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## *INNOVATION LETTER*

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# ONE YEAR OF NEW FOREIGN INVESTMENT LAW AND ONE CENTURY OF OLD COMMUNIST PARTY. NOTES FROM A WESTERN EXPATRIATE IN CHINA

### SUMMARY

1 Introduction – 2 Background of the new law on foreign investments – 3 Equality of foreign invested enterprises, protection of intellectual property and access to public procurement – 4 A real change? – 5 The Chinese establishment – 6 Possible outcome

## **1 Introduction**

According to the narrative illustrated in the Memorial of the First Meeting of the Chinese Communist Party, in the district of Xintiandi in Shanghai, the party was founded here in 1921. At that time, Xintiandi was a poor residential area, and later, after the war and thirty years of hard communist regime, it became poorer. Now, it is a sequence of elegant restaurants and luxury stores, embedded in renovated Shanghainese shikumen houses. This one-century anniversary has been celebrated with an exhibition of power and wealth, including light-shows on the financial towers of Lujiazui in Shanghai, a militaristic representation on Tiananmen Square in Beijing, and massive propaganda on all state TV channels, broadcasting interminable serials on the virtues of Mao Tze Dong and the heroism of the Chinese fighting against the Japanese, the Kuomintang, and the US army in Korea. With a notable silence on the three decades of mass murders and starvation between 1949 and 1978, as well as on the massacre of students in 1989.

This historic anniversary occurs one year and a half after the entering into force, on 1 January 2020, of the new Foreign Investment Law (Law) and the related Regulation for

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Implementing the Foreign Investment Law (Regulation). A more mundane anniversary, that of course nobody has celebrated.

There is a connection between the two occurrences, made by Chinese history, politics, and Western misperceptions.

## 2 Background of the new law on foreign investments

The Law and the Regulation have superseded three previous laws: the Law on Wholly Foreign-Owned Enterprises (1986), the Law on Chinese-Foreign Equity Joint Ventures (1990), and the Law on Chinese-Foreign Contractual Joint Ventures (2000).<sup>1</sup> Over the years, this legal framework made of multiple layers with many amendments and implementing regulations, became obsolete and difficult to coordinate. Besides, it was criticised as too protective for Chinese enterprises, and discriminatory against foreign enterprises, on the no-longer valid justification that foreigners were in a stronger economic and technological position.

International criticism against China's laws and policies on foreign investments focused on three main arguments: (a) unequal status of foreign invested companies towards Chinese-owned companies, (b) extortion of foreign intellectual property rights, and (c) entry barriers to public procurement.<sup>2</sup> This criticism grew on the back of three broader political issues. The first, concerning the status of China as developing country in the WTO.<sup>3</sup> The second, concerning geopolitical interests around the control of Taiwan and the South China Sea. The third, concerning human rights, recently focusing on the Uyghur population in Xinjiang and the protests in Hong-Kong.<sup>4</sup>

The political conflict has driven a dramatic increase of import tariffs on Chinese products in the US and other Western countries, followed by countering tariffs in China on their products and, recently, to the suspension of the approval by the EU Parliament

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<sup>1</sup> For an overview of the three old laws see Flavio Picaro, 'Diritto Societario Cinese: gli investimenti stranieri in Cina' [2017] *Cammino Diritto*.

<sup>2</sup> A motivated defense of China's policy in international trade can be found however in Tingliang Wang, 'Western Misperceptions and China's Approach to International Investment Law' [2019] *Santa Clara Journal of International Law* 1.

<sup>3</sup> China has been a member of WTO since 11 December 2001. Since that time, China enjoys since then the status of developing country. This gives to China the right to restrict imports to protect specific industries and raise import tariffs without reciprocity. However, nowadays China is the second-largest economy in the world, with the GDP of an economic superpower: \$14.14 trillion, and a recent Credit Suisse report highlights that the number of wealthy Chinese people overcame the number of wealthy Americans in 2019.

<sup>4</sup> See Margaret K. Lewis, 'Why China Should Unsign the International Covenant on Civil & Political Rights' [2020] *Vanderbilt Journal of Transnational Law* 131.

of an important trade treaty reached at the end of 2020 with China, frustrating years of lengthy negotiations.<sup>5</sup>

In such complex scenario, the issues of foreign investments appeared the easiest and quickest to resolve.<sup>6</sup> So, in 2019 the new unified foreign investment law, a project that was lagging since years, was resumed, revised, and passed in record time by the National Congress and the State Council.<sup>7</sup>

### **3 Equality of foreign invested enterprises, protection of intellectual property and access to public procurement**

The Law and the Regulation address bluntly the three mentioned critics concerning inequality, intellectual property, and public procurement.

First and foremost, the Law affirms that foreign investors in China enjoy national treatment.<sup>8</sup> This means that the treatment of foreigners and their investments may not be less favorable than that accorded to domestic investors and their investments.<sup>9</sup> The national treatment principle, however, is limited by the Special Administrative Measures for the Access of Foreign Investment, commonly known as “negative list”, which is a list of strategic businesses restricted to Chinese enterprises, or to joint ventures in which Chinese nationals have at least joint control. As a result, China grants national treatment to foreigners only outside the negative list,<sup>10</sup> which is updated from time to time by the State Council.<sup>11</sup> The fencing of foreign investors out of the negative list is a significant competitive advantage that China enjoys without incurring in trade sanctions, thanks to its status of developing country in the WTO.

Other main provisions of the Law set out that the state protects the investment of foreign investors, their income, and other lawful rights and interests within China,<sup>12</sup> and that foreign invested business may not be subject to obstructions or restrictions.<sup>13</sup> On

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<sup>5</sup> China-EU Comprehensive Agreement, available at <<https://trade.ec.europa.eu/doclib>> last accessed 31 March 2022. An original and critical analysis of the most contentious subjects negotiated in the China–EU Comprehensive Agreement on Investment is the one by Yuwen Li, Tong Qi and Cheng Bian (eds), *China, the EU and International Investment Law. Reforming Investor-State Dispute Settlement* (Routledge 2020).

<sup>6</sup> Interesting perspectives from lawyers and political scientists from Europe and Asia on the interactive dynamics between law and diplomacy in international trade and investment in Chien-Huei Wu and Frank Gaenssmantel, *Law and Diplomacy in the Management of EU–Asia Trade and Investment Relations* (Routledge 2019).

<sup>7</sup> Mo Zhang, ‘Change of Regulatory Scheme: China’s New Foreign Investment Law and Reshaped Legal Land’ [2020] *UCLA Pacific Basin Law Journal* 179.

<sup>8</sup> Article 4 of the Law.

<sup>9</sup> This statement has been described as an evolution of the opening of the Chinese market to foreign investors started with the reforms of 1978 and, in particular, with article 18 of the Constitution approved in 1982, which sets forth simply that the state allows foreign investors to invest in China.

<sup>10</sup> The latest version of the negative list is Order No. 32 of the National Development and Reform Commission of the People’s Republic of China and the Ministry of Commerce of the People’s Republic of China of June 23, 2020.

<sup>11</sup> The state council is the government body immediately below the president and above the ministries.

<sup>12</sup> Art. 5 of the Law.

<sup>13</sup> Art. 15 §1 of the Law.

the contrary, foreign investment is encouraged through state aid on funding, land supply,<sup>14</sup> taxes, fees reductions, exemptions, and business licenses.<sup>15</sup> The Law establishes that foreign invested companies are subject to the same mandatory standards of nationals,<sup>16</sup> and that the process for license applications is the same for national and foreign invested companies.<sup>17</sup> Foreigners may also participate to the public comment of draft laws or regulations,<sup>18</sup> also through chambers of commerce and associations, symposiums, meetings, or hearings.<sup>19</sup> Two other reassuring statements of the Law are that foreign invested companies may not be subject to expropriation, except for reasons of public interest and subject to market-value indemnity,<sup>20</sup> and they enjoy free movement in and out of the People's Republic of their contributions, profits, capital gains, assets proceeds, and royalties.<sup>21</sup> Public officials that contravene rules and discriminate foreign investors are subject to punishment under criminal law rules.<sup>22</sup> Most of the said provisions simply reaffirm the content of pre-existing laws, although in a more bold and comprehensive fashion. A more innovative principle is that foreign invested companies are subject to the standard rules of company law, without derogations:<sup>23</sup> this is probably the most visible change for foreign investors, that by the end of 2024 must amend the articles of their Chinese subsidiaries and joint ventures to align them with standard company law. This should enable more freedom to adapt the articles of companies to the needs and intentions of their shareholders, among other things on profits distribution.

To confront the most acrimonious cause of mistrust against China, the Law sets out that the intellectual property rights of foreign investors are protected. In theory, they were protected also earlier. The difference is that now infringers are liable to heavier penalties than in the past and through more expedite disputes resolution.<sup>24</sup> The protection of intellectual property applies explicitly also to public administrations, who are the main agents accused of extorting technologies, by forcing foreign companies to disclose technical data in exchange for unrelated business licenses, or other necessary

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<sup>14</sup> All land belongs to the State. Privates may obtain long-term, transferable concessions to build on it and use it: a rule that is often pointed at to affirm that China is still communist in its roots, notwithstanding its market economy.

<sup>15</sup> Art. 12, 19, 20 of the Law. Art. 6 of the Regulation.

<sup>16</sup> Art. 14 of the Regulation.

<sup>17</sup> Art. 35 of the Regulation.

<sup>18</sup> Art. 10 of the Law.

<sup>19</sup> Art. 7 of the Regulation. The public consultation is a rather efficient system through which the legislative committees in charge of drafting new rules consult important stakeholders, including foreign investors on commercial matters. This process is not just a formality: the Chinese legislative authorities have a genuine interest to learn and consider the comments they receive in their revisions.

<sup>20</sup> Art. 21 of the Law, art. 20 of the Regulation.

<sup>21</sup> Art. 22 of the Law.

<sup>22</sup> Art. 17, 41 of the Law.

<sup>23</sup> Art. 31 of the Law.

<sup>24</sup> Art. 22 of the Law.

regulatory approvals.<sup>25</sup> The Law states that no public administration may force the transfer of technology by administrative means,<sup>26</sup> implicitly recognising that this is what has happened so far.<sup>27</sup> Disclosure of trade secrets must be limited to the extent required for legitimate purposes of law, and the access to it must be limited to officials in charge of their implementation.<sup>28</sup> Whenever the disclosure of intellectual property is necessary for compliance purposes, public administrations and their employees who receive it are obliged to keep it confidential.<sup>29</sup> In all cases, public officials that breach their duties are subject to disciplinary action, or punishment established by criminal law.<sup>30</sup>

When it comes to public procurement, the Law guarantees that foreign invested enterprises may participate in governmental bids through fair competition,<sup>31</sup> without obstructions or restrictions.<sup>32</sup> To this purpose, buyers and procurement agencies may not apply discriminatory treatment, or impose ownership structures, brands, or other conditions that would penalize foreign invested enterprises.<sup>33</sup> All products and services

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<sup>25</sup> See Julia Ya Qin, 'Forced Technology Transfer and the USA-China Trade War: Implications for International Economic Law' [2019] *Journal of International Economic Law* 743. This study is an analysis of the IP extortion practices and the possible legal means to counter them. In essence, foreign investors must share confidential information relevant to technology, like production processes, designs, or even source codes with government officials to obtain or maintain market access. See many examples in Jyh-An Lee, 'Forced Technology Transfer in the Case of China' [2020] *B.U. J. SCI. & TECH. L.* 324. This article observes that also the mandatory JVs forced in certain industries by the negative list have been an effective tool to acquire know-how from the West.

<sup>26</sup> Art. 23 of the Law, art. 24 of the Regulation.

<sup>27</sup> See many examples in the articles referenced in footnote 26. Foreign companies who have been subject to extortions of know-how by governmental agencies are reluctant to declare it in public, to avoid retaliations and obstacles to their business in China. However, many real-life cases have been summarised in the the Joint Submission of January 2019 on the draft Foreign Investment Law of the American Chamber of Commerce in China and the U.S. Chamber of Commerce: "[...] In practice, when foreign-invested enterprises apply for High and New-Technology Enterprises (HNTE) designation, some local governments require patents to be registered in China, otherwise the application is not approved. Moreover, although the article bans forced technology transfer through administrative means, our organisations remain concerned about pressure through non-administrative means to force technology transfer, such as informal means by administrative agencies or their staff. [...] there remains the possibility that provisions in other laws, regulations and practices will undermine it, for example: (a) Article 69 of the 3rd Draft of the 4th Amendment to the Patent Law would allow local administrative authorities to seize confidential information including trade secrets, which would in effect be forcibly transferred to competitors[...]. (b) Articles 24, 25 and 29 of the Regulations on Technology Import and Export Administration (TIERs) of the People's Republic of China place restrictions on how technology is imported into China that are not applicable to tech transfer or IP licensing between domestic entities in China. These constitute a form of forced technology transfer. (c) Environmental, pharmaceutical, medical device or other regulations that require disclosure of confidential information including trade secrets which are not necessary to accomplishing the purposes of the regulations, or sharing information obtained in such regulatory review with third parties such as competitors or experts affiliated with competitors. (d) We also understand that there are interpretations of the Supreme Court on Article 329 of the Contract Law as well as other regulatory requirements to register all intellectual property agreements involving foreign parties with the Ministry of Commerce as a precondition for Chinese parties to pay royalty and engineering service fees to foreign parties.

<sup>28</sup> Art. 25 of the Law.

<sup>29</sup> A new patent law was also approved in Oct 2020, effective June 2021, and has increased the protection of patents and the liability of infringers.

<sup>30</sup> See footnote 22.

<sup>31</sup> Art. 16 of the Law.

<sup>32</sup> Art. 15 of the Regulation

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provided within China shall be equally treated.<sup>34</sup> Finally, the Law promises a strengthening of the supervision and investigation of the fairness of procurement processes,<sup>35</sup> and again the punishment of violations.<sup>36</sup>

#### 4 A real change?

Undoubtedly, the Law and the Regulation contain a sequence of broad-range, positive statements: equal treatment, protection of intellectual property, and fairness in public procurement are what the world's investors requests to China. However, according to many observers these rules show a "*general lack of detail and excessively vague language with respect to many key terms and provisions.*"<sup>37</sup> Vagueness gives very broad margins of discretion on their application, which consequently depends on the intentions of the officials who will apply the new rules. As a result, one year after its implementation, the Law has not really impacted the reality of the business for foreigners in China. For example, nothing has changed with regard to the transfer of money out of China, even for commercial transactions and especially in foreign currencies, that in spite of the bold language of art. 22 of the Law, still requires the same cumbersome and narrow process.

Being aware that in China, probably more than anywhere else, practice matters much more than the wording of laws (and contracts), the international community has acknowledged the Law with skepticism and is still waiting for tangible developments. The Chinese establishment, however, is not signaling any urgency. The extent of the application of the Law is now, and will continue to be, a reaction to the atmosphere that they perceive around them. Due to the epidemic and the transition of power in the US, since 2020 not much has happened, other than an increase of hostilities through export control rules, expected to intensify in the future. Consequently, the application of the Law and the Regulation has stalled, and foreign enterprises are rather experiencing an increase of regulatory restrictions, mainly motivated by national security, making their business in China increasingly difficult.<sup>38</sup>

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<sup>34</sup> Art. 16 of the Law.

<sup>35</sup> Art. 17 of the Regulation.

<sup>36</sup> Art. 41 of the Regulation.

<sup>37</sup> Submission of the American Chamber of Commerce in China and the U.S. Chamber of Commerce on the draft Foreign Investment Law Implementing Regulations of December 2019.

<sup>38</sup> Recent examples are the Anti-Foreign Sanctions Law and the Data Security Law, both enacted on June 10, 2021. For an overview of the economic theories behind national security, see Chieh Huang, 'China's Take on National Security and Its Implications for the Evolution of International Economic Law' [2021] Legal Issues of Economic Integration 119.

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## 5 The Chinese establishment

Meanwhile, the one-century anniversary of the Communist Party has affirmed more than ever the strength of the Chinese establishment, the suffocation of any dissent, and the end of the Western myth that economic prosperity will bring democracy.<sup>39</sup> In reality, wealth has become the main tool of the party to strengthen its dictatorial power, because people regard the lack of freedom as the price to be paid for prosperity and stability. In the public messaging surrounding the one-century anniversary, most emphasis is on the millions of people brought out of poverty (omitting that they were brought and kept in poverty for decades by the same regime) and on the number of rich people in nowadays China. The rest is all about the unity and independence of the country, as opposed to the divisions and subordination of the “century of humiliation” ended in 1949.<sup>40</sup> Wealth, unity, and independence from foreigners are the three recognised achievements of the Communist Party and the reasons why Chinese people broadly support it, with only marginal, insulated and promptly eradicated exceptions. From this perspective, the Communist Party has done what imperial dynasties did in past centuries, when they took over from a previous dynasty, each time after years of political decline, invasions, and famines. As in the imperial history, unity and independence were achieved first, and the path to economic prosperity was found later (in the communist era, only after the death of Mao Tze Dong and the fall of the orthodox followers of his ideology). The communist dynasty is steadily in charge, it will stay for long, and it will not make compromises on the foundations of its power: not on Hong Kong, Taiwan, Xinjiang, Tibet, or any other territory that in the past was part of the Chinese empire; not on the blind obedience to the Communist Party’s doctrine, dogmatically dictated in all schools to educate citizens to submission; not on any foreign influence on how the treatment of their citizens, perceived as interference on internal affairs reviving past humiliations. Whenever the regime will feel mistreated on any of those fronts, it will take action against the maltreaters.

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39 See Rana Mitter and Elsbeth Johnson, ‘What the West gets wrong about China’ [2021] Harvard Business Review, available at <[hbr.org/2021/05/what-the-west-gets-wrong-about-china](https://hbr.org/2021/05/what-the-west-gets-wrong-about-china)> (last accessed 31 March 2022). This interesting article quotes an eloquent part of a speech of former U.S. President Bill Clinton in 2000: “By joining the WTO, China is not simply agreeing to import more of our products, it is agreeing to import one of democracy’s most cherished values: economic freedom. When individuals have the power [...] to realize their dreams, they will demand a greater say.”

40 Term used in China to refer to the century following the Opium Wars of 1839-1842 and 1856-1860, during which the largest empire of the world was turned step by step, through unequal treaties, military expeditions and insurrections, into a fragmented and battered territory controlled by brutal invaders, foreign economic exploiters and war lords.

## 6 Possible outcome

With this background, unilateral trade sanctions cannot be expected to push China in any constructive direction. Let alone sanctions to allegedly defend religious minorities or street protests in ex-Western colonies: all complex political situations with substantial economic implications, where the freedoms of speech and religion voiced by Western commentators are only the surfaces of the problems. If the US, the EU and their allies will continue down a path of hostilities, based on allegations that they do not raise towards other powerful regimes (other than Russia and its satellites), the dynasty will feel disrespected and will react aggressively. The Law and the traditional benign diplomatic declarations of China on harmony in international relationship will remain empty words.<sup>41</sup>

To move out from the deadlock, Western countries should rethink the agenda towards China on many areas of confrontation.

China should be accepted for what it is: a nation ruled by an establishment that thanks to decades of mass executions, suffocation of dissent, threatens and massive propaganda enjoys the unconditional support of the large majority of a huge population, which is politically passive and does not want to be saved by the West. After all, Chinese people have suffered and worked hard to get where they are and deserve to be collectively respected.

The forced indoctrination that is currently taking place in reluctant autonomous provinces is the same, although much less bloody, that took place in the past seventy years in the rest of the People's Republic. Either we accept China with the legacy of its communist dictatorship and we do business here, or we do not: it is an hypocrisy to object to the hard regime in Xinjiang and Hong Kong, and to forget the hundreds of thousands of Chinese victims of the campaigns against the right, the great leap forward, the terror of the cultural revolution (celebrated during my youth by our left-winged intellectuals), as well as nowadays repression in Mainland China, while continuing to make billions in the Chinese market.

The possibility to push Western human rights in China was real in the 80s, until the massacre of Tiananmen Square of 1989, which was a turning point in Chinese history. It was let go for greed and ingenuity: for the profitable perspectives of a new, huge market, and the blind belief that, thanks to economic growth, China was anyway on the path to democracy. Western powers made only formal condemnations of the bloodshed of students who wanted political, and not only economic change. But Western companies continued seamlessly to bring massive investments and technologies into China, chasing the multiplied returns that they ultimately have cashed out. Thanks to that, and

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41 Cf. Chieh Huang, 'China's Take on National Security and Its Implications for the Evolution of International Economic Law' [2021] *Legal Issues of Economic Integration* 119.

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to the hard work of Chinese dreaming western living standards, China has grown at record speed, acquiring a much stronger negotiating power and developing sophisticated trade and investment strategies.<sup>42</sup> Now, trying to influence China politics is a useless rhetorical exercise. Unless, perhaps, Western economies were able to make real pressure by completely retreating from China and embargoing it, through a joint action that would be very difficult to coordinate and would severely impact their GDP: something hard to imagine in times of high public debt.

Taiwan should be defended from a military aggression, if necessary also by deploying defense forces in the Pacific, but not by supplies of weapons to its local military, that could ignite a regional war with potential intercontinental impact. Taiwan should be rather persuaded through international diplomacy to open a negotiation for its adhesion to the People's Republic, maybe with a referendum and possibly as autonomous province, allowing the Communist Party to make offers to buy Taiwanese consensus, for instance on taxes, welfare, or committing investments in infrastructures. A peaceful unification would close a deep wound left by the civil war of the past century, without any serious geopolitical unbalance for the West (in particular for the US, whose influence in the South East lies on the ties with Japan, South Korea, Australia and India, not so much with little Taiwan island.)

China is an advanced and developed country. The exceptions of its scarcely populated rural and desertic areas do not change the fact that China has the second economy of the world, aiming at becoming the first. So, the paradox of its protected treatment in the WTO as developing country must end. To achieve this goal, the energies of Western nations in the international community should focus on it. The WTO is the only legitimate venue where the People's Republic can be confronted, respectfully, to level its playing field with other developed economies. Ending the distraction and disturbance of bilateral trade wars or other useless arguments and focusing on a joint effort at the WTO would force China to dialogue, because this is not a topic that they may elude claiming that it is an internal affair. They would have no alternatives than an equal dialogue, with the only possibility to gain a little more time and some graduality.<sup>43</sup>

In the context of a fair WTO negotiation, the unilateral sanctions and tariffs against China of the past few years should be unilaterally revoked, to de-escalate tensions and

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<sup>42</sup> See Julien Chaisse, *China's International Investment Strategy: Bilateral, Regional, and Global Law and Policy* (OUP 2019).

<sup>43</sup> See Bernard Hoekman and Robert Wolfe, 'Reforming the World Trade Organisation: Practitioner Perspectives from China, the EU, and the US' [2021] *China & World Economy* 1. See also Ronald Eberhard Tundang, 'US-China Trade War An Impetus for New Norms on Technology Transfer' [2020] *Journal of World Trade* 943; Vivienne Bath, 'China's Role in the Development of International Investment Law -From Bystander to Participant' [2020] *Asian J. WTO & Int'l Health L & Pol'y* 359.

prompt the same step by the Chinese government on countering measures, setting a suitable climate for negotiations.<sup>44</sup>

If one day China will accept the undeniable status of developed country, the unbalanced situation of its trade barriers can be resolved by the WTO agreements, with no need to amend them. At the same time, one must consider that China's production costs are continuing to increase thanks to the improvement of social conditions, and that Western industries have learned hard lessons from major global trade disruptions caused by epidemics, natural disasters and accidents: these facts should slowly revert the wild industrial delocalisation towards faraway cheap labor.<sup>45</sup> Pursuing these goals should slowly adjust the trade balance with China and relax today's tensions. At that point, the encouraging words of the Law may have a serious chance to evolve into the daily business practice of an open, competitive, and regulated market: undoubtedly and unfortunately, under a repressive political regime, but contained within the borders of a largely supportive and actually proud nation. Otherwise, we will have other unpromising Chinese anniversaries.

Shanghai, September 2021

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<sup>44</sup> See Henry Gao, 'WTO Reform and China: Defining or Defiling the Multilateral Trading System?' [2021] *Harvard International Law Journal Special Issue 1*. For a different perspective, see Angela Huyue Zhang, 'The U.S.-China Trade Negotiation: A Contract Theory Perspective' [2020] *Georgetown Journal of International Law* 809. This Article illustrates the circumstances when a trade agreement is difficult to write, unlikely to succeed and impossible to enforce. As an alternative to a trade agreement, this article advocates for a stronger economic integration as a commitment device. By allowing each country to hold the other's assets, economic integration can push cooperation between nations when trust is lacking.

<sup>45</sup> With the side effect of reducing the massive pollution caused by global trade transportation.