

Historical Overview of Chinese FDI Regulations

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The new Foreign Investment Law 中华人民共和国外商投资法 (FIL) of China was adopted by the 13th National People's Congress on March 15, 2019 and will come into force on January 1, 2020. The FIL will replace three existent laws – Sino-Foreign Equity Joint Venture Enterprises Law (EJV); Sino-Foreign Cooperative Joint Venture Enterprises Law (CJV); Wholly Foreign-Owned Enterprises Law (WFOE) – which have been the foundational legal frameworks governing Foreign Invested Enterprises (FIEs) since their inception with China's reform and opening up in the late 1970s.

Chinese lawmakers argued that the FIL was an adaptation to the demand of the times. It would assure fair competition between foreign and domestic firms, thus impelling domestic companies to move up the industrial value-chain. The law, they argued, is an investment-friendly measure, with simplified screening and approval, strengthened dissemination and implementation powers, and thus expected to create a better business operating environment by strengthening the faith of foreign investors (Xinhuanet 2019). But this optimism is also met by criticism as being inadequate (Bradsher 2019) and in reality a recipe of eliminating extant benefits from FIEs (Dickinson 2019).

With a lot left in the grey zone, the real impacts of the new regime is still to unfold as the State Council introduces implementing rules and as

existent FIEs ultimately transition into the new system. Presently, as Yukon Huang, the former World Bank's country director for China, puts it, the FIL can best be interpreted as a "statement of intention" of China in transforming its legal systems to address issues raised by foreign businesses and thus it is unlikely that there will be an overnight change in behaviour or for that matter the spirit of the new law will consistently be adhered to (CEIP 2019).

This first, brief note in the series will layout a historical background of the legal regimes that have governed FIEs since China's opening up to foreign investment in 1979.

A Brief Historical Recap

China's modern foreign investment regime dates back to the politically tumultuous times of reform and opening up of the late 1970s. Through several generation of amendments and continuous updating of the laws in the past four decades, it has today reached a new milestone. The Sino-Foreign Equity Joint Venture law was the first FIE law to be adopted in 1979. It signalled the first steps of a move away from a planned economy to a free, market-oriented one. But given that the political ideology of the times still heavily leaned towards a planned economy, the law was at best a very basic framework of principles with only 15 articles (Gao 2017, 51-90; Yu 2019, 50; Sun 1998, 20-21). It was in effect a starter, an attempt to

initiate the process of international exchange and transfer of advanced technology.

The law had various unique (prohibitive) features which in today's standards would come across as far too restrictive. Companies structured as an EJV could constitute foreign companies, enterprises, individuals and other economic organizations in collaboration only with Chinese business entities but not Chinese individuals. It also required all foreign initiatives to seek administrative approval before the commencement of operation.¹ Article 6 was particularly controversial. It required the chairman of the board of directors to be a Chinese citizen chosen by the Chinese JV partner. The chairman was vested with substantive powers of signing JV contracts, which essentially meant that the foreign party had to fully depend on the veto powers of their Chinese chairman. Because of the deficiency of foreign exchange, the law also required JVs to give first priority to Chinese domestic companies while procuring material and also discouraged the remittance of revenues and profits outside of China (Gao 2017, 58).

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The EJV law, however, was very inflexible, especially with its requirements of matching capital contribution to profit/loss distribution, and thus emerged two other laws: Wholly Foreign Owned Enterprise Law (1986) and Contractual Joint Venture Law (1988). Both of these laws were largely structured on the EJV, but with unique features to regulate new models of foreign investments. WFOE law (Gao 2017, 90-94; Yu 2019, 52) was aimed at regulating enterprises established exclusively with foreign capital and they were required to be involved in advanced technology and machinery and export a minimum of 50% of their produce. The CJV law (Gao 2017, 95-96; Yu 2019, 51-52) on the other hand was initially

a special regulation directed to encourage investments from overseas Chinese. It regulated enterprises where foreign and Chinese partners engaged in a venture with an operation term limit as decided upon through contracts. The differentiating point of the CJV law was the flexibility it provided partners to decide on several terms of engagement. Initially it was the only law that allowed investors to freely negotiate the representation of their board based on their own criteria, and also established a time-limited, unified verification process. Also, partners through entering into mutual contracts could decide on the proportion in which the profits and losses would be shared, and this could be different in proportion to their capital contribution. CJVs could be established as a separate legal entity or otherwise. (Yu 2019, 51).

As more foreign investors flocked to Chinese shores and China's economic conditions improved, there were growing appeals for further liberalization. With these economic churning, Deng Xiaoping's call for a socialist market economy set the political background for a transformation of China's legal framework. Domestically, in the 1990s China for the first time adopted modern commercial regulations like Company law, Contract law, among others (Gao 2017, 125) and also began the process of further liberalizing its basic FIE laws. The first amendments came in 1990. The EJV law now expressly stated that it would not nationalise FIEs, except for public interest and in exchange for "proportional compensation". And the controversial Article 6 asking for the chairman of the board to be Chinese was also removed. It was now left to investors to decide on the existence of a time cap on their JV. The 1990s, therefore, set the momentum for China to further open up its markets and this process continued into the 21st century.

Accompanying these laws was the creation of new administrative geographies - Special Economic Zones (SEZs). SEZs essentially were clearly demarcated areas where China began experimenting with its new economic policies, before applying them nationally. In 1980 Shenzhen, Zhuhai and Shantou in Guangdong province and Xiamen in Fujian province, were declared as the first SEZs wherein foreign investors would enjoy preferential financial, investment and trade

¹ This provision was amended only in 2016.

privileges. Subsequently in 1984 smaller versions of these early SEZs called as Economic and Technological Development Zones (ETDZs) were created. By 1992 there were about 49 ETDZs. In 1988 the province of Hainan was designated as the fifth SEZ and the following year Shanghai Pudong New Area was named the sixth one. The SEZs and ETDZs with its policies of inexpensive land, tax holidays, rapid customs clearance, tax exemption on imported raw material and exported finished products, relaxed political interventions, among other such policies, became central to attracting FDI. By 2007 the initial five SEZs had an actual utilised FDI value of US\$7.3 billion, while ETDZs accounted for about US\$17.3 billion (Zeng 2012).

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The second round of amendments came at a time when China was accessioning to the WTO. The EJV law was amended to allow FIEs to be exempted from buying insurance only from Chinese companies, they could litigate disputes in court in the absence of an arbitration clause or where arbitration failed to bring about an agreement, and they no longer required to work with an assigned “department in charge”. Under all three laws FIEs could now procure materials from companies other than Chinese. WFOEs no longer required to be involved only in projects involving advanced technology, as was earlier stipulated, and the export quotas were also repealed, thus allowing them to sell in the domestic markets directly or through agents. The CJV law underwent further relaxations such as, unlike the EJV, it no longer required an unanimous board decision for resolutions approval, unless certain scenarios were specified (Gao 2017).

The 1990s also saw the introduction of the investment guideline system known as the Catalogue of Industries for Guiding Foreign Investment (外商投资产业指导目录) (Yu 2019, 56-58). The Catalogue system, introduced in 1997, initially categorised investments into sectors that were *encouraged*

and *permitted* through lenient approval requirements and incentives such as tax cuts; *restricted* and thus being subject to certain limitations such as share ownership; and finally sectors in which foreign money was altogether *prohibited*. Like other legal vehicles governing foreign investments, the Catalogue has also undergone multiple amendments over the years. In 2017 the Catalogue was accompanied with the so-called Negative List (负面清单), which has since been implemented nationwide. The list categorises sectors only into restricted and prohibited. Accordingly, foreign investments in any sector not part of the Negative List are treated at par with domestic investments. The latest amendment in June 2019 renames and replaces the earlier version of the Catalogue (2017 edition) with the Catalogue for Encouraged Industries for Foreign Investment (鼓励外商投资产业目录) (Glueck et. al 2019). This is divided into National Catalogue and Central and Western Catalogue. The latter is aimed at specifically encouraging investments in the relatively underdeveloped provinces in the Central and Western regions of the country (Ndr.gov 2019).

Under all three laws, FIEs in China has so far had to undergo a case-by-case approval mechanism which is slated for change under the new law. All FIEs first pre-register their name with the State Administration of Industry and Commerce (SAIC). Investors then obtain clearances from land, environment and planning departments. Following this investors compulsorily need to seek for approval from the National Development and Reform Commission or the local Development and Reform Commission or the State Council, depending on the sector and the total value of the investment. Investment projects over US\$500 million in sectors listed under the Encouraged or Permitted categories in the Catalogue, require the approval of the State Council; between US\$300-US\$500 million NDRC approval is required; and for projects below the threshold of US\$300 million only the approval of the local DRC. Investment projects in the restricted sectors with a value of US\$100 million or more require the approval of the State Council. Between US\$50-US\$100 million NDRC approval is required. And anything below US\$50 million, local DRC approval is sufficient. Finally once the project

has been approved, the Ministry of Commerce (MOFCOM) must approve of the formation of the FIE, except for projects approved by local DRCs, for which the local DRC approval is adequate (AMCHAM 2012).

As China's economy matured a new concern began to emerge for the state – raising defences against potential political trojan horses that entered China in the appearance of a foreign investment. And so was born a new discussion on legislating a National Security Review (NSR). China never had a formal, systematic national security review like that of the Committee on Foreign Investment in the United States (CFIUS) (Li 2015). Although the Merger & Acquisition (M&A) law and Anti-Monopoly law had provisions related to national security, a dedicated national security regulation only emerged in 2011. China's State Council first promulgated the "Circular on the Establishment of National Security Review System Pertaining to the Mergers and Acquisitions of Domestic Chinese Companies by Foreign Investors" and subsequently MOFCOM followed up with implementing rules of the national security review. In 2015 the NSR underwent further changes with a widened scope. Outside the Free Traded Zones (explained below) the NSR is triggered on a range of M&A involving foreign investors: military and military supported enterprises; agricultural products; infrastructure; key technologies, among others (Stratford et.al 2015). The scope of the NSR is more expansive in the free trade zones because the regulations in these regions allow to regulate foreign investors which have a "significant impact" on investees within the industries listed in the NSR. Greenfield investments and investments in cultural and internet businesses established within these free trade zones can also be subject to NSR (Zhang 2018).

Another important feature of China's legal reforms has been the Free Trade Zones 自由贸易区 (FTZs). The first FTZ was established in Shanghai in 2013 and since then the number has risen to 11, expanding from the coastal regions to inland China. The FTZs have been modelled as testing grounds for further opening-up policies and liberalisation of trade and investment in China. It provides for special incentives in terms of tax and other benefits as well as lesser intervention from customs

(Dezan Shira and Associates 2017). In 2015, a negative list encompassing all FTZs was introduced indicating sectors where foreign investments were either restricted (requiring special approval) or prohibited in the FTZs. Subsequently, in 2017 a nationwide list was released (Koty et.al 2017). Both these lists underwent further amendments in 2019 with the total items on the national list being reduced from 48 to 40 and items on the FTZ list being reduced from 45 to 37. Several items spanning industries including mining, manufacturing, information technology, among others, have been removed from the lists (Seto et.al 2019).

Conclusion

In the previous 40 years China's rules governing economic activity in general has undergone a sea change. With barely a semblance of any modern day legal architecture as China entered a new era of economic openness, over the past 40 years it has added much flesh to its barebone legal structure. The FDI law was one of the first laws in the reform and opening up era, coming even before its domestic Company Law. Even though initially far too conservative and restrictive, over time China opened itself up further to foreign capital. Although, over the years China's FDI policy has been to constantly monitor and channel such capital in ways that best realised China's economic interests. This is best reflected in the industrial clusters built through Special Economic Zones, initially in the southern coastlines neighbouring Hong Kong and Taiwan and then gradually expanding northwards and more recently in Central and Western China. Such clustering not only aided the long term development of industrial ecosystems but also helped China test its new reforms in a controlled environment before national adoption. To be sure, foreign investors also benefitted greatly from China's FDI policies which provided preferential incentives like tax cuts and cheap land. China's three FDI laws also made the rules of engagement comprehensible and transparent, in contrast to that of India's which is more nebulous and convoluted (Sweeney 2010). Also, unlike India, China more actively sought out for foreign investments and thus

was driven to reforms to tailor its laws to different investment forms (Sweeney 2010). FDI laws in China were also aided by the decentralisation of administrative authority and incentivising local bureaucrats by linking promotion to economic activity, the realisation of which was critically dependent on attracting foreign investors.

Overall China's FDI laws has pretty effectively aided the inflow of foreign capital, technology and expertise. For instance in 2018, even as global FDI slide by 13% and the US-China trade further intensified, China attracted US\$139 billion in foreign capital (Xinhua 2019). The new FIL which will come into force on 1 January 2020, is being promoted by China as an instrument that will continue to sustain China's attractiveness to foreign investors by levelling the playing field between foreign and domestic investors. Undoubtedly, the law in many ways will make foreign investment entry smoother through its emphasis on 'national treatment', however its shallow depth and ambiguous treatment of some important facets of the legal regime has left much in the grey zone. Subsequent articles in the series will analyse some of these features of the new law.



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