect to the impact or potential impact that they may have on national security; the decisions on security review adopted under the law are final, thus introducing a standard of potential selection on any type of investment aimed at the PRC market (art. 35).

This general provision, as was to be expected, was shortly to be specified in an appropriate regulatory text governing the perspective, given the silence of the Implementing Regulation for the Foreign Investment Law, which contains no details regarding the object, standards and procedures about the security review system. [37]

On December 19, 2020, the National Development and Reform Commission and the Ministry of Commerce jointly released the *Measures for the Security Review of Foreign Investment* which became effective from January 18, 2021. [38]

The issue had been previously regulated by the Standing Committee of the National People's Congress within the *Anti-Monopoly Law*, which called for a review mechanism based on the protection of national security with specific reference to concentration of undertakings by mergering and acquiring a domestic enterprise or by other method [39] and by the

[37] *See* art. 40 of the Implementing Regulation.

[38] Rules also find reference in what was expressed within the Fourth Plenary Session of the 19th Central Committee of the Chinese Communist Party with regard to the necessity to build a new higher-level open economic system and improve the foreign investment security review system. The Fifth Plenary Session of the 19th Central Committee of the Chinese Communist Party had required a coordination of development and security, with security development integrated into all fields and the entire process of national development, improving the national security review and supervision system.

[39] *See*, *Anti-Monopoly Law of the People's Republic of China*, adopted at the 29th Session of the Standing Committee of the 10th National People's Congress on August 30, 2007 and effective as of August 1, 2008. According to the art. 31 "Where a foreign investor participates in a concentration of business operators through a merger or acquisition of a domes-

General Office of the State Council on February 2011 with the *Notice on Establishment of Security Review System Pertaining to Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* thus marking the birth of China's national security review regime and then by the Ministry of Commerce which in the same year issued the *Provisions on Implementation of Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* providing more detailed procedural rules on national security regime. [40]

In 2015, in accordance with the usual operating mode of the Chinese government, a general regulation, not limited to merger and acquisition cases, was introduced on the matter through the *Tentative Measures for the National Security Review of Foreign Investment in Pilot Free Trade Zones*, with a restricted (territorially and provisionally) scope of application but with more specific references to the conditions and procedures the review system would be applied, later found in the more recent *Measures for the Security Review of Foreign Investment*. [41]

In July 2015, the 15th Meeting of the Standing Committee of the 12th National People's Congress approved the *China Security Law*, providing for the establishment of national security review and oversight management systems and mechanisms related to foreign commercial investment, special items and technologies, internet information technology products and services, projects involving national security matters, as well as other major matters and activities that impact or might impact national security (art. 59).

The introduction of this analysis and review system at such a scale, officially resulting in the Law on Foreign Investments in 2020, is also a reply to a number of foreign Countries that, in recent years, have introduced or widen mechanisms with similar purposes that the pandemic phenomenon has confirmed and increased, due to economic and security concerns on the part of governments around the world.

The *Measures for the Security Review of Foreign Investment* in force since the beginning of 2021 extend the scope of application compared to the former rules, as the whole national territory is subject to the new regime with regard to the foreign investments in China, whether directly or indirectly and regardless as to whether the target is a foreign-invested-

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tic enterprise or another method and state security is involved, a state security review shall be conducted in accordance with relevant state provisions in addition to the examination of the concentration of business operators conducted in accordance herewith".

[40] Announcement of the Ministry of Commerce (No. 53 [2011]), issued on August 25, 2011 and effective as of September 1, 2011.

[41] *See* the *Notice of the General Office of the State Council for the Issuance of Tentative Measures for National Security Review of Foreign Investment in Pilot Free Trade Zones referred to Shanghai Pilot Free Trade Zone, Guangdong Pilot Free Trade Zone, Tianjin Free Trade Zone, Fujian Pilot Free Trade Zone*.

enterprise or a domestic one and with no restriction to merger and acquisition transaction but with extension to green-field projects.

In these terms, the wording of art. 2 of the *Measures* with the provision of a general clause is intended to include under its application any form of structure or reinvestment through a foreign invested enterprise. With reference to the industry sectors involved, the *Measures* add new areas [42] but the assessment whether a target will be "controlled" by foreign investors will rest on the "actual control" standards. [43]

8. *Conclusions*

The Law on Foreign Investment, together with the Implementing Regulations and the Interpretation of the Supreme Court is a positive step in the direction of promoting and protecting foreign investment in China.

Although it provides high-level guidance, in some cases vague and lacking in implementing provisions even with reference to the State Council's Regulations, the discipline of the different issues analyzed proves how the government has promptly intervened in the matters identified to fill these provisions with content, partly reducing the margins of uncertainty with regard to the enforcement of this discipline, particularly in those areas in which it has amended or established rules of a procedural nature for the purpose of protecting lawful rights and interests recognized in principle and to be coordinated with the Law of Civil Procedure.

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[42] According to the *Measures for the Security Review of Foreign Investment*, a foreign investment transaction is subject to security review if it is (i) in sectors related to national defence and security, such as arms and arms related industries; or (ii) in geographic locations in close proximity of military facilities or defence-related industries facilities; or it (i) involves critical sectors significant for national security, such as critical agricultural products, critical energy and resources, critical equipment manufacturing, critical infrastructure, critical transportation services, critical cultural products and services, critical information technology and Internet products and services, critical financial services and key technologies; and (ii) will result in foreign investors' obtaining actual control of the invested enterprise.

The scope of transactions subject to security review expanded, compared to the 2001 rules, by including: (i) foreign investments in geographical locations within near proximity of any military facilities and defence-related industries facilities; and (ii) foreign investments in critical cultural products and services, critical information technology and Internet products and services and critical financial services where foreign investors will also gain actual control of the invested enterprise.

[43] See art. 4, comma 2: (a) if the foreign investor holds more than 50% equity in the target; or (b) if the foreign investor holds less than 50% equity but exercises significant impact in the board of directors, board of shareholders or general meeting of shareholder by means of voting rights; or (c) other circumstances where the foreign investor may have a significant impact on the target's business decision-making, human resources, finance, technology etc.

For the purposes of understanding the context and the direction in which the Chinese government is moving, it should also be noted that article 4, paragraph 4 of the Law on foreign investment, provides for the relevance of any treaties or international agreements concluded by the People's Republic of China or to which it is party that may accord more favorable access treatment to Foreign Investors.

On 30 December 2020, China and European Union concluded in principle the EU-China Comprehensive Agreement on Investments (CAI), a bilateral treaty that will replace existing bilateral investment treaties between individual EU Member States and the Mainland China and will provide a uniform legal framework.

The Comprehensive Agreement's main purpose would be to enhance the protection and reduce the barriers of bilateral investments, which in turn significantly improves the market access for EU companies in China and vice versa. In addition, the CAI also promotes the sustainable development initiatives by highlighting the core environmental standards and labour rights.

The agreement is, however, a political and symbolic victory for China in terms of projecting an image of strong cooperation with the European Union, at the same time against the prospects for a renewed transatlantic approach.

Foreseeable improvements for Europe will be selective with respect to market access, non-discrimination, and operating conditions in China, and many of the market openings offered by China are mostly a repackaging of existing commitments analyzed in this article. Some crucial and structural issues, are not, however, addressed – such as domestic procurement rules that discriminate against foreign investors or restrictions on cross-border data flows.

Reading the provisions of the Comprehensive Agreement on Investments in the context of broader ongoing developments in Chinese law, however, one finds, for example, that both the Foreign Investment Law and the Data Security Law permit "corresponding measures" for discriminatory actions against Chinese companies by other states.

The recent provisions promulgated by the Ministry of Commerce of the People's Republic of China about *Rules on Blocking Unjustified Extraterritorial Application of Foreign Legislation and Other Measures*, which came into force on January 9, 2021, grant the relevant PRC authorities certain powers to block the extraterritorial application of foreign laws and measures if it is considered that they unjustifiably prohibit or restrict Chinese citizens and organisations from engaging in "normal economic, trade and related activities" with another State, or a citizen or organisation of that State, in violation of international law and the basic principles of international relations. [44]

[44] Mofcom likely drew on international precedent, including "a series of resolutions call-

This leads to believe that the high expectations generated by China to create a foreign investment environment in the Country that is open, fair and transparent, although extremely important, will be subject, in practice, to possible downsizing and/or enforcement depending on the corresponding actions that China's international partners will take within their own territories.

ing for the repeal of unilateral laws and measures with extraterritorial effects imposed on enterprises and individuals of other countries" adopted by the United Nations since the 1990s and on experience from the European Union's 2018 Blocking Statute.