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China's Inward FDI Strategy: Considering the Foreign Investment Law (FIL) 2020

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While much academic commentary tends to focus on China's strategy in relation to outward Foreign Direct Investment (FDI), notably the controversial Belt and Road initiative, FDI into China has grown steadily over the past 20 years along with the country's dramatic ascent to the second largest economy in the world. China's FDI inflows rose to US $180 billion in 2021, second in the world after the US.[1] In 2022 FDI inflows into China had grown another 12 per cent[2] – a remarkable advance given ongoing troubles in the global economy with many countries struggling to recover from the Covid-19 pandemic. While the country is often held with some suspicion by the West for both economic and political reasons, it remains among the world's most popular destinations for foreign capital.

Despite its success in attracting FDI, there remains a perception, particularly within China itself, that China's potential to promote inward FDI has not yet been fully realized, in part due to heavy restrictions and complex regulations. Reforms to China's foreign investment law framework have been in development for some time.[3] China has been at the forefront of international investment law for many decades, having concluded numerous International Investment Agreements (IIAs) which have enabled the country gradually to move towards a more liberalized environment for foreign investors with a view to fuelling its economic development.[4] Perhaps the most noteworthy among these is the Regional Economic Partnership Agreement (RCEP), the world's largest free trade agreement by GDP, which went into force in early 2022.

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[1] https://www.statista.com/statistics/1016973/china-foreign-direct-investment-inflows/ (accessed January 2023)

[2] Ibid (accessed June 2023)

[3] M Zhao, 'Analysis and Interpretation of the New Foreign Investment Law of the People's Republic of China' China & WTO Review 2019:2, at 353-354

[4] M Enrigh, 'China's Inward Investment Approach and Impact' in J Chaisse ed. *China's International Investment Strategy: Bilateral, Regional and Global Law and Policy* (Oxford University Press, 2019)

Increasingly, though, it is a country's domestic laws which dictate its responsiveness to the needs of foreign investors, and which make a country an attractive destination for multinationals. China's Foreign Investment Law (FIL) of 2020 is the basic law governing FDI in China, establishing core principles for the promotion, protection and market access of foreign investment.[5] Before the FIL took effect, foreign investors faced many obstacles in relation to establishment as well as ongoing investment treatment compared to Chinese counterparts. For example, foreign investors were restricted from investing in certain sectors unless it was done through a Joint Venture with a Chinese party. Chinese Joint Venture laws imposed specific requirements on corporate formation, foreign ownership ratios, corporate governance as well as operational management. Furthermore, there was insufficient protection of IP rights and in some cases, mandatory technology transfer, a feature which was heavily criticized by the US and other Western countries.

China's new FIL was designed to address some of these concerns. Comprised of forty-two articles in six chapters, the FIL emphasizes foreign investment promotion, protection and administration, and imposes legal liabilities on both foreign investors and Chinese regulators if they violate of Chinese foreign investment rules. While the law is still relatively new and as such its effects cannot be properly assessed (particularly given the unusual economic situation created by the Covid-19 pandemic and its aftermath), the FIL has been favourably assessed in terms of its potential to have a positive impact on FDI in China.[6] Some have gone as far to state that the FIL is the China's most important development in the field of international economic relations since the country's accession to the World Trade Organization 2001.[7]

Among the most important features of the FIL is its promise to foreign enterprises of national treatment, enabling them to compete on a par with domestic enterprises, for permitted investments.[8] This is extended to nationwide (as opposed to merely geographically designated areas) pre-establishment treatment, via a Negative List of prohibited sectors (other sectors being presumptively open for foreign investment, see more below). Moreover, foreign

[5] Adopted at the Second Session of the 13th National People's Congress on March 15, 2019, went into effect 1 January 2020
[6] X. Liu, Y. Duan, 'An Analysis of the Positive Impact of the Implementation of Foreign Investment Law on the Business Environment 2020' 2nd International Conference on Economic Development and Management Science (EDMS 2020)
[7] M Zhao, 'Analysis and Interpretation of the New Foreign Investment Law of the People's Republic of China' China & WTO Review 2019:2, 353
[8] Art 4

investors may actually enjoy preferential policies (better than locals) in certain sectors and regions as designated by the Chinese authorities.[9] Additionally, the FIL specifically allows FIEs to raise funds through public offerings of equity and debt securities.[10] China's welcoming stance to FDI is perhaps best captured by Article 3 of the FIL which states:

> The State shall adhere to the basic state policy of opening-up and encourage foreign investors to make investments within the territory of China. The State shall implement policies on high-level investment liberalization and convenience, establish and improve the mechanism to promote foreign investment, and create a stable, transparent, foreseeable and level-playing market environment.

These new provisions were specifically designed to encourage FDI into China and it is hard to resist the conclusion that they were at least partially responsible for China's record inward FDI in 2021 and 2022.

On investment protection (the treatment received by foreign investors after they have established themselves in China), the FIL sets out that the state may only expropriate and requisition the investment of foreign investors in accordance with the law and for the needs of public interest. Such expropriation and requisition shall be conducted in accordance with legal procedures; timely and reasonable compensation shall be given.[11] The fear of expropriation is perhaps the greatest risk to foreign investors and this statement should help give some assurance that capital commitments are not at risk from arbitrary political interventions. The FIL further establishes that foreign investors' capital contributions, profit, capital gains, income from asset disposals, royalties from IP rights, lawfully obtained compensation or indemnity amounts, and proceeds from liquidation, may be freely remitted in or out of China in RMB or foreign currency.[12] This commitment is essential to giving foreign shareholders the confidence to invest in China knowing that any profits can be returned home without undue restrictions. The FIL further prohibits government officials from forcing foreign investors to transfer their technology, and require authorities to take effective measures to protect the trade secrets of foreign investors that they have learned while performing their duties.[13] Forced technology transfer was surely among the most resented of China's policies toward foreign investment, especially in knowledge-intensive

[9] Art 14
[10] Art 17
[11] Art 20
[12] Art 21
[13] Arts 22 and 23

fields. Additionally, local governments must comply with policy commitments made to, and investment agreements entered into with, foreign investors, and shall reasonably compensate those foreign investors if it is necessary to adjust those commitments or agreements due to national or social public interest reasons.[14] This assurance is crucial also given China's tight control over is society and culture. Interestingly, there is no provision for fair and equitable treatment (FET) or full protection and security (FPS) in the FIL; these are traditional protections afforded to foreign investors in IIAs. The vagueness of FET has been widely criticized for its excessive empowerment of foreign investors, undermining the capacity of states to regulate in their self-interest. In that sense it is not surprising that it has been omitted from China's foreign investment legislation.

Regarding procedural protections for foreign investors, the FIL stipulates that the state should establish a complaint mechanism for foreign-invested enterprises, co-ordinate and improve major policies and measures in the complaint of foreign-invested enterprises. If a foreign-invested enterprise or its investors believe the administrative acts of the administrative organs infringe on its legitimate rights and interests, they may apply for administrative reconsideration and bring administrative proceedings, in addition to applying for co-ordinated settlement through the complaint mechanism of the foreign-invested enterprise.[15] This should provide much comfort to foreign investors concerned about China's judicial system and any perceived lack of independence or anti-Chinese bias.

In terms of market access, as mentioned above FDI into China is still prohibited or restricted in a number of areas, through the use a Negative List (those sectors not listed are accessible on a non-discriminatory basis).[16] The Negative List, officially entitled "Special Administrative Measures for Foreign Investment Access", is a document that is jointly issued by the Ministry of Commerce (MOFCOM) and the National Development Reform Commission (NDRC). The list is updated periodically and has been steadily narrowing over the years. Commentators have noted, though, that the classification of various sectors is based on Chinese practice and can be confusing for foreign businesses.[17]

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[14] Art 25
[15] Art 26
[16] The Special Administrative Measures (Negative List) for Foreign Investment Access (2021 Edition) includes areas such as agriculture, forestry, rare earth mining, printing and publications, utilities (heat, water, electricity), media, education and telecommunications (with varying restrictions), geographic surveys, performing arts, among numerous other sectors.
[17] Y. Zheng, 'China's new Foreign Investment Law: deeper reform and more trust are needed' Columbia FDI Perspectives on topical foreign direct investment issues, No. 264, 4 November 2019

China's FIL abolished long-standing separate laws on wholly foreign-invested enterprises and Sino-foreign Joint Ventures. In areas where FDI is permitted, foreign invested enterprises of all types will be subject to the same legal frameworks as domestic Chinese companies, such as Chinese Company Law. Under the FIL, applicable FDI rules, meaning rules for investments in greenfield ventures as well as those relating to M&A, largely depend on whether the intended investment activity is on the Negative List. The FIL covers several types of foreign investment. First, establishment of a foreign invested enterprise ('FIE') in China, independently or jointly with any other investor. Second, the acquisition of shares, equities, property or any other similar rights and interests of an enterprise in China in a new project in China, independently or jointly with any other investor. Finally, investment in any other way as may be stipulated by laws, administrative regulations or provisions of the State Council.[18]

In addition to the general national Negative List in China's FIL, there is also Negative List particular to the Free Trade Zones ('FTZ'). These are designated geographic zones where special rules apply typically granting greater market access with a narrower range of prohibited and restricted activities.[19] As of 2022, China has 21 FTZ in operation and they remain a significant feature of their trade policy, having been initiated in the 1980s.[20] There is also an Encouraged List of activities (the 'Catalogue') that the government wishes to promote and for which various incentives are offered, with separate categories for activities encouraged either nationally or, even more liberally, in less developed parts of the country.[21] Items included in the FTZ Negative List may be either prohibited outright to foreign investment or may be restricted. Prohibited activities include tobacco wholesale/retail, stem cell and genetic treatments, social surveys, film and TV production, compulsory education, and others. Restricted activities include automotive manufacturing, basic and value-added telecommunications services, transportation, energy, utilities, banks and financial institutions, agriculture, and others.

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[18] Art 2

[19] The Negative List for Free Trade Zones includes agriculture, mining, utilities, wholesale retail, transport, information technology, leasing and business services, education, scientific research health, sports and entertainment.

[20] J Huang, 'Reform Starting from China's Free Trade Zones: The Case of the Negative List of Non-conforming Measures' in J Chaisse ed. *China's International Investment Strategy: Bilateral, Regional and Global Law and Policy* (Oxford University Press, 2019)

[21] The newly released catalogue (2021) contains a total of 1,235 items, increased by 10 percent from 1,108 items in the previous version, with 127 items added (65 new items in the national list and 62 new items in the regional list) and 88 items modified.

Where an activity is restricted by China, approval is expressly at the discretion of the competent authorities. Along with the State Administration for Market Regulation (SAMR), MOFCOM and NDRC are the main government authorities for foreign investment review. Under the old regime, any investment that fell within the restricted sector category had to be approved by MOFCOM before registration with SAMR. Under the FIL, the prior approval of MOFCOM is no longer required. Instead, as part of the corporate registration process, SAMR will review the information provided by foreign investors to verify whether the underlying foreign investment is in compliance with the restrictions set out in the Negative Lists. In addition, foreign investments that involve fixed-asset projects may require the approval of the NDRC. The authorities may approve of, ask for modification of or deny the investment. In any case, a joint venture with a Chinese party will be required for any restricted venture, often with the Chinese party holding a controlling interest.

In addition to the restrictions on FDI that falls under the Negative List, foreign investment will also be subject to a national review if it "affects or may affect national security." The rules do not expressly apply to Joint Ventures with Chinese parties, although an analogous informal review may take place in those cases. This process resembles that of Canada's 'net benefit' test found in the Investment Canada Act.[22] It appears to be more permissive the strict regime found in the US Foreign Investment Risk Review Modernization Act (FIRRMA)[23], for example. Under the existing review system of China's FIL, the security review applies to acquisitions of all or parts of domestic military industrial enterprises and tertiary enterprises, enterprises located near major and sensitive military facilities, and other entities related to national defence or security.[24] The review mechanism is also triggered by acquisitions in other national security related sectors such as major agricultural products, major energy and resources, infrastructure, transportation services, key technologies and key equipment manufacturing. If an acquisition by a foreign investor is likely to trigger national security concerns, the foreign investor should notify MOFCOM of the transaction.[25]

[22] R.S.C., 1985, c. 28 (1st Supp.) Art 16(1)
[23] H.R.5841 - Foreign Investment Risk Review Modernization Act of 2018, 115th Congress (2017-2018)
[24] 'Measures for Security Review of Foreign Investments,' Adopted at the 13th Commission Affairs Meeting of the National Development and Reform Commission on November 27, 2020. Issued by the National Development and Reform Commission and the Ministry of Commerce on December 19, 2020. Effective from January 18, 2021.) https://www.bakermckenzie.com/-/media/files/insight/publications/2021/01/foreign_investment_security_review_measures.pdf?la=en&hash=A8090D728204CEEE5B761495C1DC5AD4 (unofficial translation, October 2022)
[25] Ibid, Article 4

Upon receiving a notification, if MOFCOM determines that a national security review is required, it will establish an inter-ministerial panel, principally run by NDRC and MOFCOM, to conduct the review and issue a decision within 100-120 working days. Depending on the sensitivity of the transaction, the inter-ministerial panel will conduct a 'general review' or 'special review.' If the inter-ministerial panel determines that the transaction is likely to have a major impact on national security, MOFCOM will require the applicant to either terminate or restructure the transaction (including transferring back equity interests or assets if the acquisition has already been closed.[26]

There are complex approval requirements by the China Securities Regulatory Commission and MOFCOM apply where an investor intends to acquire parts of a listed company, for example in the context of major acquisitions and changes of control of listed companies.[27] Particular attention may be required to avoid the need to make a general tender offer when acquiring more than 30 per cent of the shares of a listed company. Foreign investors can acquire equity or assets of SOEs or their subsidiaries.

There is no provision for the enforcement of protections contained in the FIL, meaning that foreign investors remain subject to the vagaries of the administration of these rules by Chinese officials.[28] Fines for breach of China's FIL are capped at CNY 500,000.[29] China's FIL, does however incorporate a "complaint mechanism" for foreign-funded enterprises.[30] Where a foreign-funded enterprise deems that any administrative act infringes its legitimate rights and interests, it may seek resolution through the complaint mechanism. The foreign investor may also apply for administrative review, or lodge an administrative litigation. It is not clear whether this system is available to challenge an approval decision by MOFCOM or whether it relates exclusively to post-establishment, e.g. an expropriation.

Commentators have observed the link between China's FIL and some of its newer international investment treaties including the 15-nation Regional Comprehensive Economic

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[26] Ibid, Article 8

[27] Provisions on the Supervision and Administration of Depository Receipts Under the Stock Connect Scheme between Domestic and Overseas Stock Exchanges http://www.csrc.gov.cn/csrc_en/c102034/c1885832/1885832/files/Provisions%20on%20the%20Supervision%20and%20Administration%20of%20Depository%20Receipts%20under%20the%20Stock%20Connect%20Scheme%20between%20Domestic%20and%20Overseas%20Stock%20Exchanges-20220211224952657.pdf (unofficial translation, October 2022)

[28] Y. Zheng, 'China's new Foreign Investment Law: deeper reform and more trust are needed' Columbia FDI Perspectives on topical foreign direct investment issues No. 264, 4 November 2019

[29] Art 37

[30] Art 26

Partnership (RCEP) and the EU-China Comprehensive Agreement on Investment (CAI).[31] The RCEP investment chapter contains strong investor protections typical of a conventional IIA, such as FET and FPS,[32] prohibitions of performance requirements,[33] and guarantees against expropriation without compensation.[34] The CAI, on the other hand, does not have substantive investment protections (such as expropriation or FET). In that sense China's FIA, which has strong investor protections, but lacks FET and FPS, is somewhere between the RCEP and CAI in terms of its empowering of foreign investors. It has been rightly observed by commentators much of the CAI merely replicates investment market access and protections found in the FIA and other instruments.[35] With 15 signatories throughout the Indo-Pacific, including Japan and Australia, the RCEP is the world's largest RTA by GDP. Yet it is often decried for lacking the depth of the Comprehensive Progressive Trans-Pacific Partnership (CPTPP) of which China is not currently a member.[36] RCEP is important from the perspective of inward FDI into China because it represents a much greater commitment towards liberalization than any of China's previous international investment agreements (IIAs) with RCEP parties. Inward investment into China from Korea and Japan surged in the months after RCEP went into effect.[37]

As noted above, RCEP's investment chapter contains a broad definition for investment and strong protections, including FET, FPS and guarantees against indirect expropriation without compensation, the latter of which is framed in Western 'fair market value' terms.[38] Even more importantly, and unusually for China, RCEP also offers pre-establishment national treatment[39], effectively granting foreign investors from RCEP countries a right of entry into China. This is modified by a negative list of restricted sectors, which is more open than most of China's previous FTAs. Restricted sectors for foreign investment listed by China include research and development in selective breeding of

[31] N Tao, 'Latest Developments of China's Foreign Investment Policy and Law' Asian Yearbook of International Economic Law 2022, 109 and H Wang, 'The RCEP Investment Rules and China: Learning from the Malleability of Chinese FTAs' in J Chaisse ed. *China's International Investment Strategy: Bilateral, Regional and Global Law and Policy* (Oxford University Press, 2019) (noting the RCEP's general impact on China's approach to international investment law)
[32] Art 10.5
[33] Art 10.6 (these are significantly more detailed than in a conventional IIA)
[34] Art 10.13
[35] B Mercurio, 'Five Points You Should Know on the EU-China Investment Agreement' Global Trade and Investment Advisors (4 Feb 2021)
[36] China is currently pursuing accession to the CPTPP.
[37] 'RCEP highlighted for promoting global trade' China Daily (17 January 2023)
[38] Art 10.13.2
[39] Art 10.3

livestock and crop production, fishing, and the exploitation of natural resources including the extraction of rare earths. There are also foreign participation restrictions in automobile manufacture and in the delivery of various financial services.[40] The RCEP further achieves greater liberalization for foreign investment because of standstill provisions[41], which ensure that signatories will not retreat from existing commitments, binding liberalisation at the status quo levels, and also through ratchet provisions[42], which tie parties to any autonomous liberalisation they might introduce in the future. The negative-listing approach of investment sectors includes a built-in standstill mechanism in the form of the list of non-conforming measures which prevents RCEP parties from introducing any new restrictions in the future. These features of the RCEP are uncommon among ASEAN countries and represents a step-forward for China and the other RCEP countries.[43]

Furthermore, the RCEP investment chapter's prohibition on performance requirements further promises that investment protections will not be conditional on technology transfer.[44] The FIA is an embodiment of the RCEP's requirement that parties 'endeavour to facilitate investment' through extensive investment promotion provisions uncommon in many IIAs.[45] RCEP does not include explicit provisions on the 'right to regulate' granting further room to manoeuvre for foreign investors in China.[46] On the other hand, RCEP contains a strongly-worded essential security provision.[47] It is noteworthy also that RCEP does not include an investor-state dispute settlement (ISDS) clause, although parties reserved the right to include this at a later date. Given the adverse treatment faced by many Chinese companies operating abroad in recent years, it seems quite likely that China may push to have ISDS included in the RCEP in order to safeguard against potential bias from domestic courts in other RCEP countries.

It is noteworthy also that Chapter VI of the FIA establishes that if any country or region takes discriminatory prohibitions, restrictions or other similar measures against China with respect to investment, China may take retaliatory measures against the country or region

[40] Annex III: Schedule of Reservations and Non-Conforming Measures for Investment in China
[41] E.g. Art 8.7
[42] Art 10.8.1 c)
[43] H Gao, 'The Investment Chapter in the Regional Comprehensive Economic Partnership: Enhanced Rules without Enforcement Mechanism' ERIA Discussion Paper Series No. 446 (September 2022)
[44] Art 10.6 f)
[45] Arts 10.16 and 10.17
[46] This is tempered by the Annex on Expropriation which narrows the scope of protection against expropriation based on measures undertaken for 'legitimate public welfare objectives.'
[47] Art 10.13 (framed in self-judging language)

in accordance with “actual conditions.” This provision reflects the principle of reciprocity in international economic relations and promotes the principle of non-discrimination as a basic principle of international investment law. This view may be tested in the coming years as economic relations between China and the West have entered a period of decline.

China would seem to be prepared to be more open to its RCEP partners than it is generally, as is the nature of preferential FTAs. For the broader world, China’s FIL will be instrumental in China remaining an attractive destination for foreign investment, especially for countries with which it does not have an FTA. In an era where there is much antipathy towards China, notably within Western advanced countries, the security offered by legislation such as FIL will be vital in ensuring that China retains its status as a leading destination of foreign investment. China’s recent commitments in favour of FDI liberalization in FTAs, in particular the mega-regional RCEP with the high-growth Indo-Pacific region, will also play a vital role in this process. Where investing on non-preferential terms, foreign investors will continue to need the assurances of legal safeguards offered in domestic instruments like the FIL which manages to strike a sensible balance between respecting the needs of multinational companies while being responsive to China’s historic and understandable sensitivities in areas of national security and industrial policy.