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Bilateral China / US Investment - Is 2014 the Year?

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A New Year – A New Direction

The Paltry Purse

Why **China buys United States Treasury bonds** and not United States companies has befuddled deal- makers ever since China crossed the trillion dollar mark in foreign exchange reserves. One would expect that the world's largest economy and the world's second largest economy would each be major investors in the other. In 2010, however, when China's foreign investment abroad jumped by 20%, the United States ranked 7th as a destination for China's investment dollars. Admittedly the top three countries, Hong Kong, the British Virgin Islands and the Cayman Islands, may serve as a half-way point for outbound funds and so disguise the ultimate destination of the investment; but since none of these countries has a tax treaty with the United States, it is unlikely that they serve as pass-through corporate vehicles for investment in America. And while the United States might make excuses for coming behind these three former or existing British colonies, the United States also ranked in 2010 behind Luxembourg, Australia, and Sweden, and was only slightly ahead of Canada.[1]

Times are changing, however. There has been a rapid increase in the amount and rate of investment by Chinese companies in the United States in the last three years. At the end of the second quarter of 2013, the United States with cumulative investment from China of $57.8 billion ranked only behind Australia with $59.2 billion.[2] With the September 2013 closing of the Shuanghui International acquisition of pork producer, Smithfield, for $7.1 billion and several large real estate investments, the United States took the lead as the preferred destination for China investment.[3] Included within the United States numbers during the first nine months of the year is $12.2 billion invested in 55 Greenfield projects and acquisitions in the United States.[4]

Investment flows in the opposite direction, that is, from the United States to China, are at a disappointing, though historically consistent, low level and do not appear to have experienced the bounce that Chinese investment incurred so recently. The United States only managed to rank 6th as an investor in 2011, the most recent year for which official figures are available; a position it also enjoys on a cumulative basis for all investment in China in the past decade.[5]

The Year of the Horse

The year of the horse is supposed to represent the steadfastness and diligence of the Chinese people in overcoming obstacles. The recent rise in Chinese investment in the United States may indicate that Chinese investors have now learned how to overcome the difficult bureaucracy that limits their outbound investment. Also, China's promised reforms to come out of the Third Plenum to be held in November 2014 may again open the door to American companies to invest in China. If so, the Year of the Horse may be the first time for substantial Chinese investment in the United States and a renewed investment appetite for American companies to go to China.

It is quite possible that there is already substantially more investment in the United States than is reported in the official statistics. For small scale investments, Chinese entrepreneurs seem to simply ignore China's rules about obtaining permission to invest abroad and so their investment may not be picked up by the Bureau of Statistics. And since the acquisition company is most likely a newly incorporated United States company owned by one or more individuals, which then receives acquisition funding from a corporation in Hong Kong or the BVI, the Department of Commerce may not have statistics on the purchase.

Indicative of the fact that Chinese acquisitions may be greater than the statistics report is the success of the Detroit Chinese Business Association (DCBA). The DCBA started in 1998 as a small business club, and now has more than 1,500 members and a wide range of partnerships with local government agencies, business associations and other community organizations.[6] Many of its members are suppliers to the automobile industry, who purchased small factories in the Midwest and are now allocating production between factories in China and those in the United States.

Another indication that investment in the United States by Chinese nationals may be greater than the statistics is the number of advertisements for **EB-5 visa** program lawyers and consultants in Mainland Chinese newspapers. The EB-5 program, known as the **"investor visa program",** grants to investors that create more than 10 jobs in the United States, a permanent resident visa for each member of the investor's family. It is unlikely that the Bureau of Statistics in China would know of such investors, since the required amount of the investment is only one million dollars (or $500,000 in depressed areas), well below national reporting requirements. Moreover, since each Chinese individual may outwardly remit $50,000 without government scrutiny or approval, groups of friends are formed each year to wire the full amount to Hong Kong, where it is combined into the investor's account, and then invested to obtain the visa. The following year, another friend benefits. And while the Department of Homeland Security's Citizen and Immigration Services estimates that the program, which was created by Congress in 1990, as of June 30, 2011 has resulted in more than $1.5 billion in capital investments and created at least 34,000 jobs, there is no breakdown by applicant nationality. The number of investor applications, however, has doubled in the past three years and much of this increased interest in the program seems to be from China.[7]

Continuing Quandary

Even though the statistics may be incomplete, nevertheless the two-way exchange of investment is clearly less than one would expect for the world's two largest economies.

Why is the money missing? While there may be many reasons for the poor state of bilateral China-U.S. investments, three of the contributing factors are the law, the attitudes, and the politics.

The Law as to Outbound Investments

China's Outbound Foreign Investment Regime

With foreign exchange reserves of more than $3.66 trillion as of the end of September 2013,[8] China should be acquiring the rest of the world; instead, companies engaging in outbound investment have appeared hesitant, confused, and amateurish.

There have been several well-publicized success stories, such as Lenovo's acquisition of IBM's notebook business, Zhejiang Geely's acquisition in 2010 of Ford Motor Company's Volvo brand, and Pacific Century's acquisition of the Saginaw division of General Motors Corporation. There also have been equally well-publicized failures, such as CNOOC's aborted attempt to acquire Unocal Oil Company in 2005and Sichuan Tengzhong Heavy Industrial Machinery Co., Ltd.'s failed attempt to acquire General Motors' Hummer brand in 2010.

One reason that the world's largest holder of foreign exchange reserves seems incapable of making significant foreign acquisitions stems from China's own system of regulating foreign merger and acquisition activity. While some unsuccessful cases are the result of political opposition in the target country, such as the Huawei proposed acquisition of 3Com, both the scarcity of acquisition attempts and the limited number of success stories is due largely to the domestic throttle being held tightly in the closed position. The “Go Abroad” program exists in name and propaganda, but until quite recently it should have been re-labeled as the “Go Abroad with Our Permission” program.

One of the striking features of the recent increase in China acquisitions in the United States is that private or semi-private Chinese companies are leading the way, while large State-owned enterprises are no longer the principal investors. The Shuanghui-Smithfield acquisition makes private concerns the largest investors in 2013 and last year, private firms for the first time accounted for more than half of the total deal value, largely due to Wanda’s acquisition of AMC theaters. According to a study by the Rhodium Group, during the first nine months of 2013, private firms were the acquirers in 84% of the deals and the total investment of such private deals was 74% of the total.

Regulating the World

It would not profit the objective of this article or please the reader’s patience to provide an overly dense description of China’s regulation of outbound foreign investment. China regulates investment abroad in much the same manner that it regulates inbound investment. The **National Development and Reform Commission (NDRC), the former State Planning Commission**, or its local provincial affiliates must review and approve outbound investments. Formerly any resource investment above $30 million and any non- resource investment above $10 million had to go to the national level NDRC for approval. Although the respective amounts were raised in 2011 to $300 million for resource projects and $100 million for non- resource projects, an approval from the planning authorities is still required both before the Chinese buyer begins serious substantive negotiations and after the buyer has completed those negotiations and wishes to implement the acquisition.[9]

While the NDRC applies ‘state planners’ perspective to the outbound foreign investment approval process, MOFCOM, in coordination with the Ministry of Foreign Affairs, reviews and must approve the documents as to legal content and for compliance with China’s foreign affairs policies.[10]

Finally, since China’s currency is not freely convertible, the State Administration of Foreign Exchange (SAFE) needs to register outbound investment projects so that required conversions of currency may be made when capital crosses the border.[11]

For those familiar with China’s inbound investment regime, the outbound system will seem familiar. All outgoing investment, just as all incoming investment, requires multiple government approvals. And while, just as with the inbound investment program, China has recently raised the approval levels of the provincial planning and foreign investment authorities, the relaxation is not a lifting of controls, but an attempt to makes those controls more efficient.

Does It Work?

It is probably too early to say whether China’s system for regulating outbound investment works. It may well be that the complicated bureaucracy for major outbound investments avoids major mistakes and losses. The general impression to date, however, is that Chinese companies entering into international merger and acquisition activities are unsure of themselves, slow to react, and unlikely to conclude the deal. This general impression is due in part to the fact that the approval system hamstrings the Chinese negotiator. He must learn about the target company in sufficient detail to file the preliminary application with the NDRC, but is not supposed to sign a confidentiality agreement or other substantive document without the required NDRC Confirmation Letter.

China’s strict, watch-dog approach to inbound investment projects has been successful, since everyone wanting to enter the Gates of the Forbidden City must pass through the emperor’s guard. But when Chinese companies go abroad and compete in free markets for acquisitions, there is seldom enough time to report home and allow the state planning approval process to work. One explanation for why private companies are becoming the investors in America, as opposed to State-owned enterprises, is that the private entrepreneur is more attuned to making the China State Planning system and the American free market work together. Where investment negotiations tend to be government to government, such as Russia, South America, Sub-Sahara Africa, and the Arab World, the State-owned enterprise continues to dominate.

Must It Be This Way?

Since the problem is obvious, why not fix it by allowing companies with capital to invest abroad as they see fit? To do so would effectively mean that China had given up its capital controls and made the Renminbi a capital account convertible currency. When China is willing to float the RMB, Chinese buyers will swamp the M&A markets. Until that time, and so long as other competitive bidders are in the market, it is likely that China acquisitions will focus on those businesses with direct and immediate connections to the China market such as resource transactions and the purchase of brand names where the goods are now made in China. Private companies, which are used to avoiding or skirting foreign exchange controls, will be the principal investors in the United States.

The Law as to Inbound Investments

Investing in China has always been about getting the necessary required approvals. And, although this process is very time consuming, since it applies to everyone, an investor either accepts the process or does not invest. The attractiveness of the Chinese market has brought a great many investors to the doors of the approval authorities. In recent years, however, as China has modernized its legal system, it has also made the investment process far more cumbersome.

While there are many examples of the increased complexity of investing in China, there are two recent ones of considerable importance: the Anti-Monopoly Law and the National Security Review system. Since all investments have been subject to an approval regime and no reason needed to be given for a refusal, the complexity of the new laws seems unwarranted. If China were to reform its foreign direct investment regime to provide that all investors have a legal right to invest so long as they abide with certain specifiedlaws, then the new complexity would be justified, since an open door to investment should have protections for monopolistic conduct and national security.

The Anti-Monopoly Law

There are a number of open questions about the Anti-Monopoly Law.[12] First, is it a law that only applies to foreigners? The curious language of Article 7 of the law, which exempts the State-owned sector from the law's prohibitions, appears to create not only an uneven playing field, but two separate fields:

With respect to the industries which are under the control of by the State-owned economic sector and have a bearing on the lifeline of the national economy or national security and the industries which exercise monopoly over the production and sale of certain commodities according to law, the State shall protect the lawful business operations of undertakings in these industries, and shall, in accordance with law, supervise and regulate their business operations and the prices of the commodities and services provided by them, in order to protect the consumers' interests and facilitate technological advance. The undertakings mentioned in the preceding paragraph shall do business according to law, be honest, faithful and strictly self-disciplined, and subject themselves to public supervision, and they shall not harm the consumers' interests by taking advantage of their position of control or their monopolistic production and sale of certain commodities. [13]

Apparently the State will protect the public against State-owned enterprises, while the NDRC, SAIC, and MOFCOM, which are the three departments that jointly compose the Anti-Monopoly Enforcement Authority, will protect China against the foreigner. To date, only foreign related acquisitions have been subject to MOFCOM review as to whether such a concentration would reduce competition. While far more domestic acquisitions take place, domestic companies do not file reports and data on their merger, and proceed without any MOFCOM interference.

While clearly all acquisitions or concentrations should be subject to rules preventing a decrease in competition, the Anti-Monopoly Law appears to be having the effect of enhancing an offer from a domestic buyer over a foreign one. If only the foreign investor need submit the detailed documentation required to establish either that its proposed acquisition does not fall under the law's purview or, if it does, that competition will not be harmed, then clearly the acquisition target will be able to sell itself to a domestic buyer much faster than to a foreign one.

Just as China's outbound approval process makes Chinese bidders in America slower than their American competitors when faced with a competitive purchase situation, the application of the Anti-Monopoly Law to all acquisitions of domestic enterprises by foreign companies, assuming the applicable thresholds are met, favors the domestic buyer over the foreign buyer.

National Security Review

Article 31 of the Anti-Monopoly Law provides that for those acquisitions of domestic enterprises by foreign investors where national security is involved, national security investigations shall be conducted pursuant to relevant national regulations.

Neither national security nor the relevant national regulations were specified in the Anti-Monopoly Law.

This confused state existed until March of 2011 when the State Council issued a notice launching the security review system.[14] The Security Review Procedure defines most forms of foreign investment where an interest owned by a domestic enterprise is transferred to a foreign company, including when the percentage of foreign ownership is simply increased, as being included in the merger and acquisition activities subject to review.[15] Where the investor establishes a WFOE with no acquisition of Chinese assets or equity, the national security review is not required. It is also required that the foreign investor take control of the domestic entity, although the definition of control includes “actual” or “indirect” control.[16] The national security review is supposed to occur whenever any merger or acquisition involves: foreign investors' merger or acquisition of military industrial enterprises or military industry related supporting enterprises, enterprises located near key and sensitive military facilities, and other entities relating to national defense; foreign investors' M&As of key domestic enterprises in areas such as agriculture, energy and resources, infrastructure, transport, technology, assembly manufacturing, etc., whereby the foreign investors might acquire the actual controlling right thereof.[17]

The Security Review Procedure is much more than a way to prevent the acquisition of military technology by foreigners, since not only are enterprises owned by the military or supplying weapons included, key domestic enterprises in areas such as agriculture, energy, resources, infrastructure, transport, technology, and major equipment manufacturing are also to be protected.

In the review process, the reviewing body is supposed to consider the following factors:

1. Impact of the transaction on the national security, including the domestic product manufacturing capacity, domestic service provision capacity, and relevant equipment and facilities needed for the national security;
2. Impact of the transactions on the stable operation of national economy;
3. Impact of the transaction on the basic living of the people; and
4. Impact of the transaction on the research and development capacity for key technologies related to the national security.[18]

The problem with this very broad description of what constitutes “national security” related acquisitions is that almost every acquisition might fall under the heading.

In order to provide a procedure for potential acquirers of domestic enterprises that may be required to go through the Security Review Procedure, MOFCOM issued provisions on the implementation of the Security Review System Notice.[19] The MOFCOM Security Review Procedures require that whether considering an acquisition under the Domestic Acquisition Regulations or reviewing a transfer of equity in an existing FIE, the local commerce department shall not accept the application if the deal falls under the scope of security review, unless the applicant has successfully applied to MOFCOM for a security review.[20] A potential foreign acquirer may approach MOFCOM in advance of filing a required application.[21]

The approval of foreign acquisition activity in China has been delegated down to the provincial level if the amount involved is less than $300 million, but the new Security Review Procedure re-inserts the national government into any transaction that may have a security component. Because the definition of what constitutes national security includes matters such as the “stable operation of the national economy” or

the “effect on the research and development capabilities of key national security technologies,” many transactions may be subject to central government review. In any ambiguous case, it is quite unlikely that provincial authorities will proceed with consideration of an acquisition that might somehow – no matter how vaguely – affect national security.

It is difficult to understand what is being protected by this national security review system. Have foreign investors been stealing Chinese military technology? Has Iran tried to purchase the State Nuclear Power Technology Corporation? As with the Anti-Monopoly Law, it would seem simply another way to give the Central Government power to vet inbound investment.

The Attitudes

Discussing attitudes is highly subjective and so a proper warning must be given: the opinions below may be only those of the author, not held by anyone else, and possibly quite incorrect.

China Inbound Investment

China’s comparative success in handling the economic downturn of 2008-2010 has given it a new confidence in itself. Foreign experts no longer appear quite so expert. The vast accumulation of foreign exchange reserves means that a foreign investor’s money is of little importance and, unless the investor is willing to fully disclose its technology, there is little interest in establishing a partnership. Moreover, there is now a labor shortage in China for skilled workers, so providing jobs is not enough.

For these reasons, the approval authorities in China are considerably more stringent in their application of the relevant laws to foreign investors. Projects that the Catalogue on Foreign Investment permit to be developed by wholly foreign owned enterprises are not being approved (as a matter of internal policy) only if done in a joint venture format with an open sharing of technology.

China Outbound Investment

The Chinese entrepreneur’s attitude toward outbound investment is extremely enthusiastic. Without the bureaucratic controls on the outbound foreign investment system, the average Chinese with money would no doubt be an investor outside of China.

The government, however, is divided on the wisdom of buying companies abroad. The acquisition of necessary raw materials and natural resources is supported, but when Chinese companies wish to acquire foreign companies for technology, manufacturing capabilities or foreign distribution, there is a definite division among the leadership. Some believe that such acquisitions are necessary if China is to assume its rightful position as a world-class industrial leader. Others believe that Chinese companies will be the big losers in international M&A activity and over time give back the precious foreign exchange treasure trove that China has earned through its export of low priced goods.

The American Attitude toward Investment in China

Although almost all companies recognize that China is a large and attractive market, the recent recession reduced the amount of new investment available to penetrate the market. Companies like Coca-Cola, General Motors, Wal-Mart and Yum Brands that earn large profits in China have continued to invest those domestic profits in developing the market, but the number of new entrants appears to have lessened. Private equity funds that have money, but not technology to license or products to make and sell, have experienced definite difficulties in acquiring businesses in China and many are frustrated with the roadblocks they encounter. Service companies have become interested in China, but except for franchising restaurants, have found the entry of pure service businesses to be difficult.

While once the foreign investor could do no wrong, today it seems he can do no right. Under the prior tax law, all foreign investors received a two year tax holiday and three years at half tax, and many were granted especially low tax rates due to their high technology. Now, everyone pays the same tax rate and most of the tax preferences seem to go to domestic enterprises, through arcane rules requiring domestic innovation or ownership of core technology. Moreover, recent administrative prosecutions under the Anti-Monopoly Law against foreign-owned milk powder and pharmaceutical companies appear to be politically motivated, rather than an attempt to protect the Chinese consumer.

The Politics of Cross Border Investment

American Politics

American politicians have long prospered from badgering American companies about exporting jobs to China and China for manipulating its currency. As with any sound bite, there is some truth in the criticism. In almost all cases, however, the politicians making the comments have no intention of either preventing American companies from producing their goods wherever they choose, or imposing countervailing duties on China as a currency manipulator. Instead, the politics of the sound bite is to put one’s name forward during the 6:00 news.

The harmful effect of such sound bite rhetoric, however, is that it encourages Chinese officials to make their system less open to United States investors and to tilt the playing field even further against American companies.

Chinese Politics

The Security Review system established by China in 2011 is a good example of the harmful effect of political sound bite wisdom from America. Prior to the introduction of the Security Review system, China had delegated the approval power down to the provincial level for all investments below $100 million (and has now raised that limit to $300 million). Local approval is generally must faster, more open, and less political than consideration of an investment at the national level.

The Security Review system, however, re-centralizes in MOFCOM the approval power for any acquisition or investment that might possibly have some national security element, including an effect on the national economy. But since the Security Review regime is closely modeled on the Committee on Foreign Investment in the United States (CFIUS) and there has been considerable propaganda in China how the CFIUS system is used to prevent Chinese companies from investing in the United States, it is primarily a tool designed for tit for tat retribution against American companies when the United States government does something that displeases Beijing. It is hard to imagine a company from another foreign country that will be prevented from buying a Chinese company due to security concerns.

Since all foreign investments into China must be approved by the government, China has always been able to stop any unwanted investment, particularly if it would impact national security. But since

American politicians like to intervene in CFIUS like decisions, such as CNOOC's acquisition of Unocal or Huawei's acquisition of 3Com, China now has a retaliatory tool to use to disrupt American investment in China. The new tool will be used and will likely have nothing to do with security.

The Negative List

The Shanghai Pilot Free Trade Zone announced in September of this year may open the door to a new round of reform. One of the unique aspects of the Zone is its "negative list," which was first published in October.22 The negative list reverses China's foreign investment system, since anything that does not appear on the negative list may be established without review or approval. The foreign investment approval process only applies to those specific items listed on the negative list. Such a system, if extended to all of China, would greatly increase foreign investment by decreasing bureaucratic uncertainty.

Likelihood of Two-Way Investment in 2014

Bilateral investment between the United States and China would be good for both countries. It is hoped that the recent increase in Chinese investment in the United States and the new experimentation in China, such as the Pilot Free Trade Zone in Shanghai, are leading indicators that the Year of the Horse will see galloping bilateral investment.

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21 MOFCOM Security Review Procedures, Art. 4.

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