

ADVISORY | International Trade & Investment

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COVINGTON PREPARES UNPRECEDENTED STUDY OF FOREIGN INVESTMENT RESTRICTIONS IN CHINA FOR EUROPEAN TRADE NEGOTIATORS

China is engaging in simultaneous bilateral investment treaty (BIT) negotiations with the United States and the European Union. This presents the most significant opportunity for foreign investors in China to influence market access restrictions and other restraints on foreign investment in the country since China's accession to the World Trade Organization (WTO) in 2001.

To assist trade negotiators and other stakeholders in the [BIT negotiation process](#), Covington, led by Tim Stratford (a former Assistant US Trade Representative and now Managing Partner of Covington's Beijing office), has developed an unparalleled database of publicly recorded laws, regulations, and other measures containing provisions that frame or limit foreign investment in China. The Covington team searched hundreds of thousands of measures issued by 80 central government agencies¹ and five representative provincial-level governments, and in the process identified hundreds of provisions restraining foreign investment in China.

Beyond published measures, we reviewed key trade publications and conducted interviews with industry groups to identify and catalogue administrative practices that also may have a restraining effect on foreign investment. As foreign business leaders in China are well aware, many of the biggest obstacles to foreign participation in the Chinese economy are imposed unofficially by government officials exercising legal or extralegal discretion.

A [public version of the report](#) ("Report") prepared for the EU's Directorate General for Trade is available on the EU DG Trade website. The Report does not include details of all the measures identified in the course of drafting the Report. We would be pleased to discuss specific measures affecting particular sectors with interested parties.

A New Taxonomy for Restraints on Foreign Investment in China

Based on our review of Chinese measures, we developed a standardized system for categorizing foreign investment restraints (both legal measures and, separately, administrative practices) frequently encountered in China that will (1) provide a framework for further analysis and investigation and (2) allow government officials and industry representatives to more effectively discuss and coordinate when developing priorities for BIT negotiations and other relevant engagements with the Chinese government.

For the purposes of this study, the Covington team focused on *horizontal measures* (those cutting across industry sectors) and *sectoral measures* for ten select industry sectors² -- issued by both

¹ The term "agencies" is defined broadly to include legislative and judicial bodies as well as executive agencies within the government.

² The ten selected sectors were: (1) automobile manufacturing, (2) chemical manufacturing, (3) construction and infrastructure (including water supply and sewage treatment), (4) distribution, (5) energy, (6) financial services (including banking, securities, and insurance), (7) healthcare (including pharmaceutical, medical

central government agencies and five representative provincial-level governments (measures issued by geographic subdivisions of the provinces down to the district and county levels were included when available). The provincial-level governments selected were Beijing, Shanghai, Tianjin, Chongqing, and Guangdong -- all but the last being municipalities with provincial status in the Chinese system.

Restraining Measures

To facilitate our ability to identify restraining measures, we defined the following three *categories* of restraints:

- **Category 1:** Restraints that favor *domestic* investors or investments over foreign investors or investments;
- **Category 2:** Restraints that favor *state-owned* investors or investments over privately-owned (including foreign-owned) investors or investments; and
- **Category 3:** Restraints that *possibly* favor domestic investors or investments over foreign investors or investments, depending on whether foreign-invested enterprises (FIEs) established in China would be regarded as "Chinese" entities and therefore deemed eligible to receive, on an equal basis, benefits made available to such entities.

After developing a broad set of search terms designed to identify measures containing these three categories of restraints, we narrowed our original list of 263,238 published measures down to a list of 29,742 measures that each contained one or more of our search terms. We then conducted a careful, provision-by-provision review to identify those provisions that actually contained restraining language. This manual review process identified over 800 restraints, which could be divided into three broad groups:

1. *Pre-establishment restraints* that impede market access for foreign investment;
2. *Post-establishment restraints* that treat foreign-invested entities less favorably; and
3. *Broad policy statements* that *potentially* result in less favorable treatment for foreign investors and investments during both the pre-establishment and post-establishment stages.

We found that within these three groups, restraining measures in China could be further subdivided into (i) four types of pre-establishment restraints – discriminatory local partner/equity requirements, market entry restrictions, approval process restraints, and technology transfer-related measures – and (ii) three types of post-establishment restraints – differentiated treatment through targeted enforcement, government financial support, and government procurement. In addition, we determined that the large number of *broad policy statements* we identified also constitute an important group of restraints, even though they do not mandate specific discriminatory treatment in and of themselves, because they often lead central government agencies or local governments to promulgate discriminatory measures or to exercise their administrative discretion in ways that disadvantage foreign investors and investments.

Restraining Administrative Practices

Investment activities by foreign businesses are also subject to restraining administrative *practices*, which reflect the following three characteristics of China's administrative system:

device, and cosmetics manufacturing, as well as healthcare services), (8) mining, (9) professional services (including legal, accounting, consulting, and architecture), and (10) telecommunications.

1. Industrial policies explicitly designed to support the development of domestic industries and champions;
2. Relatively opaque approval processes led by officials explicitly mandated to help China achieve its industrial policy goals; and
3. The absence of effective recourse if approval authorities have not complied with international commitments or China's own regulations.

We reviewed articles in relevant trade publications, conducted interviews with foreign business executives and industry associations, and reflected on our own extensive experience in the Chinese market, and in the process identified 21 administrative practices that can negatively impact foreign investment in China. These practices, discussed in further detail in Section 3 of the Report, impact rule-making, administrative approvals, standard setting, and judicial processes and enforcement.

Conclusion

China's restraining measures and practices are both underpinned by the same fundamental goals, which include, in particular, promoting domestic champion companies and fostering indigenous innovation. Under these circumstances, foreign countries face two fundamental questions when negotiating trade agreements with China:

1. How can the Chinese government be persuaded to accept effective foreign investment liberalization disciplines if such disciplines in many cases run counter to China's current fundamental economic policies and system of governance?
2. How should such disciplines be crafted to ensure their effectiveness in practice?

With these questions in mind, the Report should be useful to trade negotiators, trade associations, and individual companies in carrying out the following four tasks: (1) identifying negotiation priorities; (2) testing the comprehensiveness and efficacy of proposed BIT texts; (3) tracking ongoing regulatory developments in China; and (4) probing specific policy issues in further detail.

As China considers how far it is willing to go in liberalizing and reforming its foreign investment regime and underlying governance practices, foreign governments, industry associations, and individual companies will have the greatest positive impact when they respectfully present well-founded arguments showing the problems associated with specific measures and practices and the benefits China would derive from adopting and implementing well-crafted reforms. We hope the Report will contribute to more rigorous and well-informed efforts in this direction.

If you have any questions concerning the material discussed in this client alert, including specific Chinese measures not included in the public Report, please contact the following members of our international trade and investment practice group:

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