

The following three articles comprise a sequenced compilation written by Paul Edelberg on China's measures to open access to the China market to foreign investment from 2012 through 2019. Attorney Edelberg is a partner at Fox Rothschild LLP and is currently chair of the Asia Pacific Division of the Section of International Law of the American Bar Association. This compilation was submitted as part of the materials in support of his participation on a panel, "One Belt, One Road: The Next Front Line for the US," presented at the 2020 Annual Meeting of the Section of International Law.



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Is China Really Opening Its Doors to Foreign Investment?

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By Paul Edelberg

On January 17, 2017, the State Council issued a circular on a new foreign direct investment policy to open up China's economic system. At first glance, it would appear that this policy is a reaction to the slowdown in China's economy. However, in actuality, this recent initiative is connected to a longer-term effort, formulated in 2012, which aims to gradually open up Chinese markets to foreign direct investment (FDI) and to more closely conform with international standards. Understanding the historical background of this policy is important, as it can shed light on the Chinese Government's long-term objectives and the potential ramifications of the recent legislation.

This article will discuss the evolution of China's opening-up policies, paying close attention to regulations regarding partial or full foreign ownership of Chinese enterprises. The issue is topical, as China has recently been involved with intense negotiations between both the U.S. and the European Union (EU). On the one hand, the U.S. and the EU have pushed for increased access to China's markets, which would simultaneously increase investment opportunities for the involved parties. Conversely, China has attempted to minimize foreign presence within key industry sectors, until it is deemed that its domestic companies have become efficient enough to compete with outside forces. Although the World Trade Organization requires China to allow foreigners some access to its markets, this opening has been at a pace too gradual to satisfy the U.S. and EU. Importantly, the country has strictly regulated foreign investment, permitting only some FDI through Chinese entities with partial or full foreign ownership, commonly known as foreign-invested enterprises ("FIEs"). This article will review the historical regulation of FIEs and the recent dramatic changes in this regulatory scheme.

A. Background

At the core of the Central Government's regulation of foreign ownership of Chinese entities, otherwise known as foreign direct investment ("FDI"), is the Foreign Investment Industries Guidance Catalogue (The "FDI Catalogue") promulgated by the National Development and Reform Commission ("NDRC") and The Ministry of Commerce ("MOC"). The FDI Catalogue sets forth three explicit categories; encouraged industries, restricted industries and prohibited industries to foreign investment.

Those industries that are encouraged are accompanied by special incentives for foreign investment. Often, these industries receive preferential treatment or economic benefits. Some have restrictions on the percentage of foreign ownership or other qualifications. Those industries that are restricted have limitations such as percentage ownership, qualifications of the foreign investor, majority Chinese ownership, etc. Restricted industries typically require special approval from MOC upon demonstration that

the restrictive conditions have been satisfied. Approval for FDI in a restricted industry has taken much longer than the six-month time period for permitted industry investments. Those industries that are prohibited do not permit any foreign investment. These industries are considered to be deeply linked to China's national security, infrastructure, or economic well-being.

A fourth unmentioned category is permitted foreign investments. Industries that fall under this category historically have required MOC approval, although the process is more perfunctory and less substantive. Generally, the approval process for FDI within the permitted category takes approximately three to six months, and it involves not only applications to MOC, but also to a myriad of other governmental agencies, including the State Administration of Industry and Commerce ("SAIC").

Industries in the permitted category

Inbound FDI into China must also abide by the "Three Basic Laws", or the three regulations that govern foreign ownership entry into China: the Law on Wholly Foreign-Owned Enterprises (The "WFOE Law"), the Law on Sino-Foreign Equity Joint Ventures (the "EJV Law"), and the Law on Sino-Foreign Cooperative Joint Ventures (the "CJV Law"). The WFOE Law has governed the formation of wholly foreign-owned enterprises ("WFOEs"), which are entities that are 100% foreign-owned. The EJV Law governs the formation and structure of equity joint ventures ("EJVs"), which are legal entities that have partial foreign ownership and partial Chinese ownership. The CJV Law governs the structure of a contractual joint venture, while is a more contractual relationship, akin to contractual joint ventures in the West. Under the "Three Basic Laws" there were minimum requirements on capital, the timing of capital contributions, cash contributions for foreign contributions, capital contribution verification reporting requirements and restrictions on the repatriation of capital. Combined, these factors meant that forming an entity under the Three Basic Laws was both cumbersome and time consuming. This article will later discuss how the recent State Council legislation has transformed this process.

Other formation requirements included name approval, business license approval with the SAIC, organization codes certification, registrations with provincial and local tax bureaus, bank registration, social welfare bureau registration and other registration filing requirements with various governmental agencies. In addition, FIEs have had to comply with additional provincial and local FDI policies.

This cumbersome process is in contradiction to the ease of entity formation in many Western countries. It has served as a market entry barrier to foreign investment in China and has created disadvantages for FIEs in China that compete with domestic Chinese entities.

B. The Twelfth Five Year Plan

The Chinese Government has a long-term economic planning process, which includes outlining five-year plans adopted by the National People's Congress. In furtherance of the Twelfth Five Year Plan (2011), the NDRC thereafter adopted the Twelfth Five Year Plan on Foreign Capital Utilization (the "12th Foreign Capital Five Year Plan") in 2012, which revolved around modernizing China's market economic system. Its stated goals were to make the markets fair, open, and transparent, to implement a unified market entry

system, to provide national treatment for both foreign and domestic companies, to create a Negative List concept (discussed below), to create special economic free trade zones and to eliminate protectionism and favoritism for domestic companies. The 12th Foreign Capital Five Year Plan also emphasized a focus on emerging industries, such as energy, environmental, information technology, biotech, advanced equipment manufacturing new materials, new energy vehicles, healthcare and service sector industries. Resource-intensive and environmentally damaging industries were deemphasized and financial reform and opening up to foreign investment were promoted under this plan.

This blueprint was the foundation for many of the market entry reforms that were to occur over the next several years.

C. Free Trade Zones

China (Shanghai) Free Trade Pilot Zone

In October of 2013, the Central Government introduced the China (Shanghai) Free Trade Pilot Zone, commonly known as the Shanghai Free Trade Zone ("SFTZ"). The SFTZ is a designated area within Shanghai located near logistic sites. For businesses formed within the SFTZ, certain restrictions and prohibitions under the FDI Catalogue are lifted or eased, and market access is more readily made available. Therefore, companies that form in the SFTZ can conduct business within the SFTZ, or in some cases within all of Shanghai, that they would otherwise not be able to conduct on a national basis. The SFTZ also created the concept of a "Negative List," which is a list of industries that are exempted from the market entry easing of the SFTZ. For those items on the Negative List, the old process of approval is still in place.

The SFTZ was designed as a pilot project and a model for future free trade zones in other parts of the country and for eventual national implementation. As discussed later, other similarly modeled free trade zones have been created. The discussion on the SFTZ that follows applies in substantial part to the other free trade zones as well.

The components of the SFTZ include (i) a lifting or lessening of market entry restrictions and prohibitions by industry sector, (2) the streamlining of procedures for forming FIEs, (3) financial reform, and (4) special customs procedures to ease the movement of goods to and from the Zone. The financial reforms are some of the most innovative and ambitious under the SFTZ, and include the following:

- Capital convertibility, in which capital accounts are freely convertible and in which the conversion of capital to foreign currencies will not be subject to foreign exchange controls;
- Cross border settlements in RMB, allowing some level of settlement within certain cross-border trades to be made in RMB; and
- Interest rate liberalization, in which both loan rates and deposit rates are permitted to be determined by market conditions.

The SFTZ Negative List lifts or eases a number of restrictions and prohibitions applicable to FIEs on a national basis. For example, the SFTZ permits wholly foreign-owned enterprises (WFOEs) for ship management companies, luxury cruise vessel manufacturing, aircraft and aeronautics equipment design and manufacturing, auto electronics manufacturing, value-added telecommunications services, foreign-owned entertainment facilities, medical institutions, and paper manufacturing. These are departures from the FDI Catalogue. The SFTZ also permits majority JV ownership for human resource agencies, construction companies, entertainment artist industries and non-Chinese maritime transport companies. In some of these instances, the easing or lifting was accompanied by certain qualification requirements or minimum capital requirements. Foreign law firms are allowed to form contractual joint ventures with Chinese law firms within the SFTZ. Minority ownership is allowed in certain direct selling businesses and basic telecommunication businesses if specified qualifications are met. Therefore, a foreign company wanting to engage in one of these businesses in China could do so under the SFTZ rules in Shanghai, although not permissible outside of the Zone.

The SFTZ provides for an expedited formation process for FIEs in those industries that are not encompassed within the Negative List. For non-Negative List FIEs, a streamlined application process was established providing for one-stop shopping to the Shanghai Administrative Committee formed within the SFTZ (the "Administrative Committee"), which Administrative Committee will then coordinate with the various agencies typically involved in the approval process. Shareholders in a SFTZ FIE can agree on their respective capital contributions and the mode and time limit of payment and these shareholders have responsibility only for their pledged capital contributions and not for their JV partners' contributions. Most importantly, the approval process is replaced with a filing registration process, which is the same for both domestic and foreign investors. Only basic information is required. This is a major deviation from the approval requirements applicable nationally. The annual inspection requirement is replaced by an annual reporting requirement, which is subject to public inspection. Under the SFTZ policies, enforcement actions against an FIE will be published on an integrity, or credit information, system.

With companies on the Negative List, the old approval processes still apply. It should be noted that foreign-invested mergers and acquisitions are outside the scope of the Negative List approach and are subject to the standard lengthy MOC approval process.

The Shanghai Free Trade Zone also offers expedited customs procedures. Finally, the SFTZ introduces the concept of national security review as a much larger component of the formation process for foreign invested entities.

As a mechanism for attracting foreign investment, the SFTZ reportedly has had limited success. While the vast majority of enterprises formed in the SFTZ are domestic enterprises taking advantage of certain aspects of the Zone, there have also been notable foreign entries such as Apple's Apply Pay mobile payment service and Amazon.com's e-commerce operating center to sell imported products into Shanghai. Financial leasing companies such as Volvo Financial Leasing have also set up operations in the SFTZ. The favorable customs procedures have been implemented. But many of the financial reforms have either been slow in implementation or not effective, impeding the financial funds management of FIEs in the SFTZ.

Tianjin, Fuzhou and Guangzhou Free Trade Zones

In 2015 the Central Government introduced three new free trade zones in Tianjin, Fuzhou and Guangzhou. These free trade zones are structurally similar to SFTZ, and they emphasize industries that the Government wants to promote in those particular regions. The announcement of these free trade zones was coupled with a reduction in the Negative List to eighty-five restricted industries and thirty-seven prohibited industries, changes that also applied to the SFTZ. Despite this reduction, there was no significant opening of industries.

Other Free Trade Zones

Also in 2015, the government announced the Beijing Pilot Program, which was designed to open access to the science and technology, internet information, culture and education, financial services, commerce and tourism, and healthcare industries. However, no regulations have been issued as of yet. The government also announced plans to organize seven new free trade zones, although there has similarly been no progress made on this initiative as of now.

National Security Review Within the Free Trade Zones

On April 8, 2015 the General Office of the State Council released the Measures for the National Security Review of Foreign Investment in Pilot Free Trade Zones. These Measures outline the national security review process for foreign investment within established free trade zones. The procedures are integrated with the process for national security review established in 2011 for transactions resulting in foreign controlling interests (the "National Security Review Rules"). The Measures cover transactions that affect or might affect national security or national security capabilities or that involve sensitive investment subjects, sensitive targets of acquisition, sensitive industries, sensitive technologies, and sensitive regions. This broad scope extends beyond traditional national security industries and includes transactions involving important agricultural products, energy sources and resources, basic facilities, transport services, culture, information technology products and service, key technologies, and major equipment manufacturing.

Modeled after the U.S.'s CFIUS structure, the National Security Review Rules established a Joint Conference headed by NDRC and MOC. If the Administrative Committee in a free trade zone determines that a transaction or investment submitted for approval in the free trade zone might be subject to national security review, or if the foreign investors have submitted the transaction or investment for national security review, then the Administrative Committee will suspend the free trade zone application process until the national security review is completed.

The Measures encompass investments in new enterprises or projects, foreign mergers and acquisitions and contractual and other indirect transactions resulting in foreign controlling interests.

D. Company Law and Registration Amendments

While the free trade zones provide for market access on a localized level, the Chinese Government has also addressed market access easing on a national level. Specifically, the Company Law Amendments (2013) promoted the government's "lenient entry, strict supervision" policy, as it was known, and consisted of several major changes.

The first major change was the elimination of minimum capital requirements. Previously, the law required statutory minimum amounts of registered capital and a 20% minimum capital contribution for each investor, as well as a requirement that at least 30% of registered capital be in the form of cash.

A second change was the elimination of deadlines for capital contributions. Prior to this measure, initial capital contribution requirements outlined that payments had to be made within thirty days and total contributions had to be collected within two years. Now, rather than Government enforcement of this requirement, the various investors of the FIE became empowered to enforce their own subscription requirements in accordance with their governing documents.

Capital registration procedures were also simplified. The Amendments eliminated the capital verification report that verified to the Government when capital is contributed, among other things.

E. FDI Catalogue

The Negative List concept that was introduced into the Free Trade Zones was effectively a replication of the FDI Catalogue but with revisions lessening or lifting certain restrictions. For FIEs that were outside of the Free Trade Zones, the FDI Catalogue continued to govern. In 2015, NDRC and MOC released a revised version of the FDI Catalogue, cutting the number of restricted industry sectors in half from the 2011 version of the FDI Catalogue, from 79 to 38. The 2015 revision further expands the list of industries in which WFOEs are now permitted or in which Chinese majority ownership is required. Some of these changes were based on the Government's experience with the Negative List within the free trade zones.

On the one hand, the FDI Catalogue has been used to encourage foreign investment in growth industries within China or in industries where foreign expertise is sought. However, the Catalogue also outlines a number of restrictions and prohibitions which limit foreign investment in areas with gross overcapacity or environmental concerns or in industries that are tied to national security or national infrastructure considerations. Thus, the FDI Catalogue is a primary instrument that the Chinese government uses to direct industrial expansion and to shape economic growth.

The 2015 FDI Catalogue eliminated the restrictions on the following industries, thereby permitting FIE investment:

- Non-value-added E-commerce for technology, media and telecommunications;
- Certain types of chemical manufacturing;
- Pharmaceutical manufacturing;

- Certain types of transportation equipment manufacturing;
- Railway freight transportation companies;
- Direct, mail order and online selling companies; and
- Distributing and selling of audiovisual products.

It also loosened or eliminated the requirement for joint ventures for certain e-commerce platforms, for the construction and operation of branch and intercity railway lines and related infrastructure projects, and for the operation of entertainment performance sites. Service sector restrictions were similarly reduced. For example, WFOE ownership of e-commerce platforms is now allowed, in keeping with the allowance of e-commerce platforms in the SFTZ. Finally, the restrictions were removed on the manufacturing of certain medical and pharmaceutical products.

On the other hand, the 2015 FDI Catalogue re-imposed restrictions on FIE ownership of medical institutions, which can no longer be wholly owned and must be owned as equity joint ventures or contractual joint ventures. WFOE ownership of medical institutions is still permitted in the free trade zones, however. In addition, secondary educational institutions must be owned by EJV or CJV in which the Chinese investors own at least 50% of the equity.

In December of 2016, NDRC and MOC published for comment a revised draft of the FDI Catalogue, probably in anticipation of finalizing the pending negotiations on the U.S.-China Bilateral Investment Treaty with the Obama Administration. This draft reduced the number of prohibited and restricted categories from 93 to 62, and it relaxed and in some cases lifted restrictions on foreign investment in the service, manufacturing and mining industries, including:

- railway transportation equipment manufacturing;
- new energy vehicle equipment manufacturing;
- motorcycle manufacturing;
- precious metal mining and exploration;
- lithium exploration;
- exploration of oil sands, oil shale and shale gas;
- edible oil processing;
- credit investigation and rating services.

This draft is still pending.

F. Foreign Investment Law

On January 19, 2015, MOC released The Draft Foreign Investment Law (the "Draft Law"), which aimed to overhaul the existing FIE investment structure and incorporates many of the innovations implemented in the Free Trade Zones. Specifically, the Draft Law included the following features:

- "National treatment" for most FIEs, providing for the same registration process as for domestic enterprises. Most FIEs no longer need to register with MOC, and just need to register with SAIC;
- The repeal of the Three Basic Laws;
- The law would encompass most foreign interests, including domestic enterprises controlled by foreign interests and greenfield investments.

The Draft Law also incorporates the Negative List concept. Companies wishing to invest in industries on the Negative List would still be required to apply through MOC under the existing procedures and would not be granted national treatment. FIEs within the scope of the Negative List would be required to obtain an entry permit for restricted investments through a newly established MOC process. However, the entry permit process would incorporate certain innovations applicable to non-Negative List FIEs. Once a proposed FIE established compliance with restrictions for that particular industry, MOC would no longer approve the formation documents, but would simply record the registration, consistent with the Company Law Amendments.

The Draft Law incorporates existing merger and acquisition and antitrust and national security review processes. The national security review process, which would gain increased attention, has many of the same features as the CFIUS process in the U.S.

The Draft Law introduces a substantial reporting and inspection process, with requirements for reporting within thirty days after the foreign investment is made, annually and at the time of any change in application terms. The reports would require extensive disclosure of the business operations and finances, although proprietary information would not be disclosed. These reports would be open for public inspection.

The Draft Law also heightens the supervisory role of the applicable government authorities, including mechanisms for lodging complaints, resolutions and disputes, whistleblower features, "integrity" and wrongdoing public listings and penalties for violations and improper behavior.

It was anticipated that the Draft Law would be acted upon fairly soon after its January 2015 announcement. However, with the lapse in time and some of the other innovations discussed below since the announcement of the Draft Law, it is not clear what the current status of the Draft Law is or whether any eventual new foreign investment law will retain all of the features of this Draft Law.

G. Recent Developments

On October 8, 2016, the NDRC and MOC jointly issued Circular No. 22, which states that the national Negative List shall be determined by reference to the FDI Catalogue. In other words, no new pronouncement in the form of a Negative List would be published, but rather the FDI Catalogue and the Negative List would be synonymous. Circular No. 22 further stated that FIEs that are in the encouraged list and are not subject to shareholder or management requirements, and FIEs within the permitted scope no longer need to file for approval, consistent with the Company Amendments. The examination and approval procedures will be replaced by a recordal system, whereby a mere filing with MOC would be required. This process would also apply to corporate changes, such as capital increases, change in business scope, share transfers, and change of legal address. These changes were also reflected in MOC's pronouncement on October 8, 2016 of the *Provisional Measures on Management of the Establishment and Changes of Foreign Invested Enterprises*. Furthermore, the Three Basic Laws were amended to incorporate the recordal process, rather than the approval process. (Note that the Draft Foreign Investment Law called for the repeal of the Three Basic Laws.)

Under the recordal process, the registration with MOC can occur online. Within three days after recording, MOC will issue a recordal certificate. That certificate is not required for obtaining the business license with SAIC and can be recorded within 30 days after registration.

In December of 2016 the Chinese Government announced revisions to the FDI Catalogue that would further encourage FDI, as discussed above. In conjunction with that pronouncement, on January 17, 2017 the State Council issued a circular for a "new open economic system." The new State Council measures will lower restrictions on foreign investment in banking, securities, investment management, insurance and accounting sectors. While implementation of the State Council circular has yet to be finalized, these measures are aimed to send a message to the rest of the world that China seeks to take the lead in fighting protectionism and in promoting globalization. It is instructive to note that the State Council announcement preceded the inauguration of the Trump Administration by a few days.

The new measures to the FDI Catalogue and the State Council circular, when taken together, relax the restrictions on foreign access to bank financial institutions, securities companies, fund management companies and insurance institutions. Rules regarding access to oil shale production, oil sands production, and shale gas production were similarly lessened. The measures also remove access restrictions for equipment manufacturing, rail transportation, motorcycle manufacturing, and fuel ethanol production and oil production. Finally, it liberalizes the restrictions on foreign access to the accounting and auditing service sector, the building design service sector and the rating agency service sector were liberalized under these new measures. The new policy additionally:

- allows FIEs to list on the Shanghai and Shenzhen Stock Exchanges as well as a new Third Board, which would be the country's biggest over-the-counter exchange;
- encourages cooperation between domestic manufacturers and manufacturing FIEs to conduct research and development and eases resident and business policies for high-level talent;

- permits the subsidization of industrial land for as low as 70% of national standard leasing costs;
- reaffirms the recordal system;
- eliminates the requirement on registered capital for FIEs and reaffirms national treatment.

It purports to provide the same access for FIEs for government procurement opportunities as now exist for domestic companies.

Finally, it authorizes local governments to introduce policies favorable to FIEs, including tax policies, and to encourage employment, economic development and technology innovation. These local government efforts are particularly encouraged in the central, western and northern regions of China, where economic development is needed.

These measures effectively implement on a national basis many of the innovations in the free trade zones. They aim to spur FDI at a time when China is experiencing a drop in foreign investment and a slowdown of its economy. They also appear to be timed as a counterweight to the new anti-globalization policies of the Trump Administration, as China seeks to fill a perceived void that may be created by a less global U.S. and to benefit from this void.

H. U.S.-China Bilateral Investment Treaty

The U.S. and China have been engaged in negotiations on a bilateral investment treaty since 2008. Significant progress has been made, and in April of 2016 the terms of a potential treaty were nearly complete. While the substance of these negotiations is not within the public domain, it was reported that the final obstacle was the production by the Chinese Government of a Negative List that was acceptable to the U.S. Government. That list had not been forthcoming, although the December 2016 proposed Negative List may well have fulfilled that requirement.

In part based upon the market entry reforms discussed in this article, one can speculate that the U.S. has been seeking a more expedited entry process, with some level of national treatment for U.S. companies doing business in China as well as a more limited Negative List. A treaty most likely would require some level of reciprocity in treatment.

The U.S.-China negotiations parallel negotiations between the European Union and China for their own bilateral investment treaty. It is assumed that the two treaties would be similar if adopted.

Under the Obama Administration, it was anticipated that the treaty would be presented to Congress in 2017. It is less clear whether the Trump Administration will continue the negotiations or whether it will abandon the bilateral investment treaty.

I. Limitations on Foreign Access

In contradistinction to the efforts made by the Chinese Government to enact laws and announce measures to make foreign market entry into China by foreigners more accessible and less cumbersome, the Chinese Government has made foreign entry into certain realms more difficult.

China's Ministry of Industry and Information Technology, in conjunction with the State Administration of Press, Publication, Radio, Film and Television ("SARFT"), issued new rules effective March 10, 2016 setting stiff rules limiting, and to a certain extent prohibiting, online publications by foreign entities. The restrictions cover not only traditional news media, but also texts, pictures, maps, games, animations, audios, and videos. Technical equipment, related servers and storage devices must be housed in China. Content is controlled and subject to Government supervision. Cooperating domestic enterprises must obtain SARFT approval.

The Chinese Government has also shown increased resistance to non-governmental agencies ("NGOs") establishing offices in China. China adopted a law effective January 1, 2017 whereby NGOs must register with the designated governmental authority for its area of interest and with the Ministry of Public Security. Some of the requirements include the following:

- The NGO must have operated substantively for a two-year period;
- The NGO must be subject to civil liability and have sufficient resources to pay for damages;
- The NGO must have a clear mission; and
- The NGO must demonstrate how it benefits Chinese society.

It encourages NGOs in the areas of culture, health, technology, sports, environmental, education and areas of economic benefits to China. A number of NGOs that were already in China were required to relocate outside of China upon enactment of the new law until such time as their NGO registrations are accepted. There are concerns this new law will be used to limit the admittance of legitimate foreign NGOs and to monitor their activities. Clearly the Chinese government has drawn a distinction between opening up its markets for economic growth and allowing nonprofit organizations from impacting policy.

These two examples of tightening Chinese controls on foreign access highlight the Central Government's reluctance to loosen its control over the dissemination of information within China and the influence of foreign nonprofit organizations over Chinese social policies.

J. Conclusion

China's free trade zones, and in particular the SFTZ, have had some success in opening markets to foreign investment on a local level. While foreign companies wish for a less restrictive Negative List in the free trade zones, some have been able to take advantage of these pilot free trade zones. The Chinese Government's introduction of the Company Amendments, of national treatment for FIEs and of the recordal system are clearly improvements and eliminates procedural obstacles to market entry. The Draft

Foreign Investment Law is also evidence of the Government's positive direction towards loosening market access restrictions. The sticking point is the Negative List, which from a foreign perspective is overly broad and restrictive. This is the substantive block to truly open market access by foreign companies on a national basis.

China's market entry reforms have not been *ad hoc*, but rather a thoughtful process of experimentation and gradual adjustment, thereby promoting stability and the growth of its domestic industries. While the Chinese Government will time the introduction of reforms to promote its economic or political agenda, it has clearly signaled that it is willing to open its doors to foreign entry and to achieve some level of reciprocity.

With a long history of foreign domination, China fears foreign economic control. The Government wants to restore China to the global greatness it once possessed and to become a global player and leader. An orderly and negotiated opening to foreign economic interests is in China's interest.

On the other hand, as a WTO member China can be criticized for slowly opening its markets and for protecting its domestic enterprises. Chinese companies have been free to expand globally on a one-way street. The Western countries allow Chinese companies fairly open access to their markets and are simply asking for an even playing field.

Provided China continues its efforts to open up and carries through on the implementation of its new reforms, there is hope for a favorable resolution of this debate. A well-negotiated U.S.-China Bilateral Investment Treaty would go a long way to finding an appropriate balance to these two conflicting perspectives.

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IS THE DOOR INTO CHINA STILL OPEN?

By Paul B. Edelberg¹

This article is a sequel to my article entitled “*Is China Really Opening Its Doors to Foreign Investment?*” that appeared in the January 30, 2018 issue of the China Business Review. That article discussed China’s efforts from 2012 through 2016 to open its markets to foreign direct investment (“FDI”). This article reviews the further actions of the Chinese government in this regard since January of 2017, particularly in light of the trade war with the U.S.

In my original article, I reviewed China’s market-opening initiatives in the following areas: the Foreign Investment Industries Guidance Catalogue (the “FDI Catalogue”), the Pilot Free Trade Zones (the “FTZs”), the Company Law and Registration Amendments, the draft Foreign Investment Law, and the U.S.-China Bilateral Investment Treaty. I also discussed Circular No. 22 issued jointly by the National Development and Reform Commission (“NDRC”) and the Ministry of Commerce (“MOFCOM”), and the Statement of Policy released by the State Council on January 17, 2017, for a “New Open Economic System” (Guo Fa No. 5). The significant developments since that time have been with regard to the FDI Catalogue and the Negative List, as discussed below. The Draft Foreign Investment Law has been dormant, although many of its concepts have been incorporated into existing policies and laws, the most significant being the “national treatment” granted to foreign-invested enterprises (“FIEs”), that are engaged in permitted activities. The U.S.-China Bilateral Investment Treaty no longer appears to be alive under the Trump Administration. China’s Central Government has also created new free trade zones modeled after the existing free trade zones, with a focus on Central China and Northeastern China.²

China’s State Council issues statements of policy for the Central Government to be implemented by the respective governmental agencies. Guo Fa No. 5, released by the State Council on January 17, 2017, called for liberalizing access by FIEs to certain industries listed as restricted in the FDI Catalogue. On August 8, 2017, the State Council released Guo Fa No. 39, which reinforced policies of Guo Fa No. 5, as well as promoted the “Made in China 2025” initiative. Together, these two State Council pronouncements encouraged the following changes:

- Continuing the Central Government’s policy of promoting opening-up measures and national treatment;
- Relaxing restrictions in the service industry, mining industry and manufacturing industry;

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² There are now 11 FTZs located in Shanghai, Tianjin, Chongqing and in the provinces of Fujian, Guangdong, Henan, Hubei, Liaoning, Shanxi, Sichuan and Zhejiang.

- Supporting FDI in innovation-driven industries, including the provision of financial and tax incentives;
- Transforming and upgrading manufacturing industries;
- Attracting high-level overseas talent to China;
- Relaxing restrictions in the banking, financial, securities, and insurance sectors;
- Liberalizing accounting, auditing, architectural design and credit rating services; and
- Supporting infrastructure and environmental projects, including those projects that are part of the One Belt-One Road initiative.

On the other hand, Guo Fa No. 5 proposed that controls on the telecommunications, internet, culture, education and transportation fields should be kept in place.

These Statements of Policy reinforced President Xi Jinping’s “Made in China 2025” initiative, introduced in 2015 to promote advanced technology and services in the manufacturing and service sectors. This initiative encourages FDI and high-end manufacturing, smart manufacturing, green manufacturing and modern logistics.

On June 28, 2017, the NDRC and MOFCOM jointly released the 2017 FDI Catalogue, which for the first time introduced a national Negative List, akin to the Negative List concepts introduced in the Free Trade Zones. The 2017 FDI Catalogue implements many of the same principles set forth in Guo Fa No. 5 and furthers the “Made in China 2025” policies. Then in June of 2018 NDRC and MOFCOM jointly issued three releases. One introduced a revised Negative List (the “2018 Negative List”) reducing the number of measures subject to the list from 63 to 48, effective July 28, 2018. The second introduced a revised Negative List for the FTZs (the “2018 Negative List”) reducing the number of measures subject to the list from 95 to 45, effective July 30, 2018. The third set forth in the *Measures for the Record-Filing of the Incorporation and Changes of Foreign-Invested Enterprises* (the “2018 Special Administrative Filing Measures”) simplified new filing procedures, effective June 30, 2018.

The 2017 FDI Catalogue

The 2017 FDI Catalogue restructured the format to provide for two categories, the encouraged category and the Negative List. The Negative List consists of those industries that previously were considered restricted industries and prohibited industries. The reformatted FDI Catalogue has also been referred to as the “Special Administrative Measures,” referring to the fact that industries in industries listed in the Negative List and those industries in the encouraged category that are subject to restrictions must go through the MOFCOM approval process (and in

some cases NDRC approval), unlike permitted industry investments which were afforded national treatment.

The 2017 FDI Catalogue reduced the number of restricted measures from 93 to 63. It liberalized certain market access restrictions in the manufacturing, mining, and services sector. Certain restrictions in the encouraged category were eliminated by moving the encouraged activity to the permitted category, thereby eliminating those restrictions, but at the same time taking away the incentives formally provided to those activities when in the encouraged category. Certain industries in the restricted category were deleted, thereby making them permitted activities.

The 2018 Special Administrative Measures

As previously stated, NDRC and MOFCOM made significant further changes to the Special Administrative Measures in June of 2018. These revisions were generated in part as a gradual continuation of China's opening-up long-term planning policies discussed above and in my previous article. China would like to attract more foreign investment from Europe in particular to offset American policies, as can be evidenced by the encouragement in the 2018 Negative List of foreign investment in the auto industry, which are highlighted below and which invite German auto manufacturers in particular to have a greater presence in China. While the new measures do not distinguish among countries, it is speculated that U.S. auto manufacturers will meet more resistance when applying for approvals than their European counterparts.

At the same time NDRC and MOFCOM also liberalized the Negative List for all of the FTZs. These changes continued the policy of experimenting on new opening-up measures in selected areas on a controlled basis for eventual national application.

Also as part of this 2018 revision, MOFCOM, which is responsible for overseeing the planning for the FTZs, introduced the 2018 Special Administrative Filing Measures. These measures were modest. One allows for submitting of applications in a "one window, one application" process whereby application information required by MOFCOM can be submitted together with the filing with the Administration of Industry and Commerce. The second simplifies the filing requirements for establishing a FIE or when a non-FIE must convert to FIE status due to a merger or acquisition. These revised procedures do not apply to existing FIEs, which still must apply to MOFCOM and Administration of Industry and Commerce separately.

It should be noted that encouraged industries are no longer part of the Negative List and will be dealt with separately.

Industry Analysis

Here is an abbreviated analysis of the revisions made in the 2017 Catalogue, the 2018 Negative List and the 2018 Pilot Negative List:

- *Mining and Quarrying Activities*: The 2017 Catalogue encouraged foreign investment in unconventional oil and gas. Certain restrictions on the processing of unconventional oil and gas and on smelter of rare metals were removed. Mining and processing of certain precious metals are now permitted. The 2018 Negative List

expands the relaxations by allowing the exploitation and exploration of graphite and special and rare types of coal. It also permits the smelting and separation of certain rare earth ores and tungsten, although exploration of tungsten is still not allowed.

The 2018 Pilot Negative List removes the restrictions on exploration and mining of oil and natural gas. Foreign investment in refining and processing of radioactive mineral products is permitted in a FTZ.

- *Agriculture*. The 2017 Catalogue permitted the processing of soybean oil and other oils. The 2018 Negative List removes the equity requirement on the growing of new varieties of crop seeds except for wheat and corn, which is restricted to minority ownership.

The 2018 Pilot Negative List goes further and permits up to 66 percent foreign ownership for new varieties of crop seeds for wheat and corn.

- *Transportation Manufacturing*: In the 2017 Catalogue certain transportation equipment was removed from the encouraged list, but the shareholding limits were lifted. Civil satellite manufacturing remained encouraged in the 2017 Catalogue, but no longer with any shareholding limits. In 2017 the equity ratio was removed for certain new energy vehicles, the scope of which has been expanded in the 2018 Negative List. The 2017 Catalogue permitted motorcycle manufacturing by an FIE that is wholly owned by foreigners (a “wholly foreign owned enterprise”, or “WFOE”). The 2017 Catalogue required no more than 50 percent foreign ownership for the manufacture of the same kind of vehicle. The 2018 Negative List removes these equity restrictions on commercial vehicle manufacturing, with equity restrictions for passenger vehicles staged to be lifted in 2022. Under the 2018 Negative List, the prohibition against more than two joint ventures for the same kind of vehicle will be lifted in 2022.
- *Transportation Services Industry*: A demand for rail services and the maritime Silk Road initiative have led to the loosening of shareholding limits in the 2017 Catalogue. This includes international marine transportation services, urban subway and light rail and cargo handling. Domestic air transportation companies remain both encouraged and restricted, but a nationality restriction has been added, meaning that one major partner must be Chinese. The 2018 Negative List goes further and lifts a Chinese majority ownership restriction for passenger railway transportation companies and for international shipping agencies and maritime transport companies.
- *Communication and Telecommunications Industries*:

The 2018 Pilot Negative List extends to the other FTZs the ability for FIEs in the Shanghai FTZ to own up to 50 percent of basic value-added telecommunication services other than e-commerce companies. It also lifts certain restrictions on

foreign ownership in storage and forward services, call centers, domestic multi-party communications services and internet access services.

- *Water and Environment*: Water conservation project construction and operation were moved in the 2017 Negative List from encouraged to permitted, since Chinese companies are more competitive in this area.
- *Public Health and Social Work*: Chinese ownership of senior aging facilities is no longer required per the 2017 Catalogue. Senior aging facilities can be owned and operated in a WFOE. Ownership of medical institutions are still subject to restrictions, however.
- *Culture, Sports and Entertainment*: Under the 2017 Catalogue FIEs may own a minority stake in the operation of performance sites (i.e. movie theaters). However, much of the industry is left unchanged, as many activities in this category are still prohibited from foreign ownership of any kind. The 2018 Negative List specifically prohibits foreign ownership of performing artists.

The 2018 Pilot Negative List permits minority foreign ownership of performing artist groups located in an FTZ and majority foreign ownership of performance agency companies in an FTZ.

- *Wholesale and Retail Trade Industries*: Under the 2017 Catalogue, FIEs can now open large-scale agricultural product wholesale markets as a WFOE.
- *Leasing and Commercial Service Industries*: Under the 2017 Catalogue, credit investigation and rating services are now open to WFOE ownership. Accounting and audit is now a permitted activity and no longer requires any Chinese ownership. However, engagement in the legal profession by foreign law firms is still prohibited.

The 2018 Pilot Negative List allows under certain limited circumstances the practice of law by foreign law firms in the FTZs.

- *Financial Services*: Significant openings occurred in the 2018 Negative List in the financial services industry. The limit of 20% ownership of a stake in a commercial

bank by one foreign investor has been lifted, as has been the limit of 25% aggregate foreign ownership of a commercial bank.

Under the 2018 Negative List, securities investment firms, futures firms and insurance companies are no longer limited to a 50% foreign ownership stake, but rather can own up to a 51% stake. The 51% limitation will be removed by 2021.

- *Shipping*: The restrictions on the design, manufacture and repair of ships have been removed in the 2018 Negative List.
- *Aviation*: The 2018 Negative List removes restrictions on the design, manufacture or maintenance of regional aircraft, drones and helicopters of 3 tons or more
- *Infrastructure*: The 2018 Negative List lifts restrictions on electricity grid construction and management and railway lines construction and management.
- *Gas Stations*: The 2018 Negative List now allows WFOE ownership of refined oil retailers by foreign entities that have more than 30 branches and sales of different types and brands of refined oil from multiple suppliers.
- *IT Services*: The 2018 Negative List relaxes restrictions will lift restrictions on the establishment and operation of internet surfer business establishments like internet cafes in 2021, although no specifics as to what restrictions would be lifted were given.
- *Weaponry*: The 2018 Negative List lifts restrictions on the manufacturing of weapons and ammunition, the application of which will be limited to weapons manufacturers in those countries that will permit this type of manufacturing in China.
- *Other 2018 Pilot Negative List Features*: The 2018 Pilot Negative List also lifted certain restrictions on foreign investment in aviation manufacturing, prospecting and exploration of petroleum and natural gas, wholesale selling of tobacco and cigarettes and foreign education institutions.

Conclusion

The Central Government of China has signaled that it wants to continue its stated objective of further liberalizing market access for FIEs. This is a continuation of a carefully planned policy first announced in the 12th Foreign Capital Five Year Plan. However, there is reason to question whether the changes over the last year have been significant and whether the changes promoted in Guo Fa No. 5 and Guo Fa No. 39 will actually come to fruition. The changes in the 2017 FDI Catalogue and the 2018 Negative List, which over a two-year period reduced the restrictive measures for industries on the Negative List from 93 to 48, were modest for the most part, with the exception of the auto manufacturing and financial services measures, which should attract foreign investment. Some of these changes are merely consolidation of existing categories, while

others will not have significant impact or encouragement to foreign companies. Many of the industries under the old FDI Catalogue are still prohibited or restricted. Moreover, not all of the declared policies of the State Council, the NDRC and MOFCOM have been followed on the local level.

The Trump Administration has stated several objectives it seeks to reach a resolution of its trade issues with China. Many of the stated policies enunciated by the State Council reflect a Central Government policy of addressing some of these concerns. However, the “Made in China 2025” and related technology transfer issues will be difficult issues for the two countries to bridge, as the U.S. demands run counter to the State Council enunciated FDI policies.

Moreover, the protectionist reaction of the U.S. Government and the trade war threatened by the Trump Administration have compelled the Chinese Government to slow down any liberalization to better position itself in its negotiations with the U.S. One hopes that the Trump Administration’s protectionist actions are designed to bring the Chinese Government to the negotiating table and to bargain for greater market access to the Chinese market and more reciprocity by the Chinese Government. The remainder of this year should be telling as to whether the U.S.-China negotiations will lead to greater and fairer foreign access to the China market or to a retraction by both sides. This author believes that the two countries will work out their differences to the extent feasible, but in the long run, China will continue its gradual policy of liberalization as its industries develop, and will continue a certain level of protectionism and promotion of its “Made in China 2025” for the foreseeable future.

AN UPDATE: CHINA'S NEW FOREIGN DIRECT INVESTMENT LAW IMPROVES FOREIGN MARKET ACCESS

By Paul B. Edelberg¹

The purpose of the Article is to provide an update to the two articles that I have submitted as materials for the Asia-Pacific Forum in Hong Kong sponsored by the ABA Section of International Law. Those two articles are entitled “Is China Really Opening Its Doors to Foreign Investment?” published in the January 2018 China Business Review and my subsequent article “Is the Door to China Still Open?”

To bring my readers up to date, there has been a significant change in China's foreign direct investment regime in 2019. In March of 2019, the National People's Congress enacted the Foreign Investment Law of the People's Republic of China (the “2019 Foreign Investment Law”). In 2015, the Ministry of Commerce issued a draft of a foreign investment law. While some of the concepts have been carried forward, the 2019 Foreign Investment Law deviates in important respects from the prior draft.

Subsequent to its enactment, the National Development and Reform Commission (“NDRC”) and the Ministry of Commerce (“MOC”) published on June 30, 2019 revised negative lists (“2019 Negative Lists”) and a revised encouraged investment list (“2019 Encouraged List”). These publications were part of a continuing process of periodic revisions to the negative lists (and formerly the Foreign Investment Catalogue) to broaden market access to foreign entities. The 2019 Negative Lists also further the legislative purpose of the 2019 Foreign Investment Law.

A. 2019 FOREIGN INVESTMENT LAW

The 2019 Foreign Investment Law applies to all direct and indirect foreign investment activity in the People's Republic of China (the “PRC”) by foreign entities (called “foreign-invested enterprises” or “FIEs”) and takes effect on January 1, 2020. It covers joint ventures, wholly foreign-owned enterprises (“WFOEs”), equity participations and greenfield investments, thereby expanding the scope of China's regulatory regime on foreign direct investment to investments not formally covered under existing laws. At the same time, the 2019 Foreign Investment Law repeals the old laws governing foreign direct investment and in particular, equity joint ventures, contractual joint ventures and WFOEs (the “Prior FDI Laws”).

Interestingly, the 2019 Foreign Investment Law does not directly address its applicability to variable interest entities (“VIEs”), which is a contractual form of entity created to circumvent the Prior FDI Laws governing foreign direct investment in China. Many major Chinese ventures, particularly in the IT area, such as Alibaba, Baidu and Tencent, are VIEs. These are prominent Chinese enterprises. In the 2015 draft of the foreign investment law, there was specific mention of VIEs, but none is made in the 2019 Foreign Investment Law. The final version of the 2019 Foreign Investment Law states that it will also cover other investments “in any other way stipulated by laws, administrative regulations or provisions of the State Council” (per English translation). Because of the success of many of the Chinese VIEs, the Chinese Government is still grappling

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with how to address the governance of these entities. (Reference to the Chinese Government means the national government of the PRC.)

The most significant aspect of the 2019 Foreign Investment Law is that it provides “National Treatment” to all FIEs that do not come within the scope of the 2019 Negative Lists. “National Treatment” means that the FIEs will be treated as any domestic enterprise would be. This includes the registration process as well as the governing laws. Notably, under the Prior FDI Laws, FIEs had to take the form of an equity joint venture, contractual joint venture or WFOE, and had to follow the governance procedures of those laws to the extent they superseded the Company Law. With their repeal, all FIEs will now be governed solely by the Company Law, which applies to all domestic enterprises. In this author’s view, this is a positive development in that the Company Law provides greater flexibility than, for example, an equity joint venture. An equity joint venture requires proportionate ownership and consent of both equity partners to transfers of interest, and is subject to minimum capital requirements. Notably the highest authority in an equity joint venture is the board of directors. Under the Company Law, the shareholders are the ultimate authority of the enterprise. Therefore, unanimous consent will not be necessarily required for many actions, and parties will be able to negotiate the terms of the joint venture without the limitations of the equity joint venture law. Existing FIEs will have a five-year grace period to convert their present form of enterprise to one governed by the Company Law. This may require renegotiation of terms of the existing joint venture agreement.

With National Treatment, an FIE must comply with the same local laws governing domestic enterprises, including employment laws, social insurance requirements and trade union laws. The 2019 Foreign Investment Law contains certain protections for FIEs, including a directive that local governments not take action that would be biased against FIEs, equal treatment on participation in government procurement, enhanced IP protection, mandate for no governmental disclosure of trade secrets, and no forced technology transfers. Parties will be free to negotiate terms of any technology transferred on their own. FIEs may conduct public securities offerings and will be assured free transferability of capital contributions, profits and other revenue. FIEs will be permitted to join chambers of commerce and trade associations within China. A complaint mechanism and procedure will be established for FIEs. The 2019 Foreign Investment Law authorizes special economic zones and the establishment of preferential treatment for specific industries to encourage foreign investment in provinces and municipalities.

The government will maintain certain oversight over FIEs entitled to National Treatment. The law directs the establishment of an FIE-information reporting system and a public FIE credit information system. It directs the establishment of a national security review mechanism. It provides for administrative enforcement and penalties for violations of the new law. And finally, it authorizes reciprocal retributive measures if a country takes any disciplinary, prohibitive or restrictive measures against the PRC.

B. 2019 NEGATIVE AND ENCOURAGED LISTS

As stated above, National Treatment is afforded only to those enterprises whose investments are not covered under the 2019 Negative Lists. The 2019 Negative Lists are effective on July 30, 2019. Two negative lists were published. The first negative list applies nationally to all investments (the “2019 National Negative List”). The second encompasses investments within

and subject to the Pilot Free Trade Zones (“FTZs”) established in different locales within China as discussed in my prior publications (the “2019 FTZ Negative List”). The negative lists for the FTZs are more permissive than the national negative list and have been developed to experiment on a pilot basis to authorize certain foreign investments designed to promote China’s development in fields needing foreign investment. Over the years some of these pilot authorizations have later been implemented on a national basis through incorporation into the national negative list.

These 2019 Negative Lists replace the predecessors issued in 2017 and 2018.

The following is a brief description of the revisions in the 2019 Negative Lists. An exhaustive analysis of all of the revisions to the negative lists is beyond the scope of this article.

1. 2019 National Negative List

The 2019 National Negative List reduces the number of categories from 48 to 40, and adopts certain items previously in the FTZ negative list. It expands the level of foreign investment in certain respects in the areas of transportation, infrastructure, culture, mining and agriculture. It drops restrictions on foreign investments in enterprises such as call centers, certain other value-added telecommunication companies and exploration and development of natural gas and oil, tungsten, fluorite, antimony and molybdenum. It increases the number of industries in which Chinese control is no longer required, such as domestic shipping companies and agencies, performance management agencies, and construction and operation of movie theaters. Finally, it shortens the phase-in period on authorization of foreign ownership in certain industries stated in the prior negative list by specified dates. This includes most automotive manufacturing companies and securities, futures and life insurance companies and agencies.

2. 2019 FTZ Negative List

Categories on the 2019 FTZ Negative List are reduced from 45 to 37. Briefly, minority ownership is allowed in cultural and artistic performance groups. Restrictions on foreign ownership in the fishing industry, in the printing industry, in smelting and processing of radioactive material and in nuclear fuel production have been lifted.

Since the FTZ negative lists are designed to be more permissive and have been introduced as a pilot for eventual national application, the 2019 FTZ Negative List is a precursor for future broadening of the national negative list.

3. 2019 Encouraged List

The 2019 Encouraged List covers industries in which the Chinese Government wants to encourage foreign investment. These investments are subject to special administrative procedures and are given incentives for investment, such as preferential tax treatment, below-market land acquisition pricing and other preferential treatment. Some of the investments are limited to central and western China, areas in which the Chinese Government is trying specially to encourage technological development. The 2019 Encouraged List added 121 additional areas in which foreign investment is encouraged.

Some of the new items on the list include 5G core competencies, etching machinery for integrated circuits, cloud computing equipment, industrial robots, new energy vehicles, smart and autonomous autos, and cell therapy medicine. Within the service sector, engineering consultancy, accounting, operation of special railway lines and artificial intelligence are included. These investments clearly are focused on technological developments.

For U.S. companies interested in investing in industries on the Encouraged List, caution must be given to the recently enacted Export Reform Act of 2018, a U.S. federal law that imposes prohibitions and/or restrictions on exports of certain technology constituting “emerging and foundational technologies”. Those technologies are in the process of being defined by the Department of Commerce through its regulations, which should be forthcoming soon. FIEs must be careful not to export these technologies to China simply because they are on the Encouraged List without first complying with the Export Reform Act of 2018.

C. CONCLUSION

The 2019 Foreign Investment Law signals on paper a major step by the Chinese Government to facilitate investment in that country by FIEs. It removes certain roadblocks and obstacles that have made entry into the Chinese market cumbersome. It also eliminates some of the disadvantages faced by FIEs, such as equal treatment in government procurement. We can speculate that the timing of this new law was generated in part by China’s negotiations with the Trump Administration, although many of its concepts were contained in the 2015 draft law and are consistent with China’s most recent five-year plans. It will be seen how quickly and consistently this new law will be implemented, particularly on the provincial and local levels.

Regardless of its administrative implementation, FIEs should act now to review their governing documents and to enter into negotiations with their joint venture partners to restructure their agreements to conform to the Company Law.

The above is an abbreviated summary of recent developments prepared specifically for the ABA Section of International Law’s Asia-Pacific Forum being held in Hong Kong in October of 2019.