



# Research on Defects and Optimization of Legal Mechanism for Foreign Investments

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## ABSTRACT

The promulgation of the Foreign Investment Law is a new stage and a new starting point for China's foreign investment system. It shows China's determination to actively respond to the reform to the outside world, attract foreign investment, create a sound business environment, and strengthen the protection and management of foreign investment. Compared with the "three laws" on foreign investment, the main points of the Foreign Investment Law are clearer. It has creatively constructed a unified law of foreign investment behavior, established various systems for managing foreign investment, highlighted the state's management, promotion and protection of foreign investment, and enriched and expanded the connotation and denotation of foreign investment. However, the limitations of the Foreign Investment Law are very obvious. In the subsequent legislation, law enforcement and judicial practice, the state needs to strengthen relevant rules, clarify the legal consequences, and put forward the mandatory measures. On the basis of considering the international and domestic environments, details and policies should be reinforced, and the relationship between the various laws and regulations should be linked up.

**Keywords:** *The foreign investment, limitation, system construction.*

## 1. INTRODUCTION

Under the background of the prolonged and repeated outbreaks of the global epidemic and the difficult recovery of the world economy, China's business environment continues to improve and its high-quality development has yielded new results. China will set up 61,000 foreign-invested enterprises in 2021, increasing 23.3 percent year over year. The establishment of a complete foreign investment system is the necessary condition for enhancing market attractiveness. Since the implementation of the Foreign Investment Law in 2020, experts and scholars from all walks of life have widely discussed this law, and a great deal of research has been done on its advantages and disadvantages. Some scholars analyzed the historical background and development trend of the foreign investment Law and its impact on the business environment. [1] Some scholars study the legal supervision system under the VIE framework, [2] or the influence of foreign investment law on overseas investment and bilateral investment. There are also articles focusing on the foreign investment management methods and approaches in a certain region, [3] or starting from the local law, the detailed study of the tax legal issues in the law, investment definition, etc. [4] On

the basis of previous relevant research, this paper studies its core points, analyzes the dilemma of its development, and on this basis, summarizes the ways and methods to improve the Foreign Investment Law. Finally, it takes company law as an example to analyze the connection with other laws and regulations.

## 2. HISTORICAL DEVELOPMENT OF FOREIGN INVESTMENT LAW

Foreign investment law is the manifestation of foreign jurisdiction of host country. Today, capital flow is expanding in the global scope. Foreign investment activities have become an important force to promote China's social and economic development in international investment activities. China's identity and interests have changed a lot.

After 1979, the three laws on foreign investment were gradually promulgated. These laws include how to regulate foreign investment activities in form, structure and production activities. In order to better meet the needs of worldwide trade development, China concentrated on revising the three laws on foreign investment in the early 21st century, eliminating the special requirements for some foreign-invested

enterprises. The Enterprise Income Tax Law, introduced in 2007, have abolished the special tax treatment for domestic and foreign enterprises and unified the income tax rates. In 2013, the implementation of the three laws were suspended, the pre-establishment negative list model will be piloted, and previous items requiring approval will be subject to archival management. In 2014, three new free trade zones were added in Guangzhou, Fuzhou and Tianjin. The successful operation of pilot free trade zones and the accumulation of experience have laid a foundation for the establishment of a complete and unified legislation system for foreign investment, which has been promoted to the whole country. [5]

In 2019, China issued a new Foreign Investment Law. It is the basic law under the framework of China's overseas investment. Meanwhile, its promulgation reflects the main keynote of China's active expansion of opening-up and promotion of foreign investment in China, as well as the concept of propelling high-quality development of national economy, the policy of optimizing business environment and export-oriented economic model. The relevant supporting regulations and judicial interpretations have also provided clear content and specific rules for their implementation and application. They constitute the basic system of foreign capital law in China jointly. [6] In general, the legislative purpose, basic principles and detailed provisions have achieved substantial improvement to a considerable extent compared with the previous. Moreover, they have opened a new chapter in opening up and the reform, and the construction of laws on foreign investment.

### **3. DIFFICULTIES IN THE REFORM AND DEVELOPMENT OF FOREIGN INVESTMENT LAW**

#### ***3.1. Conflicts with the Validity of Laws of Other Departments***

In settling the legal disputes on foreign investment, the Foreign Investment Law and other laws often conflict on the application of special law or general law. Since the Foreign Investment Law and other laws have the same body of legislation, the order of application in case of conflicts also needs to be considered.

For example, conflicts between the negative list and policies of other industries exist. On the cooperation between Chinese and foreign medical institutions, it is stipulated in the negative list that medical institutions should engage in joint venture and cooperation. However, according to the policies issued by some provinces, medical institutions of sole proprietorship have broken the provisions of the negative list. [3] As for the connection between the negative list and other laws and regulations, for example, according to Provisions on the administration of Foreign-invested road Transport

Industry, for the investors, the Chinese side need to hold the shares. Besides, there are also requirements for the operation period. However, there is no relevant stipulation for the operation period in the negative list.

#### ***3.2. Some Concepts Are Vague and the Content Is Not Clear and Specific.***

As the Foreign Investment Law includes only 6 chapters and 24 chapters, the content focuses more on guidance and principle, without giving more precise meaning to the law. Meanwhile, there are many imperfections in the specific details.

The scope of foreign investors stipulated in the new law is still used, but the concept of Chinese investors has not been defined. Before the promulgation of the Foreign Investment Law, the VIE structure used to be explicitly included in the draft. However, the VIE structure or related concepts were not introduced after the new law was promulgated. This involves how to define a foreign-invested enterprise and whether the definition is based on the place of registration or the location of the actual controller. However, Article 18 stipulates that local governments can formulate policies and measures to promote foreign investment within the scope of its authority, which is not a rigorous statement and does not specify a clear scope and range. This exposes local governments to the risk of abuse and creates opportunities for local protectionism. Meanwhile, to some extent, risks to the local and national market order have been brought. On the issue of compensation for expropriation and requisition, the compensation scope, the specific reference standards, and the ways of compensation haven't been put forward. On other issues, the new law fails to establish unified rules for entry, clarify the details of the negative list, and implement the linkage mechanism of administrative examination and approval process. In addition, after the promulgation of the new law, for the enterprises that were established during the period of the three laws for foreign investment, a five-year transition period has been retained. However, there are problems such as the change of the governance structure of the existing joint ventures and the convergence of practical operation, which must be improved in the subsequent judicial interpretation.

#### ***3.3. Absence of Mandatory Punitive Measures***

Although the fifth chapter of the new law stipulates legal liability for violating the law, it is more of making guiding provisions and lacks enforceable and mandatory sanctions, which gives foreign investors a certain amount of space to escape from the law and is not conducive to the stability of market order.

For example, the security review system has certain problems. The subject of review body is unclear and it's not a standing body. Various departments have different

powers and responsibilities and the division of labor is unclear. Meanwhile, it lacks an effective supervisory mechanism. China has not yet made clear rules on how to regulate the conduct of specific review bodies. Besides, the criteria for review are not clear. The foreign Investment Law has no provisions on the review standards, and the provisions on the review standards in the measures for security and examination are also absent, thus failing to coordinate and prevent foreign investment risks. These problems lead to the lack of relief channel for investors' right. The state security review decides that administrative reconsideration and administrative litigation shall not be filed. Moreover, the right of investors to obtain relief cannot be effectively guaranteed.

China's foreign investment information reporting system has the following problems. The relevant provisions in the new law are not complete. Business risks of foreign capital are not included in the report. The relevant provisions of duty are imperfect. Those enterprises that fail to report within the time limit or after making a supplementary report and revising will be ordered to correct within a time limit by the competent departments. If the amount of fine after the event is too low, a deterrent effect on foreign-invested enterprises will not be generated. There are no circumstances for establishing exemption reports. [4] It is not conducive to reducing the burden on small businesses and enhance the sustainable development. The absence of these mandatory penalties results in the situation that the expected legislative effect could not be reached.

### ***3.4. The Negative Impact of COVID-19 on the Foreign Investment Law***

As an ongoing global public crisis, COVID-19 has not only increased the instability of the changing world, but also caused a huge impact on the global trade governance system in terms of international investment. The implementation of the Foreign Investment Law has not achieved the expected effect. Due to the control of the epidemic, transportation, logistics and other industries have been regulated. The transnational commodity trade supply chains have been severely hit, and China's import and export trade have been negatively affected.

Firstly, the COVID-19 pandemic has also prompted the international community to think anew about rules for foreign investment. Under the circumstance of unfriendly international politics and environment, when formulating the relevant laws, countries should not only consider the interests of investors, but also put forward higher requirements for national regulatory capacity. Secondly, the policy restrictions encountered by foreign invested enterprises don't come from the legislation that specifically targets foreign investment much of the time. Meanwhile, they are more likely to be subject to the laws applicable to both domestic and foreign-funded enterprises. After the outbreak of the epidemic, more

countries have encouraged domestic enterprises to shift the production lines and investment back home, thus promoting the reform of entities and procedural rules of foreign investment laws. [7] Finally, on the legal structure, the key problems of the regulations of foreign investment law are becoming more and more prominent. For example, the security review system is emphasized in the law. On the basis of paying more attention to national security, countries have increased the security checks of foreign investment and strengthened the control of capital outflow. Although most countries have introduced many policies that promote investment and development in order to maintain the national stability and the smooth operation of economy, the problem of balancing the interests of investors and the regulation of state rights still needs to be considered. Besides, the transnational investment activities have been hindered to some extent.

## **4. THE CORE POINTS AND IMPROVEMENTS OF THE LEGAL CONSTRUCTION OF FOREIGN INVESTMENT**

At present, the development of foreign-invested enterprises shows a good trend. However, in the foreign investment activities, the lagging of the foreign investment law is gradually being revealed. There are certain contradictions between the foreign investment law and the foreign investment enterprises. This is due to the dual-track system applied to the Foreign Investment Law. The dual-track legislation has certain defects. The reason is that the complicated international situation leads to the application of treaties by various countries from many aspects, and the application of domestic and international laws on investment is not the same. Each country has the right to independently decide how to apply and interpret laws. Too much emphasis on the importance of obligations or the independence of the law will violate the purpose of its implementation. The dual-track legislation is a legislative model for domestic enterprises and foreign enterprises. However, it lacks a certain amount of coordination, which leads to the disorder of the foreign investment legal system. At present, the foreign investment law still has the characteristics of planned economy and has certain contradictions with market economy. The coherence with the Company Law is poor, and the contradictions and problems are prominent. There are the overlap, interlacement and conflict in the contents of foreign investment laws, which generates certain obstacles for foreign investment instead. The purpose of establishing legal proceedings is to make power work within a predetermined framework and ensure justice through procedural operation. Based on these limitations, China's foreign investment legal system should be improved from the following aspects.

#### **4.1. National Review System Under the COVID-19 Pandemic**

China has been encouraging greater market opening. In order to promote reform and opening-up, the Foreign Investment Law stipulates that the state can set up special economic zones according to needs and encourage the technical exchanges and cooperation at home and abroad. Therefore, in the context of COVID-19 pandemic, the security review in the process of foreign investment is an effective means to defuse national safety risks and one of the ways for the state's intervention to ensure economic development. The new Foreign Investment Law has clearly incorporated the national security reviews into the legislation. Although the provisions on the range of application, the system and the applicable procedures are not clear, the effectiveness of the law has been significantly improved and the concept of the overall national security concept has been put into practice.

China needs to establish a security review system for foreign investment that is compatible with the existing legal system and national policies to provide an institutional guarantee for deepening the reform comprehensively and fostering a sound business environment. In view of the late start and slow development of China's foreign investment security review system, compared with some foreign countries, there is still a great gap.

Forming a sound security review system can learn from other countries such as strengthening the supporting legislation foreign investment security review, setting up the relief channels and supervision mechanism of foreign investment security review, and promoting international coordination of foreign investment security review, etc.

First of all, special legislation can be established for foreign investment security review. The principle provisions should be specifically elaborated. The review subject, review standards, review scope, review procedures and the penalties that foreign investors should receive for violating China's foreign investment security review regulations can be listed. In particular, in terms of review standards, Canada's and Australia's experience in this area can be followed. [8] The review standards for greenfield investment, and M&A investment can be set respectively. Corresponding review fees according to the investment target amount can be paid, so as to maintain the normal operation of each security review department.

Secondly, to be specific, the relief channels and supervision mechanism of foreign capital safety review can be added to the existing laws and regulations. For one thing, the role of the courts at all levels should be brought into full play. The hearing procedure of foreign security review should be added, allowing the parties or stakeholders of the foreign investment to initiate the application for hearings. Hearings on non-sensitive and publicizable investment contents can be conducted.

Meanwhile, it will be taken into consideration in the final ruling of the foreign investment security review. Therefore, the investment rights of foreign investors could be protected to the maximum extent. For another thing, the annual review report can be issued to ensure the transparency of foreign investment security review to the greatest extent. The annual report shall be based on the number of cases reviewed annually, the industry and field that the cases are distributed. Moreover, the review items that foreign investors should pay attention to, etc. In this way, the legitimate investment rights and interests of foreign investors can be protected. [9]

#### **4.2. The Model That Fuses the Pre-Establishment National Treatment and the Negative Lists**

Generally, the pre-establishment national treatment is usually combined with the negative list system, which indicates that the pre-establishment national treatment is not absolute and exceptions are allowed. Foreign capital enjoys equal status and rights with domestic capital when entering China's domestic market. However, it does not mean that there are no restrictions on the admission of foreign investment.

In 2013, Shanghai Free Trade Zone took the lead in piloting the negative lists. The negative lists have been revised four times in the past ten years, and are constantly changing with the times. The follow-up of various supporting measures has accelerated the implementation of the negative list system. In the protection and promotion of relevant investment, a series of measures to encourage investment have been put forward, and strict entry and exit conditions have been raised. In the two chapters on investment management and legal liability, the legal consequences of violating the negative list by the foreign investors in different industries and fields have been stipulated.

According to specific National conditions, China can issue a wide variety of targeted, different versions of the list in different areas. Therefore, while establishing the legal system of negative lists management, Ministry of Commerce can still issue a national negative list to specify the areas where foreign investment is absolutely off-limits. [10] Meanwhile, local governments should be given the right to formulate and revise the negative list.

For the different versions of negative lists, two things need to be done. Firstly, specific administrative agencies should be given the legislative authority to enact and issue laws at the legislative level. Secondly, it is necessary to make clear the formulation and promulgation of legal procedures in allowing the specific versions to be added to the negative lists, and make clear the specific review procedures for negative lists. On this basis, judicial review system for negative lists should be established. To be more specific, courts examine the

legality of negative lists, so as to guide the construction of a relatively sound legal environment for foreign investment. [11] For example, through legislation, local governments can be empowered to apply to the negative lists issuing department of the State Council for the verification of the specific negative lists that are in accordance with their own social and economic development and submitted by them. Meanwhile, after the "local negative lists" that are revised by local governments being approved, they can be implemented. Hence, the ability of local governments to attract foreign investment can be strengthened.

### **4.3. Information Reporting System**

The Foreign Investment Law prescribes the foreign investment reporting system in form, requiring all foreign-invested enterprises to report to the competent authorities through registration or publicity systems, no matter which system they are based on. In other words, if necessary, the content and scope of information reporting should be strictly controlled. This is a post reporting system, which is conducive to the supervision and regulation of the supervision departments according to the information provided. This measure is conducive to the normal operation of foreign investment activities. It will also help reduce the burden of some foreign-invested enterprises under the premise of being regulated. However, it is stipulated in Article 34 that departmental information sharing will not need to be submitted again. Besides, there are no clear policies and regulations to define the scope of information sharing and disclosure. There is no classification for that, either. The reporting process and format also need to be discussed. In order to realize the information sharing among departments, the effective combination of operation process and management process of government should be strengthened. Meanwhile, we should draw lessons from other countries' legislation on how sharing mechanisms can be unified effectively and how to share information reports from different enterprise types effectively. The enterprises and administrative departments in charge shall be regulated under a strict standardizing system.

First of all, it is necessary to include the risk issues of the foreign investment management. The operational risk management can help the enterprises to implement self-improvement, so as to raise the level of the whole enterprise. Therefore, the risk management is very important for enterprises. Information supervision departments should be included in the scope of regulation. For example, the business risks of foreign investment can be reported in the initial reports, alteration reports, and annual reports.

Secondly, the responsibility for violating the information reporting system should be clarified. For example, when determining the amounts of fines in a specific range, they should be considered according to the

actual situation. For some enterprises that have delayed the reports, lighter penalties can be adopted. Moreover, heavier punishment measures can be adopted for those large enterprises that have rejected admonition. Hence, a deterrent effect on other foreign-invested enterprises will not be generated to a certain degree.

Finally, the relevant reporting mechanism needs to be improved. The single form of the reporting system will greatly limit the enthusiasm of the informants. China can broaden the channels for citizens to report and collect information through a variety of methods. In addition, the threshold for informants can be lowered. Under the condition of providing true information about the informants, only providing relevant facts or certain clues can lead to successfully reporting. [12] All these measures can improve the efficiency of supervision and have better regulation effects.

### **4.4. Investment Protection System**

The new Foreign Investment Law has strengthened the protection of foreign investment from various perspectives.

Firstly, the process of legalization review has become more standardized. According to Article 4 of the new law, the State Council shall formulate and adjust the negative lists in accordance with the explicit authorization in this law. [13] Article 24 has stipulated that the normative documents formulated by the government and relevant departments shall not conflict with laws and regulations. Moreover, this norm also stipulates that the rights, interests and obligations of the enterprises shall not be impaired without authorization, and that the business activities of enterprises shall not be interfered without authorization. It stipulates that the entry criteria for markets shall not be established without authorization. Article 26 of the Implementation Regulations shall review the legality of relevant normative documents.

Secondly, the policy formulation and implementation rules have become more transparent. All departments work within the scope prescribed by law and the power shall be delegated level by level. [14] According to Article 7 and Article 10 of the new law, the documents related to foreign investment shall be publicized timely and they cannot be taken as the basis of management if they are not published.

Thirdly, China should insist the congruence between domestic and foreign investment. After establishment, foreign investment will enjoy national treatment. In the state's supervision and management of domestic and foreign investment, the same treatment will be implemented, and the same legal system and rules will be applied. For the foreign investors investing in industries and sectors that require licensing, they can put forward the application in accordance with the procedures and thresholds consistent with domestic investment. In

modern society ruled by law, preferential and discriminatory treatments lack legitimacy and rationality whether they are based on the nature or the nationality of the investment enterprises.

Therefore, investment protection can be promoted from the following aspects. Firstly, the legal content should be clarified. The new law should set detailed management on taxation, market supervision and management regulations similar to safeguard measures should be formulated. Secondly, punitive measures can be improved. The procedures of appeals and trial supervisions can be added. For the judgments that are not favorable to the parties, the relief in appeal and retrial procedures shall be provided, so as to make up for the drawback of fewer solutions in substantive law through due procedures. Thirdly, the legal provisions should be carried out in detail. It can help foreign investors to guarantee the smooth operation of investment activities in the conflicts of interest. Finally, the construction of examination and approval system should be regarded a key point. In the process of review and supervision, China should pay close attention to whether the investment activities of foreign investors are legal, whether the principle of pre-establishment national treatment has been violated, and whether the business projects truthfully reflect the normal flow direction of the investment projects. Hence, the construction process of foreign investment legal system can be further promoted.

## **5. COHESION AND COORDINATION OF FOREIGN INVESTMENT LAW AND RELEVANT LAWS**

In order to ensure the orderly development of foreign investment and ensure the effective management of foreign investment to the greatest extent, the Foreign Investment Law needs to be connected with other laws and regulations. Meanwhile, various provisions need to be refined, so as to build a complete legal system for foreign investment.

Taking the Company Law as an example, the current law of foreign investment enterprises in China is a mixed legislation of commercial organization law, industrial policy law and economic management law. The misplacement of the nature of legislation will inevitably lead to the obvious conflicts between the current law of foreign investment enterprises and the enterprise laws including the Company Law.

First of all, the Company Law is a common law and the Foreign Investment Law is a special law. Under normal circumstances, the special law should be applied preferentially. For situations in which there are no clear provisions in the Foreign Investment Law and the Company Law, solutions should be found in the supporting legal interpretations or regulations of the Foreign Investment Law. In cases where there are explicit

provisions in the Company Law but no explicit provisions in the Foreign Investment Law, the Company Law shall be applied. As for the legislative technical issues of convergence and coordination, they can be analyzed according to the attributes and objectives of specific systems.

Secondly, the contents that the two laws mainly regulate are different. The content of the Foreign Investment Law is more macroscopic, focusing on the principled and guiding policies and objectives of the state in the field of foreign investment. The content of the Company Law regulation is more microcosmic, focusing on refining the various specific rules in the process of enterprises' interaction activities. [15] These two laws complement each other and jointly coordinate the activities of foreign-invested enterprises.

Finally, the two laws have different divisions of function. The Foreign Investment Law have deleted the original contents of the Law on Foreign-invested Enterprises, and allotted the establishment, activities, alterations and dissolutions of enterprises and other contents to the Company Law for adjustment. Meanwhile, between the two laws, there are no legal conflicts that are generated by different provisions on the same matter. [16]

The life of law lies in its enforcement. To enhance the connection between the Foreign Investment Law and the Company Law, the two laws need to be combined in many ways. Judicial interpretation or subsequent legislation can be adopted to enhance the connection between the two laws. Taking the matters of national security review as an example, the convergence of the two laws mainly focuses on the commercial registration system. The legal control of the influence of newly-added market entities and foreign capital control on national security should be completed before the approval of commercial registration. In the Foreign Investment Law, the negative lists system and the national review system are two sets of parallel models of practice with considerable overlap in the objectives of the reviews. However, there are great differences in the standards, scope and transparency of the reviews. In order to improve efficiency, the order of the two systems can be adjusted appropriately. The foreign investment projects that have passed the negative list review can then be transferred to the national security review, which can reduce the costs of governance to a greater extent.

## **6. CONCLUSION**

In a word, the reform of the foreign investment system is a systematic project, which meets the needs of China's reform and opening up and the rapid development of the economy and trade globalization. Under the background of these needs, this paper discusses the Foreign Investment Law and its supporting rules. Starting from discussing the limitations of Foreign

Investment Law, this paper analyzes its conflicts of law application, defects of content, and enforcement measures, etc. From the national review system, the negative list system, the information reporting system, and the investment protection, the main solutions and schemes of the legal defects have been explored. The purpose of this paper is to theoretically explore the possibility of overall reform of the existing foreign investment legal system, so as to attract the attention of more relevant legal researchers. Since the reform covers a wide range of areas, involves numerous items, and includes complex problems, it is not easy to successfully complete it. The study of these issues can promote the continuous improvement of foreign investment system in the subsequent legislation, law enforcement and judicial practice. In this way, China will move towards a higher level of investment liberalization and facilitation.

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