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Hearing on the Foreign Investment Climate in China

I. China's Treatment of Foreign-invested Firms¹ in 2014

2014 was a challenging year for foreign business in China. Across many sectors, foreign companies reported a rise in legal and administrative investigations into their local business operations and into normally routine matters such as taxes, visas and customs. For larger companies, a rise in enforcement of China's Anti-monopoly Law ("AML") introduced new elements of risk for local operations and added complications for global M&A. This increase in legal and administrative enforcement actions has led many in the foreign business community to conclude that business in China is becoming more difficult,² with some even suggesting that "multinational companies are under selective and subjective enforcement by Chinese government agencies."³

Given this concern, it is fitting that the Commission has called this hearing to address the overall business environment for foreign firms. It is my hope that our efforts today will contribute to a better understanding of the changing business environment facing foreign firms in China.

Though concerns have been raised about a rise in discriminatory conduct against foreign businesses, my own view is that the dominant trend in 2014 was that of increased enforcement nationwide, equally affecting both domestic and foreign companies. One of the lessons I've learned from handling China legal matters over the last decade is that most of my law firm clients' claims of anti-foreign bias often stem from a misunderstanding of China and its laws rather than overt government action.

In suggesting this trend, I am not turning a blind eye to the reality that foreign firms are not always treated fairly in China, nor am I ignoring the fact that foreign-bias may have played a role in certain investigative decisions, such as AML.⁴ Rather, I suggest we view the current foreign business climate as being shaped by two interrelated factors:

- First, a long-term trend whereby the Chinese government seeks to condition foreign investment in line with its own national economic and industrial policy goals.

¹ "Foreign," in this report, refers to any company established in China with any amount of foreign-investment. "Domestic" refers to those companies with no amount of foreign investment.

² A recent survey by the American Chamber of Commerce in China found that 60% of member companies reported feeling less welcome in China than before -- a 20% rise over 2013. 49% of companies reported that they felt foreign firms were being singled out unfairly by the Chinese government. See American Chamber of Commerce in China, *Challenges and Opportunities in China's Investment Environment 2014*, available at: <http://www.amchamchina.org/wp-investment2014>.

³ *Id.*

⁴ See Section IV.B.

- Second, a more recent trend whereby the Chinese government is enacting substantial administrative reforms, one effect of which is an increase in administrative enforcement.

In the remainder of this section, I will address this second, more recent, trend. In Section II, I will cover the first trend, i.e., the mechanisms China uses to condition foreign investment to ensure it contributes to China's own national economic and industrial policy goals.

A. Administrative Enforcement Activity against Foreign Business in 2014

In 2014, the foreign business community in China witnessed a number of government actions seen as negatively affecting the foreign business climate:

- A notable increase in China's enforcement of its AML, including:
 - Combined fines of \$46 million against Volkswagen and Chrysler, and nearly \$200 million in fines against 12 Japanese auto-parts manufactures in separate price-fixing investigations;
 - Numerous investigations into domestic pharmaceutical manufacturers;
 - Blockage of a planned global shipping alliance between Moller-Maersk, CMA CGM, and MSC Mediterranean; and
 - Ongoing investigations into the local business practices of Microsoft and Qualcomm.
- Multiple anti-corruption investigations against foreign pharmaceutical companies, including a \$500 million bribery fine levied against British Pharmaceutical company GlaxoSmithKline.
- Numerous campaigns in China's state-run media targeting, among others, KFC, Apple, and McDonalds for alleged consumer rights violations.
- A domestic backlash against foreign information technology providers and calls for eliminating foreign technology in key sectors by 2020.
- From my law firm's own clients, we are seeing greatly increased enforcement on all sorts of relatively routine business matters such as customs duties, employee layoffs, visa checks, and tax payments.

In several of these cases, we should recognize that there appears to have been concrete evidence of wrongdoing sufficient to justify a government response. But looking at some of the more borderline cases -- the more routine administrative difficulties -- it is difficult to ascertain whether this rise in enforcement has been motivated by anti-foreign bias or driven by some other factor. One effect of China's general lack of legal transparency is an inability to precisely determine the driving factors behind government action. And from the foreign perspective, there is often a tendency to view any adverse action as some form of "bias," when really it just may be how things are done (or being done) in China. In

the present case, the recent rise of administrative and legal enforcement actions against domestic companies suggests that more than just simple anti-foreign bias is motivating these recent changes.

B. Administrative Enforcement Activity Against Domestic Business in 2014

When viewed in isolation, it seems perfectly reasonable to conclude that some amount of selective enforcement is motivating the increase in administrative and legal enforcement actions against foreign firms. However, looking at the past year for domestic businesses we see many of the same pressures:

- Politically, President Xi Jinping is spearheading a large, possibly unprecedented, anti-corruption campaign targeting Communist Party officials at all levels, including those in the management ranks of State-owned Enterprises. Seeking out the “tigers and flies” of official corruption, this campaign has led to administrative raids of thousands of domestic businesses suspected of bribery violations involving corrupt officials. Though these investigations have also ensnared some foreign companies, the numbers affected and business disruption caused pale in comparison to domestic firms.
- Although there are important questions to be asked regarding China’s application of the AML against foreign companies, we must also recognize that Chinese authorities have not been reluctant to carry out AML investigations against its own domestic companies. According to NDRC statistics, AML enforcement agencies have carried out investigations against 339 companies since the promulgation of the AML in 2008, of which only 33 were foreign companies.⁵⁶ Generally, these investigations fail to garner the type of Western press coverage that follows actions against foreign companies, even though the damage awards are similar. For instance, over the last two years we have seen the following major fines levied against domestic companies for price fixing:
 - \$107 million against milk powder manufacturer Wuliangye;
 - \$18.6 million against three domestic cement manufacturers;
 - \$73.5 million against two Chinese liquor producers; and
 - \$18 million against 23 auto-insurers.
- Industry observers speculate that one of the main motivations behind the recent increase in AML investigations is the possible belief of China’s National Reform and Development Commission (“NDRC”) that the AML is the best tool available to reduce prices on citizen’s daily goods.

⁵ See 中国反垄断法实施6年多 查处339家机构 外企仅33家 [“In the 6 Years since China’s AML has been implemented, 339 organizations have been investigated, 33 foreign”], China News Web, Dec. 6, 2014, *available at*: <http://finance.chinanews.com/cj/2014/12-06/6851996.shtml>.

- Chinese tax authorities have also launched twin campaigns to more strictly enforce tax laws relating to personal foreign income and to curb tax evasion by Chinese companies operating abroad.⁷

If the rise in administrative enforcement actions against foreign companies was to enhance domestic competitiveness, as some suggest, then it seems unlikely that China's administrative, party and judicial authorities would carry out equivalent, and perhaps more intrusive, investigations into its own domestic companies. That we've seen a similar increase in administrative enforcement actions against domestic companies suggests that larger elements are at play.

C. Potential Drivers of China's Increased Administrative Enforcement

Though we cannot know with certainty what exactly is behind China's rise in administrative enforcement, it is apparent that this increase coincided with Xi Jinping's rise to power and is likely due in some part to efforts to advance his ongoing anti-corruption and economic reform agenda. In particular, two major administrative reforms seem to be supporting this new role for Chinese administrative and judicial authorities.

First, Xi's plans for China's economic reform codified at the Third Plenum in November 2013 included a call for the "market to play a decisive role in allocating resources." As part of this greater market opening, a series of administrative reforms have been promulgated aiming to simplify China's investment approvals process by reducing government oversight at the initial investment approval stage. According to one of our clients, regulators are being told to keep their hands off the market, which is forcing these bureaucracies to find a new role to play outside their traditional role of industry gatekeeper. This is leading them to increase their domestic enforcement and supervision efforts.

A second complementary factor is Xi Jinping's emphasis on governing the country according to the rule of law.⁸ Highlighted in the Third Plenum Communique but made the singular focus of the recent Fourth Plenum, Xi's rule of law reforms are aimed at creating a stronger and more professional judicial corps, while also increasing the transparency of judicial decisions. China's state-run media outlets have further highlighted the "rule of law" as an essential component of Xi's ongoing corruption campaign and as a necessary basis for advancing his economic reforms. As Chinese regulators are often motivated and assessed by their ability to hew to Party dictates, it could be that this increased emphasis on rule of law – in tandem with the administrative reforms described above – may be leading to increased enforcement activity by China's administrative and judicial actors.

⁷ See, e.g., *China Starts Enforcing Tax Law for Chinese Citizens Working Abroad*, New York Times, Jan 7, 2015, available at: <http://mobile.nytimes.com/2015/01/08/business/international/china-starts-enforcing-tax-law-for-citizens-working-abroad.html>.

⁸ Some translators have offered the phrase "rule by law." Whichever the case, party documents indicate that the rule of law (or rule by law) should "be advanced under CPC leadership," indicating the continued primacy of the Party in China's administrative hierarchy, and suggesting that rule of law may not provide an independent check on Party power.

These two political developments appear to be the main drivers behind this recent trend of increased administrative enforcement activity, and may help explain why foreign firms have seen business conditions deteriorate over the last 12-24 months.

II. Legal and Regulatory Obstacles Facing Foreign Companies in China

As noted in the previous section, the foreign business climate in China is currently being shaped by two interrelated trends: a short-term trend of increased administrative enforcement, equally applied against both foreign and domestic companies, and a longer-term trend of conditioning foreign investment in line with China's national policy goals.

In this section, I will describe the second of these trends, which I view as primarily responsible for many of the legal and regulatory obstacles currently facing foreign companies in China. To do so, I will rely heavily on a recent study prepared by the law firm Covington & Burling for the European Commission Directorate-General for Trade (the "EC Report").⁹ Prepared to help EU and US trade officials prepare to negotiate bilateral investment treaties and other trade agreements with China, the EC Report identifies two mechanisms – legal restraints and extra-legal administrative practices – that act to "restrain" foreign investors and investment in China.¹⁰

These two restraints are described below.

A. Legal Restraints

"Legal restraints" are identified in the EC Report as those codified legal measures that have the potential to discriminate against foreign business, either by favoring domestic investors or investments over foreign investors or investments, or by favoring state-owned investors or investments over privately-owned investors or investments.

The report identifies three broad categories of legal restraints affecting foreign business in China:

1. Pre-establishment restraints, such as "discriminatory local partner/equity requirements, market entry restrictions [e.g., minimum-amounts of foreign equity or administrative licensing restrictions], approval process restraints, and technology transfer measures";
2. Post-establishment restraints, such as "differentiated treatment through targeted enforcement, government financial support, and government procurement"; and,
3. "Broad policy statements that *potentially* result in less favorable treatment for foreign investors and investments during both the pre-establishment and post-establishing stages."

⁹ See Covington and Burling LLP, *Measures and Practices Restraining Foreign Investment in China*, available at: http://trade.ec.europa.eu/doclib/docs/2014/august/tradoc_152739.08.10.pdf.

¹⁰ The study defines "restraint" as any mechanism "that ... can result in more favorable treatment for at least one domestic investor or investment than is available generally for foreign investors or investments."

Historically, legal restraints have been one of the more common mechanisms by which China has sought to shape or direct foreign investment over the last several decades.¹¹ However, because legal restraints are codified in existing laws, they are easily appealable before international trading bodies, making them less effective over time as China becomes more fully immersed in international trading regimes. As a result, the current trend in China is away from the use of black-and-white legal restraints in favor of administrative practices.

B. Administrative Practices

Administrative practices are defined in the EC Report to include “the practices of agencies and officials in all branches and at all levels of government, including those engaged in legislative and judicial as well as executive functions.” The EC Report then uses the term “administrative restraints” to refer to “those administrative practices sometimes used to restrain, condition or otherwise frame foreign investment, including especially those practices that are not explicitly authorized or compelled by published rules.”¹² In some cases, administrative practices may actually conflict with the written law, such as where the government places an additional requirement – e.g., the need to enter into a joint venture -- on a foreign investment project.

Based on extensive research and discussions with industry, the EC report identified 21 administrative practices falling into four broad categories:

1. Rule-Making (4);
2. Administrative approvals (6);
3. Standards setting (3); and
4. Judicial processes and enforcement (8).

These practices include such matters as verbal instructions (“Oral instructions received by administrative authorities may go beyond what is required in law”) or issues concerning legislative transparency (“Foreign attorneys have limited access to legal hearings and other proceedings.”). At their heart, they involve systemic processes, omissions or instructions that restrain foreign investment in China, but which are difficult for foreign companies to appeal because they are not formally codified and are often applied by government agencies on an *ad hoc* basis.

According to the EC Report, “foreign investors in China generally believe that **these administrative practices match or even trump published rules as a source of investment restraints**, (emphasis added) because of three characteristics of China’s administrative system:”

¹¹ The EC Report notes that legal restraints are primarily used to promote domestic national champions, encourage or protect strategic industries, and promote export or foster indigenous innovation. Local governments may also employ legal restraints to promote their own local industries or to enhance local tax revenues or employment.

¹² The EC Report seems to rely mainly on the term “administrative practice” to refer to both the administrative practice itself as well as the administrative restraint it causes. This usage is followed here.

1. “Reliance on industrial policies explicitly designed to support the development of domestic industries and creation of domestic champions;
2. The pivotal role of relatively opaque inbound FDI approval processes led by officials explicitly mandated to help China achieve its industrial policy goals; and
3. The lack of effective recourse if aspiring foreign investors believe that the approval authorities have not complied with WTO commitments or China’s own regulations.”

These three characteristics demonstrate the core components of China’s long-term trend of conditioning foreign investment in support of national policy goals, and represent some of the core problems facing foreign business in China. Because foreign firms are reticent to report the use of administrative practices by Chinese authorities, in part for fear of government backlash from these same authorities, there is a need to provide an anonymous reporting system to identify and track the use of administrative practices. In section V, I will propose one such mechanism.

III. China’s Legal Transparency and Its Affect on Foreign Companies

Although China has made great strides in developing a rule of law over the last thirty years, an ongoing lack of legal transparency continues to create compliance and regulatory obstacles for foreign business in China.

In the EC report, many of the most commonly reported administrative practices relate to legal transparency:

- “Regulatory ambiguity allow[ing] regulators to interpret laws in ways that advantage local companies or impose special conditions on foreign companies;”
- “Local discretion in deciding whether to enforce PRC laws;”
- “[Limited access of foreign attorneys] to legal hearings and other proceedings;”
- “Legal measures or court decisions not always made public;” and
- “...[A] lack of judicial independence.”

Of these issues, “regulatory ambiguity” is far and away the most commonly reported administrative practice. Here, the issue is that many of China’s promulgated laws and regulations are drafted with ambiguous or general language, and often lack definitions for key terms. The resulting lack of precision creates uncertainty for local businesses who are forced to structure their legal compliance efforts around

these vague and ambiguous legal requirements.¹³ Such difficulties are further exacerbated by the fact that Chinese court decisions are not regularly published, or, if published, often fail to include detailed legal reasoning. This prevents companies from understanding how a particular law or provision within a law has been interpreted or applied in practice.

As a result of this legal ambiguity, Chinese regulators are afforded a great deal of discretion to choose whether or how to interpret a law in response to a given activity. This provides a mechanism for political interests to affect legal interpretation, and contributes to the use of administrative practices discussed in Section II.B.

IV. China's Treatment of Foreign Companies by Sector

A. Indigenous Innovation and the Strategic Emerging Industries

China's treatment of foreign companies is determined in large part by the country's economic and industrial policies goals. To further its economic development, China seeks to attract foreign investment, technology and expertise in the "Strategic Emerging Industries" to further their own development of national champions in these industries.

This Commission is well aware of these programs, having previously addressed them in a 2011 hearing entitled "China's Five-Year Plan, Indigenous Innovation and Technology Transfers and Outsourcing."

In that Hearing, the hearing co-chair summarized these industrial policy goals:

In its newly-adopted 12th Five-Year Plan China makes clear that it hopes to move up the manufacturing value chain by making explicit mention of Strategic Emerging Industries, which the Chinese government would like to see dominated by Chinese firms. These industries are: New-generation information technology, high-end equipment manufacturing, advanced materials, alternative-fuel cars, energy conservation and environmental protection, alternative energy, and biotechnology. China's goal is to take the Strategic Emerging Industries from a current combined share of 3% of Chinese GDP to 8% by 2015 and 15% by 2020.

One of the tools the Chinese government will use to grow these Strategic Emerging Industries is indigenous innovation. This policy seeks to help China move up the value-added chain. Indigenous innovation policies have drawn criticism from the U.S. and European business communities and policy makers because China uses this policy to require foreign companies to transfer their higher technologies and know-how as a condition of doing business in China or getting government procurement contracts in China.¹⁴

¹³ Some have argued that China's ambiguous legal drafting is a positive feature, providing flexibility for China's regulators to interpret laws in line with actual circumstances and apply domestic laws fairly across a diverse national environment taking into account specific local conditions.

¹⁴ See *Prepared Statement of Commissioner Patrick A. Mulloy Hearing Co-Chair*, available at: <http://origin.www.uscc.gov/sites/default/files/transcripts/6.15.11HearingTranscript.pdf>

Given these official policies, foreign companies investing in these industries are likely to attract greater government scrutiny from Chinese officials. This enhanced administrative scrutiny is not always negative. In many cases, China has shown a great willingness to attract foreign investment in identified industries, providing tax breaks, streamlined administrative approvals and other incentives designed to spur investment. Indeed, when Western parties claim discriminatory treatment, one of the standard responses from Chinese media commentators is to point out these incentives and claim that it is, in fact, domestic companies that face the real discrimination, since they do not receive the same incentives provided to foreign companies.

For example, after several industry groups released statements calling attention to China's possible selective targeting of foreign companies in AML investigations, the state-run newspaper Global Times included comments from a Beijing-based economist -- Wang Jun of the China Center for International Economic Exchange -- stating that "recent antitrust investigations have not been targeting foreign businesses" and "in fact, in the last three decades, these overseas firms have actually been giving preferential treatment in areas such as taxation."¹⁵

Nevertheless, there remains a fear that when targeted industries have reached a certain point of domestic maturity, this formally positive treatment will shift to gradually increasing administrative interference so as to promote the long term growth prospects of Chinese firms. And there are some who feel that China's recent AML investigations may be following this path.

B. Recent Actions against Foreign Automobile, Pharmaceuticals, and Technology

As noted prior, one of the key factors driving recent AML activity against foreign automobile and pharmaceuticals manufacturers is a newly-emboldened NDRC and its apparent belief that the AML is the best tool for reducing prices. This argument is supported by the numerous AML actions affecting both domestic and foreign manufacturers of consumer goods that have occurred over the last two years.

One other potential driver is the belief among certain Western observers that the AML is being applied in areas where industrial policies have failed in China. According to an analysis of recent AML actions by The Conference Board:

"One consistent theme across AML investigations to date -- in sectors as diverse as pharmaceuticals, baby formula, IT technology, and automobiles -- is that the imposed remedies require both substantial price reductions as well as the abandonment of contractual controls that enable owners of brands and other IP to leverage those assets across their supply chains to maximum full value in the Chinese market. The fact that the investigations disregard market share and market power as the critical transgression makes it clear that this is about curbing the industry-wide power of foreign investors, and not about addressing monopoly abuses per se."¹⁶

¹⁵ See *Foreign Firms Not Being Singled out in Antitrust Campaign: Officials*, Global Times, Dec. 8, 2014 available at: <http://www.globaltimes.cn/content/895645.shtml>.

¹⁶ See The Conference Board. *China Center Quick Note: The AML Background -- Looking Behind and Beyond the Current Regulatory Salvo*, available at: <https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2880>.

The analysis then suggests that these investigations are focused on disrupting “what the NDRC calls ‘vertical monopolies’ – i.e., the power brand and IP owners have to control costs and pricing across their supply chains and, in doing so, maximize their own margins.”

If substantiated, this type of AML application raises obvious concerns for foreign business. Although my testimony today has largely focused on the trend of increased enforcement, impartially applied, I must also make clear that I believe there are valid questions and concerns to be raised regarding the Chinese government’s use of AML actions against foreign companies. With that in mind, one aspect of China’s recent AML investigations we may wish to keep in mind is that the Chinese companies most at risk of an AML action based on pricing power will generally be China’s biggest and most powerful companies, and will frequently be state-owned. Because of obvious reasons, these are the same companies the Chinese authorities are likely least willing to confront. This asymmetry between large foreign and Chinese companies could be one reason that foreign companies will be more likely to come under AML scrutiny than Chinese companies.

V. Protecting the Interests of Foreign Companies

At present, foreign investors affected by the use of administrative practices or China’s selective enforcement of its AML have little potential recourse to protect their interests. In a 2013 report on China’s investment approval process, the US Chamber of Commerce noted four factors that discourage foreign investors from using China’s official appeals mechanism:

- “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 specific criteria;
- Difficulty in providing 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 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’ future business prospects in China.”¹⁷

Given these factors discouraging formal appeal, foreign companies must often accept an extralegal administrative practice in exchange for Chinese market access. In light of this reality, one option worth considering is the creation of an online reporting platform allowing foreign companies to aggregate data from their experience in order to better understand, analyze and quantify extralegal behaviors carried

¹⁷ See U.S. Chamber of Commerce, *China’s Approval Process for Inbound Foreign Direct Investment: Impact on Market Access, National Treatment, and Transparency (2013)*, available at: https://www.uschamber.com/sites/default/files/legacy/reports/020021_China_InvestmentPaper_hires.pdf

out by Chinese officials. Such a tool could permit a company to report the type of administrative practice encountered (e.g., a request for technology transfer in exchange for a license), and record other pertinent data such as the date, location, and identity of the requesting government agency.

The Indian website “I Paid a Bribe” is one example of this type of tool. With “I Paid a Bribe,” the problem faced by Indian citizens was very similar to the one currently facing foreign business in China -- how to report potentially illegal or corrupt government conduct without incurring government retribution. By harnessing the power of the social web, “I Paid a Bribe” has now accumulated over 35,000 total reports, including not only instances of bribery requests, but also reports of “honest officials” and “bribe fighters.” It has since been replicated in other countries, including Pakistan, Kenya and Bhutan, although sadly, efforts to implement similar systems from within China have fallen afoul of government censors.¹⁸

By establishing a similar website overseas, foreign companies would have a mechanism to report extralegal conduct as well as instances of honest officialdom without the potential for government retribution. This dataset would not only help China’s efforts to institute a rule of law within China and stamp out corruption, but it would also provide a searchable dataset for foreign companies looking to invest or expand in China, allowing them to choose those localities and provinces with the cleanest officials.

Of course, design of such a system would need to confront such questions as veracity and access (for instance whether to make the platform closed to qualified individuals within designated companies or open to the public), and additional input from industry participants would be needed to assess their needs. Nevertheless such an approach would bring some degree of light and transparency into what is now a very opaque market environment.

¹⁸ See *Web Sites Shine Light on Petty Bribery Worldwide*, New York Times, Mar. 7, 2012, available at: <http://www.nytimes.com/2012/03/07/business/web-sites-shine-light-on-petty-bribery-worldwide.html?pagewanted=all&r=0>