

# **CHINA'S APPROVAL PROCESS**

## **FOR INBOUND FOREIGN DIRECT INVESTMENT:**

IMPACT ON MARKET ACCESS NATIONAL TREATMENT AND TRANSPARENCY



## **Message from U.S. Chamber of Commerce**

This is the second of two U.S. Chamber of Commerce reports intended to promote deeper understanding and highlight the importance of foreign direct investment (FDI) between the United States and China. The U.S. Chamber believes that increasing two-way FDI can yield significant benefits for both countries. Increased FDI has already led to greater economic growth, more jobs, and expanded opportunities in both China and the United States. It has strengthened the relationship between the world's two largest economies and has led to greater global stability and prosperity.

The first report, *Faces of Chinese Investment in the United States*, aimed to promote greater Chinese investment into the United States and help demystify the U.S. investment climate for Chinese business leaders interested in the American market. In addition to sharing the wisdom of Chinese manufacturers, service providers, and business leaders who run state-owned and private companies both large and small, the report made the case for why Chinese investment in the United States helps ordinary Americans.

This second report, based upon research conducted by Covington & Burling at the U.S. Chamber's request, includes a detailed analysis of China's inbound FDI approval process and discusses implications for U.S. companies related to market access, national treatment, and transparency in China. Arguably the most comprehensive and detailed work published to date on China's inbound FDI approval process, the report draws extensively on interviews conducted with a number of foreign companies doing business in China. It also compares China's inbound FDI approval process with the process China uses to approve investments by domestic investors, as well as with the measures that exist in the United States for reviewing inbound FDI.

We hope that this second report will help to inform stakeholders in both countries about the challenges that exist for U.S. and other foreign firms investing in China. We also hope it will stimulate discussion regarding solutions that could reduce barriers to investment in a manner that contributes to China's development and economic rebalancing objectives.

Negotiating a high-standard U.S.-China bilateral investment treaty (BIT) with these issues in mind would be a promising way to expand two-way investment. The U.S. Chamber looks forward to supporting the efforts of both governments to reach an agreement that achieves the substantive objectives of the 2012 U.S. Model BIT. This will require taking fully into account the characteristics of China's inbound FDI approval regime outlined in this report.

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The U.S. Chamber of Commerce believes strongly in keeping the U.S. economy open to foreign investment, as it is in our own best interests. There are voices in the United States whose response to restrictions on American companies abroad is to propose new trade and investment restrictions of our own. The U.S. Chamber opposes such an approach — but proactive steps by China to liberalize its own investment regime and further welcome inbound FDI into China would nevertheless help broaden support in the U.S. for increased inbound Chinese investment.

Sincerely,

Handwritten signature of Tami Overby in black ink.

Tami Overby  
Vice President, Asia  
U.S. Chamber of Commerce

Handwritten signature of Jeremie Waterman in black ink.

Jeremie Waterman  
Executive Director, China &  
Senior Policy Advisor, Asia  
U.S. Chamber of Commerce

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## CHINA'S APPROVAL PROCESS FOR INBOUND FOREIGN DIRECT INVESTMENT:

### Impact on Market Access, National Treatment, and Transparency

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# CHINA'S APPROVAL PROCESS FOR INBOUND FOREIGN DIRECT INVESTMENT: IMPACT ON MARKET ACCESS NATIONAL TREATMENT AND TRANSPARENCY



## I. EXECUTIVE SUMMARY

China's approval process for inbound foreign direct investment (FDI)<sup>1</sup> drives many of the headline economic issues currently being discussed between China and its trading partners, as well as internally within China. A central feature of government-to-government talks is the concern, often expressed by foreign companies, that aspects of China's inbound investment approval process impede their investment in China, extract valuable commercial concessions as a price for market entry, and favor domestic over foreign companies.

While some Chinese policy-makers believe these approval processes are helping China achieve its industrial policy and economic development goals, others believe that the time has come to rethink the state-directed development model China has relied on for the past 30 years, especially given slowing gross domestic product (GDP) growth,<sup>2</sup> declining inbound FDI,<sup>3</sup> and lagging competitiveness of state-owned enterprises.<sup>4</sup> In particular, a February 2012 report published jointly by the Development Research Center of the State Council and the World Bank argues that

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<sup>1</sup> The Organisation for Economic Co-operation and Development (OECD) defines FDI as "investment by a resident entity in one economy that reflects the objective of obtaining a lasting interest in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor on the management of the enterprise. The ownership of at least 10% of the voting power, representing the influence by the investor, is the basic criterion used." <http://www.oecd-ilibrary.org/sites/factbook-2011-en/04/02/01/index.html?contentType=&itemId=/content/chapter/factbook-2011-38-en&containerItemId=/content/serial/18147364&accessItemIds=&mimeType=text/h> (Last accessed: September 12, 2012). See also *OECD Benchmark Definition of Foreign Direct Investment - 4th Edition*, 2008, <http://www.oecd.org/daf/internationalinvestment/investmentstatisticsandanalysis/oecdbenchmarkdefinitionofforeign-directinvestment-4thedition.htm> (Last accessed: September 12, 2012).

<sup>2</sup> See, e.g., "China Q2 GDP Growth 7.6 percent, Slowest in 3 Years," Thomson Reuters, July 12, 2012, <http://www.reuters.com/article/2012/07/13/us-china-economy-gdp-idUSBRE86C04220120713> (Last accessed: September 17, 2012).

<sup>3</sup> See, e.g., "Sliding Investment in China Signals Confidence Waning," Bloomberg News, August 16, 2012, <http://www.bloomberg.com/news/2012-08-16/china-s-july-fdi-falls-8-7-from-year-earlier-to-7-58-billion.html> (Last accessed: September 17, 2012) ("Foreign direct investment in China fell to the lowest level in two years in July [2012]... Investment declined 8.7 percent from a year earlier to \$7.58 billion, the eighth drop in nine months and the smallest inflow since July 2010.")

<sup>4</sup> *The Nature, Performance, and Reform of State-Owned Enterprises*, Unirule Institute of Economics, April 12, 2011, <http://english.unirule.org.cn/Html/PassedRes/20100419182217566.html> (Last accessed: September 14, 2012).

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in order for China to avoid the “middle-income trap” and further advance its economy, it must undertake fundamental reforms and move to complete its transition to a market economy.<sup>5</sup>

China and the U.S. recently demonstrated their shared interest in further promoting bilateral investment by announcing in May 2012, at the Fourth Meeting of the U.S.-China Strategic and Economic Dialogue (S&ED IV), their decision to restart negotiations on a bilateral investment treaty (BIT).<sup>6</sup> BIT discussions are also under way between China and the European Union (EU).<sup>7</sup> Foreign investors are closely watching these negotiations and other interactions between the governments on these issues, as they may directly affect market access and opportunities to do business in China.

To fully understand and address the concerns of all of the interested parties in these discussions, it is necessary to understand the various elements of China’s inbound investment approval process and the stages in the process where the perceived problems arise. This process potentially involves eight different types of approvals, though the process varies somewhat based on industry and locale, whether the investment is in certain services industries, and whether it involves the purchase of a strategic interest in a Chinese publicly traded company.

The types of approvals and corresponding approval authorities are as follows:

***TYPE A:*** Anti-Monopoly Law Review of Concentrations  
*Ministry of Commerce (MOFCOM)*

***TYPE B:*** National Security Review  
*MOFCOM and a Ministerial Panel*

***TYPE C:*** Name Pre-Approval and Enterprise Registration  
*Administration of Industry and Commerce*

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<sup>5</sup> *China 2030: Building a Modern, Harmonious, and Creative High-Income Society*, Development Research Center of the State Council and the World Bank Group, February 27, 2012, <http://www.worldbank.org/en/news/2012/02/27/china-case-for-change-on-road-t-030> (Last accessed: September 9, 2012).

<sup>6</sup> “Joint US-China Economic Track Fact Sheet - Fourth Meeting of the US-China Strategic and Economic Dialogue,” US Department of Treasury, May 4, 2012, <http://www.treasury.gov/press-center/press-releases/Pages/tg1567.aspx> (Last accessed: September 8, 2012).

<sup>7</sup> “China, EU to Seek Bilateral Investment Treaty,” Chinese Government’s Official Web Portal, July 14, 2011, [http://www.gov.cn/misc/2011-07/14/content\\_1906538.htm](http://www.gov.cn/misc/2011-07/14/content_1906538.htm) (Last accessed: September 8, 2012). Japan, Korea, and Canada have also recently completed investment agreements with China, though these agreements do not address market access issues.

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***TYPE D:*** Local Site-Related Opinion Letters

*Land and Resources Department, Environmental Protection Department, Planning Department, and the State-Owned Assets Supervision and Administration Commission*

***TYPE E:*** Project Approval

*National or local Development and Reform Commission or State Council*

***TYPE F:*** Foreign Investment Approval

*MOFCOM or local Commerce Department*

***TYPE G:*** Regulatory Approval

*Relevant industry regulator, if applicable*

***TYPE H:*** Approval of Strategic Investment in a Chinese Publicly Traded Company

*MOFCOM and China Securities Regulatory Commission, if applicable*

According to interviews conducted under condition of anonymity with a number of foreign companies doing business in China, the four types of approval most likely to create market access, national treatment, and related challenges for potential foreign investors are the Anti-Monopoly Law Review, Project Approval, Foreign Investment Approval, and Regulatory Approval. Moreover, the foreign companies interviewed reported three characteristics of China's foreign investment approval process that appear to foster and facilitate these challenges:

- Industrial policies explicitly designed to support the development of domestic industries and the creation of national champions;
- Relatively opaque inbound FDI approval processes explicitly mandated to help China achieve its industrial policy goals; and
- Lack of effective recourse, in many cases, if aspiring foreign investors believe that the approval authorities have not complied with World Trade Organization ("WTO") commitments or China's own regulations, given difficulties with producing evidence and fears of retaliation if complaints are lodged against approval authorities.<sup>8</sup>

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<sup>8</sup> U.S. Ambassador to the WTO Michael Punke raised the problem of retaliation in a speech on November 30, 2011, when he said,

China's trading partners have heard from their enterprises on too many occasions that Chinese regulatory authorities threaten to withhold necessary approvals or take other retaliatory actions against foreign enterprises if they speak out against problematic Chinese policies or are perceived as responding cooperatively to their governments' efforts to challenge them.

(continued...)



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Given these three characteristics of the approval process, the result has sometimes been the application of vaguely written or unpublished rules in ways that restrict or unreasonably delay market entry by foreign companies, including in industries where China has made market access commitments. In other cases, government regulators have, in effect, blocked foreign investment in specific industry sectors simply by failing to promulgate investment and licensing approval requirements applicable to foreign investors in those sectors, as in the case of electronic payment services. Other times, approval authorities have orally communicated deal-specific conditions for investment approval beyond those required by written law, clearly for the benefit of the local joint venture partner.

Comparisons between China's inbound and domestic investment approval processes and between the inbound investment approval processes of China and the U.S. suggest that one way China could reform its current inbound investment approval processes could be to reduce the number of approvals required. For example, China could decide —

- To implement more fully the principle of national treatment by applying the same approval process for inbound investment that it applies to domestic investors (except that inbound investment would still be subject to a possible national security review, as is the case for inbound investment into the U.S.); or
- To implement more fully the principle of reciprocity by eliminating completely the two types of approvals required for China inbound investment that are most related to China's industrial policy goals and that are not required for inbound investment in the U.S. (namely, project approval by the national or local Development and Reform Commission or State Council, and foreign investment approval by MOFCOM or the local Commerce Department).

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In recent years, a pattern also has seemed to emerge of the Chinese government's reflexive resort to trade actions in response to legitimate actions taken by the United States or other trading partners under their trade remedies laws.

This type of conduct is at odds with fundamental principles of the WTO's rules-based system.

The United States strongly urges China to eliminate any basis for these adverse perceptions. All WTO Members need to encourage — not discourage — foreign enterprises that want to shed light on policies they perceive to be problematic. And, if a WTO Member believes a trade action taken by another Member raises concerns, procedures provided by the WTO, such as the WTO's dispute settlement mechanism, are available to try to resolve those concerns.

<http://www.ustr.gov/about-us/press-office/press-releases/2011/november/remarks-united-states-ambassador-world-trade-orga> (Last accessed: September 17, 2012).

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Other avenues for reforming China's inbound investment approval process could be through improving transparency and the effectiveness of the administrative and judicial appeal processes. Options could include —

- Adopting further specific measures, in consultation with all stakeholders including foreign investors, to implement demonstrably and fully China's WTO and bilateral commitments related to transparency;
- Establishing clear criteria for administrative approval and denial; and
- Issuing strong assurances by senior leaders, with concomitant instructions to lower officials, that investors' use of these review processes will not be viewed negatively by China's approval authorities and will not be discouraged.

The ongoing U.S. and EU BIT negotiations with China provide an opportune context for exploring the necessity, benefits, and prospects of these and other possible reforms. The U.S. Model BIT, for example, sets out U.S. goals and expectations on a number of relevant issues important to investors, including “National Treatment” (Article 3), “Performance Requirements” (Article 8), “Publication of Laws and Decisions Respecting Investment” (Article 10), “Transparency” (Article 11), “Review and Appeal” (Article 11(7)), and investor-state and state-state dispute settlement (Sections B and C). In each negotiation with a potential BIT partner, U.S. negotiators must seek agreement on a final text that achieves the substantive objectives of these provisions, while maintaining a balance of commitments that is acceptable to both parties. In BIT negotiations with China, this will require taking fully into account the characteristics of China's inbound FDI approval regime outlined in this report.<sup>9</sup>

To the extent that China's economic policymakers believe that industrial policies favoring domestic companies over foreign investors are in China's best interest, China is unlikely to carry out the kinds of comprehensive reforms that foreign investors believe are needed to address their fundamental concerns. In this respect, some recent developments have not been encouraging to foreign investors. For example, the 2011 revisions to the *Catalogue of Industries for Guiding Foreign Investment* liberalize investment restrictions in only a small number of sectors and actually institute new limitations in others,<sup>10</sup> while a new 2011 national security review for inbound FDI scrutinizes investments for their impact on economic security and social stability.<sup>11</sup>

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<sup>9</sup> For example, phrases such as “wherever possible” and “in accordance with domestic procedures” in Article 11(6) of the US Model BIT may prove too vague to ensure sufficient transparency in China's investment approval process, including ensuring that regulators adhere to reasonable timelines in approval decisions and provide rationales in writing for administrative decisions on particular covered investments.

<sup>10</sup> *Catalogue of Industries for Guiding Foreign Investment* (2011 Revision) (National Development and Reform Commission and Ministry of Commerce, Order No. 12, 2011). See also “Final 2011 Catalogue Offers Few New Openings for Foreign Investment,” The US-China Business Council - China Market Intelligence, January 11, 2012, (continued...)

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However, foreign investors were heartened by China's S&ED IV commitments to: (i) "implement a more proactive opening-up strategy and expand the areas open to foreign investment and the degree of openness"; and (ii) develop "a market environment of fair competition for enterprises of all kinds of ownership and to provide non-discriminatory treatment for enterprises of all kinds of ownership in terms of...regulatory policies."<sup>12</sup>

As China considers how best to implement these new commitments, foreign governments, industry associations, and individual companies will have greater impact if they can present hard economic data and compelling arguments showing that proposed policy changes and trade and investment agreements will contribute significantly to China's own economic development and more sustainable relations with its trade and investment partners.

In the meantime, there are many related questions that could usefully be explored further. For example, this report does not include detailed analyses of Chinese approval policies and practices for specific industries where WTO commitments exist related to market access, national treatment, and elimination of trade-distorting conditions on investment. Nor does it include detailed comparisons between Chinese and U.S. approval policies and practices for such industries, or substantive economic analyses demonstrating the impact of different approaches on economic development. Such analyses and comparisons could help facilitate future constructive discussions on these topics between government officials and industry representatives from both countries.

## II. CHINA'S WTO COMMITMENTS RELATED TO APPROVAL OF INBOUND FDI

Before describing China's current approval process for inbound FDI in detail, it is useful to review the commitments China made with respect to this process as part of its accession to the WTO in December 2001. Although China's policies guiding investment in selected industries are generally not affected by its WTO accession agreements,<sup>13</sup> China committed to eliminating

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<https://www.uschina.org/members/publications/cmi/2012/january/11/02.html> (Last accessed: September 17, 2012) ("The retention of many of the previous investment restrictions is disappointing, but not a surprise. Given China's desire to increase investment in the United States and other markets, however, the new catalogue represents a missed opportunity to reduce investment barriers at a time when investment issues are gaining more attention in the bilateral relationship.")

<sup>11</sup> *Notice of the General Office of the State Council on Launching the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, Section 1 (General Office of the State Council, Order No. 6, 2011).

<sup>12</sup> "Joint US-China Economic Track Fact Sheet - Fourth Meeting of the US-China Strategic and Economic Dialogue," US Department of Treasury, May 4, 2012, <http://www.treasury.gov/press-center/press-releases/Pages/tg1567.aspx> (Last accessed: September 8, 2012).

<sup>13</sup> China's accession agreements include the *Protocol on the Accession of the People's Republic of China* (continued...)

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certain trade-distorting conditions on investment, to granting market access and national treatment to foreign companies in a wide range of industries, and to improving overall transparency in the investment approval process. These commitments are memorialized in the *Report of the Working Party on the Accession of China* (Working Party Report), and most relate to the WTO's *General Agreement on Trade in Services* (GATS). Specific commitments include the following:

## **A. Elimination of Trade-Distorting Conditions on Investment**

In response to concerns expressed by other WTO members, the Working Party Report reflects China's commitment to ensure that permission for investment in general —

. . . would not be conditional upon performance requirements set by national or sub-national authorities, or subject to secondary conditions covering, for example, the conduct of research, the provision of offsets or other forms of industrial compensation including specified types or volumes of business opportunities, the use of local inputs, or the transfer of technology.<sup>14</sup>

China also committed that “consistent with its obligations under the WTO Agreement and the Draft Protocol, the freedom of contract of enterprises would be respected by China,”<sup>15</sup> and “the terms and conditions of technology transfer, production processes, or other proprietary knowledge, particularly in the context of an investment, would only require agreement between the parties to the investment.”<sup>16</sup> In addition, “permission to invest . . . would be granted without regard to the existence of competing Chinese domestic suppliers.”<sup>17</sup>

## **B. Market Access**

Market access commitments related to inbound FDI are described primarily in China's Schedule of Specific Commitments on Services (Services Schedule), which is an annex to the *Protocol on the Accession of the People's Republic of China* (Protocol).<sup>18</sup> Except as otherwise expressly

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(WT/L/432, November 23, 2001) and the *Report of the Working Party on the Accession of China* (WT/ACC/CHN/49, October 1, 2001).

<sup>14</sup> Working Party Report, Para. 203.

<sup>15</sup> *Ibid.*

<sup>16</sup> *Ibid.*, Para. 49.

<sup>17</sup> *Ibid.*, Para. 203.

<sup>18</sup> Annex 9 of the Protocol, Schedule of Specific Commitments on Services List of Article II Exemptions, circulated in documents WT/ACC/CHN/49/Add. 2 and WT/MIN(01)/3/Add. 2.

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specified in the Services Schedule or elsewhere in the accession agreements,<sup>19</sup> China committed to grant broad market access and national treatment to foreign companies in specific services sectors listed in the Services Schedule, including through the establishment of a “commercial presence” in China.

Given that market access in some service sectors is conditioned in the Services Schedule upon the foreign party entering into a joint venture with a local Chinese party, some members of the WTO Working Party “expressed concern regarding the existing practice of imposing conditions on the Chinese companies that were allowed to partner with foreign service suppliers,” noting that “this could amount to *de facto* quotas, as the number of potential partners meeting those conditions might be limited.”<sup>20</sup> To address this concern, “China confirmed that a foreign service supplier would be able to partner with any Chinese entity of its choice, including outside the sector of operation of the joint venture, as long as the Chinese partner was legally established in China.” In such cases, the joint venture would be required “to meet the prudential and specific sectoral requirements, on the same basis as those for domestic enterprises,” and that these requirements “must be publicly available.”<sup>21</sup>

Outside of the service sectors, specific market access commitments were also made with respect to investment in the automotive sector.<sup>22</sup>

## C. National Treatment

For sectors included in the Services Schedule, China committed to accord “services and service suppliers of any other [WTO] Member, in respect of all measures affecting the supply of services, treatment no less favorable than that it accords to its own like services and service suppliers,” unless exceptions to national treatment are specified in the Services Schedule for the particular sector.<sup>23</sup> For example, in some sectors, China provided in the Services Schedule that foreign service providers — including those operating through a commercial presence in China — must meet specific professional qualifications or follow licensing procedures that differ from those required for domestic suppliers.

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<sup>19</sup> For example, in Annex 1, licensing criteria for basic telecommunications services were specified.

<sup>20</sup> Working Party Report, Para. 314.

<sup>21</sup> *Ibid.*

<sup>22</sup> *Ibid.*, Paras. 204-207.

<sup>23</sup> GATS, Art. XVII.

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### D. Transparency

In addition to making generally applicable commitments to improve transparency following accession to the WTO,<sup>24</sup> China committed to “ensure that China's licensing procedures and conditions would not act as barriers to market access and would not be more trade restrictive than necessary.”<sup>25</sup> In addition, China committed that for those services included in the Services Schedule, it would ensure that —

- “China's licensing procedures and conditions were published prior to becoming effective;
- In that publication, China would specify reasonable time frames for review and decision by all relevant authorities in China's licensing procedures and conditions;
- Applicants would be able to request licensing without individual invitation;
- Any fees charged . . . would be commensurate with the administrative cost of processing an application;
- The competent authorities of China would, after receipt of an application, inform the applicant whether the application was considered complete under China's domestic laws and regulations and in the case of incomplete applications, identify the additional information that was required to complete the application and provide the opportunity to cure deficiencies;
- Decisions would be taken promptly on all applications;
- If an application was terminated or denied, the applicant would be informed in writing and without delay the reasons for such action . . . [and] would have the possibility of resubmitting, at its discretion, a new application that addressed the reasons for termination or denial;
- If an application was approved, the applicant would be informed in writing and without delay . . . .”<sup>26</sup>

In addition, China agreed that for services included in the Services Schedule, “relevant regulatory authorities would be separate from, and not accountable to, any service suppliers they regulated.”<sup>27</sup>

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<sup>24</sup> Working Party Report, Paras. 324-336, and Protocol, 2(C).

<sup>25</sup> Working Party Report, Para. 308.

<sup>26</sup> *Ibid.*

<sup>27</sup> *Ibid.*, Para. 309. Exceptions were carved out for courier and railway transportation services.

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### **E. Appeal Process**

In the event that an application for inbound foreign investment is denied, China committed to “maintain tribunals, contact points, and procedures for the prompt review of all administrative actions.”<sup>28</sup> Moreover, “such tribunals shall be impartial and independent of the agency entrusted with administrative enforcement and shall not have any substantial interest in the outcome of the matter.”<sup>29</sup>

The review procedures “shall include the opportunity for appeal, without penalty, by individuals or enterprises affected by any administrative action subject to review.” Moreover, “if the initial right of appeal is to an administrative body, there shall in all cases be the opportunity to choose to appeal the decision to a judicial body. Notice of the decision on appeal shall be given to the appellant and the reasons for such decision shall be provided in writing.”<sup>30</sup>

## **III. CHINA’S APPROVAL PROCESS FOR INBOUND FDI**

This section describes the inbound FDI approval process as set forth in China’s published laws and regulations. As noted in Section VI, the actual implementation of the process may vary in specific cases depending on the context of a particular investment project and local rules and practices.

### **A. Pre-Establishment Approval Process**

#### **1. Foreign Investment Catalogue**

A starting point for understanding China’s regulatory framework for inbound FDI is the *Catalogue of Industries for Guiding Foreign Investment* (Foreign Investment Catalogue or Catalogue).<sup>31</sup> Maintained by MOFCOM and the National Development and Reform Commission (NDRC) under the authority of the State Council,<sup>32</sup> the Catalogue is a lengthy

<sup>28</sup> Protocol, 2(D). See also Working Party Report, Paras. 76-79.

<sup>29</sup> *Ibid.*

<sup>30</sup> *Ibid.*

<sup>31</sup> *Catalogue of Industries for Guiding Foreign Investment* (2011 Revision) (National Development and Reform Commission and Ministry of Commerce, Order No. 12, 2011). See also *Catalogue of Priority Industries for Foreign Investment in Central and Western China* (2008 Revision) (National Development and Reform Commission and Ministry of Commerce, Order No. 4, 2008) (addressing planned investments in China’s non-coastal regions as part of China’s “Great Western Development Strategy”).

<sup>32</sup> *Provisions Guiding Foreign Investment Direction*, Art. 3 (State Council, Order No. 346, 2002).

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document that subdivides industries into “encouraged,” “restricted,” and “prohibited” categories. (Industries not specifically listed within the Catalogue are considered permitted by default.<sup>33</sup>) The Catalogue thereby promotes foreign investment in certain industries while limiting or altogether prohibiting foreign investment in others. The Catalogue was most recently amended in December 2011.

An industry’s designation in the Catalogue carries implications beyond whether foreign investment is permitted. Different designations often lead to different levels of approval scrutiny or tougher application requirements for prospective investors. For example, foreign investment in “restricted” industries is often subject to stricter government review and more burdensome application requirements, which may prolong government approvals for prospective investors. Foreign investment in “encouraged” industries, on the other hand, may be subject to less stringent government review or tariff exemptions.<sup>34</sup>

In addition to industry classification, the Catalogue may require that investment take certain forms and/or that the foreign shareholder’s proportion of investment in the enterprise be limited. For example —

- Following the Catalogue’s listing of an industry, a parenthetical may indicate that the investment is “limited to Sino-foreign equity/cooperative joint venture operations” or “limited to Sino-foreign equity joint venture operations.”
- The parenthetical may also indicate that the Chinese partners must be “controlling shareholders” or may limit the proportion of foreign investment to an amount not exceeding 49% or 50% of total equity.

## 2. Industrial Policies

The categorizations and conditions in the Foreign Investment Catalogue are largely based on China’s industrial policies, which are set forth in various guiding documents, including the five-year plans (FYPs) that lay out China’s economic and development goals for given five-year periods. In March 2011, the nation’s 12<sup>th</sup> FYP was released following its approval at the annual meeting of the National People’s Congress. While the 12<sup>th</sup> FYP focuses on a number of important social and economic issues, the core of its economic objectives rests on a planned restructuring of the domestic economy to encourage domestic consumption, the development of a domestic services sector, higher value-added manufacturing, and improved environmental

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<sup>33</sup> *Ibid.* Art. 4.

<sup>34</sup> *Announcement on Implementing the Catalogue of Industries for Guiding Foreign Investment (2011 Revision)* (General Administration of Customs, Announcement No. 4, 2012).



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protection. The plan also encourages the creation of “national champions,”<sup>35</sup> especially in so-called “strategic emerging industries.”<sup>36</sup>

Industrial policies may, in fact, trump corresponding Catalogue provisions. For example, Note 2 of the Catalogue states that “if there are other provisions in the special regulations or industry policies of the State Council, such provisions shall prevail.” This allows, for example, the *Policy on Development of the Automotive Industry*, an industrial policy issued by the NDRC and approved by the State Council, to include more rigorous domestic equity ownership and government approval requirements than are called for under the Catalogue.<sup>37</sup>

### 3. Obtaining Government Approval

Foreign investors may, in principle, invest in any non-prohibited industry, but only after obtaining Chinese government approval. The party responsible for seeking government approval depends on the form of the investment. Most FDI in China is structured as either a joint venture (JV) or a wholly foreign-owned enterprise (WFOE).<sup>38</sup> Applications for government approvals

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<sup>35</sup> 具有国际竞争力的大型企业集团 or 具有国际竞争力的世界一流企业, *juyou guoji jingzhengli de daxing qiye jituan* or *juyou guoji jingzhengli de shijie yiliu qiye*.

<sup>36</sup> 战略性新兴产业, *zhanluxing xinxing chanye*. These industries are: biotechnology, new energy, high-end equipment manufacturing, energy conservation and environmental protection, clean-energy vehicles, new materials, and next generation information technology. See *Outline of the 12<sup>th</sup> Five-Year Plan for National Economic and Social Development of the People's Republic of China*, Chapter 10, Section (1) (National People's Congress, March 14, 2011) [http://www.gov.cn/2011lh/content\\_1825838\\_2.htm](http://www.gov.cn/2011lh/content_1825838_2.htm) (Last accessed: September 13, 2012).

<sup>37</sup> *Policy on Development of the Automotive Industry*, Chapter 10, Arts. 40-51 (National Development and Reform Commission, Order No. 8, 2004). Automobile manufacturing was listed as an encouraged industry subject to a 50% equity restriction in the 2007 Foreign Investment Catalogue, but then it was removed from the Catalogue in the 2011 revision. Such removal would typically suggest that foreign investment in that industry is now permitted without any form of equity restriction, subject to the review process outlined in Chart 2. However, the *Policy on Development of the Automotive Industry* requires the Chinese party of a Sino-foreign joint venture to hold at least 50% equity and for all Sino-foreign joint venture automobile projects to be reported to the State Council by NDRC for approval, regardless of the total investment amount. Additionally, a foreign investor is prohibited from opening more than two production lines for any “whole automobile” type (e.g., passenger cars or motorcycles). *Ibid.*, Art. 48. See also *Provisions Guiding Foreign Investment Direction*, Art. 4 (State Council, Order No. 346, 2002) (“Foreign-invested projects that are encouraged, restricted, and prohibited shall be listed in the Foreign Investment Catalogue. Foreign-invested projects that do not fall into the categories of encouraged, restricted, or prohibited projects shall be permitted. Permitted foreign-invested projects shall not be listed in the Foreign Investment Catalogue”)

<sup>38</sup> Other potential types of foreign-invested entities and commercial presences in China include: representative offices, foreign-invested partnership enterprises, foreign-invested holding companies, and foreign-invested joint (continued...)

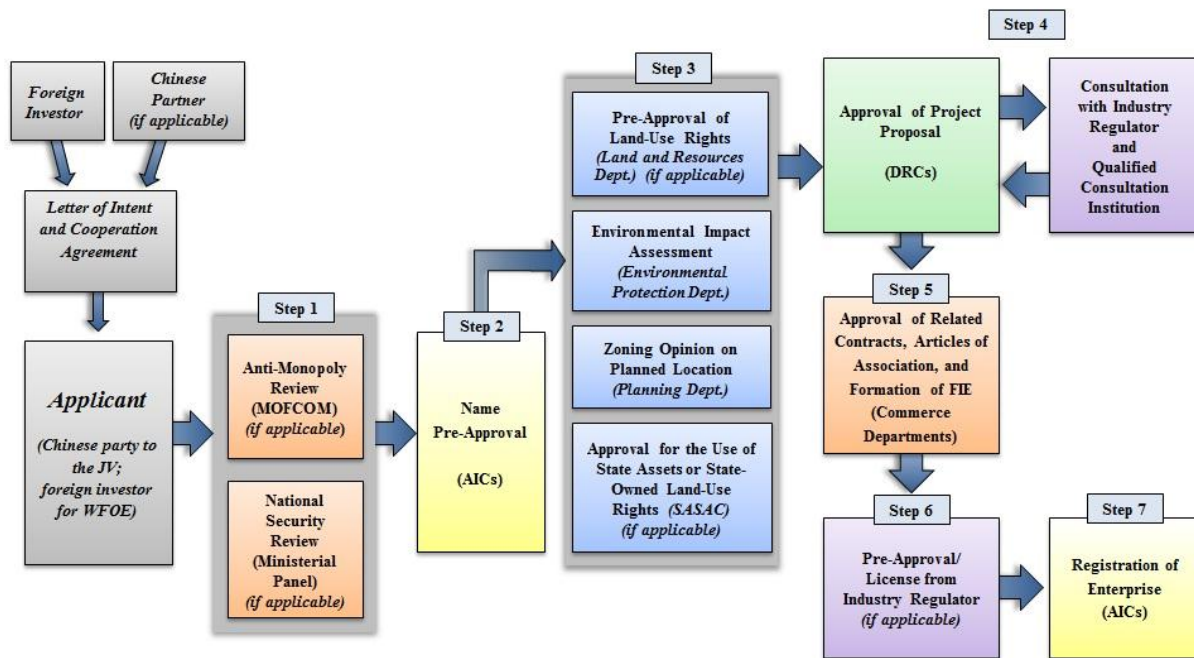
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will be undertaken by the foreign investor if the foreign-invested enterprise will be a WFOE, and by the Chinese partner if the enterprise will be a JV. (In describing the foreign investment approval processes, this report refers generally to the “applicant.”)

The required approvals and the processes for obtaining them may vary depending on the specific industry and/or local regulations. Below we outline the generally applicable approval process for investments and then explain how the process differs for investments in certain service industries.

**Chart 1: General Approval Process for Inbound FDI**



## a) General Investment Approval Process

### *STEP 1.1: Anti-Monopoly Law Review of Concentrations*<sup>39</sup>

stock limited companies. As discussed in Section III(C), it is also possible for foreign companies to make strategic investments in Chinese publicly traded companies, through a somewhat different approval process.

<sup>39</sup> Although the approvals in Step 1 may be undertaken later in the process, applicants often submit their application earlier given the length of time needed for review. The applicant may initiate Steps 2 through 5 during this review period.

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China's Anti-Monopoly Law (AML) defines a “concentration” as a merger, an acquisition of assets or equity that confers control over another company, or an acquisition of “a decisive influence” over another company through contract or other means.<sup>40</sup> Proposed concentrations are subject to pre-closing review by MOFCOM if, in the prior fiscal year —

- The total turnover<sup>41</sup> of all parties, combined, exceeded either RMB 10 billion (US \$1.57 billion)<sup>42</sup> worldwide or RMB 2 billion (US \$315 million) in China; and
- The total turnover in China of each of at least two parties to the concentration exceeded RMB 400 million (US \$63 million).<sup>43</sup>

A transaction that is subject to pre-closing review under the AML may not proceed without clearance from MOFCOM. If the agency determines that the transaction presents no competition issues — the result in the large majority of filed transactions since the AML went into effect in August 2008 — it will clear the deal and permit it to close, although the time needed to secure clearance varies considerably, as discussed below. If, on the other hand, MOFCOM concludes that a transaction “could have the effect of eliminating or restricting competition,”<sup>44</sup> it will either negotiate remedies with the parties to address its concerns or, as has happened in one case, block the transaction entirely.

The AML also requires MOFCOM to consider during merger review the effect of the transaction on the development of the national economy, without further clarifying how or the degree to which such a factor could affect the final review outcome — for example, whether such considerations may trump competition concerns.<sup>45</sup> It is also unclear to what degree MOFCOM has the authority to review the mergers of state-owned enterprises (SOEs) under the AML, or whether the central role of SOEs in national

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<sup>40</sup> *Anti-Monopoly Law of the People's Republic of China*, Art. 20 (Standing Committee of the National People's Congress, Order No. 68, 2008).

<sup>41</sup> Turnover in China refers to revenue derived from sales provided by the company to customers located within the borders of China. Turnover figures must be calculated for each party's entire corporate group; though if the transaction involves the sale of less than the seller's entire business, the seller's turnover includes only the portion that relates to the business that is being sold.

<sup>42</sup> The exchange rate used throughout this report is RMB 6.35 = US \$1.

<sup>43</sup> *Provisions on the Thresholds for Declaring Concentration of Business Operators*, Art. 3 (State Council, Order No. 529, 2008).

<sup>44</sup> *Anti-Monopoly Law of the People's Republic of China*, Art. 28 (Standing Committee of the National People's Congress, Order No. 68, 2008).

<sup>45</sup> *Ibid.*, Art. 27(5).

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economic development plans would exempt some SOE transactions from AML review.<sup>46</sup> This issue is further discussed in Section VI(B)(1).

In addition, neither the AML nor its implementing regulations set forth specific rules with respect to whether or when the formation of a joint venture must be reported as a concentration. In practice, the establishment of a joint venture is considered to be a concentration subject to pre-closing review if the above turnover thresholds are met. Generally, the creation of a WFOE is not subject to such a review.<sup>47</sup>

Under the AML, MOFCOM's review period consists of three phases — an initial review period of 30 calendar days, a second phase of up to 90 additional calendar days, and an extended third phase of up to 60 additional calendar days for “exceptional cases.”<sup>48</sup>

In practice, although the duration of these phases is limited by the statute, the process can take longer, because the initial phase does not begin until MOFCOM deems the parties’ filing to be complete. With MOFCOM in control of the start of the review clock, parties often consult with the agency and provide their filings in draft form, to ensure that their filings will include the information that the case team requires in order to accept the filing as complete.

As a result of such consultations, MOFCOM may not officially begin its review until one or more months after the parties submit their initial draft filing. If an investigation is opened, applicants are officially notified if and when the review has entered the second

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<sup>46</sup> See Jim O’Connell, “The Year of the Metal Rabbit: Antitrust Enforcement in China in 2011,” *Antitrust*, Vol. 26, No. 2, p. 66, Spring 2012. See also *Ibid.*, Art. 7, which states,

The state protects the lawful business activities of business operators in sectors that affect the national economic lifeline and state security and are controlled by the state-owned part of the economy as well as sectors in which exclusive operation and exclusive sale are implemented, it oversees and regulates the business acts and prices of the goods and services of such business operators in accordance with the law, safeguards the interests of consumers and promotes technological progress.

Business operators in the sectors specified in the preceding paragraph shall operate in accordance with the law, act in good faith, implement strict self-regulation, accept monitoring by the public and may not use their controlling position or exclusive operation/exclusive sale position to harm the interests of consumers.

<sup>47</sup> Article 20 of the AML defines “concentrations of undertakings” as: (i) mergers between undertakings; (ii) share or asset purchases; or (iii) other transactions that transfer the ability to exercise decisive influence over undertakings. The creation of a WFOE thus is not a notifiable transaction under Article 20.

<sup>48</sup> The term “exceptional cases” has not been defined by the AML or any of MOFCOM’s implementing regulations. *Anti-Monopoly Law of the People’s Republic of China*, Arts. 25-26 (Standing Committee of the National People’s Congress, Order No. 68, 2008).

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phase.<sup>49</sup> Although the great majority of transactions are cleared without conditions, many are not cleared until some point after the initial 30-day review phase, even in cases where the agency does not identify any competition issues. There are various possible explanations for these delays, including the small number of case handlers relative to the number of filings the agency receives, and MOFCOM has acknowledged such delays as a concern.

### *STEP 1.2: National Security Review*

Proposed mergers and acquisitions by foreign investors will be subject to national security review procedures if the foreign investor would “obtain actual control” of a domestic enterprise in the following sectors as a result of the transaction:

- Military and military support enterprises;
- Enterprises in the vicinity of key and/or sensitive military facilities;
- Other entities associated with national defense and security; and
- Domestic enterprises engaged in sectors that “relate to national security,” including key technologies, major equipment manufacturing industries, important agricultural products, energy and resources, infrastructure, and transportation services.<sup>50</sup>

A foreign investor may voluntarily file with MOFCOM if it believes that a transaction is subject to national security review. Local Commerce authorities or other government agencies may also request that a foreign investor submit a national security filing.<sup>51</sup>

MOFCOM or local Commerce authorities (collectively the Commerce Department) do not have final approval authority on national security matters. If MOFCOM determines that the transaction is subject to review, it must forward the filing within five working days to the Ministerial Panel, an interagency panel consisting of representatives from MOFCOM, NDRC, and other departments.<sup>52</sup> Within five working days, the Ministerial Panel will request written opinions from relevant government agencies, which have 20

<sup>49</sup> *Ibid.*

<sup>50</sup> *Ibid.*, Art. 31. See also *Notice of the General Office of the State Council on Launching the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, Section 1 (General Office of the State Council, Order No. 6, 2011).

<sup>51</sup> *Ibid.*, Section 4 (1) (2).

<sup>52</sup> *Ibid.*

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working days to respond. If any department determines that the transaction may affect national security, then the Ministerial Panel should initiate a special review within five working days, and the Ministerial Panel will have an additional 60 working days (longer if the transaction is submitted to the State Council) to issue an approval, disapproval, or approval with conditions.<sup>53</sup>

The relatively recent development of China's national security review law and the subsequent lack of decided and reported cases leave fundamental questions concerning the national security review process, including the following:

- The definition or other defining criteria of “national security”;
- The extent and circumstances under which MOFCOM may apply these provisions retroactively to cover transactions that have already been closed; and
- The time frame ultimately necessary to complete a national security review, particularly for transactions that are submitted to the State Council for final approval.

To our knowledge, the Ministerial Panel has yet to issue a disapproval or approval with conditions decision following a national security review, and foreign investors who have voluntarily filed their transactions with MOFCOM have not been informed of the precise procedure or received any official decisions in connection with the reviews.

### *STEP 2: AIC “Name Pre-Approval”<sup>54</sup>*

After undertaking the above actions, or as a first step if AML and national security reviews are unnecessary, an applicant must register the name of the foreign-invested enterprise it intends to form with the State Administration of Industry and Commerce (SAIC) or with a relevant local Administration of Industry and Commerce authorized by SAIC (collectively the AICs).<sup>55</sup> Pre-approval is normally provided on the same day the application is made.<sup>56</sup>

<sup>53</sup> *Ibid.*, Section 4 (3).

<sup>54</sup> 企业登记预先核准, *qiye dengji yuxian hezhun*.

<sup>55</sup> *Regulations of the People's Republic of China on Registration Administration of Companies*, Arts. 6-9; Arts. 17-19 (State Council, No. 451, 2005). See also *Measures for Implementing the Administration of Enterprise Name Registration*, Arts. 22-24 (State Administration for Industry and Commerce, Order No. 10, 2004).

<sup>56</sup> *Measures for the Implementation of Administration of Enterprise Name Registration*, Art. 24 (State Administration for Industry and Commerce, Order 10, 2004).

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### *STEP 3: Receipt of Various Site-Related Opinion Letters*

An applicant will then need to obtain multiple written opinions or replies related to its use of land from various government authorities for inclusion in the application materials required for submission to the local Development and Reform Commission. Required written opinions will usually include: (i) an “opinion on pre-approval of land-use rights”<sup>57</sup> issued by the Land and Resources Department; (ii) an environmental impact assessment issued by the provincial or central-level administrative authority for environmental protection; (iii) a zoning opinion<sup>58</sup> on the planned location of the investment issued by the provincial planning department (i.e., that the project location conforms with city planning); and (iv) an opinion on the use of state assets or state-owned land-use rights, issued by the State-Owned Assets Supervision and Administration Commission (SASAC), if applicable.<sup>59</sup> While these opinions are generally required of all foreign-invested enterprises (FIEs), in practice certain service industries may be exempted from such requirements by industry-specific regulations.

### *STEP 4: DRC Project Approval*

The NDRC or relevant authorized local Development and Reform Commissions (collectively the DRCs) are, in principle, responsible for reviewing and approving or rejecting all foreign investment projects, though in practice such DRC “project approval”<sup>60</sup> is generally required only for investments in fixed assets, manufacturing, or specific energy or resource sectors.<sup>61</sup> An applicant is generally required to submit its application to the local DRC, which may then forward the application to NDRC for approval depending on how the industry is designated in the Catalogue and the planned total amount of foreign investment. Certain investments may also require State Council review.

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<sup>57</sup> 项目用地预审意见书, *xiangmu yongdi yushen yijianshu*.

<sup>58</sup> 规划选址意见书, *guihua xuanzhi yijianshu*.

<sup>59</sup> *Interim Administrative Measures for the Verification and Approval of Foreign Investment Projects*, Chapter 3, Art. 6, Sections 4-6 (National Development and Reform Commission, No. 22, 2004).

<sup>60</sup> 项目核准, *xiangmu hezhun*. See *Decision of the State Council on Investment System Reform, Catalogue of Investment Projects Ratified by the Governments*, Section 12 (State Council, Order No. 20, 2004). See also *Interim Administrative Measures for the Verification and Approval of Foreign Investment Projects*, Arts. 3-4 (National Development and Reform Commission, Order No. 22, 2004).

<sup>61</sup> As a matter of best practice, applicants normally consult with DRC and Commerce Department officials on a case-by-case basis prior to commencing the application process.

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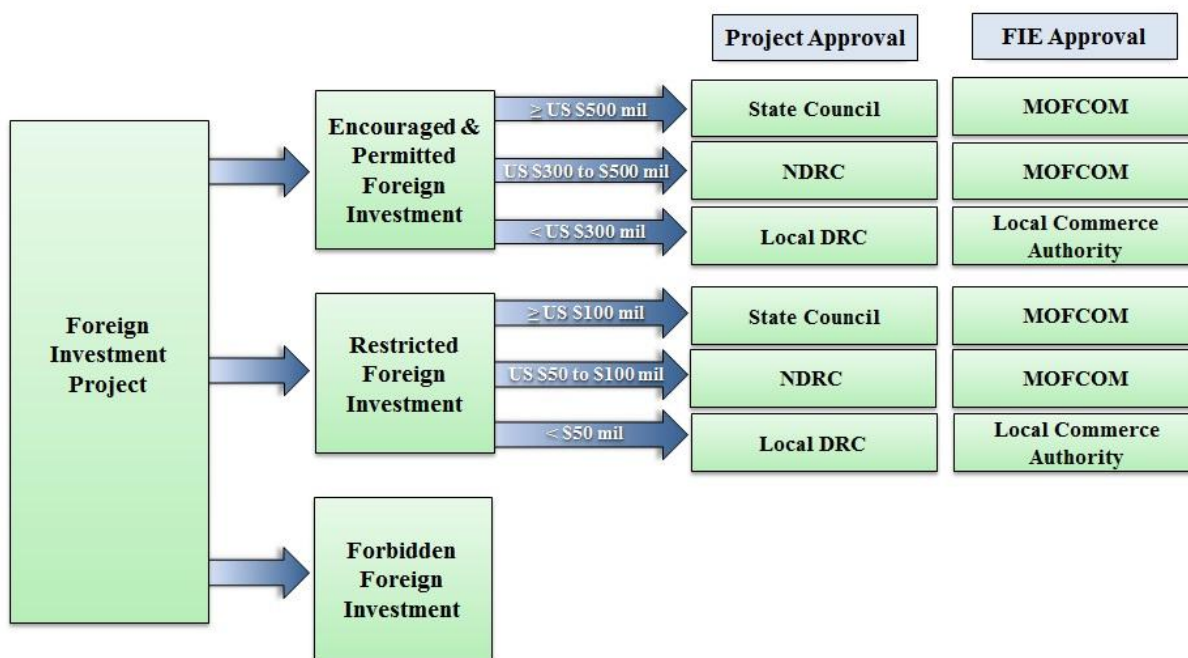
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Chart 2 illustrates how Catalogue designation and the planned total amount of foreign investment (in U.S. dollars) affect which DRC and Commerce Department (either MOFCOM or the relevant local Commerce authorities) ultimately approve the project and whether State Council approval is also required. Typically, 20 business days are required for each level of DRC review (extendable to 30 business days at DRC discretion), though local DRC approval may proceed more quickly.<sup>62</sup>

**Chart 2: Ultimate Approval Authorities for Inbound FDI<sup>63</sup>**



<sup>62</sup> *Interim Administrative Measures for the Verification and Approval of Foreign Investment Projects*, Art. 10 (National Development and Reform Commission, No. 22, 2004). See also *Interim Implementation Measures of Beijing Municipality for the Examination and Approval of Foreign-Invested Projects*, Art. 11 (Beijing Development and Reform Commission, No. 2598, 2005).

<sup>63</sup> *Decision of the State Council on Investment System Reform, Catalogue of Investment Projects Ratified by the Governments*, Section 12 (State Council, Order No. 20, 2004). See also *Interim Administrative Measures for the Verification and Approval of Foreign Investment Projects*, Arts. 3-4 (National Development and Reform Commission, Order 22, 2004). See also *Certain Opinions of the State Council on Further Facilitating the Utilization of Foreign Capital*, Section 4 (16) (State Council, Decree No. 9, 2010). See also *Notice of the National Development and Reform Commission on Doing a Good Job in Delegating the Power to Approve Foreign-Invested Projects*, Section 1 (National Development and Reform Commission, Order No. 914, 2010). See also *Notice of the Ministry of Commerce on Decentralizing the Examination and Approval Power for Foreign Investment*, Section 1 (Ministry of Commerce, Order No. 209, 2010).



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In accordance with relevant regulations, submissions to DRCs should contain extensive project proposal information, including the following:

- “Project name, duration of operation, and basic information on the investors;
- Project construction scale, primary construction content and product(s), main technologies and processes, target market, and anticipated number of staff;
- Project construction location, and requirements for land, water, energy, and the amount of consumption of main raw materials;
- Environmental impact assessment;
- Prices for the public products or services involved; and
- Total investment of the project, registered capital and the contribution of each party, form of capital contribution and financing plan, equipment required to be imported and associated costs.”<sup>64</sup>

The applicant should also attach the following documents to the application submission:

- The business license of the domestic partner (if any)<sup>65</sup> and of the foreign investor;<sup>66</sup>
- The latest audited enterprise financial statement and the credit-worthiness certificate of each investor;
- A letter of investment intent (and, for a capital increase, merger, or acquisition project, the resolution of the company board);
- A letter of financing intent issued by a bank (if applicable); and
- The local authorities’ site-related opinion letters.<sup>67</sup>

In addition, foreign and domestic investors must submit an energy conservation assessment in the form of a written report or a standardized form, in accordance with the investment’s anticipated energy needs. This is reviewed independently by the DRC within five to 15 days of submission, or the review may be entrusted to an independent

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<sup>64</sup> *Interim Administrative Measures for the Verification and Approval of Foreign Investment Projects*, Arts. 5-6 (National Development and Reform Commission, Order No. 22, 2004).

<sup>65</sup> Issued by AIC, 营业执照, *yingye zhizhao*.

<sup>66</sup> Issued in the foreign investor’s home jurisdiction, 商务登记证, *shangwu dengjizheng*.

<sup>67</sup> *Ibid.* Art. 6.

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appraisal institution, in which case the review may not exceed the time limit for overall project examination and approval.<sup>68</sup>

The DRCs may also seek opinions from the industry regulator or an evaluation from a “qualified consultation institution.”<sup>69</sup> The applicable regulation states that such consultants shall “put forward an appraisal report to the NDRC within the prescribed time limit.”<sup>70</sup> However, an exact time limit for the consultations is not specified in the law, and in fact the time required to complete the consultations is specifically exempted from the fixed period of review that is designated elsewhere in the regulations.<sup>71</sup> The law also fails to specify a time limit for applications that are submitted to the State Council for approval.

The DRC is charged with reviewing and approving or disapproving project applications based on whether the project meets the following conditions:<sup>72</sup>

- Conforms to the relevant central-level laws and regulations as well as the provisions of the Foreign Investment Catalogue and the *Catalogue of Priority Industries for Foreign Investment in Central and Western China*;
- Meets the requirements of mid- and long-term planning for national economic and social development, industry planning, and industry structure readjustment policies;
- Conforms to the public interest and relevant central-level provisions on anti-monopoly;
- Meets the requirements of land utilization planning, overall urban planning, and environmental protection policies;

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<sup>68</sup> *Interim Measures for Energy Conservation Assessment and Examination of Fixed-Asset Investment*, Art. 14, (NDRC, No. 6, 2010).

<sup>69</sup> 有资质的咨询机构, *youzizhide zixun jigou*. *Interim Administrative Measures for the Verification and Approval of Foreign Investment Projects*, Arts. 8-9 (National Development and Reform Commission, Order No. 22, 2004).

<sup>70</sup> *Ibid.*, Art. 9. See also *Administrative Measures for Entrusted Investment Consultation and Evaluation* (2009 Revision), Art. 10 (National Development and Reform Commission, Order No. 802, 2009).

<sup>71</sup> See *Interim Administrative Measures for the Verification and Approval of Foreign Investment Projects*, Arts. 8-9 (National Development and Reform Commission, Order No. 22, 2004) (“The authorizing period specified in the preceding paragraph shall not include the period for assessment conducted by an entrusted consultation institution.”)

<sup>72</sup> The regulation is vague as to the extent conformance or non-conformance with these criteria affects project approval decisions. See, e.g., *Interim Administrative Measures for the Verification and Approval of Foreign Investment Projects*, Art. 12 (National Development and Reform Commission, Order No. 22, 2004) (“The conditions of the NDRC for verification and approval on project application reports are...”).

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- Meets the central-level requirements for technology and process standards; and
- Conforms to the relevant central-level provisions on capital project management and foreign debt management.<sup>73</sup>

The imposition of such broad criteria raises the possibility that the criteria could, at times, be applied in ways that would violate the market access, national treatment, and transparency commitments China has made in specific sectors, as well as China's broader commitment not to impose trade-distorting conditions on foreign inbound investment. This issue is discussed in further detail in Section VI.

### *STEP 5: Commerce Department Approval*

Once the relevant DRC (or the State Council in certain cases, as noted on Chart 2) has approved a project, the relevant Commerce Department is responsible for “examining and approving the formation of the FIE.”<sup>74</sup> This process includes reviewing the relevant contracts and articles of association of the proposed new entity.<sup>75</sup> In general, inbound foreign investment projects approved by the NDRC will be subject to approval by MOFCOM, while foreign investment projects approved by the local DRC will be subject to approval by the local Commerce authority.

Depending on the form of the investment, the foreign investor will need to submit the following:<sup>76</sup>

- A written application for formation of the FIE;
- A feasibility study report;
- Articles of association;
- The project approval opinion issued by DRC;
- Authority opinions regarding site-related land-use rights, zoning, and environmental impact; and

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<sup>73</sup> *Ibid.*

<sup>74</sup> 外商投资企业设立审批, *waishang touzi qiye sheli shenpi*.

<sup>75</sup> *Provisions Guiding Foreign Investment Direction*, Art. 12 (State Council, Order No. 346, 2002). See also *Decision of the State Council on Investment System Reform, Catalogue of Investment Projects Ratified by the Governments*, Section 12 (State Council, Order No. 20, 2004).

<sup>76</sup> General guidelines may be found at MOFCOM's website: <http://wzzxbs.mofcom.gov.cn/app/entp/guide> (Last accessed: July 25, 2012).

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- For an Equity JV (EJV): (i) the JV contract; and (ii) a candidate name list of the chairman, vice chairman, and directors of the board;<sup>77</sup>
- For a Cooperative JV (CJV): (i) the JV contract; (ii) a project proposal; (iii) the business license or registration certificate of each party to the CJV; and (iv) a candidate name list of the chairman, vice chairman, and directors of the board;<sup>78</sup> and
- For a WFOE: (i) a list naming the legal representative (or candidates for the directors of the board); (ii) a legal certification document and credit worthiness certificate; (iii) a written local government opinion letter; (iv) a list of supplies to be imported; and (v) other documents as required.<sup>79</sup>

The relevant Commerce Department will review the application materials for completeness and to ensure the credibility of the investors and legitimacy of the foreign investment. It will then either issue a foreign-invested enterprise certificate (FIE certificate)<sup>80</sup> to approve the establishment of the FIE, or specify its reasons for disapproval in writing. According to the applicable regulations, the Commerce Department's review may take up to 45 days for a CJV and 90 days for a WFOE or EJV.<sup>81</sup> In practice, 20 business days is usually sufficient.

According to relevant regulations, approval will not be granted if the relevant Commerce Department determines that the project does any of the following:

- Damages China's sovereignty or the social public interest;
- Jeopardizes state security;<sup>82</sup>

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<sup>77</sup> *Implementing Regulations for the Sino-Foreign Equity Joint Venture Enterprise Law of the People's Republic of China*, Art. 7 (State Council, Decree No. 311, 2001). Specific requirements may vary by locality.

<sup>78</sup> *Detailed Implementing Rules for the Sino-Foreign Cooperative Joint Venture Enterprise Law of the People's Republic of China*, Art. 7 (Ministry of Foreign Trade and Economic Cooperation, Decree No. 6, 1995). Specific requirements may vary by locality.

<sup>79</sup> *Detailed Implementing Rules for the Wholly Foreign-Owned Enterprise Law of the People's Republic of China*, Art. 10 (State Council, Order No. 301, 2001). Specific requirements may vary by locality.

<sup>80</sup> 外商投资企业批准证书, *waishang touzi qiye pizhun zhengshu*.

<sup>81</sup> *Detailed Implementing Rules for the Sino-Foreign Cooperative Joint Venture Enterprise Law of the People's Republic of China*, Art. 7 (Ministry of Foreign Trade and Economic Cooperation, No. 6, 1995); *Detailed Implementing Rules for the Wholly Foreign-Owned Enterprise Law of the People's Republic of China*, Art. 11 (State Council, Order No. 301, 2001); and *Implementing Regulations for Sino-Foreign Equity Joint Venture Enterprise Law of the People's Republic of China*, Art. 8 (State Council, Order No. 311, 2001).

<sup>82</sup> This requirement is not expressly applicable to EJVs.

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- Violates the laws of China;
- Fails to comply with the requirements of the development of China's national economy;<sup>83</sup>
- Causes environmental pollution;<sup>84</sup> or
- [For EJVs] includes obvious unfairness in the concluded agreement, contract, or articles of association, thereby harming the rights and interests of a party to the joint venture.<sup>85</sup>

These broad criteria, like those applicable to DRC approvals, could potentially be interpreted and applied in ways inconsistent with relevant WTO commitments. This issue is discussed in further detail in Section VI.

### ***STEP 6: License of the Industry Regulator (if applicable)***

China imposes licensing requirements on business activities in certain industries, and FIEs must procure such licenses/permits<sup>86</sup> prior to engaging in these activities.<sup>87</sup> Currently, licenses are required for more than 100 business activities including, for example, food and drug production, pesticide manufacturing, cigarette manufacturing, and mining.

While the resulting industry license must generally be obtained before the FIE can register with the AIC and receive its business license (see below), in practice the FIE may sometimes register with the relevant AIC and receive a general business license before obtaining the industry license. In such cases, the FIE must apply to the AIC to update its business registration after receiving the industry license. All FIEs must obtain the

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<sup>83</sup> This requirement is not expressly applicable to CJVs.

<sup>84</sup> See, e.g., *Implementing Rules for the Wholly Foreign-Owned Enterprise Law of the People's Republic of China*, Art. 5 (State Council, Order No. 301, 2001); *Detailed Implementing Rules for the Sino-Foreign Cooperative Joint Venture Enterprise Law of the People's Republic of China*, Art. 9 (Ministry of Foreign Trade and Economic Cooperation, No. 6, 1995); and *Implementing Regulations for Sino-Foreign Equity Joint Venture Enterprise Law of the People's Republic of China*, Art. 4 (State Council, Order No. 311, 2001).

<sup>85</sup> *Detailed Implementing Regulations for Sino-Foreign Equity Joint Venture Enterprise Law of the People's Republic of China*, Art. 4(5) (State Council, Order No. 311, 2001).

<sup>86</sup> 许可证, *xuke zheng*.

<sup>87</sup> *Regulations of the People's Republic of China on Registration Administration of Companies*, Art. 22 (State Council, No. 451, 2005).

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industry license (and receive the updated business license from the AIC, if necessary) before engaging in the regulated activity.

## ***STEP 7: AIC Enterprise Registration***

Within 30 days of receiving the FIE certificate from the Commerce Department, the applicant must register the FIE with the FIE Registration Bureau under SAIC or the local AIC.<sup>88</sup> This “enterprise establishment registration”<sup>89</sup> is generally a relatively transparent process that requires only the submission of certain documents<sup>90</sup> and the payment of registration fees.<sup>91</sup> In accordance with relevant regulations, the AIC will review the documents for completeness and decide whether to grant a “business license.”<sup>92</sup> If the application is approved, the AIC will issue a business license to the enterprise within 10 business days of making a decision.<sup>93</sup> (In practice, the time frame for issuance by a local AIC may be shorter.)

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<sup>88</sup> *Wholly Foreign-Owned Enterprise Law of the People’s Republic of China*, Art. 7 (Standing Committee of the National People’s Congress, Order No. 41, 2000); *Implementing Regulations for Sino-Foreign Equity Joint Venture Enterprise Law of the People’s Republic of China*, Art. 9 (State Council, Order No. 311, 2001); *Sino-Foreign Cooperative Joint Venture Enterprise Law of the People’s Republic of China*, Art. 6 (Standing Committee of the National People’s Congress, Order No. 40, 2000); and see also *Regulations of the People’s Republic of China on Registration Administration of Companies*, Art. 6 (State Council, No. 451, 2005).

<sup>89</sup> 企业设立登记, *qiye sheli dengji*.

<sup>90</sup> These documents include: (i) written application form; (ii) appointment letter/power of attorney signed by all shareholders; (iii) articles of association; (iv) capital verification certificate; (v) where the shareholders' initial capital contribution is made in the form of in-kind contribution, the transfer certification document for transferring of the shareholders' property rights; (vi) qualification certificate of investors; (vii) contact information and certification of company directors, supervisors, and managers; (viii) legal representative appointment document and identity certificate; (ix) written notice on enterprise name pre-approval; (x) certificate of domicile for the company; and (xi) other documents as required. See *Regulations of the People’s Republic of China on Registration Administration of Companies*, Art. 20 (State Council, No. 451, 2005).

<sup>91</sup> “Registration fees are calculated at .08% for the first RMB 10 million [US \$1.57 million], plus .04% for any amount between RMB 10 million and RMB 100 million [between US \$1.57 million and US \$15.7 million].” See *Regulations of the People’s Republic of China on Registration Administration of Companies*, Art. 56 (State Council, No. 451, 2005).

<sup>92</sup> 营业执照, *yingye zhizhao*.

<sup>93</sup> *Regulations of the People’s Republic of China on Registration Administration of Companies*, Arts. 54-55 (State Council, No. 451, 2005).

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The issuance of the business license formally establishes the FIE as a legal person. Importantly, it also sets forth the FIE's "business scope"<sup>94</sup> (i.e., the range of business activities in which the FIE is authorized to engage). The FIE may not undertake business activities outside of its business scope without first obtaining an amendment to that scope.<sup>95</sup>

### **STEP 8: Other Administrative Registrations**

Following registration, an FIE must obtain and file certain other administrative registrations. These include: (i) obtaining an "Organization Code Certificate"<sup>96</sup> from the Quality and Technical Supervision Department; (ii) obtaining a permit to engrave company seals from the Local Public Security Bureau; (iii) registering with state and local tax bureaus; (iv) engaging in foreign exchange registration and obtaining a permit for foreign currency accounts; and (v) registering with the Import and Export Consignees associated with Customs. These processes are generally transparent and straightforward and are not discussed further.

### **NOTE: Variances in the General Investment Approval Processes**

The general process for investment approval may vary depending on the specific industry and/or on local regulations. For example, the Beijing DRC requires industries falling under the "restricted" category in the Catalogue to obtain preliminary approval from the industry regulator before submitting their application materials under Step 4 (even though such a requirement does not appear in the official project approval measures of NDRC or the Beijing DRC).<sup>97</sup> In other cases, Step 6 may be carried out following the pre-approval name registration in Step 2. Thus, it is generally necessary to consult with the relevant authorities to confirm the investment application requirements on a case-by-case basis.

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<sup>94</sup> 经营范围, *jingying fanwei*.

<sup>95</sup> *Regulations of the People's Republic of China on Registration Administration of Companies*, Arts. 15 (State Council, No. 451, 2005). See also *General Principles of the Civil Law of the People's Republic of China*, Art. 42. (National People's Congress, 1986).

<sup>96</sup> 组织机构代码证, *zuzhi jigou daima zheng*.

<sup>97</sup> See, e.g., Item 10 as listed on the required submissions for Beijing DRC approval. Beijing Municipal Commission of Development and Reform, <http://www.bjpc.gov.cn/bsdt/bszn/xk/201009/t686417.htm> (Last accessed: July 25, 2012). See also *Interim Implementation Measures of Beijing Municipality for the Examination and Approval of Foreign-Invested Projects*, Art. 6 (Beijing Development and Reform Commission, No. 2598, 2005). See also *Interim Administrative Measures for the Verification and Approval of Foreign Investment Projects*, Art. 6 (National Development and Reform Commission, Order 22, 2005).

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### *b) Alternative Approval Processes for Certain Service Industries*

Pursuant to its GATS obligations, China has committed to open a wide range of service sectors for inbound foreign investment through the establishment of a “commercial presence.” Nevertheless, foreign investors must still receive government approval for each such investment. The approval processes for inbound foreign investment in service industries differ in various ways from the general approval process for investments described above.<sup>98</sup> Steps 1, 2, and 7 above related to AML and National Security Reviews, AIC Name Pre-Approval, and AIC Enterprise Registration remain the same, while Steps 3 and 4 regarding site-related opinion letters and DRC Project Approval may not always apply. Other variances exist by industry and occur primarily with respect to Commerce Department and industry regulator approvals (Steps 5 and 6).<sup>99</sup> The time frame for service industry review likewise depends on the industry and may take more than a year for certain heavily regulated industries.

In general, however, the approval process for a given service industry usually falls into one of four general categories.<sup>100</sup>

#### *(1) Direct Industry Regulator Approval (with no Commerce Department approval)*

To invest in certain service industries including, for example, legal, banking, securities, and education services, a foreign investor must obtain approval directly from the industry regulator.<sup>101</sup> Requirements for industry approval vary depending on the specific industry, but generally the intent of the review is to determine whether the investor is qualified to provide the specified service in China and to ensure compliance with People’s Republic of China (PRC) laws and policies. For instance, foreign-invested banks are required to meet certain criteria regarding credit standing, anti-money laundering systems, and

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<sup>98</sup> *Provisions Guiding Foreign Investment Direction*, Art. 12 (State Council, Order No. 346, 2002). See also *Certain Opinions of the State Council on Further Facilitating the Utilization of Foreign Capital*, Section 4 (16) (State Council, Decree No. 9, 2010).

<sup>99</sup> *Guiding Handbook on the Administration of Foreign Investment Access*, Part 5, I (4) Interpretations to Special Provisions (Ministry of Commerce Department of Foreign Investment, Order No. 530, 2008).

<sup>100</sup> While the processes can be categorized into four basic types, differences exist for the processes in each specific industry. It is generally necessary for foreign investors to consult specific regulations and the industry regulator.

<sup>101</sup> See, e.g., *Regulation of the People's Republic of China on the Administration of Foreign-Invested Banks* (State Council, Order No. 478, 2006).



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capital adequacy.<sup>102</sup> The process for formal establishment also varies by industry and may include several steps, such as a preparatory establishment phase.

### *(2) Commerce Department Approval (with no other industry regulator input required)*

For certain services industries, the Commerce Department acts, in effect, as the industry regulator. These industries include, for example, distribution services, direct sales, leasing, international freight forwarding, and conference and exhibition services.<sup>103</sup> In such cases, the applicant will generally apply to the local Commerce authority for preliminary examination, and the local Commerce authority will then forward the application to MOFCOM for approval to establish the FIE, with time lines for approval varying by industry.<sup>104</sup> For certain industries, MOFCOM has devolved final approval authority to the provincial Commerce authority.<sup>105</sup>

### *(3) Industry Regulator Pre-Approval and Commerce Department Approval*

To invest in other service industries including, for example, medical, telecommunications, advertising, asset evaluation, cinema, and printing services, a foreign investor must obtain pre-approval from the industry regulator, followed by Commerce Department approval to establish the FIE.<sup>106</sup> In practice, the industry regulator usually determines whether to grant the FIE approval and MOFCOM will defer to that opinion. As above, the specific requirements and time lines for these approvals vary by industry, and foreign investments in certain industries require MOFCOM approval, while others may obtain final approval from the provincial Commerce authority.<sup>107</sup>

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<sup>102</sup> *Ibid.*, Art. 9.

<sup>103</sup> See, e.g., *Measures for the Administration on Foreign Investment in Commercial Sectors*, Art. 5 (Ministry of Commerce, Order No. 8, 2006).

<sup>104</sup> See, e.g., *Measures for the Administration on Foreign Investment in Commercial Sectors*, Art. 10 (Ministry of Commerce, Order No. 8, 2006); *Regulation on Direct Selling Administration*, Art. 9 (State Council, Order 443, 2005).

<sup>105</sup> See, e.g., *Notice of the Ministry of Commerce on Devolving the Examination and Approval of Foreign-Invested Commercial Enterprises*, Art. 1 (Ministry of Commerce, No. 51, 2008).

<sup>106</sup> See, e.g., *Interim Measures for the Administration of Sino-Foreign Equity Joint and Cooperative Joint Medical Institutions*, Arts. 10-13 (Ministry of Foreign Trade and Economic Cooperation, and Ministry of Health, 2000).

<sup>107</sup> See, e.g., *Provisions on the Administration of Foreign-Invested Telecom Enterprises*, Art. 11, 12, and 15 (State Council, No. 534, 2008) (permitting value-added telecommunications companies operating in a single province to be approved by the provincial Commerce Department).

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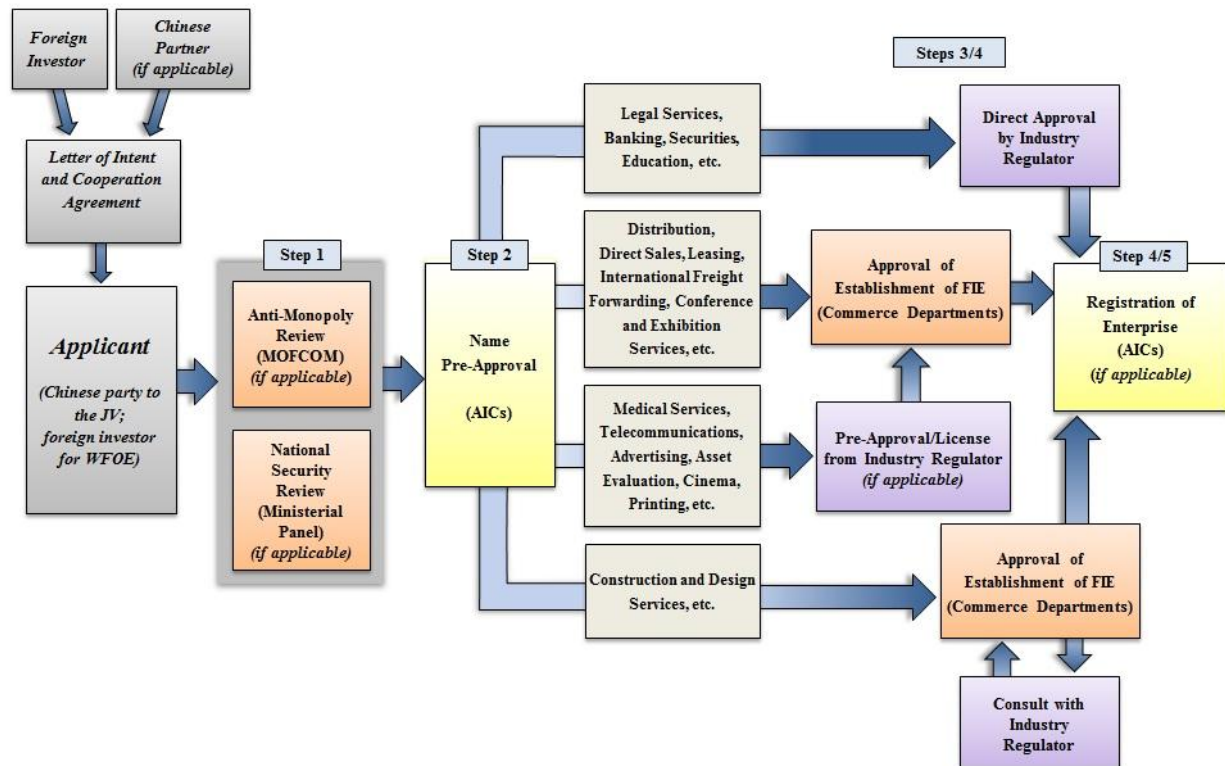


### (4) Commerce Department Approval (with input from the industry regulator)

To invest in certain service industries including, for example, construction and design services, a foreign investor must seek approval to establish the FIE from the relevant Commerce Department, which will then directly consult with the industry regulator.<sup>108</sup> Unlike in the first scenario, here the consultation with the industry regulator is carried out by the Commerce Department, not the applicants themselves.

Chart 3 illustrates these four basic approaches.

**Chart 3: Alternative Approval Process for Inbound FDI in Certain Service Industries**



<sup>108</sup> See, e.g., *Provisions on the Administration of Foreign-Invested Construction Engineering Service Enterprises*, Art. 8 (Ministry of Construction and Ministry of Commerce, Order No. 155, 2007). See also *Administrative Provisions for Foreign-Invested Construction Enterprises*, Art. 7 (Ministry of Construction and Ministry of Foreign Trade and Economic Cooperation, Order No. 113, 2002).

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### **B. Approval Processes for Post-Establishment Expansion**

Once an FIE has been established, additional government approvals are required for certain modifications of the enterprise, such as a change of registered capital, change of shareholders, amendment of business scope, merger, or the acquisition of a company in a restricted industry. In addition, further government approvals may be required if the FIE expands its presence in China by adding new products or opening new branches.

#### **1. AML and National Security Review**

Post-establishment, if an FIE enters into a transaction that meets the AML's notification thresholds, it will need to follow the procedures described in Section III(A)(3)(a)(1.1). Similarly, if at any time an FIE seeks to acquire assets or equity of a domestic enterprise in sensitive industries, the transaction may be subject to the national security review described in Section III(A)(3)(a)(1.2).

#### **2. Expansion — Adding New Products**

Additional government review may be necessary whenever an FIE wishes to produce or sell a new product. Determination of whether an FIE may introduce a new product depends on (i) whether the specific industry regulator imposes any special requirements on the introduction of new products in that industry; and (ii) whether the new product falls into the FIE's current business scope.<sup>109</sup>

##### ***a) Industry Regulator Approval***

In certain cases, the industry regulator may impose special requirements on the introduction of new products in that industry. In such cases, the FIE will be required to obtain approval from the industry regulator to produce or offer the new product.<sup>110</sup> The timing of the review period and the ease in obtaining approvals depend on the industry. Pharmaceuticals is an example of one of the more stringent industries, with a high bar for approval and a review process that may last several years.

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<sup>109</sup> *Regulations of the People's Republic of China on Registration Administration of Companies*, Art. 15 (State Council, Order No. 451, 2005).

<sup>110</sup> See, e.g., *Pharmaceutical Administration Law of the People's Republic of China*, Art. 21 (Standing Committee of the National People's Congress, 1984).

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If industry regulator approval is obtained, the FIE is permitted to offer or produce the new product provided it falls within the FIE's current business scope.

## *b) Business Scope Amendment*

When a new product falls outside an FIE's business scope, the FIE must follow a two-step process to amend the business scope. First, the FIE must apply to the relevant Commerce Department to amend its articles of association to include the new business scope and then receive a new FIE certificate.<sup>111</sup> Next, it must apply to the AIC that issued its business registration in order to request that the business scope be amended to cover the new product.<sup>112</sup> Once the business scope is amended and all requisite industry approvals have been obtained, the FIE may offer or produce the new product.

## **3. Expansion — Adding New Branches**

An established FIE that wishes to open additional branches must register with the local administrative authorities, generally following most of the steps described in Section III(A)(3) above. Certain industry-specific steps or approvals may also be required depending on the type of industry involved.

Regardless of industry, however, all FIEs are required to complete the following steps in order to establish a new branch:<sup>113</sup>

- Obtain pre-approval of name registration with the AIC (if required by the local AIC) (timing: usually provided on the same day);
- Register with the relevant AICs — both where the FIE is already registered (to change information) and where the branch is to be established (timing: approximately 10 to 15 business days each);

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<sup>111</sup> *Implementation Rules for the Wholly Foreign-Owned Enterprise Law of the People's Republic of China*, Art. 15-16 (State Council, Order No. 301, 2001); *Detailed Implementing Regulations for Sino-Foreign Equity Joint Venture Enterprise Law of the People's Republic of China*, Art. 13-14 (State Council, Order No. 311, 2001); and *Detailed Implementing Rules for the Sino-Foreign Cooperative Joint Venture Enterprise Law of the People's Republic of China*, Art. 11-13 (Ministry of Foreign Trade and Economic Cooperation, No. 6, 1995).

<sup>112</sup> *Regulations of the People's Republic of China on Registration Administration of Companies*, Art. 15 (State Council, Order No. 451, 2005).

<sup>113</sup> Note that the business scope of the branch may not exceed the business scope of the FIE. See *Regulations of the People's Republic of China on Registration Administration of Companies*, Art. 47 (State Council, Order No. 451, 2005).

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- File for the record with the local Commerce authority that initially approved the FIE (timing: one to five business days);<sup>114</sup> and
- Obtain and file additional administrative registrations (e.g., tax bureau registration) as necessary.

Currently, approximately 20 service industries also require industry regulator pre-approval prior to the opening of a new branch office.<sup>115</sup>

For general investments, the FIE branch must obtain the various site-related authority opinion letters described in Section III(A)(3)(a)(3), as well as DRC approval, prior to registration with the AIC. As part of its review, the DRC may seek input from the industry regulator and/or a qualified consultation institution.<sup>116</sup>

Chart 4 illustrates the general approval process required to add new branches. The chart does not take into account the potential differences in the process for various service industries, but is based on industries for which approvals by both the industry regulator and the Commerce Department are required in order to establish the FIE. Note that, in contrast to the process necessary for establishing an FIE, there is no need to obtain MOFCOM or local Commerce authority approval for the formation and operation of a new branch (filing for the record is all that is required),<sup>117</sup> and most of the review is conducted by the local, rather than the central-level, government authorities.

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<sup>114</sup> *Notice of the Ministry of Commerce on Further Improving Work Relating to the Examination and Approval of Foreign Investment*, Art. 1 (Ministry of Commerce, Order No. 7, 2009).

<sup>115</sup> These 20 industries and sectors are insurance, banking, advertising, conference and exhibition services, asset evaluation, certification and accreditation services, inspection and appraisal for imported and exported commodities, international maritime transportation, shipping services, international freight forwarding agency, automobile general distribution and retail dealing, oil refining, auction, pawn shop, direct selling, distribution of audio and video products, Sino-foreign cooperative accounting, headhunting job intermediary services, and the commercial sector (商业领域, *shangye lingyu*, which, according to Article 3 of the *Administrative Measures on Foreign Investment in the Commercial Sector* [Ministry of Commerce, Order No. 8, 2004], includes commission agencies, wholesaling, retailing, and franchising). See, e.g., *Regulations of the People's Republic of China on the Administration of Foreign-Invested Insurance Companies*, Art. 14 (State Council, Order No. 336, 2002).

<sup>116</sup> *Interim Administrative Measures for the Verification and Approval of Foreign Investment Projects*, Art. 8 (National Development and Reform Commission, Order No. 22, 2004).

<sup>117</sup> *Notice of the Ministry of Commerce on Further Improving Work Relating to the Examination and Approval of Foreign Investment*, Art. 1 (Ministry of Commerce, No. 7, 2009).

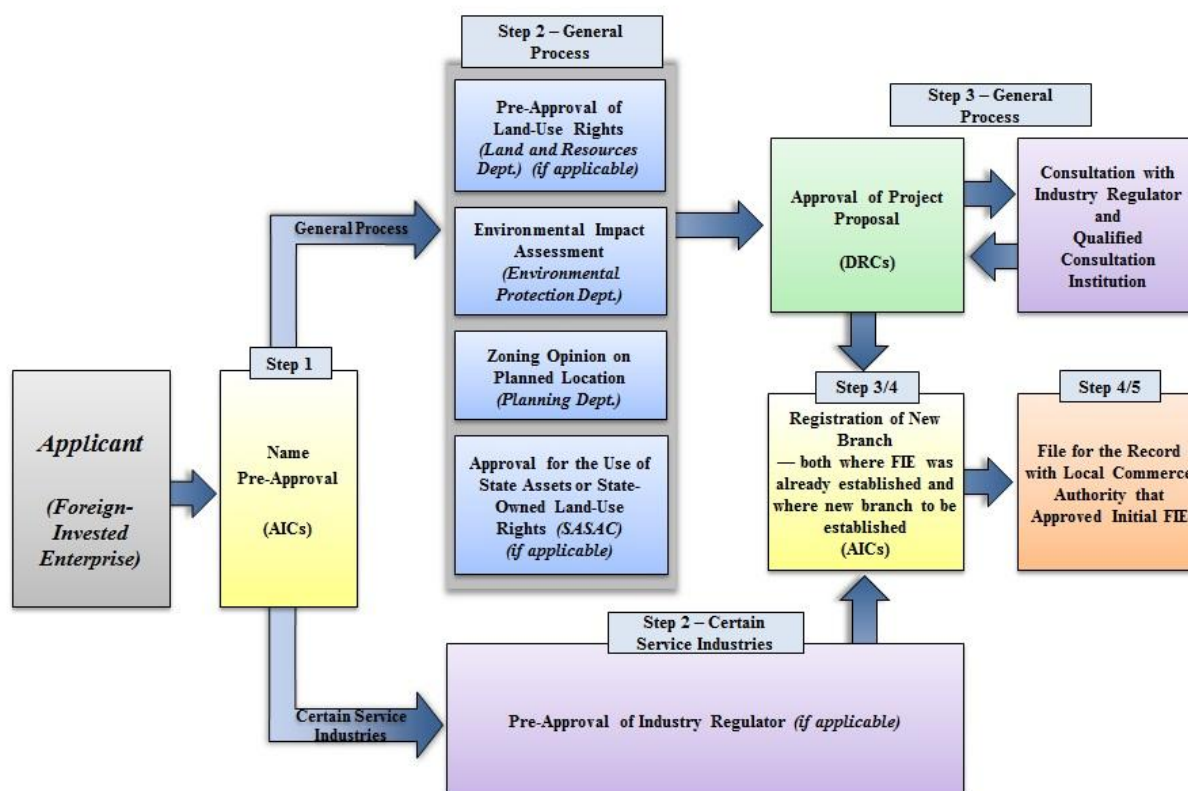
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**Chart 4: Approval Process to Add New Branches**



### **C. Strategic Investment in Chinese Publicly Traded Companies**

In addition to investing directly in China by establishing a JV, WFOE, or other corporate structure, an alternative FDI entry mechanism is through purchasing a strategic interest (i.e., at least 10% of the shares) of a publicly traded Chinese company. This method of foreign entry requires a different set of approval mechanisms than those required for creation of a new legal person or investment project, and involves the oversight of the China Securities Regulatory Commission (CSRC), the nation's principal securities regulator.

Stocks listed on any of China's mainland stock exchanges are classified as either A- or B-shares.<sup>118</sup> A-shares are the largest class of listed shares, they are RMB-denominated, and foreign

<sup>118</sup> PRC companies may also list their stock as H-shares on the Hong Kong Stock Exchange. Given Hong Kong's distinct legal system, these shares are not governed by PRC restrictions and are therefore not discussed in this Report.

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investors are generally restricted from purchasing them. B-shares represent a smaller class of listed shares, are denominated in foreign currency, and may be purchased freely by foreign investors, both individual and institutional. The limited size of the B-share market generally prevents transactions that would transfer a significant amount of control to foreign investors.

Foreign investors wishing to invest in Chinese A-shares have two options.<sup>119</sup>

First, Qualified Foreign Institutional Investors (QFIIs) are eligible to invest in up to 10% of a listed company's A-shares, as long as aggregate foreign ownership of the listed company's A-shares does not exceed 30%.<sup>120</sup> Securities companies, insurance companies, commercial banks, or other asset management institutions with more than US \$500 million in assets may qualify as QFIIs.<sup>121</sup> By April 2012, 129 foreign institutions had been approved as QFIIs, eligible to invest a total of US \$80 billion.<sup>122</sup> As these regulations generally govern portfolio rather than strategic investment and affect a limited number of specialized investors, this report will not examine QFII eligibility requirements further.

Second, foreign investors wishing to hold more than 10% of a publicly traded company's A-shares must comply with the *Measures for the Administration of Strategic Investment in Listed Companies by Foreign Investors* (Strategic Investment Measures), which stipulate that foreign investors must meet several requirements for eligibility, including most notably, that they possess at least US \$100 million in assets or US \$500 million under management.<sup>123</sup> The foreign investors must agree not to transfer any purchased shares for three years and must purchase at

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<sup>119</sup> Technically, the Strategic Investment Measures permit investment in "A-share stock of listed companies that have completed the share-trading reform and newly listed companies after share-trading reform." Share-trading reform was completed in the mid-2000s. See *Measures for the Administration of Strategic Investment in Listed Companies by Foreign Investors*, Art. 2 (MOFCOM et. al., No. 28, 2005).

<sup>120</sup> *Provisions on Issues Concerning the Implementation of the Administrative Measures for Securities Investment Made in China by Qualified Foreign Institutional Investors*, Art. 9 (CSRC, Order No. 17, 2012).

<sup>121</sup> *Ibid.*, Art. 1. See also *Measures for the Administration of Securities Investment within the Borders of China by Qualified Foreign Institutional Investors*, Art. 6 (CSRC, Order No. 36, 2006).

<sup>122</sup> See "Expanded QFII Quotas Signal of Faster Opening Up," Xinhua News, April 5, 2012, [http://news.xinhuanet.com/english/china/2012-04/05/c\\_131508564.htm](http://news.xinhuanet.com/english/china/2012-04/05/c_131508564.htm) (Last accessed: September 13, 2012).

<sup>123</sup> This requirement may be satisfied by an entity's parent company. See *Measures for the Administration of Strategic Investment in Listed Companies by Foreign Investors*, Art. 6(2) (MOFCOM, et. al., No. 28, 2005). Other criteria include: (i) that it is a foreign legal person or other organization established and operated under law with sound finances, good standing, and mature management; (ii) it has sound governance structure and sound internal control systems and criteria for management acts; and (iii) it and its parent company have no record of "grave penalties" by any regulatory institution both at home and abroad within the past three years. *Ibid.*, Art. 6.

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least 10% of the target company's listed A-shares.<sup>124</sup> Foreign strategic investments in A-shares must also comply with all other laws governing inbound foreign investment and investment in state-owned assets. For example, a foreign investor may not sidestep an equity restriction in the Foreign Investment Catalogue through the purchase of A-shares.

The steps below outline the general approval process for purchasing Chinese A-shares under the Strategic Investment Measures.

### *STEP 1: SASAC Approval (if applicable)*

In line with the investment approval process described above in Section III(A)(3)(a), foreign investment in both Chinese A- and B-shares will require SASAC approval if the purchase involves state-owned assets.<sup>125</sup>

### *STEP 2: DRC Foreign Investment Approval*

In addition, if the share purchase is in an industry requiring DRC approval for foreign investment, it will need to undergo the investment approval process described in Section III(A)(3)(a).

### *STEP 3: MOFCOM Share Purchase Approval*

Once a foreign investor has obtained any necessary approvals from Steps 1 and 2, they may then apply to purchase a minimum of 10% of a company's A-shares shares under the Strategic Investment Measures, either through the issuance of new shares ("directional issuance") by the target company or by a share transfer agreement.<sup>126</sup> The application must be made to MOFCOM by either the target company or the foreign investor following approval by the target company's

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<sup>124</sup> QFIIs purchasing shares under the Strategic Investment Measures are not subject to the 10% (30% aggregate) shareholding limitations otherwise applicable to QFII investments. *Provisions on Issues Concerning the Implementation of the Administrative Measures for Securities Investment Made in China by Qualified Foreign Institutional Investors*, Art. 9 (CSRC, Order No. 17, 2012).

<sup>125</sup> *Administrative Measures for Foreign Investors' Strategic Investment in Listed Companies*, Art. 5 (5) (MOFCOM, et. al., Order No. 28, 2005). See also *Law of the People's Republic of China on State-Owned Assets of Enterprises*, Arts. 2, 53, 54, and 57 (Standing Committee of the National People's Congress, Order No. 5, 2008).

<sup>126</sup> We are aware of one situation in which MOFCOM approved a foreign company's purchase of less than 10% of listed shares. However, in that case, there were two foreign investors, and total foreign investment exceeded 10% of listed shares.



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board and shareholders and signing of a purchase contract between the two parties.<sup>127</sup> MOFCOM will examine the documents and give or withhold its approval (or “principle reply”<sup>128</sup>) within 30 days of receipt. This approval will be valid for 180 days.

If the proposed transaction may result in a “concentration” under the AML, then the investor should file an application for AML review prior to, or concurrent with, the share purchase approval application.

### *STEP 4: Open a Foreign Exchange Account and Apply/File with CSRC*

Following MOFCOM approval, the investor will have 15 days to open a foreign exchange account to fund its purchase.<sup>129</sup> If the purchase is to be carried out by directional issuance, then the target company must submit its application documents for a directional issuance to the CSRC.<sup>130</sup> If the investment is made by share transfer agreement, then the investor must go through the formalities for share transfer at the relevant securities exchange, apply for registration and transfer at the securities depository and clearing institution, and file for the record with the CSRC.<sup>131</sup> Where a share transfer agreement results in control of the target company, the investor must instead submit a “report on the acquisition of a listed company” to the CSRC for approval, and then, if approved, apply for registration and transfer at the securities depository and clearing institution.<sup>132</sup>

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<sup>127</sup> Required application documents include: (i) an application letter for strategic investment (Annex I in the Strategic Investment Measures); (ii) the strategic investment scheme (Annex II in the Strategic Investment Measures); (iii) a directional issuance contract or share transfer agreement; (iv) an opinion of a securities institution (in the case of directional issuance) or legal opinion; (v) a commitment letter by the investor to hold the shares for three years; (vi) an investor statement that it has no record of grave punishment by any regulatory institution, home or abroad, within the last three years; (vii) a notarized investor registration certification and identity certificate of its legal representative; (viii) an audited statement of assets and liabilities for the investor from the last three years; and (ix) other documents as prescribed by MOFCOM. *Measures for the Administration of Strategic Investment in Listed Companies by Foreign Investors*, Art. 12 (MOFCOM et. al., No. 28, 2005).

<sup>128</sup> 原则批复, *yuanze pifu*.

<sup>129</sup> *Ibid.*, Art. 14.

<sup>130</sup> *Ibid.*, Art. 7.

<sup>131</sup> *Ibid.*, Art. 8.

<sup>132</sup> *Ibid.*, Art. 9. Note that an investor holding at least 30% of the target company’s shares (either individually or through another person via contract or other arrangement) must pursue any additional purchases through means of a tender offer. *Securities Law of the People’s Republic of China*, Art. 88 (Standing Committee of the National People’s Congress, Order No. 43, 2005).

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### **STEP 5:** *Complete the Share Purchase*

The foreign investor must start its share purchase within 15 days of opening its foreign exchange account and complete the transaction within 180 days of its receipt of MOFCOM approval.

### **STEP 6:** *Obtain MOFCOM FIE Certificate*

Within 10 days of the completion of the transaction, the target company must submit the following materials to MOFCOM in order to obtain an FIE certificate:<sup>133</sup>

- An application letter;
- The MOFCOM “letter of principle reply”<sup>134</sup> (i.e., the transaction approval from Step 1);
- The “shareholding certificate”<sup>135</sup> issued by the securities depository and clearing institution;
- The business license of the listed company and identity certificate of its legal representative; and
- The articles of association of the listed company.

MOFCOM will then have five days to approve the application and issue the certificate.<sup>136</sup>

### **STEP 7:** *AIC Amendment of Company Registration and Receipt of Business License for a Foreign-Invested Enterprise*

Within 30 days of receipt of the FIE certificate, the target company is required to submit the following documents to apply for an amendment of company registration with the relevant AIC and to obtain a business license for a foreign-invested enterprise:<sup>137</sup>

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<sup>133</sup> *Measures for the Administration of Strategic Investment in Listed Companies by Foreign Investors*, Art. 17 (MOFCOM, et. al., No. 28, 2005). If later divestment results in foreign ownership less than 10%, then the company must file with MOFCOM to cancel the FIE certificate. *Ibid.*, Art. 21 (MOFCOM, et. al., No. 28, 2005).

<sup>134</sup> 原则批复函, *yuanze pifuhan*.

<sup>135</sup> 股份持有证明, *gufen chiyou zhengming*.

<sup>136</sup> *Ibid.*, Art. 17 (MOFCOM, et. al., No. 28, 2005).

<sup>137</sup> *Ibid.*, Art. 18 (MOFCOM, et. al., No. 28, 2005). The business license for a foreign-invested enterprise must be amended in the event foreign equity holdings fall below 10%. *Ibid.*, Art. 22 (MOFCOM, et. al., No. 28, 2005).

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- An “application letter for alteration,”<sup>138</sup> signed by the legal representative of the company;
- The FIE certificate;
- The shareholding certificate issued by the securities depository and clearing institution;
- The foreign investor’s notarized and certified “business opening certificate”<sup>139</sup> issued by its home jurisdiction; and
- Other documents as required.

If the application is approved, the AIC will issue a business license to the enterprise within 10 business days of making a decision.<sup>140</sup> (In practice, the time frame for issuance by a local AIC may be shorter.)

### *STEP 8: Other Administrative Registrations*

Finally, within 30 days of the amendment of registration with AIC, the target company is required to obtain the various administrative registrations cited in Section III(A)(3)(a)(8) above.<sup>141</sup>

### **D. NDRC-Proposed Amendments to the Foreign Investment Approval Process**

On August 16, 2012, the NDRC issued a draft amendment for public comment of the *Administrative Measures for the Verification and Approval of Foreign Investment Projects*<sup>142</sup> (draft amendment). The draft amendment, if officially promulgated, would make the following changes to China’s foreign investment approval process:

- Remove the requirement for State Council approval of projects in the encouraged and permitted categories with a total investment amount over US \$500 million, and projects in the restricted category with a total investment amount over US \$100 million (see Chart

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<sup>138</sup> 申请变更申请书, *shenqing biangeng shenqingshu*.

<sup>139</sup> 开业证明, *kaiye zhengming*.

<sup>140</sup> *Regulations of the People's Republic of China on Registration Administration of Companies*, Arts. 54-55 (State Council, No. 451, 2005).

<sup>141</sup> *Measures for the Administration of Strategic Investment in Listed Companies by Foreign Investors*, Art. 19 (MOFCOM, et. al., No. 28, 2005).

<sup>142</sup> *Administrative Measures for the Verification and Approval of Foreign Investment Projects* (Draft for Public Comment) (NDRC, 2012).

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2 and its accompanying text), and grant final approval authority for such investments to the NDRC.

- Replace the current list of project information required for submission to the DRC with the following:<sup>143</sup>
  - Basic background on the project and investor;<sup>144</sup>
  - An analysis of the project development plan, industrial policies, and market access;
  - An analysis of planned natural resources exploitation and utilization;
  - An energy-conservation assessment;
  - An analysis of construction land use, and any potential expropriation or relocation plans;
  - An environmental and ecological impact assessment; and
  - An economic and social impact assessment.
- Add a period for the NDRC to solicit public comment for any proposed investments that might “have a substantial impact on the public interest.” As with the solicitation of third party evaluations, the time period for such public comment is undefined in the draft amendment and would be specifically exempted from the fixed period of review designated elsewhere in the regulations.
- Amend the NDRC review and acceptance criteria to include the submission of results from the national security review and energy conservation assessments; and replace the former “meets the central-level requirements for technology and process standards” requirement with “meets the requirements on regional layout and resource development and utilization.”

It remains unclear when a formal amendment will be officially promulgated and what further revisions, if any, may be made to the present draft. However, it appears that the amendments currently under consideration would not alter any fundamental elements of the existing approval process.

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<sup>143</sup> In addition, an “energy conservation assessment or energy conservation registration form” and “other documents to be submitted pursuant to other laws and regulations” are added to the list of attachments required for project applications submitted to the DRC.

<sup>144</sup> A simplified application may be used for mergers and acquisitions of domestic enterprises by foreign investors where the production or investment size of the domestic enterprise is not significantly increased.

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## IV. APPEAL PROCESS

Under Chinese law, parties that have been declined authorization to invest in China or that are otherwise dissatisfied by an agency decision may apply for administrative reconsideration where they believe they have met legal requirements for approval.<sup>145</sup> The People's Courts may also accept lawsuits brought by such parties.<sup>146</sup>

### A. Procedure and Grounds for Overturning an Administrative Decision

#### 1. Administrative Reconsideration

When an applicant is not satisfied with a government agency's decision, the applicant may, depending on the circumstances, file an administrative reconsideration application with either the government agency itself or with its supervising department (the Reviewing Agency)<sup>147</sup> within 60 days of the applicant's knowledge of the decision.<sup>148</sup> Upon submission, the Reviewing Agency will examine the reconsideration application and decide within five days if the application meets the requirements of relevant laws.<sup>149</sup> If it does, the application is approved for review and the Reviewing Agency should decide on the reconsideration application within 60

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<sup>145</sup> *Administrative Licensing Law of the People's Republic of China*, Art. 38 (Standing Committee of the National People's Congress, Order No. 7, 2004). See also *Administrative Reconsideration Law of the People's Republic of China*, Art. 6 (8) (Standing Committee of the National People's Congress, Order No. 16, 1999).

<sup>146</sup> *Administrative Procedure Law of the People's Republic of China*, Art. 11 (4) (National People's Congress, Order No. 16, 1989).

<sup>147</sup> 行政复议机关, *xingzheng fuyi jiguan*. *Administrative Reconsideration Law of the People's Republic of China*, Arts. 12 -15 (Standing Committee of the National People's Congress, Order No. 16, 1999).

<sup>148</sup> *Ibid.*, Art. 9.

<sup>149</sup> *Ibid.*, Art. 17. See also *Regulations on the Implementation of the Administrative Reconsideration Law of the People's Republic of China*, Arts. 48 (State Council, Decree 499, 2007) ("An administrative reconsideration organ shall decide to reject an application for administrative reconsideration under either of the following circumstances:

(a) The applicant deems that an administrative organ has failed to perform its statutory responsibility and applies for administrative reconsideration, and the administrative reconsideration organ finds, after accepting the application, that the administrative organ does not have the relevant statutory responsibility or has performed its statutory responsibility before the acceptance of the application; or

(b) After an application for administrative reconsideration is accepted, the application for administrative reconsideration is found to be inconsistent with any of the conditions for acceptance as set forth in the Administrative Reconsideration Law and this Regulation.")

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days (except where the time limit for administrative reconsideration prescribed by law is less than 60 days).<sup>150</sup> If the situation is “complicated,” the time for review may be extended by a maximum of 30 days.<sup>151</sup> The Reviewing Agency may affirm or nullify the original administrative decision, and the matter may be resubmitted to the government agency with instructions to take another administrative act within a specified time period.<sup>152</sup>

The Reviewing Agency “shall” nullify or declare illegal an administrative act, and “may” order the government agency to take another specific administrative act, if it finds any of the following violations:<sup>153</sup>

- The main facts are not clear, and essential evidence is inadequate;
- The law was erroneously applied;
- Statutory procedures were violated;
- Authority was exceeded or power was abused; or
- The decision is obviously inappropriate.

## 2. Administrative Lawsuit

If a matter has been submitted to a Reviewing Agency for reconsideration and the Reviewing Agency has failed to act, or if the applicant is unsatisfied with the reconsideration decision made by the Reviewing Agency, the applicant may bring an administrative lawsuit within 15 days after the time limit for reconsideration expires, or within 15 days of the reconsideration decision.<sup>154</sup> Alternatively, an applicant may skip the reconsideration procedure outlined above and instead file an administrative lawsuit against the government agency within three months of receipt of the original administrative decision.<sup>155</sup>

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<sup>150</sup> *Ibid.*, Art. 31.

<sup>151</sup> *Ibid.*

<sup>152</sup> *Ibid.*, Art. 28.

<sup>153</sup> *Regulations on the Implementation of the Administrative Reconsideration Law of the People's Republic of China*, Arts. 45 (State Council, Decree 499, 2007).

<sup>154</sup> *Administrative Procedure Law of the People's Republic of China*, Art. 38 (National People's Congress, Order No. 16, 1989).

<sup>155</sup> *Ibid.*, Art. 25.

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If the People's Court finds that any of the following conditions are met, then the administrative act "shall be annulled or partially annulled" or the defendant "shall" be ordered to take another administrative act:

- Major evidence is inadequate;
- The administrative agency erroneously applied the law or regulations;
- The administrative act violated legal procedures;
- The administrative act exceeds authority; or
- Administrative power was abused.<sup>156</sup>

It is also worth noting that, according to the WTO Working Party Report, if the Chinese government has committed to open a sector but has failed to do so within the promised time period, "authorities," which include judicial organs, are authorized to apply the commitments directly.<sup>157</sup> Consequently, it is theoretically possible that the People's Courts could overturn a reviewing authority's denial of a foreign investment application based on the fact that a WTO commitment is in place, even though regulations and rules to implement the commitment have not yet been established. However, we are not aware of any domestic PRC laws requiring the courts to take such action or of any instances where the courts have been asked to do so.

## **B. Practical Limits**

While the above describes the process and grounds for review of administrative decisions, aspiring foreign investors have seldom, if ever, attempted to rely on them, for reasons discussed further in Section VI.

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<sup>156</sup> *Ibid.*, Art. 28. See also *Provisions of the Supreme People's Court on Several Issues Concerning the Hearing of Administrative Cases of International Trade*, Art. 6 (Supreme People's Court, No. 1239, 2002). Similar interpretations can be found in *Provisions of the Supreme People's Court on Several Issues Concerning the Application of Laws in the Hearing of Anti-Dumping Administrative Cases* (Supreme People's Court, No. 35, 2002) and *Provisions of the Supreme People's Court on Several Issues Concerning the Application of Laws in the Hearing of Countervailing Administrative Cases* (Supreme People's Court, No. 36, 2002).

<sup>157</sup> *Working Party Report*, Paras. 67 and 68. ("The representative of China confirmed that administrative regulations, departmental rules, and other central government measures would be promulgated in a timely manner so that China's commitments would be fully implemented within the relevant time frames. If administrative regulations, departmental rules, or other measures were not in place within such time frames, authorities would still honor China's obligations under the WTO Agreement and Draft Protocol.")

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## V. CHINA'S APPROVAL PROCESSES FOR DOMESTIC INVESTORS AND THE QUESTION OF NATIONAL TREATMENT

This section describes the government approval processes applicable to domestic Chinese investors and compares them with the approval processes applicable to foreign investors described above. The comparison provides background for evaluating China's compliance with its national treatment obligations, and also suggests ways that the Chinese market could become more open to foreign investment if the approval processes for domestic investors were made to apply to foreign investors as well.

### A. Approval Processes

#### 1. Determining What Government Approval Is Required

As with foreign inbound investment, the approval process for domestic investment starts with determining how the targeted industry is classified. The 2004 *Decision of the State Council on Investment System Reform* included a Catalogue of Investment Projects Ratified by the Government (the Domestic Catalogue), which lists projects for which Chinese government approval is required for domestic investment.

In contrast to the Foreign Investment Catalogue, the Domestic Catalogue does not classify listed industries as "encouraged," "restricted," or "prohibited" and does not require that all domestic investment go through the DRC or State Council project approval process. Instead, the Domestic Catalogue lists industries for which project approval is required and the levels of authority (State Council, NDRC, or local DRC) required for such approvals. Domestic investment into any industry that is not listed in the Domestic Catalogue does not require any DRC approval, but may require filing for the record with the DRC.

Unlike foreign investors, domestic investors in any industry, whether covered by the Domestic Catalogue or not, do not normally need to apply for Commerce Department approval.<sup>158</sup>

These requirements are summarized in Chart 5.

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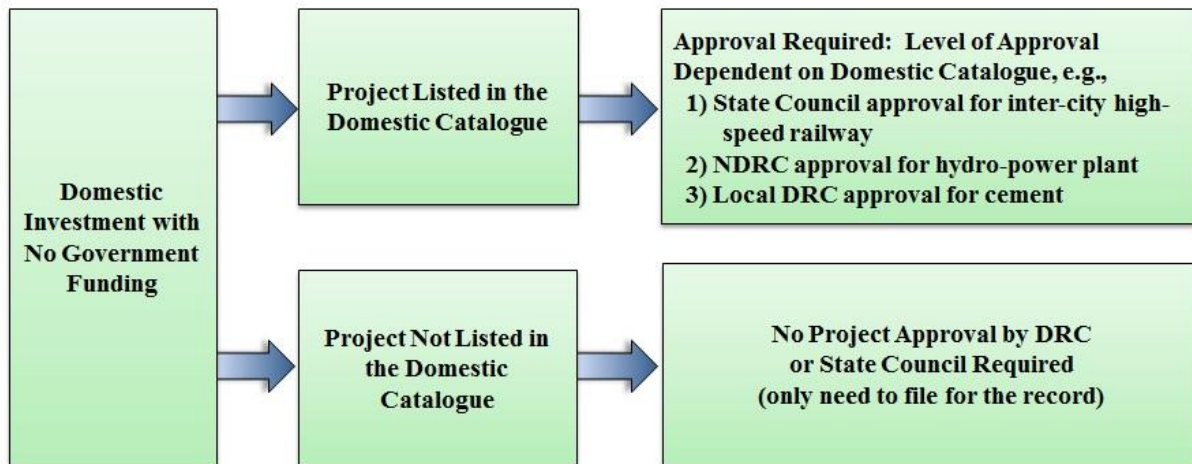
<sup>158</sup> Cf. Section III(A)(3)(a)(5). MOFCOM approval may be still necessary for domestic investors in sectors where MOFCOM acts as the industry regulator, such as distribution services, direct sales, leasing, and international freight forwarding.



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Chart 5: Project Approval Authorities for Domestic Investment<sup>159</sup>



## 2. Approval Process for Industries in the Domestic Catalogue

As noted above, domestic investment in an industry found in the Domestic Catalogue requires DRC approval. The approval process for domestic investment into these industries is as follows:

- **STEP 1:** Obtain AML review, if necessary.
- **STEP 2:** Apply to the relevant AIC for pre-approval of name registration.
- **STEP 3:** Obtain required site-related opinion documents from relevant administrative departments — e.g., a land zoning opinion, a pre-approval opinion on land-use rights, and an environmental impact assessment opinion (certain service industries may be exempt from this requirement). If the investment is to be made by an SOE, obtain pre-approval from SASAC, which is responsible for monitoring the performance of SOEs.<sup>160</sup>

<sup>159</sup> Domestic investments with government funding go through a different approval process that is not relevant to our current analysis. See, e.g., *Decision of the State Council on Investment System Reform*, Catalogue of Investment Projects Ratified by the Governments, Section 3 (4) (State Council, Order No. 20, 2004).

<sup>160</sup> See *Interim Regulations on the Supervision and Administration of State-Owned Assets of Enterprises*, Chapter 5 (State Council, Order No. 378, 2003).

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- **STEP 4:** Submit the following project proposal documents to the relevant local DRC for approval:
  - The local authority site-related opinion reports;
  - The applicant's profile;
  - Project details;
  - Construction, land, and related planning information;
  - An analysis of resource utilization and energy consumption;
  - An analysis of the impact on the local ecological environment; and
  - An analysis of economic and social effects.<sup>161</sup>

If the Domestic Catalogue indicates that central government approval is required, the local DRC will review the materials and then submit them to the NDRC. The local DRC may consult with the industry regulator and/or with a qualified consultation institution as part of its review.

- **STEP 5:** If applicable, procure the relevant industry license(s) and/or pre-approval of the industry regulator.
- **STEP 6:** Submit an enterprise establishment registration application to the relevant AIC.
- **STEP 7:** Obtain other post-establishment administrative certifications and registrations required for operation of the enterprise.

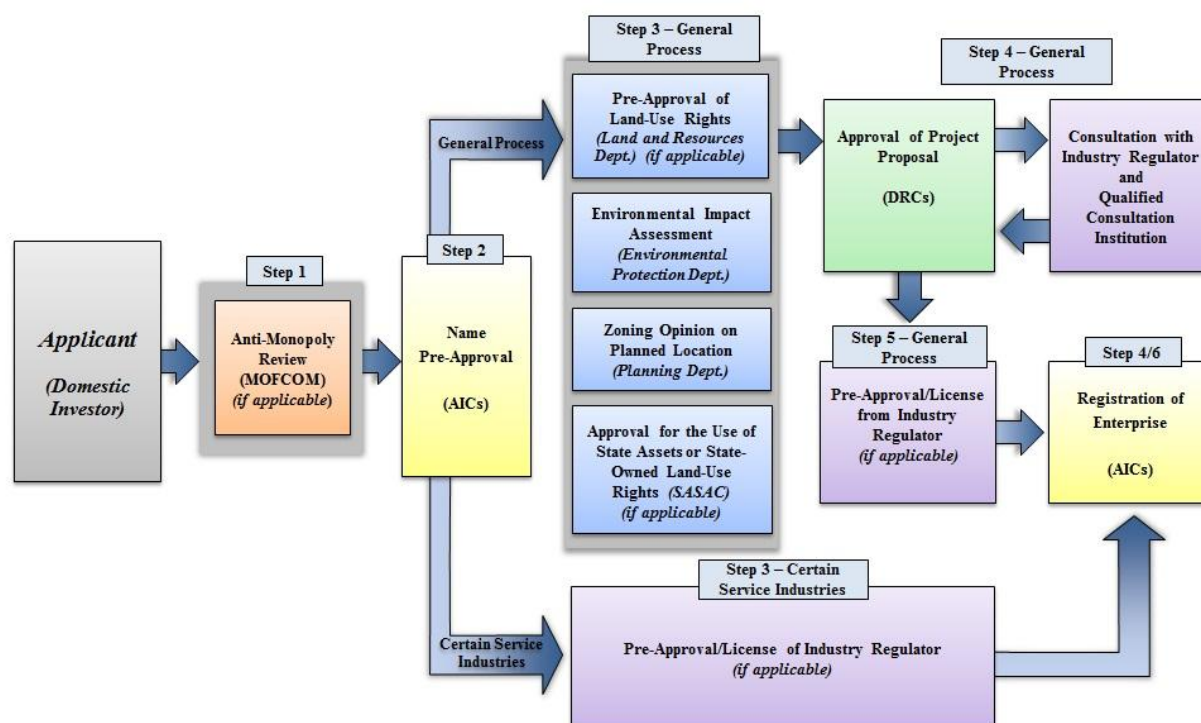
These processes are illustrated in Chart 6.

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<sup>161</sup> See *Interim Measures for Examining and Approving Enterprises' Investment Projects*, Arts. 6 and 8 (National Development and Reform Commission, Order No. 19, 2004).

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**Chart 6: Approval Process for Domestic Investment in Industries in the Domestic Catalogue**



### 3. Approval Process for Industries Not in the Domestic Catalogue

Domestic investment in an industry not listed in the Domestic Catalogue will generally follow the process outlined above, except that the domestic investor will not need to undergo the DRC approval process in Step 4. Instead, applicants must merely file the project for the record with the relevant DRC prior to obtaining the site-related opinions in Step 3.1.<sup>162</sup> The applicant may then proceed to Steps 3.1 and 3.2 (if necessary), followed directly by Steps 5 through 7. In such cases, site-related opinions and regulatory approvals, if any, required for the project are submitted to the AIC as part of the business registration process.<sup>163</sup>

<sup>162</sup> *Guiding Opinions on the Recording Filing Mechanism for Enterprise-Invested Projects*, Art. 2 (National Development and Reform Commission, No. 2656, 2004).

<sup>163</sup> *Regulations of the People's Republic of China on Registration Administration of Companies*, Art. 22 (State Council, No. 451, 2005).

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### **B. Comparison with the Approval Processes for Foreign Investors**

At first glance, the approval processes required for domestic investors in industries covered by the Domestic Catalogue appear similar to those for foreign investors — e.g., both may involve obtaining opinions from relevant local authorities, obtaining approval from DRCs or industry regulators, and registering the enterprise with AIC. Despite these similarities, however, the approval process for domestic investors can be markedly different from the process for foreign investors. For example —

- Whereas the Foreign Investment Catalogue is quite lengthy and covers 52 categories and more than 170 subcategories of industries, the Domestic Catalogue is only several pages long and covers only 13 categories and seven subcategories of industries. The large number of industries outside the Domestic Catalogue that do not require DRC approval for investments by domestic investors stands in sharp contrast to the requirement that DRC approval be obtained for the majority of inbound foreign investments.
- Similarly, while Commerce Department approval is generally not needed for domestic investors, foreign investors must obtain Commerce Department approval for almost all inbound investments.
- Even where domestic investment falls within the Domestic Catalogue and requires DRC approval, the domestic investment approval process is often less onerous than the process for foreign investment in the same industry. For example, though domestic investment in automobile manufacturing requires NDRC project approval, foreign investment in this sector requires State Council project approval.<sup>164</sup>
- Even where regulations do not provide for disparate treatment of foreign and domestic investors, agencies often, in practice, treat applications of these parties differently.<sup>165</sup>

Differences in the approval processes applicable to domestic and foreign investors raise the question of whether China is complying fully with its national treatment commitment for services included in the Services Schedule.<sup>166</sup> Definitive conclusions regarding China's adherence to this commitment would need to be formed on a sector-by-sector basis and would require a careful comparison of the specific approval processes applicable to domestic and foreign investors for that sector as well as a review of the exceptions to national treatment, if any, provided for that sector in the Services Schedule.

<sup>164</sup> See *Policy on Development of Automotive Industry*, Arts. 41-45 (National Development and Reform Commission, Order No. 8, 2004).

<sup>165</sup> See examples discussed in Section VI(B) below on “Issues that Arise During the Inbound FDI Approval Process.”

<sup>166</sup> GATS, Art. XVII. See also discussion in Section II(C) above on “National Treatment.”

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## VI. ISSUES THAT ARISE DURING THE INBOUND FDI APPROVAL PROCESS

China's approval processes for inbound FDI, described above, present many opportunities for investment approval authorities to favor domestic competitors over foreign investors, should they so desire. Apparently, a majority of foreign business people operating in China believe that this is commonly occurring. For example, according to the American Chamber of Commerce in the People's Republic of China 2012 *China Business Climate Survey Report* (AmCham Report), "only 22% [of member company survey respondents] said licenses are granted and enforced equally between foreign and Chinese companies," compared with 29% who held that view in 2011. Furthermore, 68% said that licensing requirements "slow [their] expansion and investment in China."<sup>167</sup> Likewise, in the 2012 European Union Chamber of Commerce in China *Business Confidence Survey*, when asked their perceptions of government policies affecting the business environment for foreign-invested enterprises in China, 42% of respondent companies expressed belief that such Chinese government "policies are less fair now than they were two years ago," and 43% expressed belief that government policies will be even less fair over the next two years.<sup>168</sup>

Three key characteristics of the Chinese system that appear to foster and facilitate this unequal treatment of foreign investors are: (i) industrial policies that often favor domestic competitors; (ii) relatively opaque inbound FDI approval processes that accord broad discretion to government administrators charged with implementing such industrial policies; and (iii) lack of effective recourse, in many cases, if approval authorities fail to honor China's regulations or WTO commitments related to the investment approval process. These characteristics and their impact on the foreign investment approval process are discussed below.

### A. Industrial Policies Favoring Domestic Competitors

China's government administrators are explicitly charged with ensuring that inbound investment projects meet the requirements of China's industrial policies, which include mid- and long-term plans for national economic and social development, industry planning guidelines, and industry

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<sup>167</sup> AmCham China 2012 *China Business Climate Survey Report*, p. 16-17  
<http://web.resource.amchamchina.org/cmsfile/2012/03/26/c46fc22667c5eeb231748808a9244027.pdf> (Last accessed: September 13, 2012).

<sup>168</sup> 2012 *European Business in China Business Confidence Survey*, European Union Chamber of Commerce in China, p. 24-25  
[http://www.europeanchamber.com.cn/upload/media/media/14/European\\_Chamber\\_Business\\_Confidence\\_Survey\\_2012\\_EN%5B559%5D.pdf](http://www.europeanchamber.com.cn/upload/media/media/14/European_Chamber_Business_Confidence_Survey_2012_EN%5B559%5D.pdf) (Last accessed: September 14, 2012).

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structure readjustment plans, as well as requirements for technology and process standards.<sup>169</sup> These plans provide, among other things, for the fostering of national champions, including through the selective utilization of foreign capital.

### 1. Fostering National Champions

The 12<sup>th</sup> FYP calls for the Chinese government “to encourage leading enterprises in key industries . . . to form alliances and carry out cross-regional merger and restructuring to bring up industrial concentration . . . , [to] promote the building of domestic brands, improve brand value and reputation, and accelerate the development of large-scale enterprises with internationally renowned brands and core competitiveness . . . .”<sup>170</sup> Industry development plans and specific targets regarding the number, size, ranking, industry concentration, brands, and revenues of leading Chinese companies have been established for a large number of industries, including autos,<sup>171</sup> steel,<sup>172</sup> food,<sup>173</sup> and pharmaceuticals<sup>174</sup> — to cite just a few.

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<sup>169</sup> See also discussion in Section III(A)(2).

<sup>170</sup> See *Outline of the 12<sup>th</sup> Five-Year Plan for National Economic and Social Development of the People's Republic of China*, Chapter 9, Section 4, “Guiding the M&A and Restructuring of Enterprises” (National People’s Congress, March 14, 2011). See also *Industry Transformation and Upgrade Plan (2011-2015)* (“Transformation Plan”), Chapter 3 (6) and Chapter 4 (1) (State Council, *Guofa* No. 47, 2011).

<sup>171</sup> “We shall vigorously promote the building of independent brands, encourage the merger and restructuring of enterprises, and form 3 ~ 5 large automobile enterprise groups with core competitiveness, and the industrial concentration of the top 10 enterprises shall be up to 90%.” (大力推动自主品牌发展，鼓励优势企业实施兼并重组，形成 3-5 家具有核心竞争力的大型汽车企业集团，前 10 强企业产业集中度达到 90%。) *Transformation Plan*, Chapter 4 (1).

<sup>172</sup> We shall “form 3 ~ 5 large steel enterprise groups with international competitiveness, and 6~7 large enterprise groups with relative strong competitiveness, and the production of the top 10 steel enterprises should be up to 60% of the national steel production capacity.” (形成 3-5 家具有较强国际竞争力，6-7 家具有较强实力的大型钢铁企业集团，前 10 位钢铁企业集团产量占全国钢铁总产量的 60%左右。) *Transformation Plan*, Chapter 4 (2).

<sup>173</sup> “By 2015, there shall be over 50 food industrial enterprises each with a sales revenue of over RMB 10 billion [US \$1.57 billion].” (到 2015 年，销售收入达到百亿元以上的食品工业企业达到 50 家以上。) *12<sup>th</sup> Five-Year Development Plan for the Food Industry*, Chapter 3 (3) (NDRC and MIIT, *Fagaichanye* 3229, 2011).

<sup>174</sup> “We shall develop more than five enterprises with sales revenue exceeding RMB 50 billion [US \$7.87 billion], more than 100 enterprises with sales revenues exceeding RMB 10 billion [US \$1.57 billion], and the top 100 will generate over 50% of the industry's total revenue by 2015. (到 2015 年，销售收入超过 500 亿元的企业达到 5 个以上，超过 100 亿元的企业达到 100 个以上，前 100 位企业的销售收入占全行业的 50%以上。) *12<sup>th</sup> Five-Year Plan (2011-2015) for Development of the Pharmaceutical Industry*, Chapter 3 (3) (MIIT, 2012).

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## 2. Selective Use of Foreign Capital

One of the key tools available to Chinese officials for fostering national champions and achieving other industrial policy goals is the inbound foreign investment approval process, which can be used selectively to grant foreign investors access to China's large domestic market in exchange for commitments to establish joint ventures with favored Chinese partners. As a condition of entry into such joint ventures, some foreign investors have reportedly been required to commit to transfer technology and establish research and development capabilities within China, and to provide access to international market channels to the joint ventures.

The State Council's *Opinion on Further Facilitating Foreign Investment* provides that "the relevant departments under the State Council and the local people's governments at all levels are to . . . adhere to the guiding principles of active and effective utilization of foreign capital and *selecting capital based on our own needs, and facilitating the combination of 'capital absorbing' with 'talent introducing'* to constantly improve the utilization of foreign capital"<sup>175</sup> (emphasis added). This fundamental policy directive is potentially at odds with China's WTO commitment to ensure that permission for investment "would not be conditional upon performance requirements set by national or subnational authorities, or subject to secondary conditions covering, for example, the conduct of research . . . or the transfer of technology."<sup>176</sup> However, the relatively opaque inbound FDI approval processes and absence of effective recourse in most cases make interpretation and enforcement of this WTO commitment extremely difficult.

### B. Relatively Opaque Inbound FDI Approval Processes

The relatively opaque nature of the inbound FDI approval processes enables China's investment approval authorities to favor domestic competitors over foreign investors, should they so desire, without leaving a paper trail of discriminatory written regulations that could clearly offend WTO obligations.

Foreign investors have reported this favoritism occurring in two ways: (i) through the application of vaguely worded or unpublished rules or requirements in ways that discriminate against foreign investors; and (ii) through the imposition of deal-specific conditions that go beyond any written legal requirements. In the first case, the intent seems to be to exclude or impede foreign participation in a given sector without making this goal explicit in writing. In the second case, the apparent intent is often to favor local joint venture partners in their negotiations with the foreign investor, or to support the interests of local competitors.

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<sup>175</sup> (坚持以我为主、择优选资，促进“外资”与“引智”相结合...), *Certain Opinions of the State Council on Further Facilitating the Utilization of Foreign Capital* (State Council, *Guofa* No. 9, April 6, 2010).

<sup>176</sup> Working Party Report, Para. 203.

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Foreign investors' concerns are primarily concentrated in certain steps of the investment approval process. As described in Section III, China's inbound FDI approval process potentially involves eight different types of approvals:

- **TYPE A:** Anti-Monopoly Law Review of Concentrations (MOFCOM) — Step 1.1
- **TYPE B:** National Security Review (MOFCOM and the Ministerial Panel) — Step 1.2
- **TYPE C:** Name Pre-Approval and Enterprise Registration (AIC) — Steps 2 and 7
- **TYPE D:** Local Site-Related Opinion Letters (Land and Resources Department, Environmental Protection Department, Planning Department, and SASAC) — Step 3
- **TYPE E:** Project Approval (DRC or State Council ) — Step 4
- **TYPE F:** Foreign Investment Approval (Commerce Department) — Step 5
- **TYPE G:** Regulatory Approval (relevant industry regulator, if applicable) — Step 6
- **TYPE H:** Approval of Strategic Investment in a Chinese Publicly Traded Company (MOFCOM and CSRC, if applicable)

Foreign investors in China generally have not focused their concern on approval Types C and D, though some investors have indicated that local authorities responsible for Type D approvals sometimes favor domestic competitors or seek favors for carrying out their official responsibilities. In addition, some investors have found it difficult to obtain necessary site-related opinion letters in various second- and third-tier cities where local governments have yet to establish zoning plans.<sup>177</sup> Also, foreign investor experience to date with Type B approval (national security review) has been minimal, so issues raised with that approval process have centered around ambiguities in the law,<sup>178</sup> rather than on problems in implementation. This leaves the Anti-Monopoly Law Review, Project Approval, Foreign Investment Approval, and Regulatory Approval (Types A, E, F, and G) as the four types of approval that have, in practice, generated the most concern from potential foreign investors in China.

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<sup>177</sup> AmCham China 2012 *American Business in China White Paper*, Retail Chapter, p. 286, <http://web.resource.amchamchina.org/cmsfile/2012/04/23/2ce923096d78256cc9b475f41d07f0d1.pdf> (Last accessed: September 10, 2012).

<sup>178</sup> See discussion in Section III(A)(3)(a)(1.2) above, as well as, e.g., *Comments on the Interim Provisions of the Ministry of Commerce on Matters Relating to the Implementation of the System of Security Review of Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, US Chamber of Commerce, 2011.



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Examples of how opacity in these approval processes facilitates the favoring of domestic competitors over foreign investors follow.

## 1. Written and Unwritten Regulatory Barriers

As discussed in detail in the AmCham China 2012 *American Business in China White Paper* (AmCham White Paper), Chinese investment approval authorities in a number of industries have limited market access for potential foreign investors by applying rules that are often vaguely written or unpublished in ways that restrict or unreasonably delay market entry by qualified foreign companies, including in sectors where China has made market access commitments.<sup>179</sup> For example, the NDRC decides whether projects “meet the requirements of mid- and long-term planning for national economic and social development, industry planning, and industry structure readjustment policies,”<sup>180</sup> while MOFCOM judges whether there is “obvious unfairness in the concluded agreement”<sup>181</sup> before approving an EJV application. Likewise, the AML requires MOFCOM to take into consideration the effect of transactions on the development of the national economy, rather than just competitiveness concerns.<sup>182</sup> These provisions, and others like them, provide broad scope for restricting investments that could compete with domestic companies. In some industry sectors, government administrators have, in effect, blocked foreign investment altogether, simply by failing to promulgate investment and licensing approval requirements and procedures applicable to foreign investors in those industries.

Examples of such opaque, problematic administrative practices, provided by companies on condition of anonymity, include the following:

- Branch applications by foreign-invested insurance companies are subject to lengthier review periods in practice than are applied to domestic insurance companies, and officials of the China Insurance Regulatory Commission have told foreign insurance companies orally that they can only have one branch application under consideration at a time. No such limitation has been imposed on domestic insurance companies. Accordingly, on average, foreign insurers are only able to establish one new provincial branch per year,

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<sup>179</sup> Examples of sectors where such limitations have been encountered include electronic payment services, insurance, banking, telecommunications services, and legal services. See the AmCham White Paper discussions of these sectors.

<sup>180</sup> *Interim Administrative Measures for the Verification and Approval of Foreign Investment Projects*, Art. 12 (National Development and Reform Commission, Order No. 22, 2004).

<sup>181</sup> *Detailed Implementing Regulations for Sino-Foreign Equity Joint Venture Enterprise Law of the People's Republic of China*, Art. 4 (5) (State Council, Order No. 311, 2001).

<sup>182</sup> *Anti-Monopoly Law of the People's Republic of China*, Art. 27(5) (Standing Committee of the National People's Congress, Order No. 68, 2008).

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while domestic insurers may establish two or three branches a year. These market access barriers are contributing factors to the small (and falling) size of foreign-invested insurers' market share in China, which stood at 3.06% as of year-end 2011, down from 6% in 2004.<sup>183</sup>

- The People's Bank of China promulgated a measure, effective September 1, 2010, requiring online payment service providers (such as Alipay and others) to obtain a Payment Business License<sup>184</sup> within one year.<sup>185</sup> The measure stated that licensing requirements for foreign investors would be promulgated separately following State Council approval.<sup>186</sup> However, though the one-year deadline has long since passed, no measures detailing a licensing mechanism for foreign investors have yet been released, and only one foreign investor is currently licensed to provide online payment services.<sup>187</sup> During this time, 196 domestic providers have obtained such licenses, while, according to press reports, Yahoo – perhaps the largest foreign company with a stake in online payment services in China – was essentially compelled to divest its indirect interest in Alipay, the market leader.<sup>188</sup> As a result of this opaque and open-ended delay, foreign companies have been effectively shut out of China's huge online payment market, for which the total annual transaction value is estimated at RMB 776 billion (US \$122 billion).<sup>189</sup>

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<sup>183</sup> AmCham China 2012 *American Business in China White Paper*, Insurance Chapter, p. 248, <http://web.resource.amchamchina.org/cmsfile/2012/04/23/77548053403ed8f91b958261a2118c2a.pdf> (Last accessed: September 10, 2012).

<sup>184</sup> 支付业务许可证, *zhifu yewu xukezheng*.

<sup>185</sup> *Measures for the Payment Services Provided by Non-Financial Institutions*, Art. 48 (People's Bank of China, Decree No. 2, promulgated on June 14, 2010, and effective as of September 1, 2010).

<sup>186</sup> *Ibid.*, Art. 9.

<sup>187</sup> It is unclear how that foreign investor — *Beijing Gaohuitong Shangye Guanli LLC* — was able to procure the Payment Business License given the lack of foreign licensing measures.

<sup>188</sup> See “Alipay Shifted to Jack Ma's Private Company to Speed Up Getting Government License,” TechNode, May 15, 2011, <http://technode.com/2011/05/15/alipay-shifted-to-jack-mas-private-company-to-speed-up-getting-government-license/> (Last accessed: August 3, 2012); and “Alibaba's Online Payment Service Granted Chinese License,” PC World, May 27, 2011, [http://www.pcworld.idg.com.au/article/388176/alibaba\\_online\\_payment\\_service\\_granted\\_chinese\\_license/](http://www.pcworld.idg.com.au/article/388176/alibaba_online_payment_service_granted_chinese_license/) (Last accessed: August 3, 2012).

<sup>189</sup> “Top-5 Current Trends in China's Payments Industry,” Kapronasia, July 4, 2012, <http://www.kapronasia.com/en/insight/221-top-5-current-trends-in-china-s-payments-industry> (Last accessed: August 3, 2012).

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- A WTO panel confirmed on July 17, 2012, that China was obligated to allow foreign electronic payment service providers (i.e., credit card companies) to provide local currency-denominated electronic payment services through a commercial presence in China.<sup>190</sup> This commitment should have gone into effect as of December 2006, but like online payment service companies, foreign credit card companies have effectively been blocked from entering this market because no regulations have been promulgated establishing investment and licensing procedures and standards for foreign companies in this sector. It is unclear how long it will take, following this decision of the WTO panel, for China to promulgate and implement such procedures and standards.
- Foreign automobile manufacturers have been told orally by NDRC officials that approval will not be granted for them to manufacture electric vehicles in China unless they assume a minority stake in a JV with a local company (foreign investors are generally permitted to own up to 50% of a JV in the auto industry, according to the Foreign Investment Catalogue), transfer certain core technology to the JV, and agree to local branding for the vehicles.
- MOFCOM refused to accept a foreign company's AML filings for a transaction because an involved firm had a variable interest equity (VIE) structure, despite the widespread use of this structure and the fact that no law or regulation prohibits companies with this structure from making such filings.<sup>191</sup>

## 2. Deal-Specific Conditions of Investment Approval

The requirement, in many industries, that foreign investors enter the China market together with a local partner creates numerous circumstances where investment approval authorities are able to work in a nontransparent way with the local partner to ensure that valuable intellectual property, market channels, and other assets of the foreign investor are made available to the joint venture — often on extremely favorable commercial terms for the local partner. This problem is

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<sup>190</sup> See *China - Certain Measures Affecting Electronic Payment Services*, WT/DS413/R, adopted July 17, 2012.

<sup>191</sup> A VIE structure allows foreign investors to circumvent Chinese rules restricting or prohibiting foreign ownership in certain industries by establishing a controlling relationship over a wholly Chinese-owned company by contract. The structure is typically implemented via creation of an offshore company and a 100% wholly foreign-owned Chinese subsidiary of the offshore entity. This subsidiary then enters into a series of service contracts with a Chinese company holding the requisite business licenses, which thereby give the subsidiary operational control of the Chinese company but no ownership stake. It is estimated that of the 225 Chinese companies listed on NASDAQ and the New York Stock Exchange, 108 are VIE structures. This includes major companies such as Sina, Baidu, Sohu, and Alibaba.

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exacerbated by the fact that in Sino-foreign joint ventures, the local partner serves as the investment approval process applicant on behalf of the prospective joint venture. As a result, Chinese joint venture partners are able, in many cases, to control the communication channels between the foreign investor and the government approval authorities, making the process even more opaque for the foreign investor and enabling the local partner to shape the approval requirements imposed by the authorities to its advantage. In the case of joint ventures involving SOEs, the problem is even more pronounced, as the top leaders of many large, central-level SOEs typically have deep connections with the Chinese government.<sup>192</sup>

Even when a joint venture partner is not involved, foreign investors frequently encounter what they see as “trade-distorting” or discriminatory requirements imposed on a deal-specific basis, as approval authorities often use the approval process as an opportunity to extract concessions in support of industrial policies. The relative opacity of the process and the broad discretion granted to the authorities foster an environment where oral requirements beyond what is mandated by written law may easily be imposed.

Another circumstance where lack of clarity in the approval process may disadvantage foreign investors on a deal-specific basis is when consultation of domestic stakeholders is required. Under various regulations, including the AML, government agencies must or may consult key domestic stakeholders — including local competitors — and take into account their reactions to proposed transactions. No legal criteria have been outlined regarding what type of feedback should (or should not) be considered or how that feedback should (or should not) be taken into account when evaluating the approval at hand. The time lines for such consultations are also often not specified. The lack of clarity surrounding these consultations increases uncertainty and opacity while also providing opportunities for Chinese companies to gain advantage by influencing the approval authorities.

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<sup>192</sup> “The senior managers of the central SASAC enterprises are important people within the Communist Party framework. For the top 50 or so centrally-managed SOEs ( [央企] *yangqi*), the three top positions — party secretary, chairman of the board, and CEO — are appointed directly by the Communist Party’s Central Organization Department (COD) ( [中组部] *zhongzubu*).... Almost all of the people chosen for these top three positions are [Chinese Communist Party] members, and one person can hold two positions at the same time. These positions are equivalent to a minister ( [部级], *buji*) or vice-minister ( [副部级], *fubuji*) rank in the Chinese government, and the selected executives are reviewed and approved by the Standing Committee of the Politburo. They often serve as vice-governors of provinces before or after their tenures in senior management at the SOEs.... The appointments of all the remaining high-ranking positions (vice presidents, deputy party secretary, etc.) at these 50 *yangqi* are carried out by the SASAC in consultation with the COD. The central SASAC is also nominally in charge of all major personnel decisions at the remaining 70 centrally managed SOEs. Personnel decisions in provincial, municipal, and county SOEs are also managed by the local arm of the SASAC.” *An Analysis of State-Owned Enterprises and State Capitalism in China*, a report commissioned by the US-China Economic and Security Review Commission and written by Andrew Szamosszegi and Cole Kyle of Capital Trade, Incorporated, October 26, 2011, p. 75, [http://www.uscc.gov/researchpapers/2011/10\\_26\\_11\\_CapitalTradeSOEStudy.pdf](http://www.uscc.gov/researchpapers/2011/10_26_11_CapitalTradeSOEStudy.pdf) (Last accessed: September 6, 2012).

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This problem would likely worsen if the draft amendment to update the DRC foreign investment project approval process is finalized in its current form.<sup>193</sup> As currently drafted, the amendment would add such a consultation period to the DRC project approval process for all proposed foreign investments that might “have a substantial impact on the public interest.” No further definition of this broad criterion is provided in the draft amendment, potentially resulting in the proposed consultation requirement being applied to a wide range of foreign investment projects.

Examples where these various dynamics have affected the investment approval process for specific, anonymous foreign companies include the following:

- A foreign company wishing to invest in a financial services sector open to WFOE investment under the Foreign Investment Catalogue and applicable regulations was informed by the central government regulator that the requisite industry license would not be granted unless the investment was made as a JV with a particular state-owned firm. The local partner was subsequently able to extract large commercial concessions from the foreign company, which knew that it had no option other than to reach agreement with this particular partner.
- Government and non-government stakeholders consistently informed a potential foreign investor in a pharmaceutical JV by oral means that the Chinese government would purchase its product through public tenders only if the product were manufactured in China. As direct purchase by the government accounted for approximately half of the total China market for the product, a loss of this market would have a significant impact on the foreign company’s bottom line. Because foreign investment in the manufacture of the product was classified as “restricted” in the Catalogue with foreign investors allowed to hold only a minority interest, the foreign company was forced to choose between losing half of its sales in China or transferring its intellectual property rights to a JV that it would not control.
- A proposed inbound investment by a foreign company was held up by MOFCOM during the AML review not because of competition concerns but because the NDRC disapproved of the transaction on industry policy grounds.
- A foreign company’s competitor, a Chinese SOE, was able to delay the foreign company’s merger clearance by raising concerns with MOFCOM. At the time, the foreign company was undergoing a separate litigation against the competitor and was convinced that the competitor brought the issues in retaliation.

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<sup>193</sup> See Section III(D) above.

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### C. Lack of Effective Recourse

In practice, it has been extremely difficult for applicants to obtain effective recourse when they have felt that their investment applications have been unreasonably denied or made subject to “trade-distorting” conditions.<sup>194</sup> While Section IV describes the administrative and judicial procedures established by laws and regulations for appealing administrative decisions, a number of considerations combine to create a system where aspiring foreign investors seldom, if ever, attempt such appeals. This fosters an environment in which approval authorities may feel unrestrained in using the approval process to discriminate against or extract concessions from foreign firms.

The considerations that discourage aspiring investors from attempting administrative appeals include the following:

- Very broadly defined grounds for denying investment applications and lack of an explicit affirmative duty for approval authorities to approve applications submitted to them if the applications meet clearly specified criteria;<sup>195</sup>
- Difficulty in producing solid evidence of inappropriate conduct, since approval authorities generally rely on oral communications to convey specific conditions of approval, and such communications are often relayed indirectly through a Chinese joint venture partner;
- The fact that the decisions of approval authorities and the People’s Courts are all subject to Party supervision and are expected to align with the same underlying policies of the Party; and
- The reality that potential investors are extremely reluctant to challenge the decisions of approval authorities, who have considerable power to affect companies’ business prospects in China.

The above difficulties in producing evidence and concerns regarding possible retaliation have also hindered the US Trade Representative’s (USTR) ability to bring WTO cases against China. Even when hard evidence of WTO violations may exist, individual companies are reluctant to share such evidence with the USTR, because they fear negative repercussions if they are seen as supporting an action taken against the Chinese government.<sup>196</sup>

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<sup>194</sup> See Section II(A).

<sup>195</sup> See Section III(A)(3).

<sup>196</sup> In addition to retaliatory actions against companies, China is also seen to have taken retaliatory actions against WTO member countries that have brought dispute settlement against China. See, e.g., “USTR’s Ron Kirk Says No (continued...)”

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The following examples illustrate the types of problems that commonly occur in part because approval authorities know that the applicants will likely never seek redress:

- A foreign company started to restructure its JV in 2010. As of June 2012, it was still awaiting the NDRC's final approval and had received no update on the status for six months.
- A foreign company reported that the relevant industry regulator rejected an application by an FIE to introduce a new product into the market and responded with reasons for the rejection. The applicant addressed those concerns and resubmitted the application. However, the product was rejected again for newly revealed reasons that had, in fact, been present during the initial application but had not been previously made known to applicant. Had such reasons been brought to the attention of the applicant after the first rejection, administrative resources could have been saved and unnecessary delay avoided.
- A foreign company and its JV partner were able to obtain local industry regulator authorization for their project, but when they applied to MOFCOM for final approval, they were told that the project was outside the scope of the Chinese JV partner's authorization. Later, the foreign company learned that the real reason for this rejection was a MOFCOM official's dislike of an employee at the JV partner.

## VII. CONTRAST TO U.S. APPROVAL PROCESSES FOR INBOUND FDI

Foreign investment in the U.S. is subject to fewer types of pre-establishment approval than foreign investment in China. Of the eight types of approvals identified in Section VI, foreign investment in the U.S. is subject, at most, to six: anti-monopoly review, national security review, enterprise registration, site-related and environmental approvals, industry regulatory approvals, and approvals related to strategic investments in publicly traded companies. Unlike China, the U.S. does not have general project approval and foreign investment approval requirements.

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Trade War But Troubled by China," Thomson Reuters, December 17, 2011, <http://www.reuters.com/article/2011/12/17/us-wto-usa-china-idUSTRE7BG0J520111217> (Last accessed: September 17, 2012) ("I am troubled by what I see as a trend of China to retaliate when members — not just the US, other members of the WTO — bring China to dispute settlement over legitimate matters," Kirk said in an interview. "That's not only disruptive to global trade, it's not only not in the interest of the members of the WTO. But I think long term it's not in China's interest. It begins to cut away at their credibility and their belief in the two-way value of trade in which not only they marvelously and spectacularly benefit as they have, but they're also committed and have a commensurate responsibility to open up their markets fairly to us.")

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Moreover, in contrast to China, where all foreign investments and some domestic investments require pre-establishment approval, most types of pre-establishment approvals in the U.S. are required only in special cases, and with a few exceptions, they affect foreign and domestic investors equally.

Approval processes that equally affect foreign and domestic investors, approval processes that only apply to or disparately affect foreign investors, and prospects for successfully appealing unfavorable decisions by U.S. approval authorities are discussed below.<sup>197</sup>

### **A. Approval Processes that Affect Foreign and Domestic Investors Equally**

#### **1. Antitrust Review**

The Antitrust Division of the Department of Justice (DOJ) and the U.S. Federal Trade Commission (FTC) both have jurisdiction to investigate any acquisition of voting securities or assets to determine whether “the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly” in “any line of commerce or in any activity affecting commerce” in the U.S.<sup>198</sup> Pursuant to the *Hart-Scott-Rodino Antitrust Improvements Act* of 1976 (HSR Act), parties must submit premerger notifications if their transaction satisfies the HSR Act’s “size of transaction” and “size of person” thresholds and does not qualify for an exemption, such as the exemptions for certain acquisitions of non-U.S. assets or of voting securities of non-U.S. issuers.<sup>199</sup> The U.S. antitrust agencies may review any transaction, however, regardless of whether it is subject to the requirements of the HSR Act.

Parties to transactions that are subject to the HSR Act must observe a pre-closing waiting period of 30 calendar days (15 days for all-cash tender offers), during which they must remain separate and independent entities and the acquiring person may not take or exercise beneficial ownership of the assets or voting securities that are the subject of the transaction. This period may be terminated early if the parties request it and if neither the DOJ nor the FTC wishes to conduct an investigation, or if either agency opens an investigation and is able to conclude its review during the initial waiting period. The waiting period may also be extended (known as a “second request”) if the reviewing agency determines that closer scrutiny is warranted and issues a request for additional information or documentary material. Second request investigations may last several additional weeks or many additional months, depending on the transaction and whether the parties substantially comply with the request, which is usually quite broad.

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<sup>197</sup> A discussion of site-related and environmental approvals is beyond the scope of this Report, except to note that in most cases, both domestic and foreign investors are subject to the same processes and approvals.

<sup>198</sup> Clayton Act § 7, 15 U.S.C. § 18.

<sup>199</sup> 16 C.F.R. §§ 801-03. See also 15 U.S.C. § 18.



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If the reviewing agency determines at any point that the acquisition is likely to result in a substantial lessening of competition, it will seek either to block the transaction or to remedy its concerns through a negotiated settlement (a “consent decree”) with the parties. For example, the parties may agree to divest particular assets or a line of business to a buyer approved by the agency in order to preserve the competition that the agency has determined will be lost if the transaction is permitted to proceed as originally structured.

## 2. Industry Regulator Approvals

As noted in Sections III and V respectively, foreign investors seeking to invest in China must comply with a multi-step approvals process to invest in *any* industry, and domestic investors must obtain project and industry regulator approvals in a number of industries. Within the U.S., there is no general project approval requirement, and industry regulator approvals — which are applicable to domestic and foreign investors alike — are required only in certain industries and are not usually tied to national industrial policies.

### *a) Investments in Many Industries Do Not Require Industry Regulator Approval*

Many industries including for example, the food, pharmaceutical, and medical device industries,<sup>200</sup> and the automobile industry,<sup>201</sup> do not require an investing party, whether foreign or domestic, to obtain industry regulator approval prior to concluding an investment in the U.S. Parties investing in such industries need only enter into commercial contracts related to establishing and operating their businesses and register any newly created legal entities with the company registration authorities. They must also, of course, comply with all applicable laws and regulations and obtain any necessary operating permits, which apply equally to foreign and domestic companies.

### *b) Examples Where Industry Regulator Approvals Are Required*

Certain industries require that any investing party — foreign or domestic — obtain industry regulator approval prior to concluding an investment in that industry, including for example, certain types of investment in the telecommunications industry, the renewable energy industry, and the banking industry, as described below.

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<sup>200</sup> Certain investments will require the investing company to register with Food and Drug Administration, but no approval is required.

<sup>201</sup> If the foreign investment will result in the export of technology subject to the *International Traffic in Arms Regulations*, those regulations will apply.

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### *(1) Telecommunications Industry*

Under the *Communications Act* of 1934, as amended, and the rules and regulations of the Federal Communications Commission (FCC), acquisition by any party — foreign or domestic — of broadcast television or radio stations, and of certain telecommunications services providers, satellite operators, and undersea cable licensees, can be completed only after the FCC approves the transaction.<sup>202</sup> The FCC reviews the joint application of the buyer and seller, issues a notice inviting petitions and comments of third parties with respect to the application, and generally endeavors to take action (i.e., grants, denies, or designates a hearing) within 180 days from the initial public notice of the application.

In addition, parties to some acquisitions of telecommunications providers may be required to seek approval from the relevant state public utility commission, which would review the transaction for its competitive effects on the local market.

### *(2) Renewable Energy Industry*

Under certain circumstances, approval by the Federal Energy Regulatory Commission (FERC) and/or state commissions may be required prior to investment in the renewable energy industry in the U.S., both for foreign and domestic investors.

Approval by FERC may be required for an investment in a public utility or a holding company where the transaction involves more than US \$10 million in securities and results in a change of control (generally a transfer of 10% or more of a public utility's or a holding company's voting interests).<sup>203</sup> Typically, FERC approves parties' investments, sometimes with conditions, but the parties may not close on the transaction until they receive FERC's written approval. In reviewing the transaction, FERC applies a public interest standard, evaluating the effect of the proposed transaction on rates, regulation, and competition in energy markets.<sup>204</sup>

Approval by one or more state utility or public service commission may also be required for investments where the target or investee owns or controls certain energy facilities.

Investments in regulated U.S. energy companies or facilities may also subject the investor to certain reporting requirements and regulations, such as providing the state or federal

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<sup>202</sup> *Communications Act* of 1934, Pub. L. No. 416 as codified, 47 U.S.C. § 151 *et seq.*

<sup>203</sup> *Federal Power Act*, § 203, 16 U.S.C. § 824b.

<sup>204</sup> *Ibid.*

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industry regulator with access to the investor's books and records related to the investment.

### (3) *Banking Industry*

The federal banking regulators (Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency) and certain state banking regulators generally require an investor to obtain their prior approval in connection with a significant investment in a banking organization. In order to obtain the regulators' prior approval, investors may be required to provide, among other information, detailed financial and biographical information, representations and warranties relating to the investment, business plan information, and information regarding anti-money laundering compliance. Following approval, federal and state regulators may seek to supervise and examine investors, including investors' capital, liquidity, and risk management practices. Investors also may be subject to mandatory reporting and recordkeeping requirements.

### 3. **Securities-Related Approvals and Disclosures**

If investment in the United States by a U.S. or a non-U.S. party involves entities that are registered with the Securities and Exchange Commission (SEC), US securities laws and regulations are implicated, and SEC approvals and/or disclosures may be required. Unlike the situation in China, where a foreign investor must qualify either as a QFII or a strategic investor under the Strategic Investment Measures in order to invest in Chinese A-shares, foreign investors in U.S. securities may generally invest on terms equal to those that apply to domestic investors. Below are some of the many types of filings and disclosures that apply equally to both foreign and domestic issuers:<sup>205</sup>

- Registered U.S. entities must make Form 8-K filings with the SEC to disclose events such as a change of control of the entity or any material definitive merger or asset purchase.
- Persons who will acquire beneficial ownership interest of greater than 5% of a class of voting equity shares registered under the *Securities Exchange Act* of 1934 must file a form addressing, among other things, an explanation of the transaction, the percentage of ownership, and the source and amount of any financing.
- For exchange offers, issuers must submit a form addressing, among other things, the reasons for the transaction, the bidder's financial condition and financial results of

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<sup>205</sup> David N. Fagan, "The US Regulatory and Institutional Framework for FDI," *Investing in the United States: Is the US Ready for FDI From China?* p. 45, 51-52, (Karl P. Sauvart, ed., 2009).

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operations, the shareholder's financing, and prior material contacts between the bidder and the company being acquired.

- Shareholder votes required under state corporate law or stock exchange rules for mergers, asset sales, or similar transactions require filing with the SEC a preliminary proxy statement, followed by a definitive proxy statement.

The SEC will review certain of these filings, and the parties may not complete the transaction until the SEC confirms that it has no further comments on the filings.<sup>206</sup>

In addition, all parties, both foreign and domestic, may need to meet certain requirements set by stock exchanges and individual states. For instance, stock exchanges may require the disclosure and notification of material events that may affect the value of a company's stock, and some states impose requirements for shareholder or board approval for acquisitions of stock above a certain threshold (e.g., 15%).<sup>207</sup>

The SEC offers foreign companies that choose to list in the U.S. a number of accommodations designed to make it easier for them to enter the U.S. disclosure system, including the following:

- Foreign companies may prepare their financial statements on the basis of their home country accounting principles.
- Foreign companies may submit their initial offering documents for SEC review on a confidential basis.
- Foreign companies are excused from compliance with US proxy rules as well as from the prohibition on short-swing trades and reporting of purchases and sales by insiders.
- Foreign companies are excused from filing quarterly reports with the SEC, and are instead only required to furnish to the SEC the disclosure documents that they are required to make publicly available in their home jurisdiction.
- Foreign companies are excused from a variety of disclosure requirements applicable to U.S. companies, including extensive executive compensation disclosures.<sup>208</sup>

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<sup>206</sup> *Ibid.*

<sup>207</sup> *Ibid.*

<sup>208</sup> See *Securities Exchange Act of 1934*, 15 U.S.C. § 78a *et seq.*

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### **B. Approval Processes that Apply Only to or Disparately Affect Foreign Investors**

Certain investment approval processes in the U.S. apply only to foreign investors. In addition, some limited industry regulations either apply specifically to foreign investors, or apply to both foreign and domestic investors but disparately affect foreign investors.

#### **1. National Security Review — CFIUS**

The president of the United States has statutory authorization to investigate foreign mergers, acquisitions, or takeovers of U.S. businesses from a national security perspective and to act, if necessary, to block a transaction that threatens to impair U.S. national security, where such threat is not otherwise addressed in U.S. law and cannot otherwise be mitigated.<sup>209</sup> Congress and the president have delegated the initial review and investigative responsibility to the Committee on Foreign Investment in the United States (CFIUS or the Committee), an interagency committee chaired by the Treasury Department.<sup>210</sup> Other members of CFIUS include the Departments of State, Defense, Commerce, Justice, Homeland Security, and Energy, the Office of the U.S. Trade Representative, and several components of the Executive Office of the President.

CFIUS has jurisdiction to review a “covered transaction,” which is a statutory and regulatory term of art defined generally to mean a merger, acquisition, or takeover that could result in foreign “control” over a “U.S. business.”<sup>211</sup> In other words, if a proposed inbound foreign investment is a “greenfield” investment and does not entail acquisition of an existing U.S. business, or if it would not result in the foreign investor acquiring “control” (broadly defined) of an existing U.S. business, then CFIUS does not have jurisdiction over the transaction.

If the transaction is a covered transaction, CFIUS will examine its impact on U.S. national security. In practice, these dual evaluations — whether the transaction is a covered transaction and, if so, whether it implicates national security — typically are made by the parties to the transaction and their legal counsel when determining whether voluntary notification of the transaction to CFIUS is necessary.

The CFIUS review process typically is triggered when parties to a transaction voluntarily file notice of the transaction with the Committee. If the parties do not file voluntarily, however, and CFIUS, or a member of the Committee, determines that the transaction is a covered transaction

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<sup>209</sup> This authorization is provided by Section 721 of the *Defense Production Act* of 1950 (the “Exon-Florio Amendment”), which was first adopted in 1988 and subsequently amended by the *Foreign Investment and National Security Act* of 2007 (“FINSAs”).

<sup>210</sup> FINSAs, Pub. L. No. 110-49 (2007); Exec. Order No. 11,858, 40 Fed. Reg. 20,263 (May 7, 1975).

<sup>211</sup> FINSAs Pub. L. No. 110-49 (2007); 31 C.F.R. § 800.301.

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that may raise national security considerations, the Committee may choose to review the transaction at any time.<sup>212</sup>

Once CFIUS has sufficient information to begin a review, it follows a congressionally mandated timetable that includes an initial 30-day review period, a 45-day second-stage investigation period for transactions deemed to require it, a formal report to the president if presidential action is recommended, and a decision by the president within 15 days of receiving the report.<sup>213</sup> There is a statutory presumption that CFIUS will engage in a second-stage investigation of any transaction that —

- Threatens to impair U.S. national security, if the threat has not been mitigated during the initial review period;
- Would involve control by a foreign government; or
- Would result in foreign control of U.S. critical infrastructure, if such control threatens to impair U.S. national security and the threat was not mitigated during the initial review period.<sup>214</sup>

Ultimately, the president may prohibit any transaction where, after a full investigation, credible evidence “leads the President to believe that the foreign interest exercising control might take action that threatens to impair the national security,” and other laws or measures are insufficient to protect the national security. If the transaction has already been consummated, CFIUS can recommend that the president unwind the transaction after the fact.

While CFIUS can act at any point — even after a transaction has closed — once a transaction has undergone review, it receives a kind of safe harbor protection. CFIUS can unilaterally initiate another review only if limited circumstances are met, such as if the initial review was based on false or materially misleading information or material information was omitted.<sup>215</sup>

Unlike many other countries, the U.S. does not apply an economic interest test when reviewing foreign investment. Rather, CFIUS is a tailored process focused strictly on national security, such that the vast majority of foreign investments — around 90% — are not subject to CFIUS review. In addition, the overwhelming number of transactions reviewed by CFIUS are approved

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<sup>212</sup> 31 C.F.R. § 800.401.

<sup>213</sup> Fagan, *supra* note 192, at 56.

<sup>214</sup> Pub. L. No. 110-49 (2007).

<sup>215</sup> FINSA, § 2 (*codified at* 50 U.S.C. App. § 2170(b)(1)(D)); Exec. Order No. 11,858, 40 Fed. Reg. 20,263 (May 7, 1975).

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and non-controversial. Thus, for many Chinese investments in the U.S., CFIUS is not relevant, let alone an obstacle.

However, in cases that may raise U.S. national security considerations, Chinese transactions often receive greater scrutiny than transactions by other foreign investors. Notably, the only divestment of an acquisition ever formally ordered by a U.S. president involved China. In 1990, President George H. W. Bush required China National Aero-Technology Import and Export Corporation to divest MAMCO Manufacturing Co., an aerospace company based in the U.S.<sup>216</sup>

Over the past decade, the experience of a number of Chinese companies has demonstrated that CFIUS action or political controversy can affect individual transactions involving Chinese investors. For example, in 2005 a rival bidder used political opposition to negatively affect China National Offshore Oil Corporation's ("CNOOC") bid for Unocal. Ultimately, Congress scuttled CNOOC's bid by passing a law that required federal agencies to conduct a study that would delay completion of the CFIUS review for nearly six months,<sup>217</sup> which far exceeded the 90-day maximum statutory timeframe for CFIUS review. More recently, Huawei Technologies failed in two attempted acquisitions in the U.S. in 2007 and 2010; Northwest Nonferrous International Investment Company failed in its proposed acquisition of 51% of FirstGold Corp., a Nevada-based mining company, in 2009; and Emcore withdrew the sale of a controlling share of its fiber optics business to Tangshan Caofeidian Investment Corporation in 2010.

Not all Chinese investments generate political controversy or face insurmountable challenges from CFIUS, however. In the case of the IBM/Lenovo transaction in 2005, only three conservative members of the House of Representatives expressed direct concern regarding the transaction, and after extended review by CFIUS that resulted in approval, criticism was muted. The success of the IBM/Lenovo transaction resulted in large part from a carefully planned preemptive regulatory and political strategy, which included anticipating possible CFIUS objections and carefully structuring the transaction accordingly.

## 2. Examples Where Industry Regulator Approvals Disparately Affect Foreign Investors

Certain industry approvals may affect only investment by non-U.S. parties, and in some industries, relevant government agencies may more closely scrutinize investment by non-U.S. parties. In the sample industries highlighted above where approval of an industry regulator is

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<sup>216</sup> *Order on the China National Aero-Technology Import and Export Corporation Divestiture of MAMCO Manufacturing, Inc.* (February 1, 1990), <http://www.presidency.ucsb.edu/ws/index.php?pid=18108> (Last accessed: September 13, 2012).

<sup>217</sup> *Energy Policy Act of 2005*, Pub. L. No. 109-58, § 1837, 119 Stat 594.

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required — telecommunications, renewable energy, and banking — further regulation exists that may have a disparate impact on the approval of foreign investment.

### *a) Telecommunications Industry*

The *Communications Act* establishes a 20% limit on foreign investment in US broadcast, common carrier, or aeronautical radio licensees, and a 25% benchmark for foreign investment in entities that control such licensees, such as holding companies.<sup>218</sup> The FCC has discretion to allow higher levels of foreign ownership at the holding-company level, unless it finds that such ownership is inconsistent with the public interest. If an application discloses proposed foreign investment at the holding-company level in excess of the 25% benchmark, the FCC will conduct a detailed review of the proposed ownership before making a ruling. The FCC generally will allow up to 100% indirect foreign ownership of an entity controlling a common carrier licensee as long as at least 75% of those ownership interests would be sourced from countries that are members of the WTO. With regard to entities controlling broadcast licensees, historically the FCC has not authorized foreign investment in excess of 25%. Meanwhile, in August 2012 the FCC announced that it would exercise its statutory authority to begin considering, on a case-by-case basis, foreign investment in common carrier licensees directly in excess of the 20% limit.

In exercising its discretion, the FCC will defer to any national security, law enforcement, and/or foreign policy concerns that may be raised by the DOJ, Department of Homeland Security, or Federal Bureau of Investigation — jointly referred to by the agencies as “Team Telecom” for this purpose. The timing to address Team Telecom’s questions and potentially negotiate an agreement to resolve security concerns can vary from 30 to 150 days or more.

### *b) Renewable Energy Industry*

Similarly, while government approvals for investment in the renewable energy industry apply to both foreign and domestic investors, U.S. energy regulators (FERC and state commissions) tend to be particularly cautious with potential foreign investors. This caution, applicable to both renewable and non-renewable energy investments, stems from concerns related to transparency, cybersecurity, and the regulators’ ability to maintain access to investors and information after the transaction is consummated. As a result, energy regulators may impose certain conditions with respect to these concerns in their orders approving the transaction, unless foreign investors have anticipated such concerns and addressed them to the regulators’ satisfaction in their written requests for approval of

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<sup>218</sup> See *Communications Act* of 1934, Pub. L. No. 416, Section 310(b)(3)-(4).



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the transaction or in responses to questions raised by the regulators as the applications are processed.

### c) Banking Industry

Federal banking regulators, in administering U.S. laws governing foreign investments in US banking organizations, typically will require foreign investors to provide assurances that they will make available information pertaining to their operations and activities. In addition, other requirements apply only to foreign investments in banking organizations, such as requirements that foreign bank investors be subject to consolidated supervision by a home country regulator.

## C. Appeal Processes

The default rule under the *Administrative Procedures Act* (APA) is that agency actions are reviewable, even where no statute specifically authorizes judicial review.<sup>219</sup> This presumption is overcome only where —

- Judicial review is precluded by statute,<sup>220</sup> or there is clear and convincing evidence of legislative intent to bar judicial review; or
- The agency is empowered with such broad discretion that, in effect, there is no law to apply for purposes of review.<sup>221</sup>

Under the APA, an action is “ripe” for review only if final agency action has been taken.<sup>222</sup> “Preliminary, procedural, or intermediate” decisions of the agency are also reviewable, but only

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<sup>219</sup> See, e.g., *ANA Int'l, Inc. v. Way*, 393 F.3d 886, 890 (9th Cir. 2004).

<sup>220</sup> When CFIUS cases go to the President for a final decision, judicial review of the President’s final action is precluded by statute. However, actions taken by CFIUS, such as interim and final CFIUS orders establishing measures to mitigate national security risks, are reviewable. For example, *Ralls Corporation* (“Ralls”), a Delaware corporation that is privately owned by two Chinese nationals, filed suit against CFIUS on September 12, 2012, claiming violations of the *Administrative Procedures Act* (for exceeding statutory authority and for arbitrary and capricious agency action) and the Constitution (for unconstitutional deprivation of property). *Ralls Corp. v. Comm. on Foreign Inv. in the U.S.*, No. 12-01513 (D.D.C. filed September 12, 2012).

<sup>221</sup> 5 U.S.C. § 701(a). See also *Bd. of Governors of Fed. Reserve Sys. v. MCorp Fin., Inc.*, 502 U.S. 32, 44 (1991); *Block v. Cmty. Nutrition Inst.*, 467 U.S. 340 (1984); and *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402 (1971).

<sup>222</sup> See 5 U.S.C. § 704.

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as part of the review of the agency's final action.<sup>223</sup> This approach is intended to prevent disruption of agency proceedings.

Similarly, unless an exception applies, a party must seek (i.e., “exhaust”) all available remedies at the administrative level before applying to the courts for judicial review.<sup>224</sup> The exhaustion doctrine does not apply, however, where —

- The administrative remedy is inadequate to provide the plaintiff with a remedy;<sup>225</sup>
- Exhaustion will result in irreparable injury to the complainant;<sup>226</sup>
- It is clear that the agency has acted in excess of its authority;<sup>227</sup> or
- Pursuit of an administrative remedy would be futile.<sup>228</sup>

Pursuant to the APA, courts resolve issues involving questions of fact by employing one of three tests, depending on the circumstances:

- In all instances, agency findings may be set aside if they are “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.”<sup>229</sup> Under this standard, the reviewing court may reverse the agency decision only if there is no rational basis for the agency decision.<sup>230</sup>
- If a formal trial-type hearing was required at the agency level, the reviewing court may reverse the agency's findings only if they are not supported by substantial evidence,<sup>231</sup> meaning that the evidence in the record is inadequate to support the agency's conclusions.<sup>232</sup>
- On rare occasions, agency findings of fact may be subject to *de novo* review, which allows the reviewing court not only to examine the record, but to make its own findings

<sup>223</sup> 5 U.S.C. § 704. See also *Role Models Am., Inc. v. White*, 317 F.3d 327 (D.C. Cir. 2003).

<sup>224</sup> *Myers v. Bethlehem Shipbuilding Corp.*, 303 U.S. 41, 50-51 (1938).

<sup>225</sup> See *Walker v. S. Ry.*, 385 U.S. 196 (1966).

<sup>226</sup> See, e.g., *Am. Fed'n of Gov't Emps., Local 1904 v. Resor*, 442 F.2d 993, 994-95 (3d Cir. 1971).

<sup>227</sup> *Leedom v. Kyne*, 358 U.S. 184 (1958).

<sup>228</sup> *Bowen v. City of New York*, 476 U.S. 467 (1986).

<sup>229</sup> 5 U.S.C. § 706(2)(A).

<sup>230</sup> *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983).

<sup>231</sup> See 5 U.S.C. § 702(2)(E).

<sup>232</sup> *Consolidated Edison Co. v. NLRB*, 305 U.S. 197, 229 (1938).

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of fact. The US Supreme Court has held that review *de novo* is extremely limited and is to be permitted only when “the action is adjudicatory in nature and the agency fact-finding procedures are inadequate,” and “when issues that were not before the agency are raised in a proceeding to enforce non-adjudicatory agency action.”<sup>233</sup> In addition, *de novo* review of agency action may be authorized by the agency’s statute.

Administrative agency decisions are frequently appealed — such appeals totaled 7,813 in 2010 and 7,550 in 2011. In both years, such appeals constituted 14% of filings with U.S. Courts of Appeals. In 2011, 7.9% of appeals of administrative agency decisions that were decided on the merits were reversed. For example, on December 19, 2011, the U.S. Court of Appeals for the Federal Circuit ruled on the case of *GPX International Tire Corp. v. US*, which involved an appeal of a US Department of Commerce decision to impose antidumping and countervailing duties on off-the-road tires imported from China. The Court ruled that the countervailing duty law does not apply to non-market-economy countries such as China. Similarly, in connection with *Dorbest Limited v. United States*, a case brought by Chinese manufacturers of bedroom furniture whose exports to the U.S. had been subject to an anti-dumping duty order, the U.S. Court of Appeals for the Federal Circuit struck down a Department of Commerce regulation used to value labor rates in anti-dumping proceedings.

Given the availability of these appeal processes for most administrative decisions related to foreign investment in the U.S., and the different goals and procedures of the U.S. foreign investment approval processes as compared with those of the Chinese approval processes, most of the issues identified by foreign companies wishing to invest in China do not arise for Chinese companies wishing to invest in the U.S. The major exceptions are Chinese companies’ concerns regarding the CFIUS process and regulatory approvals for foreign investment in certain highly regulated industries, which are relevant to only a small percentage of foreign investment transactions in the U.S.

## VIII. ADDRESSING CONCERNS RELATED TO CHINA’S INBOUND FDI APPROVAL PROCESS

As discussed in Section VI, foreign investors are concerned about Chinese government approval processes that may impede their investment in China, extract valuable commercial concessions as a price for market entry, and favor domestic over foreign companies. Particular concern exists when such processes operate in ways that may conflict with the letter and spirit of relevant WTO and bilateral commitments. Foreign governments are also concerned about the possible

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<sup>233</sup> *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. at 415 (1971).

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distortive impact that China's investment approval policies may have on trade and investment flows and economic development in their own countries.<sup>234</sup>

Addressing these concerns would most likely require reform of the characteristics of the Chinese system that give rise to them, namely: (i) industrial policies explicitly designed to foster domestic industries and national champions; (ii) relatively opaque inbound FDI approval processes explicitly mandated to help China achieve its industrial policy goals; and (iii) administrative and judicial review processes that generally do not provide meaningful recourse for unsuccessful investment applicants. These characteristics are discussed in turn below.

### **A. Industrial Policies that Foster Domestic Industries and National Champions**

To the extent that China's economic policymakers believe that industrial policies favoring domestic companies over foreign investors are in China's best interest, it is unlikely that China will carry out the kinds of comprehensive reforms that foreign investors believe are needed to address their fundamental concerns. Reliance by foreign governments and investors upon WTO litigation or political pressure to bring about these kinds of changes has, to date, yielded only marginal results. This is largely due to the limited scope of WTO commitments, the difficulty of obtaining solid evidence of breach of a commitment, and the subtle and varied means available to Chinese officials to achieve their underlying industrial policy objectives despite commitments to change specific regulations or practices.

Over time, however, China's policies could be influenced by ongoing discussions about the sustainability of China's present economic development model,<sup>235</sup> slowing economic performance and lagging inbound foreign investment,<sup>236</sup> political pressure from China's trading partners, and opportunities for China to grant greater market access in exchange for other benefits — including through negotiation of bilateral investment treaties with the EU, the U.S.,

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<sup>234</sup> See, e.g., 2011 *Report to Congress*, US-China Economic and Security Review Commission, November 2011, [http://www.uscc.gov/annual\\_report/2011/11report\\_chapters.php](http://www.uscc.gov/annual_report/2011/11report_chapters.php) (Last accessed: September 14, 2012).

<sup>235</sup> See, e.g., *China 2030: Building a Modern, Harmonious, and Creative High-Income Society*, Development Research Center of the State Council and the World Bank Group (February 27, 2012), <http://www.worldbank.org/en/news/2012/02/27/china-case-for-change-on-road-t-030> (Last accessed: September 9, 2012).

<sup>236</sup> See, e.g., "China Q2 GDP Growth 7.6 percent, Slowest in 3 Years," Thomson Reuters, July 12, 2012, <http://www.reuters.com/article/2012/07/13/us-china-economy-gdp-idUSBRE86C04220120713> (Last accessed: September 17, 2012); and "Sliding Investment in China Signals Confidence Waning," Bloomberg News, August 16, 2012, <http://www.bloomberg.com/news/2012-08-16/china-s-july-fdi-falls-8-7-from-year-earlier-to-7-58-billion.html> (Last accessed: September 17, 2012) ("Foreign direct investment in China fell to the lowest level in two years in July [2012].... Investment declined 8.7 percent from a year earlier to \$7.58 billion, the eighth drop in nine months and the smallest inflow since July 2010.").

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and other countries. As China debates these issues internally, foreign governments, industry associations, and individual companies will have greater impact if they can present hard economic data and compelling arguments showing that proposed policy changes, regulatory reforms, trade agreements, and pilot programs will contribute to China's own economic development, as well as to more stable and mutually beneficial relations between China and its trading partners.

### **B. Inbound Foreign Investment Approval Processes Designed to Support Industrial Policies**

Comparisons between China's inbound and domestic investment approval processes and between the inbound investment approval processes of China and the U.S. suggest that China could reform its current inbound approval process by reducing the number of approvals required and increasing transparency.

#### **1. Reducing the Number of Required Approvals**

As one approach, China could decide to implement more fully the principle of national treatment by applying the same approval process for inbound foreign investment that it applies to domestic investors (except that foreign investment would still be subject to a possible national security review, as is the case for inbound investment into the U.S.). This means that foreign investment approval by the Commerce Department would no longer be required, and the range of projects subject to DRC approval would be significantly reduced to include only those covered by the Domestic Catalogue. The separate catalogue covering foreign investment would be eliminated.

Alternatively, China could decide to implement more fully the principle of reciprocity by eliminating completely the two types of approvals required for inbound investment that are most related to China's industrial policy goals and that are not required for inbound investment in the U.S.: (i) project approval by the DRC or State Council; and (ii) foreign investment approval by the Commerce Department. This could potentially result in treatment of U.S. investors in China more comparable to the treatment Chinese investors receive in the U.S. (provided that industry regulators in both countries employ licensing criteria that treat foreign and domestic investors on a relatively equal basis).

#### **2. Increasing Transparency in the Foreign Investment Approval Process**

As described in Section VI, lack of transparency exists at various stages and in multiple forms throughout the foreign investment approval process. Several options for improving transparency in the process could include:

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- Modifying laws and regulations to be more precise in language and less broad in their requirements and evaluation criteria, including by —
  - Modifying DRC, Commerce Department, industry regulator, AML, and other investment approval processes to require that projects and investments be approved unless they violate specific laws and regulations, and to mandate compliance with China's international obligations;
  - Publishing time lines for stakeholder, expert, and outside government agency consultations and other approval process steps that currently lack deadlines; and
  - Including definitions in laws and regulations when vague words or concepts such as “public benefit” or “obvious unfairness” are used;
- Ensuring that relevant regulations are in place allowing foreign investors to apply and obtain approval to engage in business activities in sectors where China has made market access commitments;
- More consistently publishing drafts of proposed regulations for public comment;
- Adopting further specific measures, in consultation with foreign investors, to implement demonstrably and fully China's WTO and bilateral commitments related to transparency;<sup>237</sup> and
- Allowing foreign investors to participate with their proposed JV partners in submitting JV investment approval applications and communicating directly with approval authorities.

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<sup>237</sup> For example, in addition to the WTO commitments regarding transparency described in Section II, the US and China both committed, at the Third Strategic Economic Dialogue in December 2007, to:

When possible, publish in advance any measure covered by its WTO obligations that are proposed for adoption, and provide where applicable interested persons a reasonable opportunity to comment on such proposed measures. Each country may comply with this obligation by regularly publishing such proposed measures in its designated official journal or by posting and permanently maintaining these measures on an official website;

Publish in its designated official journal any final measure covered by its WTO obligations before implementation or enforcement.

<http://beijing.usembassy-china.org.cn/121307sed3.html> (Last accessed: September 14, 2012).

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### **C. Limited Effectiveness of China's Administrative and Judicial Review Processes**

As noted in Section VI, foreign investors seldom, if ever, seek administrative or judicial review of unfavorable decisions by investment approval authorities, despite the provision in Chinese laws for such reviews. This is very different from the situation in the U.S., where regulators are commonly sued, and plaintiffs often prevail. The availability in the U.S. of transparent and effective administrative and judicial review processes helps to curb unlawful and inappropriate conduct and ensure accountability of U.S. government officials — including accountability to aspiring inbound foreign investors.

Steps that could be taken to improve the effectiveness of the administrative and judicial review processes in China could include:

- Establishing clear criteria requiring approval of projects and investments unless they would violate specific laws or regulations if approved. In the event an application is denied, requiring a written statement within a prescribed deadline detailing the specific laws and regulations that would have been violated if the investment had been approved; and
- Issuing assurances by senior leaders, with concomitant instructions to lower officials, that investors' use of the administrative and judicial review processes will not be viewed negatively by investment approval authorities and other regulatory officials, and establishing credible channels for handling complaints if such authorities take retaliatory actions against applicants.

## **IX. CONCLUSION**

This report has provided a basic outline of China's approval processes for inbound FDI, set against the backdrop of: (i) relevant WTO commitments made by China; and (ii) comparisons with China's approval processes for domestic investment and U.S. approval processes for inbound FDI. It has also discussed issues that potential foreign investors have encountered in practice when seeking foreign investment approvals in China, as well as possible approaches for addressing these issues.

On a technical level, there are many additional topics related to China's inbound FDI approval processes that could usefully be explored in greater depth. For example, this report does not include detailed analyses of Chinese approval policies and practices for specific industries where WTO commitments exist related to market access, national treatment, and elimination of trade-distorting conditions on investment. Nor does it include detailed comparisons between Chinese and U.S. approval policies and practices for such industries, or substantive economic analyses demonstrating the impact of different approaches on economic development. Such analyses and

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comparisons could facilitate future constructive discussions on these topics between government officials and industry representatives from both countries.

Indeed, the newly launched (or re-launched) U.S. and EU BIT negotiations with China create an opportune context and an urgent need for such discussions. The U.S. Model BIT, for example, sets out U.S. goals and expectations on a number of relevant issues important to investors, including “National Treatment” (Article 3), “Performance Requirements” (Article 8), “Publication of Laws and Decisions Respecting Investment” (Article 10), “Transparency” (Article 11), “Review and Appeal” (Article 11(7)), and investor-state and state-state dispute settlement (Sections B and C).

In each negotiation with a potential BIT partner, U.S. negotiators must seek agreement on a final text that achieves the substantive objectives of these provisions, while also maintaining a balance of commitments that is acceptable to both parties. In BIT negotiations with China, this will require taking fully into account the characteristics of China’s inbound FDI approval regime outlined in this report.