

Development of China's Foreign Investment Law¹

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This article (as of 5 October 2016) discusses the changes which have recently been made, and changes which remain to be made to the operation of China's foreign investment laws since the draft *Foreign Investment Law of the People's Republic of China* was published by the P. R.C. Ministry of Commerce on 19 January 2015. This article addresses the changes already approved and taking effect from 1 October 2016, and probable further amendments to China's foreign investment laws, which remain to be considered by the State Council of the P.R.C. and by the National People's Congress of the P.R.C.

Keywords: China, business, foreign investment

The draft *Foreign Investment Law*, published by the P.R.C. Ministry of Commerce on 19 January 2015 (referred to in this article as "the draft *Foreign Investment Law*"), contains a comprehensive updating and unification of China's foreign investment laws. China's currently complicated web of laws and regulations for foreign investment has evolved since 1979 as China's economy has developed over that period. However, legal and commercial uncertainty, ambiguity, conflict, and bureaucratic delays have resulted from the operation of China's multiple and fragmented current foreign investment laws. Foreign investment law is vitally important for China. Since 1992 the amount of foreign investment in China has increased greatly as the P.R.C. government has accelerated China's transition to a socialist market economy². In 2014 China became the world's top destination for foreign investment, having overtaken the United States of America. The following table shows the growth in foreign investment in China from 1983 to 2015.

Foreign Capital Invested into China, 1983–2015

Year	Foreign Capital Invested in China (US \$ millions)	Year	Foreign Capital Invested in China (US \$ millions)	Year	Foreign Capital Invested in China (US \$ millions)
1983	2,260	1994	43,213	2005	63,805

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² Article: "The Role of Civil Commercial Law in China's Socialist Market Economy", by Ian Duncan, in *Quarterly Journal of Chinese Studies*, Vol. 1, No. 2, Winter 2012, pp.1- 13.

Year	Foreign Capital Invested in China (US \$ millions)	Year	Foreign Capital Invested in China (US \$ millions)	Year	Foreign Capital Invested in China (US \$ millions)
1984	2,870	1995	48,133	2006	67,076
1985	4,760	1996	54,805	2007	78,339
1986	7,628	1997	64,408	2008	95,253
1987	8,452	1998	58,557	2009	91,804
1988	10,226	1999	52,659	2010	108,821
1989	10,060	2000	59,356	2011	117,698
1990	10,289	2001	49,672	2012	113,294
1991	11,554	2002	55,011	2013	117,586
1992	19,203	2003	56,140	2014	119,600
1993	38,960	2004	64,072	2015	126,270

Sources: P.R.C. Ministry of Commerce (MOFCOM) (2014&2016³), and KPMG (2015)

The continuing growth in foreign investment in China is increasingly benefitting the expanding services sector and the high- tech sector – while manufacturing heavy industry growth slows and the prospects of slower overall economic growth continue in China – which has become the world’s second- largest economy. However, although China’s rate of growth has slowed over recent years, China’s economy continues to grow at approximately 7% per year. Foreign investment into China is a vitally important part of that continuing growth.

The pending adoption of aspects of the draft *Foreign Investment Law* can provide China’s first unified foreign investment law. For purposes of doing business in China, it will put P. R.C. companies and P. R.C. businesses on a more equal footing with foreign- owned companies and foreign businesses. Most foreign investors will no longer be subject to a separate regulatory regime from Chinese investors, and under the “national treatment” principle, will be treated in almost the same way as Chinese investors. Under the draft *Foreign Investment Law*, and under the amendments passed by the Standing Committee of the National People’s Congress on 3 September 2016, taking effect from 1 October 2016, there will no longer be any need for foreign investors to apply for pre- establishment approval from the P.R.C. authorities, unless the investment is within the “restricted” or “prohibited” industries listed in the new “national negative list”. The use of a “negative list” has been successfully pioneered since 2013 with the establishment of the *Shanghai Pilot Free Trade Zone*, and the operation of the four free trade zones of Shanghai, Guangdong, Fujian and

³ Ministry of Commerce of P.R.C., 22 January 2016.

Tianjin. The Standing Committee of the National People's Congress of the P.R.C. announced in early September 2016 that the “*negative list*” management system for foreign investment in China would be implemented nationwide from 1 October 2016⁴.

The draft *Foreign Investment Law*, as released by the Ministry of Commerce on 19 January 2015, together with the already - announced amendments to foreign investment laws⁵, significantly reduces barriers to foreign investment, removes many of the current ambiguities and conflicts, and reduces time-consuming bureaucratic processes. It also aims to remove the current ability of foreigners to avoid restrictions on foreign investment in restricted areas of business through the current use of “variable interest entities”⁶ (VIEs). How effectively this can be achieved in reality by the draft *Foreign Investment Law* remains to be seen. What the draft *Foreign Investment Law* means for VIEs in sensitive industries like information technology or communications (for example, the VIEs currently used by Alibaba and Baidu) is not yet clear. Hopefully the currently ongoing work by P.R.C. government agencies to have those government agencies agree on the content of a final draft *Foreign Investment Law* will address this aspect and produce an effective and beneficial result.

The National Development and Reform Commission, a major “*reform and development*” authority of the P.R.C., has been preparing its own draft of changes which it believes are required to effectively update China's foreign investment law. The National Development and Reform Commission has not yet published its own proposed draft law on foreign investment. This means that the process of updating China's foreign investment laws will be prolonged – because the Ministry of Commerce (which announced the draft *Foreign Investment Law* on 19 January 2015) and the National Development and Reform Commission are now working together to produce a consolidated draft foreign investment law. That consolidated draft foreign investment law has not yet been published. If and when a consolidated draft foreign investment law is agreed upon and published, it can then be considered by the State Council of the P.R.C. and by the National People's Congress of the P.R.C.

On 2 March 2016, China's Ministry of Commerce said that it was working on amendments to the draft *Foreign Investment Law of the People's Republic of China* which was first released by the Ministry of Commerce on 19 January 2015 for public comment.

The draft *Foreign Investment Law* (as published by the Ministry of Commerce on 19 January 2015) provides for five major areas of changes to China's existing laws:

1. Three laws currently controlling foreign investment in China will be repealed⁷.

These three existing laws⁸ are;

1. *Sino-Foreign Equity Joint Venture Law* (EJV),

⁴ Wang Yang, Vice Premier of the State Council of the P.R.C., addressing the *China International Fair For Investment and Trade*, in Xiamen, 8 September 2016.

⁵ National People's Congress, & Xinhua, 6 September 2016.

⁶ The last paragraph of Article 14 of the 19 January 2015 draft Foreign Investment Law of the People's Republic of China.

⁷ Article 170 of the 19 January 2015 draft Foreign Investment Law of the People's Republic of China.

⁸ For details and history of these 3 separate laws, see, Kay-Wah Chan in “Commercial Law of the People's Republic of China”, Thomson Reuters, 2012, p. 242 & pages 389 to 445.

2. *Sino-Foreign Contractual Joint Venture Law (CJV)*, and
3. *Wholly Foreign-Owned Enterprise Law (WFOE)*.

If these three current laws are repealed, the legislative and regulatory control of foreign investment will no longer depend on whether the investment is made by an EJV, a CJV or a WFOE. These types of organisations will cease to exist for new foreign investment. Existing foreign-invested enterprises currently operating as EJVs, CJVs or WFOEs will be given 3 years to change as necessary to comply with the new *Foreign Investment Law*⁹ and (as may be relevant) with the Company Law of the P.R.C., the Partnership Law of the P.R.C., the Law of the P.R.C. on Individual Proprietorship Enterprises, and any other relevant P.R.C. laws and regulations.

2. There will be a more comprehensive definition of foreign investment. Instead of the currently differing laws and regulations for EJVs, CJVs and WFOEs, the draft *Foreign Investment Law* uses a new definition for the term “*foreign investment*”. Under the draft *Foreign Investment Law*, the term “*foreign investment*” is defined¹⁰ as including any of the following investment activities conducted directly or indirectly by foreign investors:

- (i) Setting up a company in the P.R.C.,
- (ii) Acquiring shares, equity, property shares or voting rights in any P.R.C. enterprise,
- (iii) Providing financing for a period of one year or longer to any P.R.C. enterprise in which any of the interests prescribed in (ii) above is held by the foreign investor,
- (iv) Obtaining any right for exploration and development of natural resources in the P.R.C. or for infrastructure construction or operation in the P.R.C.,
- (iv) Acquiring real estate rights (including land use rights) in the P.R.C., or any title to any house in the P.R.C.
- (v) Controlling any P.R.C. enterprise or holding equity in any P.R.C. enterprise by any agreement, or by any trust, or any other way.

(vii) Under the last paragraph of Article 14 of the draft *Foreign Investment Law*, any transaction done outside of the P.R.C. which results in any foreign person or foreign entity acquiring actual control over a P.R.C. enterprise shall be deemed to be an investment within the P.R.C. by that foreign investor. (This is aimed at those foreign investors who have been circumventing P.R.C.’s current foreign investment laws and regulations by using a “*Variable Interest Entity*”). A Variable Interest Entity (VIE) may currently be a P.R.C.-owned company, with all its capital provided by P.R.C. nationals, and all its directors being P.R.C. nationals. But the money to set up and operate this P.R.C.-owned company is lent to these P.R.C. nationals by foreign investors – often via a WFOE set up by the foreign investors. The last paragraph of Article 14 of the draft *Foreign Investment Law* extends the restrictions on “*foreign investment*” to VIEs¹¹. Under the draft *Foreign Investment Law*, VIEs will no longer be able to easily circumvent the restrictions imposed by current P.R.C. laws and regulations. How effectively the new *Foreign Investment Law* will operate to control public company VIEs (such as Alibaba and Baidu) remains to be seen, and will depend largely on

⁹ Article 157 of the 19 January 2015 draft *Foreign Investment Law* of the People’s Republic of China.

¹⁰ Article 14 of the 19 January 2015 draft *Foreign Investment Law* of the People’s Republic of China.

¹¹ Article 14 of the 19 January 2015 draft *Foreign Investment Law* of the People’s Republic of China.

the provisions contained in the yet-to-be-published final version of the draft *Foreign Investment Law* to be reproduced by the P.R.C. government agencies.

Also targeting VIEs, the draft *Foreign Investment Law* contains new definitions of “foreign investor”¹² and new definitions of “control”¹³ which focus on the concept of de facto control/effective control, according to the “substance over form” principle.

3. Periodic Reports and Filing by foreign investors and foreign – invested enterprises will replace pre-establishment approval by P.R.C. authorities. Under the draft *Foreign Investment Law* and under the significant amendments adopted on 3 September 2016 by the Standing Committee of the National People's Congress of the P.R.C., most foreign investment into the P.R.C. will no longer require pre-approval from P.R.C. authorities. An exception will be where a foreign investor wants to invest in any of the “restricted” industries or “prohibited” industries on the “national negative list” (a list probably to be based on the “*Catalogue of Restricted and Prohibited Industries for Foreign Investment*”) or if the amount invested exceeds the maximum amount allowed by the P.R.C. authorities¹⁴. The P.R.C.'s “*Foreign Investment Guidance Catalogue*” (“*the Catalogue*”) is a nationwide directory for foreign investment, and has been in use since 1995. It is jointly administered by the Ministry of Commerce and the National Development and Reform Commission, and has been revised in 1997, 2002, 2004, 2007 and 2011. The “*Catalogue*” is intended to guide investment into specified categories of business and away from other specified categories of business by dividing businesses into “encouraged”, “restricted” and “prohibited” categories. Those businesses not specifically listed in any of those three categories are currently considered to be “permitted”.

Under P.R.C. laws and regulations over many years until now, to set up a foreign-invested business in the P.R.C. all foreign investors have been required (before setting up and operating any foreign-invested business) to submit a report for pre-establishment approval and get approval by the relevant P.R.C. authorities. The draft *Foreign Investment Law* abandons the current case-by-case pre-establishment approval system and instead imposes extensive filing/reporting obligations that are distinct from the pre-establishment approval process. Under the draft *Foreign Investment Law*, and under recent September 2016 amendments, any person or entity setting up any foreign-invested enterprise in the P.R.C. will be required to submit/file an initial report¹⁵ (before the foreign-invested enterprise is established, or within 30 days after that establishment/investment) but will not be required to wait for approval (unless the proposed foreign-invested enterprise is within the “national negative list” of “restricted” or “prohibited” industries). That initial report will be required to give information about the foreign investor, and about the form of the new foreign-invested enterprise – including financial information¹⁶. After establishing the foreign-invested

¹² Article 11 of the 19 January 2015 draft Foreign Investment Law of the People's Republic of China.

¹³ Articles 18 & 19 of the 19 January 2015 draft Foreign Investment Law of the People's Republic of China.

¹⁴ Articles 24, 25 & 26 of the 19 January 2015 draft Foreign Investment Law of the People's Republic of China.

¹⁵ Article 85 of the 19 January 2015 draft Foreign Investment Law of the People's Republic of China.

¹⁶ Article 87 of the 19 January 2015 draft Foreign Investment Law of the People's Republic of China.

enterprise the foreign investor will need to submit periodic reports to the relevant P.R.C. authority in accordance with the “*foreign investment information reporting system*”¹⁷.

4. Pre – establishment approval to be required only for “prohibited” or “restricted” investments. Under the draft *Foreign Investment Law*, foreign investors may not invest in any business or industry specified as a “*prohibited investment*” in the P.R.C. *Catalogue of the Prohibited Investment*¹⁸.

Also under the draft *Foreign Investment Law*, foreign investors may not invest in any business or industry specified as “*restricted investment*” in the P.R.C. *Catalogue of the Restricted Investment* or in any business or industry specified in the *Catalogue of the Prohibited Investment* unless and until an application for an entry permit has been filed with and approved by the relevant P.R.C. regulatory authority¹⁹.

5. National Security Review. The draft *Foreign Investment Law* provides for the establishment and operation of a “*unified national security system for foreign investments*”²⁰. It may be that the National Development and Reform Commission, as the main “*reform and development*” authority of the P.R.C., will jointly administer the *National Security Review for Foreign Investment*²¹. Under the draft *Foreign Investment Law*, a foreign investor will be able to apply for a National Security Review of any proposed or existing foreign investment²². Under the draft *Foreign Investment Law*, the relevant P.R.C. authority may at any time initiate and conduct a National Security Review of any foreign investment²³.

2016 amendments to China’s foreign investment laws. On 3 September 2016 the Standing Committee of the National People’s Congress of the P.R.C. voted on and passed significant amendments to China’s foreign investment laws, to take effect on 1 October 2016. Those significant amendments were revisions to the following 4 laws of the P.R.C.²⁴:

1. *Sino-Foreign Equity Joint Venture Law (EJV)*,
2. *Sino-Foreign Contractual Joint Venture Law (CJV)*,
3. *Wholly Foreign-Owned Enterprise Law (WFOE)*, and
4. *Law on the Protection of Investment of Taiwan Compatriots*.

Those amendments replaced previously - existing Ministry of Commerce pre - establishment approval requirements with new filing/reporting requirements for the above types of foreign - invested enterprises - provided the foreign - invested enterprise is not

¹⁷ Articles 75 to 91 of the 19 January 2015 draft Foreign Investment Law of the People’s Republic of China.

¹⁸ Article 25 of the 19 January 2015 draft Foreign Investment Law of the People’s Republic of China.

¹⁹ Articles 25, 26, 27, 30 & 32 of the 19 January 2015 draft Foreign Investment Law of the People’s Republic of China.

²⁰ Article 48 of the 19 January 2015 draft Foreign Investment Law of the People’s Republic of China.

²¹ Article 49 of the 19 January 2015 draft Foreign Investment Law of the People’s Republic of China.

²² Articles 50 to 54 of the 19 January 2015 draft Foreign Investment Law of the People’s Republic of China.

²³ Articles 55 to 71 of the 19 January 2015 draft Foreign Investment Law of the People’s Republic of China.

²⁴ National People’s Congress of the P.R.C., 3 September 2016.

subject to national market access restrictions, including the provisions of the new “*national negative list*”. The filing with the Ministry of Commerce must be made after the pre-registration approval of the foreign-invested enterprise's name and should be made either before the issue of the foreign-invested enterprise's business licence, or within 30 days of the issue of the foreign-invested enterprise's business licence.

From 1 October 2016, under these amendments, a foreign-invested enterprise that does not engage in any restricted business listed on the “*national negative list*” will only have to file certain specified information with the Ministry of Commerce. This should save time, reduce costs, and significantly improve the predictability and efficiency of foreign investment transactions. Also, these foreign-invested enterprises will now have much greater flexibility in negotiating transaction documents because these documents (including joint venture contracts, share transfer agreements, company articles of association, and board resolutions) will no longer be subject to pre-establishment filing with, or approval by the Ministry of Commerce.

The new foreign investment law regime imposes on foreign-invested enterprises more unified (and in some respects more extensive) information and reporting requirements than the multiple and fragmented foreign investment approval regime which has previously applied to foreign-invested enterprises.

Because foreign investment in China is administered by several P.R.C. government authorities (including the Ministry of Commerce, the National Development and Reform Commission, the State Administration of Foreign Exchange, and the State Administration for Industry and Commerce), many current laws and regulations will probably need to be amended or repealed in conjunction with the introduction and operation of the “*national negative list*” and other amendments to China's current foreign investment laws.

Conclusion. Following agreement about all aspects of the draft *Foreign Investment Law* between the relevant P.R.C. government agencies (including the Ministry of Commerce and the National Development and Reform Commission) the amended foreign investment law takes effect after approval by the State Council of the P.R.C. and by the National People's Congress of the P.R.C., as China's first unified foreign investment law.

Combined with the extensive and very effective changes to the *Company Law of the P.R.C.* during recent years²⁵, the operation of the new *Foreign Investment Law* should bring great benefits to P.R.C. companies and P.R.C. business people, to foreign investors doing business in the P.R.C., and to the P.R.C. economy and society as a whole. In some ways the draft *Foreign Investment Law* can be seen as a further development of company law in China – because in the course of facilitating and controlling foreign investment, it will (together with the *Company Law of the P.R.C.*, the *Partnership Law of the P.R.C.* the *Law of the P.R.C. on Individual Proprietorship*, and relevant regulations) also control the types and structures of companies and other business vehicles and entities used for foreign investment in China.

The evolution of the civil commercial laws of the P.R.C. (including the current foreign investment laws and regulations), and the P.R.C.'s increasing international trade and

²⁵ Article: Synopsis of Company Law of the P.R.C., by Ian Duncan, in Quarterly Journal of Chinese Studies, Vol. 4, No. 1, Autumn, 2015, pp.1- 5.

commerce has been accompanied in recent years by increasing professionalism and increasing levels of integrity and effective governance throughout the Courts, the Procuratorates, the legal profession, and the government departments administering the P.R. C.'s foreign investment laws. Until recent years, many aspects of civil and commercial laws (including the foreign investment laws) were inconsistently and subjectively interpreted and applied – often because of the lack of qualified personnel and the extent of corruption and protectionism at local levels. During recent years the P.R.C. government has proactively and successfully addressed these aspects in order to establish and maintain effective and correct judicial, administrative and private sector operation of civil commercial laws. The current revision of the foreign investment law gives P. R. C. citizens, P. R. C. businesses, and international businesses operating in the P.R.C. much greater confidence and security for foreign investment and business operations in the P.R.C.

When it is finalised and takes effect, the new unified foreign investment law will benefit the Chinese economy, will provide greater confidence, certainty, security and convenience for foreign investors and for businesses in China, and should support the continuance of China as the world's top destination for foreign investment.

In the course of the development of China's foreign investment laws, and the constantly changing factors in the development of China's socialist market economy and society, **the only constant is change**. We can therefore anticipate further significant amendments to the foreign investment law of the People's Republic of China.

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