Reactions to China's cross-border investment and international investment law

by

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China is now one of the world's most important outward investors. The salient features of the country's cross-border direct investments (discussed in the first section) include that its foreign direct investment (FDI) has grown rapidly, that state-owned enterprises (SOEs) play a dominant role and that outward investment takes place within an elaborate regulatory framework. Not surprisingly, the rapid rise of China's outward FDI – and especially the mergers and acquisitions (M&As) increasingly used as the principal mode of entry into foreign markets – has received considerable, often sceptical, attention on the part of host countries' newspapers, the business community and governments – warranting trust-building endeavors from stakeholders (discussed in the second section). China needs to adapt to these developments, not only in its national policies, but also in its approach to its international investment agreements (IIAs), in the framework within which Chinese firms invest abroad (discussed in the third section).

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I. Salient Features of China's Outward FDI and Policy Issues Related Thereto

China has become a major player in the world FDI market. The country's outward FDI flows grew from US$7 billion in 2001 to US$116 billion in 2014 (UNCTAD STAT n.d.),[1] for an accumulated stock of US$730 billion. In terms of outflows, this made China the single most important *home* country among *all emerging markets* (UNCTAD 2014, 7), and the third largest among *all* home countries. In fact, China's outward FDI flows have almost caught up with China's inward FDI flows: in 2001, the percentage of outward FDI flows as compared to inward FDI flows was 15 per cent; in 2013, it was 90 per cent.[2]

By the end of 2012, China's 16,000 multinational enterprises (MNEs) had established ~22,000 foreign affiliates in 179 countries and territories (MOFCOM 2013). Chinese firms have invested substantially in both developed and developing countries, increasingly using M&As as a mode of entry. Chinese's FDI distribution across sectors and geographic regions is however difficult to ascertain, as more than two-thirds of China's non-financial sector outflows are channelled via financial centers and tax havens (MOFCOM 2012); consequently, the countries and sectors in which they are ultimately invested is unknown. It seems likely, however, that services and natural resources are the most important sectors.

These figures should not disguise, however, that, globally, China's average share in world FDI outflows averaged only 5 per cent during 2010 – 2012, while its share in the world's outward FDI stock was 2 per cent in 2012.

Apart from its speedy rise, there are two other features that characterize China's outward FDI. The first is that, in contrast to virtually all other major outward investors, SOEs account for a

[1] Unless otherwise indicated, all data are from UNCTAD Stat.

[2] *UNCTAD Stat*, http://unctadstat.unctad.org/ReportFolders/reportFolders.aspx.

substantial share of China's outward FDI flows and stock. By the end of 2011, the 113 central SOEs controlled by the State–owned Assets Supervision and Administration Commission (SASAC n.d.) alone accounted for 66 per cent of China's non-financial FDI outflows and 76 per cent of China's non-financial outward FDI stock in 2011. This raises the question of whether China's outward FDI serves purposes other than commercial ones (Sauvant 2012). As discussed below, these concerns have led to the creation or strengthening of regulatory review processes of incoming M&As, especially for certain sensitive industries. Obama's September 2012 veto of a Chinese windmill project near a military base in Oregon – the first such veto in twenty-two years– is emblematic of these concerns (*In Rare Move* 2012).

The second feature relates to China's relatively sophisticated regulatory framework dealing with outward FDI. This framework has moved, within two decades, from restricting to encouraging (Sauvant and Chen 2013, 141-163). Embedded in an overall development strategy, China's "going out" strategy has two principal purposes: (1) to facilitate and support outward FDI to create globally competitive Chinese firms; and (2) to encourage outward FDI that contributes directly to China's development, especially by obtaining natural resources, promoting exports, or strengthening China's technological base. The government has put in place an institutional structure and various instruments ("home country measures") for this purpose.

Although a number of government institutions participate in outward FDI, the principal ones are the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM). In 2006, these and other institutions established a "Sector direction policy" that provides guidance for specific promotional measures on the basis of investment that is encouraged, allowed and prohibited (Sauvant and Chen 2013, 141-163). The specific instruments used to encourage outward FDI include various subsidies (including financial and fiscal support);

priority rights (e.g. access to loans, to foreign exchange or to overseas financing); expedited approval; and tax rebates on (or waivers for) the export of goods. Within the formal regulatory framework, these home country measures appear equally available to both SOEs and private enterprises.

Finally, a network of 128 bilateral investment treaties (BIT) as of 1 June 2013 (UNCTAD 2013), as well as a number of other IIAs, provides protection to China's outward investors. Although these treaties were originally concluded with inward FDI in mind, they have evolved over time to reflect China's evolution as an outward investor.

Yet, although China's regulatory framework for outward FDI appears sophisticated, the approval process is complex and cumbersome. With further growth of outward FDI, this approval process must be simplified, if not replaced by mere notifications: given the growing number of Chinese outward investors and their foreign affiliates, examining and approving each individual investment decision might simply overwhelm the authorities. Broader reform efforts seem to foreshadow such revamping: as of May 2014, only deals valued at more than US$1 billion require official approval, as compared to the previous value threshold at more than US$100 million (NDRC n.d.). It would also be more efficient to create a "one-stop shop" for the measures available to qualifying outward investors. The combination of both approaches would lead to control measures regarding outward FDI being replaced by incentives to support the government's broader economic development goals. This would make home country measures even more important, to encourage outward FDI that contributes as much as possible to the country's development.

With China becoming a net outward investor, the government's interest in protecting its outward investments may trump its interest to protect its own firms from inward FDI in certain sectors.

This, in turn, likely will have implications for China's policy stance on international investment agreements. In July 2013, China and the United States reached a watershed accord to continue their negotiations of a BIT on the basis of pre-establishment national treatment and the negative list approach to exceptions from such treatment (Li 2014), which pinpoints the shift in emphasis in the country's perspective from a host country to a home country.

Further, China is not the only country that has used home country measures to promote national objectives regarding the outward FDI of its firms. Virtually all developed countries pursue similar policies and support them through appropriate instruments (Sauvant et al. 2014). Hence, if home country measures become an object of international negotiations, a number of countries would be directly affected.

For some developed countries, however, it is undesirable to help firms investing abroad, as investors from emerging markets, and especially SOEs from China, have become significant outward investors. Home country measures have been seen as giving special advantages to SOEs, distorting the competitive outward FDI landscape in the markets in which they invest. Based on the concept of "competitive neutrality" (OECD 2005) no entity in an international market should have undue competitive advantages vis-à-vis its competitors. Thus, measures to help firms in their outward FDI, even when available equally to both public and private entities, may be evaluated in terms of their impact on competitive neutrality.

To date, international discussions have focused on advantages enjoyed by SOEs, despite the fact that (1) home country measures are available to both public and private firms and (2) there is no systematic evidence that home country measures provide SOEs with competitive advantages, regardless of whether SOEs are based in developed economies or emerging markets (Sauvant et al. 2014). A recent OECD study concluded the same, noting: “[e]xisting information on such advantages is often either anecdotal or limited to individual cases” (Kowalski et al. 2013).

The competitive neutrality discussion continues in the OECD, but has also gained traction in the negotiations of the Trans-Pacific Partnership (TPP) Agreement, with a view toward imposing discipline on SOEs. Depending on the outcome of these negotiations, the support that China’s SOEs obtain when investing abroad may become a difficult policy issue.

II. The Perception and Reception of China’s Outward FDI in Host Countries

China’s outward FDI faces considerable attention and rising scepticism. This scepticism stems from the speed with which this investment has grown; the leading role of SOEs in China’s outward FDI; potential negative effects associated with FDI (such as foreign control over critical resources and industries, the delocalization of research and development capacities, a reluctance to process natural resources in host countries, poor working conditions, adverse environmental effects, and uncompetitive advantages and behavior); the fear that host countries do not benefit fully from this investment; perceived unfair competition; the negative image of the home country in some host countries and the fear that China’s outward FDI might compromise national security. A review of important host countries among developed countries and emerging markets for China’s outward FDI sheds more light on these matters.[3] Chinese greenfield investment, however, is generally welcome (as opposed to M&As), notwithstanding concerns regarding FDI in natural resources and telecommunications.

[3]Extensive research was conducted between early September 2013 and the end of March 2014 on countries that accounted for some two-thirds of China’s outward FDI stock in 2011 (as reported by MOFCOM – see MOFCOM 2012), not counting Chinese FDI in tax havens and financial centers). Consulted were primarily newspapers and official statements in the countries concerned.

In most of the host countries to Chinese FDI, *newspapers* tend to represent a more critical constituency – albeit unevenly (Gallagher 2013). National security concerns are particularly salient in the United States, France, and the United Kingdom. Chinese FDI receives attention in natural resource-rich countries, such as Australia, Canada, Kazakhstan, and Zambia. The fear is that, when critical resources are controlled from abroad, the benefits associated with such projects may not be equitably distributed between foreign investors and host countries, including environmental concerns (Pheakdey 2013) and fear of imported labor and poor working conditions (Zoljarga 2013). The business press in some countries, however, are more neutral in tone.[4]

The *business community* itself is not strongly engaged in the public debate on this subject. Big businesses typically support an open international investment regime that provides strong protections for investors and investments and access to markets. Moreover, China is an important export market and host country for many firms, which renders enterprises reluctant to advocate restrictive policies. Given perceived competitive threats, however, firms and business associations may lobby the government to take action, as the arrival of new competitors is rarely welcome. In the case of FDI by SOEs, concerns regarding possible competitive advantages are more acute (BCTT n.d.).

Finally, *governments* reflect the conflicted attitude of other stakeholders. On balance, however, government *executives* maintain a welcoming attitude, both towards incoming FDI in general, and from China in particular. Chinese FDI was especially welcome in European countries affected by the Euro crisis, as a means to forestall the bankruptcy of domestic firms and re-

[4] In the United States, for example, Chinese investments in depressed areas, such as Detroit, were positively commented upon (Chen 2010).

launch economic growth. Some countries introduced regulations to facilitate such investment.[5] In Russia and Kazakhstan, authorities welcome Chinese FDI, although there are also fears that China's role might become too strong (Panibratov 2014). South-East Asian countries are closely linked with China through regional value chains, and governments therefore regard Chinese FDI as a positive factor for their development.

Government executives also have concerns, however, and are subject to pressure from their *legislatures*, or individual members of such bodies. Concerns relate to various issues, but typically focus on national security and the role of SOEs in China's outward FDI. Security concerns are particularly pronounced in the United States, where the Committee on Foreign Investment in the United States (CFIUS) – consisting of members of various Departments of the United States government – reviews and, depending on the outcome of the reviews, investigates M&As by foreign companies in the country. If CFIUS finds that the national security of the United States is negatively affected by a particular M&A, it can require mitigation measures or, ultimately, recommend to the President of the United States that the transaction be vetoed. While CFIUS regularly reviews M&As, it was only twice in that institution's history that it recommended to veto a transaction. Most recently (in 2012), this involved the purchase by Ralls Corporation, a wholly-owned United States subsidiary of Sany Group (a Chinese heavy machinery manufacturing company), of four limited liability companies previously formed to develop windfarms in northern-central Oregon; the assets of these companies were located in close proximity to a military base. Ralls had to divest itself fully from the companies involved (Schlager 2014).

[5] *E.g.*, Ireland introduced new regulations simplifying visa processes (Ireland Houses of the Oireachtas 2012).

In Australia and Canada, governmental concerns focus more on the control of natural resources and the net benefits associated with their exploitation, although other tests are employed as well. The discussions surrounding the take-over of Australia's Lynas (*China's CNMC to Acquire* 2009) and the acquisition of Canada's Nexen (Austen 2012) exemplify this. In the first case, Australia's Investment Review Board disallowed the transaction out of concern that it would threaten supplies of rare earths to non-Chinese customers (*Australia Blocked China* 2011). The second transaction was approved by Canadian regulators, as well as CFIUS, whose approval was needed as Nexen had assets in the United States (Rocha 2013). In India, questions relating to Chinese FDI and security were raised in Parliament (Satyanand 2015). Perhaps the best-known parliamentary reaction towards Chinese FDI in general was a 2005 resolution adopted by the U.S. House of Representatives overwhelmingly condemning the attempted take-over of the U.S. firm Unocal by CNOOC of China (U.S. Congress 2005).

These various pressures are reflected in the fact that a number of countries have strengthened or established review mechanisms for incoming FDI, focused on M&As by SOEs. Countries must walk a fine line between mitigating concerns and maintaining an attractive investment climate for Chinese MNEs. These mechanisms focus on national security and net benefits for the host country, including concerns about SOEs being advantaged by subsidies.

Although the competitive advantage concern is now discussed in international negotiations, many countries have strengthened their mechanisms to review incoming M&As, to ensure that such transactions are in their national interest. In the United States, the Foreign Investment and National Security Act, adopted in 2007, strengthened the role of the Committee on Foreign Investment in the United States in reviewing incoming M&As. Among other things, it requires that incoming M&As by SOEs be notified and subjected to investigations. In December 2012, Canada issued guidelines to clarify the investment process applicable to acquisitions of a certain size by SOEs, stating that "[e]ach case will be examined on its own merits; however, given the inherent risks posed by foreign SOE acquisitions in the Canadian oil sands the Minister of Industry will find the acquisition of control of a Canadian oil sands business by a foreign SOE to be net benefit to Canada on an exceptional basis only" (Government of Canada 2012). In February 2008, Australia announced a new policy requiring the Treasurer to examine specific issues when considering applications for investments by foreign governments and their agencies, including notions of independence and security (Australian Government 2010).

The measures taken by these three countries create the tools to block, if necessary, undesirable M&As – both from China and other countries. It is noteworthy, however, that these actions occurred in reaction to China's rapid rise in outward FDI, and the screening mechanisms are particularly strong for M&As by SOEs.

From China's perspective, government activities impacting Chinese (SOE-dominated) outward FDI through host country review mechanisms are, not surprisingly, of concern.

In sum, the perception and reception of China's growing outward FDI in China's principal host countries have been decidedly mixed, both regarding the entry strategies of Chinese MNEs into host countries and the reactions to such investment by various host country constituencies. As recently stated by the Governor of China's Central Bank, "[d]ifferent entities have behaved differently. There may have been some phenomena of Chinese investors [that were] not so good, not so satisfactory" (Blas 2014). As China's outward FDI grows, it may well be that scepticism towards such investment will continue to grow.

The question then becomes: what can be done to deal with the reaction to China's outward FDI in order to avoid a backlash and build trust?

At the national level, SOEs – as the main outward investors – have a responsibility to make sure that their investments abroad are well-planned, prepared, and received. This is particularly important when investments take the form of M&As and are in sensitive industries or involve iconic targets. Once established, SOEs must make additional efforts to be, and be recognized as, good corporate citizens. This can be achieved, for example, by sourcing from local suppliers, employing nationals in high corporate positions, becoming members of local associations, and engaging in various corporate social responsibility (CSR) activities. Additionally, affiliates could support the Group of 7 initiative of establishing a global facility that helps developing countries negotiate large scale contracts with MNEs.[6]

China's government also has a role to play. For example, it could more closely enforce the various instruments already in place to guide the behaviour of its foreign investors abroad. More ambitiously, China could complement its "going-out" strategy with a systematic and broad-based "going-in" strategy (Sauvant and Chen 2014), to maximize not only the benefits of the country's outward FDI for China, but also for the development of host countries in which Chinese firms invest – in short, embody the characteristics of sustainable FDI. Such a "going-in" strategy would not only enforce the current regulatory framework for the behaviour of Chinese MNEs abroad, but also monitor its implementation, expand it to focus on emerging sustainability issues (e.g., CO2-neutral foreign affiliates), make voluntary guidelines mandatory or condition the availability of certain support measures for outward FDI on the observation of CSR rules. Adoption of a "going-in" strategy by China along these lines could serve as a model for other home countries, both developed and developing.

[6] In its June 2014 Summit, the Group of 7 announced "a new initiative on Strengthening Assistance for Complex Contract Negotiations" (*The Brussels G7 Summit Declaration* 2014).

Most importantly, the mixed perception and reception of China's outward FDI in host countries strengthen China's interest in IIAs that protect China's outward FDI and help secure access to markets. At the same time, China would want to protect its "going-out" strategy and the various instruments it has put in place in the context of this strategy.

III. China's Changing Approach to IIAs

As mentioned above, China's IIAs programme, which was entirely focused on inbound investment since its inception in 1982, now keenly reflects upon China's positioning as an outward investor.

Indeed, in its first generation of BITs, concluded between 1982 and 1998, China took a restrictive approach to foreign investment protection, notably concerning dispute resolution. China was then a predominantly capital-importing country, and had little incentive to place its trust in a dispute-resolution mechanism that could impinge its sovereignty, which is why these first BITs only allowed investors to commence arbitration proceedings against a host state for "disputes involving the amount of compensation for expropriation" (China-Mongolia BIT, Art. 8(3)). In later generations of BITs, China broadened its consent to arbitrate "any disputes concerning investments" (China-Germany BIT, Art. 9). This broadened consent to arbitration at the turn of the century coincided with an impending announcement of China's "going-out" strategy and the subsequent fifty-fold rise in outward investment (UNCTAD STAT n.d.).

At the same time, China adopted standards of protection of foreign investment similar to those prevalent in Western countries, such as provision of fair and equitable treatment "in accordance with customary international law" (China-Peru FTA, Art. 132) or ensuring full protection and security in accordance with "commonly accepted rules of international law" (China-New Zealand FTA, Art. 143). It also departed from its position not to grant national treatment (NT) to foreign investors equal to that afforded to its own citizens when it agreed in July of 2013 to granting national treatment at the pre-establishment stage of any investment (except if made in a prohibited sector contained in an exhaustive negative list) (Li 2014).

All the while, China made sure that its SOEs (accounting for more than half of total FDI) would fall within the ambit of bilateral treaty protections through the insertion of language such as "public institutions" (China-Korea BIT, Art. 1(2)(b)) or "governmentally owned or controlled" (China-New Zealand FTA, Art. 11; China-Mexico BIT, Art. 1) investors.

In practice, however, there seems to have been some reluctance to pursue investor-state arbitration under Chinese BITs, despite their large number and the broadening of China's consent to arbitration. Although some authors cite cultural reasons (Wang 2011, 19), the reasons may be more pragmatic. Regarding inbound investment, foreign investors may be discouraged from risking resources where the chances of enforcing the award in China may be slim, as reflected by China's current legal landscape. Indeed, China expressly excluded enforceability of investor-state disputes when it acceded to the UN Convention on Enforcement of Foreign Arbitral Awards (Schreuer 2009, 930) and, in any event, China's laws do not allow enforcement against state-owned property (Wang 2011, 24-25).

IV. Quo Vadis?

China's transition towards becoming a major outward investor has led to a profound reformation of its investment treaty regime. The data demonstrate how China has evolved from a purely capital-importing country to a capital-exporting country. Yet, the size of China's outward FDI stock was merely US$730 billion in 2014, significantly smaller than that of the United States (+US$6.3 trillion).

Juxtaposing the economical raw data with the investment treaty practice of China, one cannot help but notice the correlation between the language adopted in its IIAs and its movement on the investment spectrum. Although China has had an active BIT programme since the early 1980s, it is only in its recent IIAs that China adopted the hallmarks of EU or U.S. IIAs.

It remains to be seen, however, whether China will further embrace investment protection standards newly adopted by Western economies such as proceedings transparency or protection of domestic labour and of the environment (2012 U.S. Model BIT, Arts. 29, Art. 13 and Art. 12). In light of global efforts towards encouraging "sustainable" foreign direct investment, spearheaded by the OECD and UNCTAD,[7] China may follow the lead of other capital-exporting nations. If this is the future trajectory of China's IIAs, there is hope for a largely uniform international investment law and policy regime.

[7] The OECD issued Guidelines for Multinational Enterprises in 2011 and UNCTAD set forth an Investment Policy Framework for Sustainable Development in 2012.