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Doors Wide Shut?
An Update on FDI Regulations in China

Françoise Nicolas

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Executive Summary

The fears of a rise in economic nationalism in China have been fuelled by a number of recent moves, such as changes in the law on indigenous innovation or the enactment of a national security review (NSR) regulation for M&As by foreign enterprises. The objective of the current paper is twofold: First is to provide an update on the investment environment in China in order to determine whether or not these provisions reflect a move in the direction of more protectionism, and second is to suggest ways for European countries to level the playing field for their firms wishing to invest in China.

The general message is that no clear-cut trend can be identified. While it cannot be said that the regulatory environment is increasingly rigid, there has not lately been any clear loosening of restrictiveness either.

The recently promulgated changes to the catalogue on foreign investment guidance point to further opening, in particular with fewer restricted categories. However, this positive change is counterbalanced by the persistence of ownership restrictions in particular. Similarly, although the Chinese government has backtracked on its decision to connect indigenous innovation policy and government procurement, the Chinese public procurement market is still heavily restricted for foreign investors. Lastly, the implementation of the merger review under the anti-monopoly law suggests that foreign firms are to some extent being discriminated against even if the recently enacted NSR procedure should not bring major changes to the existing regulatory setting.

More generally, with an important level of discretion left in the hands of Chinese authorities at all levels of responsibility, the business environment remains complex for foreign investors. A major problem in the Chinese case relates to the lack of transparency and of stability in the regulatory environment. The vagueness of some provisions (economic security is a case in point) and the lack of precision in the responsibilities assumed by various levels of government (be they central or provincial, as in the case of the indigenous innovation catalogues) generate an opaque and uncertain business environment. Retroactive application of some regulations is also not uncommon, further increasing the lack of predictability in the regulatory environment.

The challenge for China's partners is to find the best way, beyond regulatory reforms, to level the playing field for their firms

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operating in China. This paper calls for opening negotiations on a bilateral investment treaty between China and the EU. The treaty needs to be ambitious and comprehensive, covering both pre and post-establishment issues (market access as well as investment protection in particular). One major advantage of a BIT negotiation is that it would be based on a global approach to FDI-related issues, thus allowing trade-offs between various objectives.

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Introduction

Ten years after China's accession to the World Trade Organization (WTO), there are increasing concerns that a protectionist trend may be developing in the second largest market in the world. While the fear of a rise in economic nationalism in China has been around for some time, trying to curb competition from foreign firms so as to facilitate the development of domestic firms appears to rank higher on Chinese authorities' priority list in the wake of the global financial crisis. The absence of a level playing field for foreign firms operating in China is one of the most widely held criticisms. The rising discontent on the part of these firms has been widely publicized lately by various institutions such as the EU Chamber of Commerce or the American Chamber of Commerce (Amcham) in China.

These fears have been fuelled by a number of recent moves, such as the changes in the law on indigenous innovation or the enactment of a national security review regulation for M&As by foreign enterprises. More generally, complaints relate to the existence of persistent restrictions on FDI entry. Allegations of a deteriorating business environment faced by foreign firms in China are common[1] and are apparently vindicated by the deterioration of China's ranking in a number of publications (OECD's FDI restrictiveness index, World Bank's ease of doing business[2]).

At the same time, several signs point to potentially positive developments. In particular, the publication of the 12th Five-Year Plan may be expected to open up new opportunities for foreign firms in a number of sectors where they are likely to have a comparative advantage (green growth and services, for instance). Also, the official shift in China's economic growth model to domestic demand expansion raised huge expectations for foreign multinationals

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[1] See for instance, General Electric CEO Jeffrey Immelt's speech to the Shanghai World expo in June 2010 (http://blogs.wsj.com/chinarealtime/2010/07/02/an-earlier-inkling-of-immelt%E2%80%99s-china-woe/)

[2] China dropped from 63rd in 2010 to 87th in 2011 and 91st in 2012 in the latter ranking. In contrast, China gained 8 ranks in Forbes' best countries for business, ranking between 2010 (90th) and 2011 (82nd) but with a substantial deterioration in its "trade freedom" indicator.

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operating in China. And the issuance of a series of “opinions” by the State Council in April 2010, ahead of the revision of the guidance catalogue on foreign investment, apparently aimed at reassuring foreign investors. In very much the same vein, Chinese authorities regularly reiterate their commitment to guarantee national treatment for foreign investors as well as their willingness to enter the WTO Government Procurement Agreement (GPA), further raising foreign investors’ hopes of a more friendly business environment.

The objective of the current paper is to provide an update on the investment environment in China and to determine whether or not these provisions reflect a move in the direction of more protectionism. After a brief overview of the FDI patterns and regulatory environment in China, the paper moves to an analysis of three major pieces of legislation affecting foreign investors, namely the latest revision of the catalogue on foreign investment guidance, the regulations on public procurement and the regulation on mergers and acquisitions. As a final step, the paper suggests possible responses on the part of the European Union in particular.

The general message is that no clear-cut trend can be identified, with a combination of positive and negative signals on the part of the Chinese government. Moreover, the discrepancy between the text of the law and the way it is implemented remains a major source of both concern and conflict that does not offer an easy basis for negotiation.

On the positive side, however, higher responsiveness to external pressures suggests that it is worth maintaining pressure on Chinese authorities, while avoiding antagonizing them. The real challenge is to strike a balance between these two objectives. Acknowledging the limits of an exclusively multilateral approach, the paper calls for the negotiation of an ambitious bilateral foreign investment treaty between China and the EU in particular, rather than for the use of an aggressive strategy based on negative reciprocity.

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Background

FDI Patterns and trends

FDI has been a major driver of economic growth in China ever since the reform was launched at the end of the 1970s, with renewed momentum as a result of the second wave of reform in the early 1990s. Since 1992, the trend has been sharply upward. China has been the leading recipient of foreign direct investment (FDI) among developing countries since 1992 and has consistently ranked in the top five FDI destinations (developed or developing) over the past three years. In spite of a slowdown between 2008 and 2009, the recovery was sharp in 2010, with a record level of US$ 105.7 billion, primarily as a result of substantial flows into the real estate/property sector.[3]

According to MOFCOM data, FDI into China totaled US$ 653 billion during the period 2001-2010, growing at an average 9.5 per cent a year. In 2010, China received 125 percent more FDI than in 2001 when the country had just joined the WTO.

Preliminary data suggest that FDI inflows were on the rise again in the first ten months of 2011 (January to October), up by close to 16 percent compared to the same period in 2010. About 80 percent of these investments (US$ 76 billion out of a total of US$ 95 billion) were wholly foreign-owned investments. Since the early 2000s, however, M&As of Chinese firms by foreign investors have become a new alternative to traditional investments in joint ventures (JVs) or wholly owned subsidiaries. Currently (early 2011), inward M&A still accounts for only 3 percent of China's total FDI, a sharp contrast with the global average level of more than 70 percent.[4] Although China M&A deals only account for 8-9 percent of the worldwide total in 2011, there has been a sharp increase compared to

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[3] Investment by overseas companies rose 17.4 percent year-on-year, with more than a fifth (about 23 percent) of the money flowing into the property sector.

[4] "Officials say review of foreign takeovers good for Chinese and foreign firms", Xinhua, February 17, 2011. http://www.moldchina.org/officials-say-review-of-foreign-takeovers-good-for-chinese-and-foreign-firms.html

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the 2-4 percent they accounted for in the early 2000s, according to JP Morgan.[5]

During the first ten months of 2011, the top ten nations and regions with investment in China (based on the actual input of foreign capital) are as follows: Hong Kong (US$ 62.363bn), Taiwan (US$ 5.852bn), Japan (US$ 5.48bn), Singapore (US$ 4.763bn), U.S.A. (US$ 2.567bn), South Korea (US$ 2.186bn), U.K. (US$ 1.477bn), Germany (US$ 998million), France (US$ 724 million) and the Netherlands (US$ 668 million). These investments combined accounted for close to 92 percent of total actual use of foreign investment in the country.

Although, manufacturing activities still dominate inward investment, services have been on the rise lately as a result of a surge of investment in the real estate sector.

All this suggests that FDI inflows tend to be more influenced by the global economic situation than by changes in policy directions.

A reminder on FDI guidance

During a visit to Germany in 2011, Vice-Premier Li Keqiang said that China would "enlarge its openness" to inward investment. In addition, numerous government representatives have emphasized China's receptiveness to foreign investment. Such declarations were undoubtedly responses to repeated complaints or criticisms by foreign investors about China's alleged tightening of rules on foreign investment.

Actually, in spite of an overall open strategy vis-à-vis foreign investors, inward foreign direct investment in China has been traditionally subject to strict regulations and substantive government review. The level of scrutiny differs from one industry to the other, with the Foreign Investment Industrial Guidance Catalogue providing the main guidelines. The “Catalogue” identifies four different categories of activities: encouraged, restricted, prohibited and permitted. Following a negative list approach, the catalogue expressly defines the first three categories so that any business that is not expressly listed in one of these three categories is deemed to be “permitted”. These activities are subject to no particular restrictive or preferential treatment. Next to the catalogue for guidance, the NDRC and the Ministry of Commerce also issued the catalogue of Foreign Investment Advantageous Industries in Central and Western China (hereafter the Central and Western catalogue).

[5] http://www.asiabriefingmedia.com/store/index.php?main_page=product_info&cPath=97_94_99&products_id=538

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The two catalogues define the tax incentives, approval requirements and market entry conditions for foreign investors. Investments falling in the encouraged category are subject to less strict administrative requirements and may enjoy a number of tax preferences, such as exemption from customs duty for imported equipment for self use. Moreover, the classification also determines the level of government at which an investor must seek approval for its investment, and hence the speed at which an investment project is likely to be reviewed. Activities in restricted categories are subject to higher levels of scrutiny and stricter administrative requirements, and may be denied approval at the discretion of competent authorities. They usually require approval at the central government level, which is more difficult and less quick to obtain. Lower levels of government, be they municipal or provincial generally provide more rapid review and are also usually keener to attract foreign investment.

It is worth stressing that China is heavily dependent on FDI for its growth. This explains why the overall stance has tended to be relatively positive until recently. However, with a view to encouraging domestic capacities and the emergence of large Chinese groups with global ambitions, the policy direction has tended to change over the past few years, with a shift "away from quantity to quality", as already reflected in the 2007 revision of the Catalogue.[6]

FDI and China's development strategy

As explained in a previous paper (Nicolas 2008), FDI policy in China has been traditionally perceived and used as an instrument of industrial policy (through investment targeting in particular). As a result, the catalogue for guidance is revised regularly in order to be kept in line with the government's objectives in terms of economic development.

The recent revision of the catalogue may first be accounted for by the publication of the 12th Five-Year Plan (2011 – 2015). The major objectives of the Plan are first to rebalance the country's growth strategy by moving away from exclusive export-orientation towards developing the domestic market, and secondly to move the economy up the value chain in the coming years. In order to reach the latter objective, China is targeting seven emerging strategic industries: energy conservation and environmental protection, new information technology, biotechnology, high-level equipment manufacturing, alternative energy, alternative materials, and new energy vehicles.

[6] See Nicolas (2008) for more details.

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Table 1: The 12th Five-Year Plan's 10 Tasks

Expansion of domestic demand	Strategies to achieve economic growth based on science and education and to turn the country into a human resource-rich nation
Agricultural modernization	Strengthening social building and building of public service systems
Balanced regional development	Promotion of cultural projects
Speeding up the transition into a resource-saving, eco-friendly society	Complementing the socialist market economy
Reinforcing the competitiveness of industrial structures	Openness-based strategy for co-growth

Source: SERI Chinese Business Intelligence, 2010.

A second factor accounting for the revision of the catalogue is the perceived need to respond to the policy initiatives of some of China's partners as well as to the rising complaints by foreign firms that they face an increasingly difficult business environment in China (as a result of high profile matters involving Google or Rio Tito, for instance). The revision thus also officially aimed at reassuring foreign investors and promoting a positive business environment to encourage continued (and much needed) foreign investment.

Ahead of the revision of the catalogue, the State Council issued a series of "Opinions" (Opinion No 9) in April 2010 on further improving utilization of foreign investment. With the overall objective of cultivating an improved investment environment, four more specific objectives were identified:

- Improving the structure of foreign investment utilization (with the aim of channeling FDI in specific high-tech and environmentally friendly industries);

- Encouraging foreign investment in Central and Western provinces;

- Diversifying the means of foreign investment utilization (with more possibilities open to foreign investors through mergers or acquisitions of shares in domestic enterprises undergoing restructuring or reorganization);

- Fostering a good investment climate by optimizing the foreign investment regulatory régime.

While Chinese authorities officially acknowledge that FDI is important for the development of the Chinese economy, the State Council clearly asserts the need to channel FDI in specific directions, or to optimize its use so as to support China's development requirements and benefit China's global competitiveness. It explains in particular that the Catalogue will be revised so as to reflect the encouragement of foreign investment in high-end manufacturing, hi-

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tech, advanced services, renewable energy, energy conservation and environmental protection industries. At the same time restrictions will be imposed on polluting and energy-intensive FDI projects and on industries running at overcapacity.

The Opinion also confirms that Foreign Invested Enterprises (FIEs) will be treated on par with local firms, meaning that they may have access to preferential treatment in a number of selected sectors. Of particular note, the Opinion expressly makes applicable to FIEs the *National Industry Adjustment and Reinvigoration Plans (NARPs)* promulgated by the State Council in 2009, which provided various preferential policies to enterprises engaged in the automotive, logistics, information technology, petrochemical, equipment manufacturing and other industries.

Lastly, the Opinion also establishes that foreign-invested projects falling within the “encouraged” category and having an “intensive pattern of land use” will receive priority when applying for land use rights and may receive discounts of up to 30 percent on the statutory minimum price for the transfer premiums they pay.

On the whole, the Opinion continues a trend toward national treatment for foreign investors and favors investment in higher value-added, more efficient operations as well as in western and interior regions of China.

On a different note, however, the Opinion also recommends the creation of a national security review mechanism for M&A transactions that involve foreign investment (see section 5 below), with a view to maintaining strict control over foreign investment.

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The revision of FDI regulations[7]

General overview

As a follow-up to Opinion No. 9, Chinese authorities set out to adjust the foreign investment régime, introducing both vertical and horizontal changes.

Vertical changes relate to amendments to the Catalogue in order to "upgrade" certain industrial sectors from the prohibited or restricted category to the restricted or encouraged or permitted categories. Other vertical changes may operate in the opposite direction, with formerly permitted activities moved to the restricted category, for instance, and restricted activities moved to the prohibited category.

A major consideration underlying the revision of the Catalogue is the government's willingness to attract foreign investment in new technologies. In line with Opinion No. 9, the main purpose of amending the *Foreign Investment Catalogue* is to identify areas to be opened up further to foreign investors, in particular areas that are encouraged by the government – such as new technology, new energy and projects related to environmental protection – and at the same time set out areas where foreign investments should be more tightly restricted, such as projects that are "high-polluting, high-energy-consuming and resource-dependent".

In this respect, the revised catalogue reflects the 12th Five-Year Plan objective of adjusting China's economic structure strategically by encouraging FDI in high-end manufacturing, high and new technologies, energy-saving and environmental friendly industries.

To that end, a number of changes have been introduced with specific hi-tech activities being explicitly encouraged. By way of illustration, the seven industries that were identified in the Five-Year Plan as being strategically important in the continued development of the Chinese economy are also represented in the revision of the Catalogue under newly encouraged industries. Such is the case for energy-saving or environmental friendly projects in the textile

[7] The draft revision was issued for consultation in April 2011 and the revised catalogue was promulgated on December 24 of the same year. It will take effect from January 30, 2012

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industry, projects for the manufacture of key components for vehicles using new energies, or specialized equipment manufacturing, for instance.

As a less pronounced but definitely not secondary policy consideration, the authorities still strive to enhance the competitiveness of certain domestic sectors. To that end, limitations are imposed on foreign investors in particular in terms of ownership participation. Ownership restrictions are imposed in newly identified important sectors as well as in specific sub-categories of activities in which ownership had not been restricted in the past.

Horizontal changes relate to the quantitative and/or qualitative relaxation of certain restrictions applicable to a restricted category. Typically, this is achieved through decentralization of the approval authority from the central authority to its local level counterparts or the lowering of the total investment threshold applicable to the sector (Burks and Deng 2011).

Vertical changes: Revising the Catalogue

The changes in category are ambiguous; they may either reflect a wider opening or a tightening of the legislation.

Additions to the encouraged category

To support the development of strategic new industries, the new Catalogue adds a number of industries to the encouraged category, including research, development and manufacturing of aerospace and environmentally friendly materials; manufacturing of key components of new-energy automobiles such as high-tech "green" batteries[8]; research, development and manufacturing of Internet system equipment, software and chips; and construction and operation of vehicle battery recharging stations.

The 2011 Catalogue is expected to facilitate further opening-up of the new energy industry to foreign investment. Of particular note, China encourages foreign participation in unconventional natural gas resource exploration and exploitation, including shale gas (while the old Catalogue only encouraged the exploration of seabed combustible ice). However, what is noticeable is that only businesses in cooperative joint ventures are "encouraged" in this area.

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[8] The changes stand to benefit China's development of new-energy vehicles but also provide significant opportunities for foreign investors seeking to tap into this sector.

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Similarly, the development and production of energy saving, lightweight, high strength, high performance, multi-functional building materials rank among encouraged activities. Also to encourage foreign investment in the circular economy, the collection and treatment of waste electronic appliances and electronic products, mechanical and electrical equipment, and batteries have been included in the encouraged category.

To promote the development of the services sector, the new 2011 Catalogue adds lease and business services, venture investment enterprises, intellectual property services and professional training into the encouraged category, while no longer restricting medical care and health institutions.

Overall, these changes reflect priorities established by the State Council in the aforementioned Opinion, which aims to steer foreign capital in the direction of new, strategic industries.

Select list of newly encouraged activities (by industry):

- Mining: projects for exploration and development of unconventional natural gases, such as shale gas (cooperative JV required);

- Food production: Projects for production of natural food additives no longer subject to foreign shareholding restrictions;

- Textiles: encouraged projects are limited to energy saving or environmental-friendly projects;

- Chemicals: fewer activities encouraged, more limited scope and foreign shareholding restrictions;

- Pharmaceuticals: development of new products;

- Non-metal mineral products processing industry: development and production of energy saving, environmental protection, waste benefit, lightweight, high strength, high performance, multi-functional building materials;

- Automobile production: projects for the manufacture of key components for vehicles using new energies;

- Electronic and telecommunication equipment: high tech products (touch systems) encouraged while medium-tech products have been removed (digital camcorders, digital audio equipment, etc). ;

- General machine-building industry: Manufacturing of gear transmissions for wind power, nuclear power, high-speed trains, variable pulp marine gear transmission systems, large, heavy duty gear boxes;

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- Special equipment manufacturing: construction and operation of water treatment plants, construction and operation of recycling plants, construction and operation of vehicle charging stations and battery charging stations, etc.;

- Service industry: projects involving the provision of logistics information consulting services or intellectual property services (such as patent and trademark agents and intellectual property consulting companies) and projects for the establishment of venture capital enterprises;

- Education: training for vocational skills.

Deletions from the encouraged category

In contrast, some industries are no longer encouraged for two major reasons: either because China's domestic market players are deemed to have become well developed (and are probably thought to be in control of the technology) or because there are risks of overcapacity.

Of particular note among these activities is the vehicle assembly industry, which is downgraded from "encouraged" to "permitted". Similarly the establishment of motor vehicle research and development organizations and the manufacturing of medium tech electronic equipment products are no longer encouraged.

Interestingly, and more surprisingly, manufacturing of new-tech equipment for environment protection testing instruments, as well as manufacturing of air and water pollution prevention and control equipment are also deleted from the encouraged category.

Removals from the restricted or prohibited lists

Moreover, some activities that used to be either restricted or fully prohibited have been removed from these categories and are thus permitted.

In particular, the 2011 revision removes medical institutions from the "restricted" category and eliminates the limitation to joint ventures. That means foreign investment in medical institutions is now "permitted", and foreign investors may establish wholly foreign-owned medical institutions.

Of particular note is the relaxation of restrictions on financial leasing companies.

Although all changes point to greater liberalization, there is no clear rationale for these various changes, which cover a wide range of sectors, including industrial and service activities.

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Select list of activities removed from the restricted category:

- distribution and importation of books, newspapers and journals;
- production of carbonated soft drinks;
- medical institutions (limited to equity joint ventures and contractual joint ventures);
- importation of audio-visual equipment and e-journals;
- internet music services;
- various kinds of commercial companies engaged in franchise business, commission business and business management;
- commodity auction services;
- financial leasing companies;
- automobile wholesale, retail and logistics[9];
- construction and operation of oil refineries with an annual output of 8 million tons or less.
- metal manufacturing (manufacture of containers)
- rubber products : old tire recondition (not including radial tire), and production of industrial rubber fittings of low-performance

Only a few activities have been removed from the prohibited category, of which it is worthy of noting video screening companies, in particular.

Additions to the restricted category

In an attempt to confirm the shift away from promoting quantity in favor of enhancing the quality of foreign investment, a number of activities have been added to the restricted category. This is particularly the case for manufacturing activities making use of backward technology. By way of illustration, the following activities are now restricted:

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[9] The Chinese party shall have a controlling interest for any chain with 30 or more branches and distributing different varieties and brands of products from two or more suppliers.

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- Construction, operation of gas, heat supply and water drainage network for cities with population of more than 0.5 million (Chinese party shall hold the majority of shares);

- Various manufacturing activities in the chemical sector using obsolete technology.

Additions to the prohibited category

The revision does not include many additions to the prohibited category. However, as a follow-up to a move initiated in 2007, construction and operation of villas were moved from the restricted to the prohibited category, probably in an attempt to cool down the red-hot real estate sector.

Domestic express parcel services have also been added to the prohibited category.

Horizontal changes: Streamlining FDI approval mechanism

In a relatively short period of time, the MOFCOM released several circulars in relation to foreign investment examination and approval procedures. This activism is indicative of China's readiness to continue further delegating examination and approval competency to its local counterparts, and of its willingness to attract more foreign capital since the financial crisis.

On February 25, 2011, the MOFCOM issued the Circular No 72 on Relevant Issues Concerning the Regulation of Foreign Investment. This circular states that provincial-level branches of both NDRC and MOFCOM may now approve "encouraged" and "permitted" foreign investment projects of up to US$ 300 million, whereas previous guidelines had set the limit at US$ 100 million. Certain service sector projects and some "encouraged" projects beyond the new limit may also be approved by a provincial-level branch of MOFCOM. In contrast, the threshold for projects under the 'restricted' category will remain at US$ 50 million, above which approval from the central government is required.

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Table 2: Revised approval mechanism

Sector	Investment Amount	Approval Level
Encouraged or Permitted	Less than US$ 300 million	Provincial or local MOFCOM
	Greater than US$ 300 million and less than US$ 500 million	Central MOFCOM
	US$ 500 million and above	Central MOFCOM and the State Council
Restricted	Less than US$ 50 million	Provincial or local MOFCOM
	Greater than US$ 50 million and less than US$ 100 million	Central MOFCOM
	US$ 100 million and above	Central MOFCOM and the State Council

Overall, local government is thus given more power to approve projects involving foreign investment. This relaxation of certain regulatory thresholds and approval requirements should be deemed an improvement. With provincial-level approvals typically being easier to obtain, a decentralization of approval authority can be expected to speed up the approval process but also to make it more flexible and more streamlined.

The flip side of the coin, however, is the need for foreign investors to maintain contacts simultaneously at the two levels – central and provincial --, possibly making the investment process more complicated, in particular for newcomers. Lastly, there is also a non negligible risk of discrepancies in the way the two levels apply the new legislation. However, with the provinces generally still very keen to attract foreign investment, easier approval may also be obtained for that reason.

Also with a view to optimizing the utilization of foreign capital, Chinese authorities now allow foreign investors to set up foreign invested partnerships (FIPEs). While this may *prima facie* be seen as a positive move, opening an alternative to the standard instruments available to foreign investors (wholly foreign-owned enterprises, equity JVs and cooperative JVs), the lack of details about this apparently promising investment vehicle makes it for the time being an impractical instrument for investing in China.

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An interim assessment

The changes introduced with the revision of the catalogue point to further opening, in particular with fewer restricted categories. However, this overall positive assessment needs some qualifications, as some regulatory changes point in the opposite direction.

A major limitation to the recent reform relates to persistent ownership restrictions imposed on foreign investors. In “encouraged” and “permitted” sectors, the general rule is that no partnership with a Chinese party is required. As a result a foreign investor may set up a wholly foreign-owned enterprise. But there are exceptions to this rule in which, notwithstanding an industry’s “encouraged” status, only joint ventures are allowed. The revised catalogue generally maintains such exceptions. The manufacturing of civil helicopters is one example. While the activity is encouraged, the Chinese partner shall hold the majority of shares for helicopters of three tons or more, and for those of less than three tons, foreign investment is limited to joint ventures or cooperation. Similarly, in all encouraged mining and quarrying activities, foreign investment is systematically limited to “joint ventures and cooperation”. Such restrictions are also maintained for manufacturing of large, complete devices for chemical processing of coal, for instance. In contrast, however, the equity ratio requirement in the manufacturing of equipment for power generation with new energy resources that was previously in place to restrict foreign investment is removed in the 2012 Catalogue.

In general, ownership restrictions are imposed or maintained in the most sensitive sectors (renewable/clean energy in particular), as well as in mining and quarrying activities and in numerous activities in the general machine-building industry.

“Restricted” sectors are generally open only to joint ventures, and in some cases the joint ventures must be majority Chinese owned or contributed.

Maintaining such restrictions may have far-reaching implications because JVs are generally given less leeway than wholly foreign-owned firms. In fact, maintaining or imposing ownership restrictions may be seen as an indirect way of controlling foreign investors’ activities, in particular in the area of technology transfers since the conditions imposed on JVs are much tighter in this area.

By way of illustration, when China joined the WTO in 2001, it committed not to require that foreign companies use domestic suppliers or transfer technology as a condition of investment approvals. At the same time, however, China’s laws state that transfer of advanced technology should be included in foreign joint venture agreements, and give the government the right to approve or reject such agreements. As a result, the scope of China’s commitment is substantially reduced. In practice, more often than not

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foreign investors have difficulties setting up wholly-owned ventures in China, and in some sectors they are even forced to engage into JVs, as explained above. Once they partner with a state-owned joint venture partner or a state financier, their investment contracts invariably contain technology transfer requirements.[10]

Secondly, the changes introduced in the revised catalogue are disappointing due to the still limited opening of many service industries. In particular, the financial and insurance industries have been left largely untouched and will thus remain subject to severe limitations and restrictions, with the exception of venture capital companies, which are now encouraged, and financial leasing companies, which are no longer restricted. For the real estate industry, the revision has not brought any change in the list of restricted activities. The expectations of foreign investors were probably excessive.

Another important point is that the catalogue for guidance does not prevail over other regulatory provisions affecting FDI, such as the catalogue for guiding the adjustment of the Industry Structure, for instance. While this may be seen positively since the catalogue is not deemed to bring major breakthroughs, this may also increase the lack of transparency or predictability and may add some confusion.

Another factor adding to the complexity is regulatory instability. In China, much of the risk for foreign investors stems from the broad discretion that government authorities exercise in determining how regulations should be enforced, as well as from the ever-changing regulatory regime.

An interesting illustration is provided by the recent reform in China's online payment market, which may be seen as a typical example of China's open-door-then-closed-door approach to foreign investments (see Box). While China's rise and opening-up policy are attractive to most foreign investors, risk of sudden re-regulation substantially raises legal uncertainty, making investment decisions more risky than initially anticipated. In very much the same vein, the retroactive implementation of laws and regulations creates considerable uncertainty on the state of the law at any given time (EUCCC 2011).

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[10] Such was the case of Evergreen Solar in 2009. The firm faced difficulties raising funds to open a plant in China and had to enter into a JV agreement (backed by provincial authorities) that required Evergreen to license solar wafer technology to the new venture. As a result, Evergreen was forced to shift part of its panel production from the United States to China (http://www.power-technology.com/features/feature119046/).

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Box 1. Reform of China's online payment market

In June 2010, in an attempt to establish a legal basis for the country's booming online business, the People's Bank of China (PBoC) issued regulations saying that non bank-companies would be allowed to provide third-party online payment services.

However, while the regulations allow third-party payment providers to apply for a license with the Central Bank from September, the PBoC failed to specify the qualifications that foreign-invested payment institutions would have to meet to become eligible applicants, thus excluding them *de facto* from the new regulatory framework.

From the perspective of foreign investors, another negative move pertains to the end of the "super national treatment" offered to FIEs. The preferential policy that has favored foreign-invested companies over the past three decades was officially terminated in December 2010. Since that date the Chinese government has imposed urban maintenance and construction taxes and an education tax on foreign-invested companies, foreign companies operating in China and expatriates. Such taxes used to apply only to domestic enterprises and Chinese nationals. This move symbolizes the end of the so-called "super national treatment" offered to FDI firms and marks the beginning of a fully unified national tax system for domestic and foreign companies.[11] Although China's move to unify the tax system may be interpreted as impacting foreign investors negatively, it is consistent with relevant WTO provisions and shows that the country is gradually moving towards common international rules.

While these issues in themselves are significant, there remain persistent obstacles to public procurement and uncertainty generated by the establishment of the national security review system for M&As. These last two issues are examined in detail in the next two sections.

[11] 'China ends foreign firms' "super- national treatment"', *People's Daily Online*, 1 December 2010, (http://english.peopledaily.com.cn/90001/90778/90861/7217484.html).

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Public procurement, still a hard nut to crack

The Chinese public procurement market is substantial in size but is still perceived as closed or heavily restricted. And the recent move linking government procurement and indigenous innovation was perceived as a sign in the direction of even tighter restrictions imposed on foreign investor access. While the latter concern may have been exaggerated, the Chinese procurement market is still largely closed to foreign-invested firms.

Public procurement, a sizeable but complex market

A major source of complaint by foreign investors is the restricted access to public procurement for foreigners because of various restrictions and a lack of transparency in the process at all levels.[12] This state of play is deemed particularly negative since expenditures on government procurement have been rising sharply as a result of the fiscal stimulus package unveiled in 2008.

The size of the government procurement market *stricto sensu* was estimated at € 66 billion (or about US$ 88 billion) in 2008, but this is usually thought to be a minor share of total public procurement.

In China a distinction is made between government procurement *stricto sensu* and overall public procurement[13], and the domestic legal framework is fragmented, with two laws regulating public procurement: the Ministry of Finance's Government Procurement Law (GPL) and the NDRC's Bidding Law (BL). The value of the market covered by the two laws is estimated to be as big as € 1.2 trillion (EUCCC 2011).

The GPL defines government procurement as "procurement of goods, works and services conducted with 'fiscal funds' by government ministries and agencies at all levels (national, provincial,

[12] On this point, see WTO's China Trade Policy Review 2010.

[13] This situation has obviously to do with the very special nature of the Chinese economy, where direct and indirect state spending accounts for a much larger proportion of economic activity than in most other economies.

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municipal), public institutions and social organizations". The BL, by contrast, regulates procurement by other state-related agents, such as state-owned enterprises (SOEs) and some private companies involved in projects for public interest. As a result, the GPL covers central and sub-central government purchases, while the BL regulates all SOE tenders as well as tendering by purely private organizations.

For the time being, from a purely legal standpoint, China's approach to government procurement is not violating any of its commitments since it is not a signatory of the WTO GPA. However, the problem lies in the complexity and lack of transparency of the legal framework. For potential foreign bidders the fragmentation of the regulatory framework is a major difficulty since distinguishing the coverage of a bid under the GPL or the BL has major implications on how, if at all, foreign-invested firms can compete for the bid.

During its WTO accession negotiations, China firmly rejected the notion that GPA membership should be the precondition for its WTO entry. However, upon joining the organization, China committed to join the GPA "as soon as possible" (Wang 2009). The first concrete move took place in 2006, when China committed to make an offer on GPA coverage by the end of the following year. The negotiations have been ongoing ever since, but so far the offers put forward by the Chinese government have fallen short of its foreign partners' expectations.

In fact, despite allegations to the contrary, Chinese authorities appear to still be reluctant to access the WTO GPA. The reason is that this would be costly: first, Chinese authorities could no longer use provisions on Government Procurement as an instrument of industrial policy; moreover, engaging in negotiations and implementing new laws and regulations would also bring costs (Wang 2009).

Moreover, the fragmentation of the regulatory framework highlighted above makes the negotiation particularly difficult and there is a substantial risk that an agreement may turn out to be disappointing. A major point in the discussion about China's accession to the WTO GPA relates to the coverage of the regulatory change and the problems faced by foreign competitors would only be partly resolved if the decision opened the door to the GPL-regulated tenders but not to the much larger market under the BL.

Government procurement and indigenous innovation policy

Over the past year the discussion on access to China's government procurement has focused on regulations tying government contracts to domestic (or indigenous) innovation. One major regulation recently issued by Chinese authorities indeed restricted access to public

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procurement tenders to firms using indigenous innovation products, *de facto* making it extremely difficult for foreign firms to compete with domestic firms.

China's indigenous innovation policy …

In 2005, Chinese authorities released the so-called "National Medium- and Long-Term Plan for the Development of Science and Technology (2006-2020, hereafter the MLP)", which formally introduced the policy of "indigenous innovation" (or "self-innovation") into China's national strategy.

The rationale for the indigenous policy is the willingness, on the part of Chinese authorities, to reduce the economy's reliance on foreign technologies (and hence to contribute to developing an autonomous technological capability) and to promote the emergence of "national champions". The MLP targets 11 key sectors, the development of which should help China become a future global leader. The sectors include energy, water and mineral resources, environment, agriculture, manufacturing, transportation, information and services, population and health, urbanization, public security and national defense.

The following year, the State Council issued a notification about a number of accompanying policies on the implementation of the above program, requiring that "improving indigenous innovation" be made the most important aspect of all science and technology related work and that the promotion of "indigenous innovation" be carried out through tax incentives, financial support, etc. In particular, the government encourages Chinese firms to establish overseas R&D centers and to expand cooperation with foreign universities and R&D centers (Denmark Innovation 2010). More worrisome perhaps for foreign investors, the document further states that China will build its dominance by *"enhancing original innovation through co-innovation and re-innovation based on the assimilation of imported technologies."* Although this objective could be seen as potentially opening the door to theft of foreign technologies on a national scale, it remained largely unnoticed and failed to raise major reactions from foreign competitors.

With the MLP seeking to favor products and technologies that use intellectual property and brands developed by Chinese companies, government agencies are called to purchase goods and services produced by innovative Chinese companies.

To that end, the science and finance ministries, jointly with the NDRC, issued the Circular 618 in 2009, which defines the products that are eligible to the status of indigenous innovation products.

Rather than prohibiting competition from foreign firms, the declared objective of the regulation was to encourage innovation expenditures in China. To that end, the government aims to accredit products in six areas, including computers and application equipment,

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telecommunications products, modern office equipment, software, new energy equipment and highly efficient energy-saving products. To qualify as “indigenous innovation,” a product had to be produced by an enterprise that fully owned the intellectual property in China, had a trademark owned by a Chinese company, was registered in China and embodied a high degree of innovation. An important point is that product eligibility was not based on the enterprise’s ownership, but on whether the company carries out innovative activities and produces goods that have indigenous IPRs in China. As a result, China could not be blamed for treating foreign firms unequally.

The product accreditation process was officially meant to fulfill two main functions: the first was to provide institutional guidelines for making the process more open, fair and transparent; and the second was to generate a ‘national catalogue’ of indigenous innovation products for government procurement. The national indigenous product accreditation system thus explicitly connected indigenous innovation to government procurement.

…and its impact on foreign investors

Governments at the central, provincial and local levels are expected to use this catalogue to guide their public procurement decisions. From the perspective of foreign investors, the important point is that accredited products may enjoy preferential treatment particularly in government procurement, industrial policy, and the tendering and bidding process. In public procurement procedures, accredited products are considered 5 to 10 percent cheaper than other products, or they may benefit from a higher “quality coefficient” (this will be increased by 4 to 8 percent).

Although these policies, which give government procurement preference to companies that develop and register designs, software and other intellectual property in China, do not openly discriminate against foreign firms and aim at encouraging innovation effort in China by all firms, foreign firms have regularly reported difficulties in selling their products to government entities.

The indigenous innovation policy may have one of two impacts on foreign investors. It will either force the transfer of their IP rights to China, or it will influence their business operations in the Chinese market by limiting their ability to compete with local, domestic firms in particular on the public procurement market.

Under the formerly existing regulation, the requirement of China’s GPL (2002) that all PRC government agencies purchase domestic goods and services, was broadly acceptable because of substantial exceptions for items that could not be obtained within China. However, China’s indigenous innovation policies went well beyond favoring domestic good and services in government procurement (Grams 2010).

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Another matter of concern is that the accreditation system may force foreign firms to transfer their IPRs to Chinese enterprises in order to be granted market access in government procurement.

Delinking indigenous innovation and government procurement

The policies generated intense criticism from foreign firms, which accused the government of using the policies to prevent foreign companies from doing business in China. Pressures exerted by foreign firms apparently proved successful.

In January 2010, the Ministry of Science and Technology issued a notice that modified the policy by removing intellectual property restrictions. It provided that to be eligible for accreditation, applicants must be manufacturing enterprises that are legal persons in China (including registered foreign-invested enterprises) and their products must comply with national laws, regulations and "technology" policies. In addition, the demand that applicants own intellectual property rights was replaced with a requirement that they merely have a license to use the intellectual property or have the exclusive right to use the trademark for the product in China. The notice also stated that the product must be "advanced" according to criteria expressed only very generally, and must be "reliable" in quality.

Serious concerns remained among foreign investors on the policy's impact on market access for their products. Apparently giving in to renewed pressures, President Hu Jintao (during a visit to Washington in January 2011) promised to "delink" indigenous innovation from government procurement.

As a follow-up to this pledge, the Ministry of Finance announced that it would cut three of these indigenous innovation rules linking government procurement to indigenous innovation by domestic firms. The three rules concerned providing financial aid to domestic companies dedicated to indigenous innovation.

The three measures that were cut are:

- The Evaluation Measures on Indigenous Innovative Products for Government Procurement, which describe advantages that accredited indigenous innovation products enjoy in the government procurement process;

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- The Administrative Measures on Budgeting for Government Procurement of Indigenous Innovation Products, which lay out rules and procedures for government entities that use state funds to procure accredited indigenous innovation products; and

- The Administrative Measures on Government Procurement Contracts for Indigenous Innovation Products, which encourage government entities to use state procurement contracts to promote indigenous innovation.

While government policy on procurement has receded from the original position and “indigenous innovation” has been “delinked” from government procurement requirements, implementation of this shift is still problematic because acceptance and commitment by sub-central (provincial and municipal) governments are needed to make it meaningful. The failure of local governments to implement national policy is common. It is useful to recall that, although China is theoretically a unitary state, in practice national laws and policies are often poorly and tardily implemented.

This problem is further compounded by the fact that over the past years, a number of local governments have developed their own catalogues of accredited indigenous innovation products. Whether provincial and municipal governments will fall into line by allowing foreign competition rather than favoring local companies thus remains to be seen. Moreover, doing away with provincial catalogues will not prevent provincial governments from keeping the procurement process opaque and from using the lack of transparency to favor local firms.

Although more certainly remains to be done to allow equal access to the domestic market for Chinese and foreign companies, it is worth stressing that China accepted to backpedal under pressure from foreign investors. The sensitivity of Chinese authorities to external pressure has been observed in other circumstances, in particular when China agreed to end wind-power subsidies following a complaint the US filed at the WTO, for instance.[14]

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[14] China required aid recipients to use Chinese-made parts, thus giving Chinese producers of renewable-energy products an unfair advantage over their foreign (primarily US) competitors.

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M&A control and national security review, much ado about nothing?

Anti-Monopoly Law (AML) and M&As

A full-fledged merger control régime applying to both foreign and domestic companies is a relatively new development in China. While the discussions about the establishment of a serious antitrust mechanism started as early as 1994,[15] the drafting process met huge difficulties and took much longer than initially expected. As a result, no mechanism was in place until 2008.

To fulfill its WTO commitments and to liberalize its FDI régime so as to attract more FDI, China first issued the *Provisional Regulations on Mergers with and Acquisitions of Domestic Enterprises by Foreign Investors* ("Provisional M&A Regulations") in 2003, which was the first comprehensive set of regulations on cross-border M&As in China (Chen 2011). This legislation was followed by *the Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* ("Provisions") in 2006. The Provisions reflected a further opening to cross-border M&As in line with standard international practice.

From 2003 until 2008, more than 600 merger notifications were filed with MOFCOM and SAIC (State Administration for Industry and Commerce). Every decision ever handed down was a clearance and therefore officially no transaction was prohibited. However, not all deals were rubberstamped either; in particular, under MOFCOM's pressure the US private equity firm Carlyle Group had to drop its bid to buy a stake in the Chinese construction equipment maker Xuzhou Construction Machinery Group Inc in 2005 (Qian 2010).

This nascent antitrust mechanism was eventually complemented by the *Anti-Monopoly Law* (hereafter "AML"), which entered into force in August 2008. The AML aims at "preventing and restraining monopolistic conducts, protecting fair competition in the market, enhancing economic efficiency, safeguarding the interests of

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[15] In 1994, the 8th National People's Congress included the anti-monopoly law in its legislative plan (Qian 2010).

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consumers and social public interest, promoting the healthy development of the socialist market economy." An important feature of the law is that it does not differentiate between foreign and domestic parties.

Since monopolistic conducts may result, among other things, from "concentration of business operators that eliminates or restricts competition or might be eliminating or restricting competition", any M&A deal has to be reviewed so as to check its compatibility with the AML. If the merger is found to be incompatible with the AML, MOFCOM may either reject the deal or approve it with specific restrictive conditions with a view to alleviating identified detrimental effects.

The factors to consider in a merger review include:

1. Market share of the business concentration participant in the relevant market and the power of control in the market;
2. Concentration in the relevant market;
3. Effect of the concentration on market entrance and innovation;
4. Effect of the concentration on competitors and consumers;
5. Effect of the concentration on national economy; and
6. Other factors the anti-monopoly enforcement authority may consider relevant.

Since cross-border M&A transactions are also subject to the anti-monopoly review procedures under the AML to protect market competitiveness, foreign participants tend to fear that the law may be used to protect national corporate champions while keeping foreign corporations out of the Chinese market.

One of the factors listed in Article 27 of the AML is "the effect of the proposed concentration on the development of the national economy". This provision raises the question of whether merger enforcement will be utilized for macroeconomic or even protectionist goals unrelated with competition issues *stricto sensu*. In particular there are concerns that MOFCOM may rule against transactions by foreign firms simply because they may adversely impact domestic Chinese companies or the development of the Chinese industry.

While this concern appears to be ill-founded since the law does not make the distinction between domestic and foreign investors, a number of factors suggest otherwise.

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Immediately after it took effect in August 2008 the AML merger control provisions have been systematically enforced by the Chinese authorities,[16] and by mid-2011, 356 proposed M&A transactions have been submitted for review under the regime. The vast majority of deals have been cleared to proceed unconditionally, with just eight prohibition or conditional approval decisions by the Chinese authorities as of August 2011 and an estimated unconditional clearance rate exceeding 95 percent (Ha, Hickin and O'Brien 2011).

Interestingly enough, although domestic and foreign business operators should allegedly receive equal treatment under the AML merger control régime, MOFCOM's decisions seem to suggest that transactions by foreign acquirers are still the foremost concern of the Chinese authorities and that there is no level playing field for foreign acquirers. It is indeed telling that all of MOFCOM's conditional approval decisions to date have applied to transactions wholly between foreign multinationals,[17] while the single prohibition decision that has been announced concerned a foreign takeover of a domestic Chinese business (Coca-Cola/Huiyuan Juice).

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[16] The actual enforcement of the AML is carried out by three authorities: (1) the MOFCOM; (2) the SAIC); and (3) the NDRC. MOFCOM, the ministry primarily responsible for overseeing international trade and investment issues, is the sole authority overseeing merger control. The SAIC, which issues business licenses and administers various commercial laws, enforces AML prohibitions against monopoly agreements and abuses of market dominance. The NDRC, which investigates price fixing among other things, prosecutes price-related violations of the AML. These central authorities can also authorize local authorities to enforce the AML.

[17] In August 2010, for instance China's MOFCOM imposed conditions to Novartis' acquisition of Alcon, with the former being barred from selling one of its pre-merger opthalmological anti-infection products in China for five years, due to Alcon's dominant market share in those products in China. Novartis will also have to halt a sales partnership with a Taiwanese contact-lens maker. The latest case took place in June 2011 when MOFCOM cleared Uralkali's acquisition of Silivinit (two Russian fertilizer/potash producers) subject to requirements relating to the merged entity's future levels of supply and pricing for Chinese customers.

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Table 3: Merger reviews by MOFCOM since the implementation of the AML

Year	Cleared without conditions	Cleared with conditions	Rejected
2008	16	1 (InBev/ Anheuser Busch)	0
2009	75	4 (Mitsubishi Rayon/Lucite ; GM/Delphi ; Pfizer/Wyeth ; Panasonic Sanyo)	1 (Coca Cola/Huiyuan)
2010	116	1 (Novartis/Alcon)	0
2011*	142	1 (Uralkali/Silivilit)	0

* As of August 2011.

While MOFCOM representatives have explained that the decision to veto Coca Cola's bid for Huiyuan Juice Group was based solely on "competition law" considerations, the decision statement justifies the prohibition order in part by referring to the harm the transaction could have caused to China's domestic small and medium-sized manufacturers and the healthy development of the Chinese fruit-juice drink industry more generally. The decision thus highlights the Chinese government's reluctance to let foreign companies acquire majority interests in large, successful Chinese companies. This suggests that the AML may be used to achieve goals unrelated to competition law, that industrial policy considerations as well as the protection of China's national economic development played a significant role in the outcome, and that MOFCOM was seeking to protect 'competitors' as much as the 'competitive process'.[18]

Fears of discrimination against foreign investors are further fuelled by the still prevailing 2006 "Provisions" highlighted earlier, which allow the MOFCOM to challenge transactions in which foreign investors will acquire control of domestic entities in key industrial sectors or affecting national economic security or involving "well known trademarks or traditional brands" of China. Moreover, overlapping with these provisions, Article 31 of the AML provides that, where a foreign investor merges with or acquires an enterprise within China, or where any other form of concentration "concerns national security," the transaction will be subject to examination on national

[18] The positive aspect of the Coca Cola/Huiyuan case is that fact that the procedure was completed in a reasonable timeframe, unlike the Carlyle/Xugong deal which had to be dropped after three years of waiting for procedural approval.

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security grounds in accordance with relevant regulations, in addition to the competition review provided for by the AML. Although the provision remained very vague as to the way of implementing this review, it provided the legal basis for submitting cross-border M&As to very tight scrutiny.

There are thus good reasons to believe that existing laws and regulations are (or may be) applied more aggressively to foreign multinationals, thus preventing the emergence of a level playing field.

Recent developments tend to suggest that these fears may be exaggerated. Three important acquisitions of Chinese firms by foreign firms were approved lately by MOFCOM. First the UK-based multinational Diageo (which owns brands including Guiness, Baileys, Smirnoff and Johnnie Walker) was given the green light by MOFCOM in July 2011 for its acquisition of an additional 4 percent stake in Sichuan Chengdu Quanxing Group (Quanxing), taking its holding to 53 percent and giving it an indirect control of Shuijingfang, one of China's oldest spirits companies.

Secondly, China's antitrust regulators approved a plan by US Yum Brands Inc. to buy hot-pot restaurant operator Little Sheep Group Ltd., in what appeared to be one of the first successful foreign takeovers of a major Chinese brand.

The third and most interesting test case relates to the recent approval (December 2011) of Swiss food group Nestlé's plans to buy 60 percent of the capital of Chinese confectionery manufacturer Hsu Fu Chi for around US$ 1.7 billion.[19] When completed, the acquisition will be one of the largest foreign takeovers of a Chinese company and will give Nestlé control of the second-biggest confectionery company in China, after Mars Inc.

Diageo's acquisition of Shuijingfang was only allowed once the Chinese firm had agreed to divest a jewel in its portfolio, namely the Quanxing liquor brand, and this move was expected to alleviate the regulators' concerns that a famous Chinese brand might fall into foreign hands. As a result, this decision could not be interpreted as ushering in a new phase of resolute openness. In contrast, the recent approval of the Nestlé deal certainly sends a stronger signal.

[19] Earlier this year Nestlé's bid for a controlling stake in the China-based food company Yinlu has received the Chinese government's approval after an anti-monopoly review that lasted several months. The magnitude of the deal cannot be compared to the Hsu Fu Chi deal, however.

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Mergers and acquisitions and National Security Review

Provisions on national security review

On February 3, 2011 the Chinese State Council issued a notice entitled “Circular of the General Office of the State Council on the Establishment of a National Security Review (NSR) System regarding Mergers and Acquisition of Domestic Enterprises by Foreign Investors”. Although the NSR Notice does not make reference to Article 31 of the AML highlighted earlier, it is understood that the new system fills the gap left open by the AML.

The circular provides for review and potential rejection of acquisitions of Chinese companies by foreign investors where these acquisitions could affect national security, economic stability, social order, or R&D capabilities relating to key technologies.

MOFCOM subsequently issued interim rules and guidelines for the review process, which went into effect on 5 March 2011 and remained in force until August 31, 2011. A new regulation issued by MOFCOM on August 26, 2011 states that the government will review mergers and acquisitions of domestic companies by foreign investors for national security purposes. The regulation took effect from September 1 of the same year.

Specifically, the circular establishes a multi-agency panel that will assess the extent to which a proposed foreign investment in, or acquisition of, a domestic Chinese enterprise raises certain national security or related concerns (Security Review). The panel is made up of the NDRC and MOFCOM, as well as other ministries depending on the sector involved, under the guidance of the State Council.

Four types of M&As are subject to the M&A Security Review System:

1. purchases by foreign investors of an equity interest in non-foreign- invested enterprises in China (Non-FIEs) or subscriptions to registered capital increases of such Non-FIEs, which convert the Non-FIEs into FIEs;
2. purchases by foreign investors of an equity interest in FIEs that were held by Chinese shareholders or subscriptions to registered capital increases of FIEs;
3. foreign investors’ establishment of FIEs that are to be used to purchase assets of domestic enterprises through agreements and operate the assets or buy an equity interest in domestic enterprises; and
4. direct purchases of assets from domestic enterprises by foreign investors and uses of the purchased assets as

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investment to establish FIEs in order to operate the assets.

With the official objective of safeguarding national security, the NSR process will operate in parallel to the AML's anti-monopoly merger review provisions (see Table 4) and apply to acquisitions in any of the following Security Review Sectors: national defense, key agricultural products, key basic infrastructure, key energy and resources, major equipment manufacturing, key technology, and key transportation services.[20] This means that not all transactions subject to merger review under the AML will be subject to the NSR process, but only those involving control over a domestic enterprise in a key sector. Also, mergers between foreign companies or between domestic companies will not be subject to the NSR process. Conversely, not all transactions subject to the NSR will be subject to merger control review—for example, when the parties do not meet the merger control thresholds and when MOFCOM does not spontaneously initiate antitrust review.

After completing a Security Review in relation to a proposed transaction, the Panel will effectively have the power to block the deal, or impose conditions on it, if it considers that such measures are appropriate to address the identified concerns.

[20] Some of these Security Review Sectors overlap with the nine "pillar industries" announced by China's State Council and State Assets Supervision and Administration Commission (SASAC) in December 2006 as sectors in which state-owned enterprises should play a leading role.

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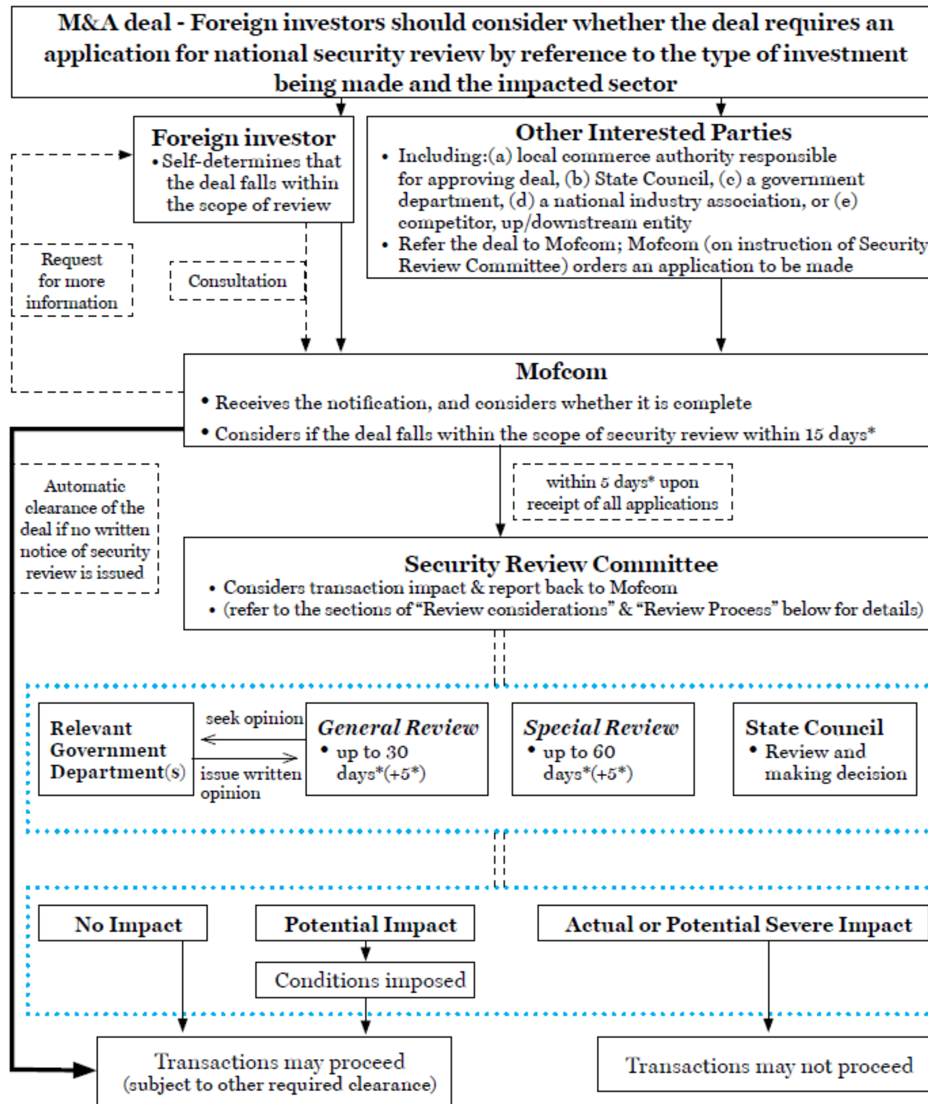
Table 4: National Security Review procedure



Source: Mayer-Brown JSM, *Legal update, Antitrust and competition*, 31 August, 2011.

Assessing the National Security Review process

The enactment of the circular raised concerns that these provisions may be used to further discriminate against foreign investors, but these concerns may be widely exaggerated for a number of reasons.

First, as explained earlier, uncertainty about the clause subjecting foreign acquisitions of Chinese corporations to a "national security review" (Article 31 of the AML) was perceived as particularly worrisome. As a result, the enactment of a new circular should be perceived as positive because it clarifies an existing law.

Moreover, the creation of the NSR process should be interpreted as a natural response to decisions made by some of China's partners. It is probably not a coincidence that the announcement came just a few days after news leaked that the US would probably block an acquisition by China's Huawei of part of American company 3Leaf.[21] Earlier similar decisions by the US regulators, such as the decision to block CNOOC's attempt to acquire Unocal in 2005 as a result of a strong political opposition, probably also account for China's initiative to create a mechanism similar to the US Committee on Foreign Investment (CFIUS), as reactions to this deal in the United States were seen by Chinese authorities as unfair and outright protectionist.

It is also worth stressing that a number of countries other than the US possess such a screening mechanism (Australia, Canada, Germany, among others) and there was talk recently about introducing such a mechanism in the EU.

Lastly, by complementing the AML, the circular provides one additional instrument. Yet, it must be recognized that Chinese authorities already possess a broad range of powers to curb foreign investment and block deals if they deem it necessary, including via the AML Merger Review process, the Rules on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (which allow MOFCOM to challenge transactions in which foreign investors will acquire control of domestic entities in key economic sectors or affecting national economic security or famous Chinese brands) and other regulatory approval mechanisms. These mechanisms have been used in the past to force or pressure the abandonment of major foreign investment proposals in China, including the previously mentioned Coca-Cola/Huiyuan deal in 2009 and the bid by the Carlyle Group in 2005.

While the scope of Security Review Sectors is limited, it is noted that the AML Merger Review already allows MOFCOM to consider the impact of any proposed transaction (whether or not conducted inside China) on China's national economic development

[21] China's New Protectionism - 24/7 Wall St. http://247wallst.com/2011/02/12/chinas-new-protectionism/#ixzz1XNbUfsUz

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and industrial policy goals. Officially, neither Coca Cola's bid nor Carlyle's bid was rejected on national security grounds, but MOFCOM managed to block or discourage the deals by making use of existing provisions. In a nutshell, while the NSR process may add another layer of regulation to inbound deals and raise the prospect of transaction delays, it is unlikely to significantly alter the existing risk profile for foreign investment in China.

Despite all this, there are some reasons for concern. First, while China's new NSR procedure bears some resemblance to the US CFIUS process, there are significant differences as well. Overall, both have the same basic goal, namely to review foreign investments in domestic companies for their effect on national security. But China's definition of "national security" is much broader, including such economic concerns as impact on domestic capacity, the domestic economy, "basic social order," and domestic R&D capabilities. Although the CFIUS allows a certain amount of discretion in defining national security in the review process, depending on individual cases and current developments, the scope of the reviews is explicitly limited to national security risks and thus excludes protecting US economic strength as a general contribution to national power. Economic security, while excluded by the US, is part of the Chinese regulation, thus leaving more leeway to regulators. Generally speaking, a major snag is that, as with many of these types of rules found in other jurisdictions, the NSR Notice leaves great discretion in the hands of Chinese government agencies.

As a side effect, the new regulations on NSR are also likely to make the environment tougher for variable interest entities (VIEs),[22] since foreign investments through VIEs can be expected to face systematic security checks.

In conclusion, although the risks associated with the implementation of the NSR process should not be exaggerated, it cannot be denied that there is scope for its being used as an instrument of protectionism. Whether these rules will constitute another serious obstacle for foreign companies doing business in China will depend on how they are applied in practice. Only implementation will tell the actual intentions of the authorities.

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[22] A Variable Interest Entity (VIE) is a corporate structure that a non-Chinese corporation may use for investment and participation in restricted industries. It is an entity in which the investor holds a controlling interest that is obtained through legal agreements rather than through share ownership. This corporate structure is widely used in businesses involving internet portals and other related media in China, which prohibits direct ownership of such businesses by foreigners.

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Concluding remarks and recommendations

Mixed signals provided by regulatory changes

The recent changes in China's FDI-related laws and regulations provide at best ambiguous signals as to the country's position vis-à-vis foreign investors. While the regulatory environment cannot be said to be increasingly rigid, there has not lately been any clear decline in restrictiveness either.

Despite official allegations that FDI should be encouraged and its utilization further improved, as reflected in the "Opinions" issued in early 2010, the changes introduced in the revised catalogue on foreign investment guidance do not really point to a much improved investment environment and fall short of foreign investors' expectations in terms of market opening. The number of activities removed from the prohibited or restricted categories and moved to the encouraged or permitted categories is very limited; in particular the much hoped for opening-up of the service industry to foreign-invested firms remains elusive. Moreover, the persistence of ownership restrictions imposed on foreign investors operating not only in restricted categories but also in some encouraged activities (in particular in sensitive industries) constitutes an important obstacle to the expansion of foreign investors' activities in the Chinese market.

Similarly, access to China's public procurement market remains largely closed to potential foreign bidders, with the fragmentation of regulations between the GPL and the BL compounding difficulties for foreign investors. In addition, China's revised GPA offer (issued in 2010) remains unsatisfactory to most current GPA members and reflects a persistent reluctance on the part of China to make substantial commitments in this area. It is also worth remembering that China's accession to the WTO GPA would be no guarantee that foreign investors would have full access to China's public procurement market.

Lastly, although the AML merger review should not *prima facie* be seen as discriminating against foreign investors, its implementation suggests that protecting domestic producers and more generally the domestic market against foreign-invested firms remains the primary concern of Chinese authorities. The exclusive

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rejection of mergers involving foreign firms is clear enough evidence of their intentions.

The Circular No 72 (*Relevant Issues Concerning the Regulation of Foreign Investment*) issued on February 25, 2011 provides an excellent example of this ambivalent stance. On the one hand, the Circular encourages foreign investment by increasing the review threshold for certain foreign acquisition that previously required review by the State-level MOFCOM, as well as simplifying certain approval and registration procedures for foreign investment. On the other hand, the Circular also seeks to strengthen regulatory review of foreign investment in certain industries that are considered to be more sensitive.

However, next to these rather negative aspects, recent developments point to some progress towards liberalization of the Chinese investment environment. First, even if the number is limited, Chinese authorities have removed some activities from the restricted, and even from the prohibited categories, thus *de facto* allowing foreign investors to operate in China in activities such as medical institutions, venture capital companies or financial leasing.

Secondly, there should be an appreciation of the fact that some of China's measures such as income tax law changes or creation of M&A and anti-trust laws represent a leveling of the playing field or the adoption of Western-style legal and regulatory regimes rather than a sign of aversion to foreign investment.

Moreover, the restrictiveness of Chinese regulations needs to be kept in perspective. Some of the provisions that have been sharply criticized as constituting obstacles to foreign investor penetration are actually not very different from what is being done elsewhere. Such is the case in particular with the NSR process, the objective of which is largely similar to that of the CFIUS, for instance. In addition, as explained earlier, in reality this regulation does not bring major changes to the regulatory environment since Chinese authorities can resort to a wide array of alternative instruments to block deals envisaged by foreign-invested firms if they deem it fit. In all fairness, rather than raise excessive concerns, the national security provision should be seen as a positive development because it is an official attempt to provide more transparency and clarity.

The ambivalence in the attitude of the Chinese authorities vis-à-vis FDI is a fairly common stance observed in a number of other emerging economies. The reason lies in the dual nature of FDI, which may be a catalyst for economic growth as well as a threat to domestic companies.

A final positive development relates to the Chinese Government's decision to backtrack on linking indigenous innovation and government procurement. Out of pragmatism, Beijing realized that this policy was a "wrong policy" and chose to give in to foreign pressures exerted in particular by the US and European business communities.

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Getting China to be more cooperative

European countries certainly have an interest in getting an easier access to the Chinese market for their firms. In line with recent initiatives, pushing for China's accession to the GPA should remain an important objective. However it should be clear that this will only solve the problem of uneasy access to China's public procurement market if the coverage is broad enough to encompass public procurement currently regulated under the bidding law, since government procurement *stricto sensu* is only a minor share of the public procurement market.

As explained in the paper, outright prohibitions may no longer be the main barriers to foreign investor entry to the Chinese market. Hidden barriers in the form of non transparent application of existing regulations are probably more important, and foreign companies would no doubt welcome greater fairness and, above all, transparency in the operation of the new regulations.

With an important level of discretion left in the hands of Chinese authorities at all levels of responsibility, the business environment remains complex for foreign investors. A major problem in the Chinese case relates to the lack of transparency and the instability of the regulatory environment. The vagueness in some provisions (economic security is a case in point) and the lack of precision in the responsibilities assumed by various government levels (be they central or provincial as in the case of the catalogues) generate an opaque and uncertain business environment. Retroactive application of some regulations is also not uncommon, further increasing the lack of predictability in the regulatory environment.

The challenge for China's partners is to find the best way, beyond regulatory reforms, to level the playing field for their firms operating in China. Initiatives should be taken with the following dual objective: streamlining investment regulations and pushing for fair enforcement of these regulations.

Taking into account China's dependence on FDI, a negotiation is likely to be less asymmetrical than is often argued. In the context of a negotiation, China's partners should keep in mind the perceived potential contribution of FDI to China's further economic development.

It is the author's conviction, that negative reciprocity is not the best possible approach and that engagement should be favored over retaliation. Positive reciprocity is the willingness to return favors, while negative reciprocity is the willingness to harm those who previously harmed you. Negative reciprocity is very likely to usher in a vicious circle of retaliation and counter-retaliation and a race to the bottom. In the discussion on FDI-related issues, the primary goal should thus be to avoid seeing the negotiation slide into tit-for-tat protectionism.

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With China being increasingly a foreign direct investor in its own right, it is in the interest of its partners that China goes on investing. The notion of withholding US or European investment access for more access in China is foolish and against American and European interests. As argued by European Trade Commissioner Karel de Gucht “Europe's open investment regime remains our strongest argument for others to grant us similar access."[23] In this context, a positive reciprocity approach is advisable.

Moreover, rather than isolating various issues such as ownership restrictions, government procurement or M&A review, a probably more efficient approach is to address all issues at the same time, for instance through the negotiation of an ambitious and comprehensive bilateral investment treaty covering both pre and post-establishment issues (market access and investment protection in particular). One major advantage of a BIT negotiation is that it would be based on a global approach to FDI-related issues, thus allowing trade-offs between various objectives.

Another point to be remembered is that for China, dealing with the EU as a whole rather than with 27 individual member-states (with slightly or substantially different regulations) would provide a substantial gain. For the time being 26 of them (the exception being Ireland) have signed a BIT with China, but the provisions under these 26 treaties are not necessarily well-coordinated or mutually coherent. This is an important bargaining chip for the EU even though China may also be tempted to play one European partner against another. A consistent collective approach is an absolute must on the European side.

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[23] Source: http://www.euractiv.fr/ue-chine-bientot-negociations-pacte-investissement-article.

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Table 5: Summary table of positive and negative regulatory changes

Positive	Negative	Ambiguous
Activities removed from the restricted category (eg. financial leasing, medical institutions, etc.)	Ownership restrictions maintained in some encouraged activities	National Security Merger Review
Activities removed from the prohibited category (video screening companies)	No major breakthroughs in opening up service activities	End of the "super national treatment" offered to FIEs
Change in approval mechanism (more decentralization)	Persistent lack of transparency (in particular the Catalogue does not prevail over other laws and regulations)	
Backpedalling on indigenous technologies	Persistent lack of regulatory stability (in particular retroactive application of some rules)	
	Substantial discretion left in the hands of Chinese authorities at all levels of responsibility	
	Persistent obstacles to public procurement market for foreign firms	

Source: author's own compilation

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