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Be Careful What You Wish For: China's Protectionist Regulations of Foreign Direct Investment Implemented in the Months Before Completing WTO Accession

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BE CAREFUL WHAT YOU WISH FOR: CHINA'S PROTECTIONIST REGULATIONS OF FOREIGN DIRECT INVESTMENT IMPLEMENTED IN THE MONTHS BEFORE COMPLETING WTO ACCESSION

I. INTRODUCTION

The People's Republic of China attracted the equivalent of \$72 billion U.S. in foreign direct investment in 2005¹ and \$60 billion U.S. in 2004.² China draws more foreign investment than any other developing nation,³ due largely to investor confidence in China's economic reforms implemented after it joined the World Trade Organization (WTO) in 2001.⁴ From its December 11, 2001 accession,⁵ China had five years to reform its markets to a state of compliance with the WTO agreement.⁶ China's obligation to the WTO requires policy changes that will allow foreign firms to enter the Chinese marketplace and compete fairly with domestic firms.⁷ While joining the WTO and engaging in further global commerce is important to Chinese officials⁸—and was the long-range intention of Deng Xiaoping's opening-up of China in 1979⁹—there is still trepidation in the

1. Geoff Dyer, *Opportunity in East China*, FIN. TIMES, Nov. 20, 2006, (FT Report: Business of Consulting), at 2.

2. *Id.*

3. Andrew Baston & Mei Fong, *In a Strategic Shift, China Hits Foreign Investors With New Hurdles*, WALL ST. J., Aug. 30, 2006, at A1.

4. See generally John I. Gordon & Xuhua Huang, *The New Climate for International Investment in China: Key Reforms Open Up China's Financial Services, Venture Capital, and Logistics Sectors*, 26 LOS ANGELES LAW. 12 (Nov. 2003) (discussing how regulations implemented between China's WTO accession announcement and 2003 were designed to increase foreign investors' ease of entry into the Chinese market, and led to increased capital inflow to China).

5. Understanding the WTO: Members and Observers, http://www.wto.org/English/thewto_e/whatis_e/tif_e/org6_e.htm (last visited Nov. 14, 2007).

6. See Press Release, World Trade Organization, WTO Successfully Concludes Negotiations on China's Entry (Sept. 17, 2001), available at http://www.wto.org/english/news_e/pres01_e/pr243_e.htm (summarizing the commitments that China must undertake to complete accession); Hong Kong Trade Dev. Council, *China's Accession to the WTO, Embracing the Opportunities, Meeting the Challenges*, <http://mas.tdctrade.com/mas/doc/www.tdctrade.com/wto/tid.htm#2h> (last visited Nov. 16, 2007) (listing the schedule for reform that China must abide by with regard to the banking industry).

7. WTO Ministerial Conference, Protocol on the Accession of the People's Republic of China, WT/L/432 (Nov. 23, 2001) [hereinafter Protocol on China's Accession]. See also sources cited *supra* notes 5, 6.

8. Raj Bhala, *Enter the Dragon: An Essay on China's WTO Accession Saga*, 15 AM. U. INT'L L. REV. 1469 (2000) (articulating the details of China's WTO accession).

9. William I. Friedman, *One Country, Two Systems: The Inherent Conflict Between China's Communist Politics and Capitalist Securities Market*, 27 BROOK. J. INT'L L. 477, 478 (2002). In

domestic Chinese business community about the increased competition from foreign firms that the WTO-compliant policies will allow.¹⁰ Several domestic Chinese industry groups have vocalized their fear of competition by explicitly seeking government protections from foreign competitors.¹¹ The government has answered that pressure with subsequent regulation reflecting a desire to “soften the impact of foreign competition.”¹²

The year 2006 should have been another year of unprecedented investment in China, particularly by firms poised to take advantage of the WTO-compliant open markets. Instead, regulators blocked foreign acquisitions and cobbled together a maze of new regulations which may ultimately deprive Chinese domestic businesses of the capital and management expertise they require to compete with foreign firms in the long run. 2006 may be remembered as the year that Chinese regulators made a dangerous trade-off, swapping the long-term sustainability of domestic firms in the open Chinese market for a few regulatory roadblocks that assuaged the protectionist fears of those firms.

Even before the five-year period of reform allowed by the WTO agreement had expired,¹³ foreign firms began to enter the domestic Chinese market and even more made plans to enter after WTO accession was completed,¹⁴ at least as players under their own brand names or as equity holders in existing Chinese ventures.¹⁵ It is no surprise that non-Chinese businesses want to position themselves for greater access to the 1.3 billion-person market,¹⁶ but this goal has not been easily achieved.¹⁷

Foreign firms in retail industries favor two ways of gaining greater access to the Chinese market: (1) acquiring Chinese businesses with existing infrastructure and licensing in place,¹⁸ or (2) establishing individual

1978 Deng Xiaoping adopted the “open door” policy, a series of reforms designed to speed up the growth of China’s economy through the use of foreign capital. *Id.*

10. Baston & Fong, *supra* note 3.

11. *Id.* See also *China’s Foreign Investment Rules to Hurt WVAS Providers*, Financial Times Information Ltd. Asia Intelligence Wire, July 28, 2006, available at <http://www.lexis.com> (last visited Nov. 19, 2007).

12. Mure Dickie, *China Issues Rules for Foreign Banks*, FIN. TIMES, Nov. 16, 2006, at 8.

13. Mure Dickie, *More Than 10 Foreign Banks to Open China Subsidiaries*, FIN. TIMES, Nov. 20, 2006, at 8. The anniversary of accession and deadline for compliance was December 11, 2006.

14. *Id.* (listing banks that anticipate entering Chinese market after November 2006). See Karen Halverson, *China’s WTO Accession: Economic, Legal, and Political Implications*, 27 B.C. COMP. L. REV. 319, 338–39 (2004) (discussing banks that entered Chinese banking market in the period between WTO commitment and completion of accession).

15. Halverson, *supra* note 14, at 338.

16. CIA, THE WORLD FACTBOOK 114 (CIA 2006), available at <http://www.cia.gov/cia/publications/factbook/geos/ch.html> (last visited Oct. 7, 2007).

17. Baston & Fong, *supra* note 3.

18. Kate Linebaugh, *Wal-Mart to Buy Grocer-Retail Chain in China—Deal Would Bolster Position in Crucial Overseas Markets After Missteps Elsewhere*, WALL ST. J., Oct. 17, 2006, at A3. In October 2006 Wal-Mart beat the French grocer Carrefour SA in the purchase of Trust-

branches on the ground under the existing foreign brand name. However, the process of acquiring Chinese businesses grew increasingly difficult when the Ministry of Commerce issued new regulations relating to mergers and acquisitions of domestic companies by foreign investors (the 2006 Regulations) in August 2006.¹⁹ The 2006 Regulations, which took effect on September 8, 2006, supersede the Provisional Regulations promulgated in April 2003.²⁰ They include an anti-monopoly probe for large transactions,²¹ provisions to protect “national economic security,”²² and channels for domestic Chinese businesses to intervene and stall acquisitions of their Chinese competitors by foreign-owned firms.²³ While Chinese officials have insisted that their enthusiasm for foreign investment has not soured,²⁴ the 2006 Regulations, and their potential to restrict foreign acquisitions, certainly reflect otherwise.²⁵

Because the WTO guidelines do not allow members to explicitly prohibit foreign entrants to their markets,²⁶ the 2006 Regulations carefully provide only the discretion to exclude foreign investment, rather than any

Mart, a large Taiwanese grocery chain with 100 branches across China. The deal has not met approval by Chinese regulators, but Wal-Mart's strategy to acquire ready-made outlets instead of building from the ground up is clear. Wal-Mart's play for Trust-Mart branches is recognized as a continuation of Wal-Mart's global trend of making acquisitions of local retailers as well as an example of a “[non-Chinese] company[y being] on the hunt for acquisitions” because “getting approvals to open new stores can be a slow process.” *Id.* Carrefour SA was still determined to make a name for itself in the Chinese marketplace; a Chongqing outlet of the supermarket chain was the site of a violent stampede for discounted cooking oil that killed three people and injured 31. Jamil Anderlini, *Stampede at China Supermarket Kills Three*, FIN. TIMES, Nov. 12, 2007, at 8.

19. Provisions for Foreign Investors to Merge Domestic Enterprises (Decree of the Ministry of Commerce, the State-owned Assets Supervision and Administration Commission of the State Council, State Administration of Taxation, State Administration for Industry and Commerce, China Securities Regulatory Commission and State Administration of Foreign Exchange), Aug. 8, 2006, effective Sept. 8, 2006), translated at <http://english.mofcom.gov.cn/> (last visited Nov. 5, 2007) (P.R.C.) [hereinafter 2006 Regulations]. The title of the law is sometimes translated as the Interim Provisions on the Takeover of Domestic Enterprises by Foreign Investors. *See id.*

20. *Id.*

21. *Id.* at art. 51.

22. *Id.* at art. 12.

23. *Id.* at art. 51 (allowing third parties to call for a review of the transaction).

24. Zhong Ming, *New Policy Ensures Better Investment Climate*, FIN. TIMES ASIA INTELLIGENCE WIRE, Sept. 27, 2006, available at <http://www.lexis.com> (last visited Nov. 19, 2007). Vice Premier Wu Yi is said to have “confirmed the government's stance that China remains unchanged in its attitude towards foreign direct investment. What is more, she stressed, the country is determined to open the door even wider.” *Id.* The article, written by a Chinese journalist under a pen name, goes on to mention U.S. Congressional actions to stymie Dubai Ports World takeover of U.S. port operations as an example of foreign investment restrictions in the name of national security.

25. Baston & Fong, *supra* note 3.

26. See Carol G. Liu, *New and Foreign Banking Markets: Scaling the Great Wall: An Analysis of Foreign Banks' Entry into China*, 9 N.C. BANKING INST. 397, 403 (2005).

overt exclusion.²⁷ Before the Regulations became effective, China shielded domestic industries from competition without violating WTO principles by bureaucratically stalling several acquisitions of its domestic firms.²⁸ In 2006, the last year before full WTO compliance,²⁹ Chinese bureaucrats wordlessly delayed or ended a number of pending transactions.³⁰ In early 2006, the Chinese investment landscape was dotted with several high profile foreign-proposed private equity transactions. For example, the Carlyle Group (Carlyle), an American private equity firm, bid \$375 million for control of Xugong Construction Machinery (Xugong), a leading Chinese producer of heavy machinery equipment.³¹ Citigroup and U.K. private equity firm CVC Capital Partners formed a joint venture to purchase 30 percent of China's Shandong Chenming Paper Holdings Ltd. for about \$625 million.³² Citigroup led a separate consortium that bid approximately \$3 billion for an 85 percent stake in Guangdong Development Bank, a troubled midsize bank in southern China.³³

As of October 2006, Chinese regulators had not permitted any of these transactions.³⁴ The Xugong deal awaited approval by Chinese government ministries for one year before Carlyle shrunk its proposal to a non-controlling share.³⁵ Meanwhile, CVC abandoned its efforts to purchase part of Shandong Chenming Paper³⁶ and bids for a stake in Guangdong Development Bank are now limited to more conservative proposals for non-controlling shares.³⁷ Each of these transactions awaited approval for several

27. See generally, 2006 Regulations, *supra* note 19 (setting standards for review of foreign investment transactions and not calling for exclusion of foreign investment).

28. Linebaugh, *supra* note 18; Mariko Sanchanta, *JFE Indefinitely Delays China Investment*, FIN. TIMES (TOKYO), Sept. 21, 2006. Acquisition of established Chinese firms is a popular way for foreign retail businesses to enter China because the time consuming and highly political work to establish local branches and licenses is completed. In manufacturing and natural resources industries, acquisition of Chinese refining and manufacturing plants is favored for the same reason; building a plant from the ground up has proven difficult and impossible for non-Chinese businesses. The Japanese steel manufacturer JFE spent two years negotiating with Chinese regulators in a failed attempt to gain approval to build a blast furnace in China. In JFE's case, locating a furnace in China would have streamlined the steel manufacturer's operations because the furnace would refine steel mined in Western China. *Id.*

29. Understanding the WTO, *supra* note 5.

30. *Chinese Deals*, FIN. TIMES, Aug. 10, 2006, available at <http://www.ft.com/cms>; *China's Chenming Scraps Sale of Stake to Citigroup Venture*, WALL ST. J., July 31, 2006, at C5. Carlyle's acquisition of Xugong Construction Machinery fell through; Citigroup and CVC Capital Partners deal to purchase a paper maker was scrapped; and Citigroup's investment in Guangdong Development Bank shrank in 2006. *Id.* See also *Battle for Rare Prize*, *infra* note 33.

31. *Chinese Deals*, *supra* note 30; *Chenming Scraps Sale*, *supra* note 30.

32. *Chenming Scraps Sale*, *supra* note 30.

33. *Citigroup and Societe Generale Battle for Rare Prize in China – Warts and All*, WALL ST. J., Aug. 8, 2006, at C1.

34. *Chenming Scraps Sale*, *supra* note 30; *Battle for Rare Prize*, *supra* note 33.

35. *Id.*

36. *Chenming Scraps Sale*, *supra* note 30.

37. Baston & Fong, *supra* note 3.

months³⁸ and then fizzled just as the Chinese Ministry of Commerce issued the 2006 Regulations in August.³⁹

While these barriers to foreign investors may have comforted domestic firms dreading greater competition in the new open Chinese marketplace, this note asserts that the 2006 Regulations ultimately will be detrimental to these domestic firms. Section II considers the background for the Chinese sentiment against foreign investment in the period between WTO accession and full compliance, the current climate of “economic nationalism,” and the manifestation of this climate in industry requests for protection. Section III argues that regulators answered the protectionist requests when they refused to approve transactions in 2006, and looks specifically at the 2006 Regulations against the backdrop of prior Chinese regulations on foreign investment. Section IV asserts that the 2006 Regulations, muddled in the overlap between centralized ministries and provincial governments, do not contribute to a legal regime that will sustain a healthy Chinese marketplace. Section V contends that since many domestic firms are still young, corrupt, inefficient and only recently independent from the state,⁴⁰ they actually need foreign investment and management expertise in order to compete with the new entrants to the Chinese marketplace. A look at the retail banking sector illustrates this point.

Chinese regulators should have spent 2006 courting the foreign investment that would help Chinese businesses attract the capital, technology and managers necessary to compete against established international firms. Not only will Chinese firms need foreign money and expertise to compete around the world, they will also need help at home when international firms are allowed to vie for a share of the domestic Chinese market that Chinese firms previously held captive. Instead, Chinese regulators slowed the influx of foreign dollars, just when Chinese firms needed it most, leaving them vulnerable to lose domestic market share and ill-prepared to compete internationally.

II. CHINA'S OBLIGATIONS TO THE WTO AND ECONOMIC NATIONALISM

In 2006, a Chinese business school professor observed: “It’s a comfortable time to get tougher with foreigners, having more of them hang around is not a top priority.”⁴¹ This describes the sentiment held by many of the Chinese business and industry leaders who have watched the growth of

38. *Chenming Scraps Sale*, *supra* note 30; *Battle for Rare Prize*, *supra* note 33.

39. 2006 Regulations, *supra* note 19.

40. Jack E. Jirak, *Equity Investment in Chinese Banks: A Doorway into China's Banking Sector*, 10 N.C. BANKING INST. 329, 339 (2006) (noting that the “Big Four” Chinese commercial banks were owned by the government until very recently).

41. Baston & Fong, *supra* note 3.

China's economy over the last five years. Even though foreign investment has helped the Chinese economy grow, especially between China's WTO accession in 2001 and the completion of obligations in 2005,⁴² the increase in foreign control has received backlash in the form of requests for protectionist regulation.⁴³ Beijing has reacted by delaying proposed acquisitions (like the Xugong, Shangdong and Guangdong transactions) and through political moves, most notably the removal of the Mayor of Shanghai, who many believe had gone too far in courting foreign investment.⁴⁴ Additionally, China has come under scrutiny from the U.S. and other nations for artificially setting its currency, the Renminbi (RMB), at a low price.⁴⁵ China's reluctance to see the RMB appreciate may also be perceived as protectionism and contribute to a backlash holding up the flow of foreign capital into China.⁴⁶

A. CHINA'S OBLIGATIONS TO THE WTO

China's obligations to the WTO include opening markets for services and products and accepting the WTO rules by revising Chinese law to accommodate them.⁴⁷ These changes had to be in place within five years of accession, which imposed a December 11, 2006 deadline.⁴⁸ Since the accession, restrictions on domestic sales by foreign firms have been eliminated and thus, foreign firms have taken an increased market share.⁴⁹ This did not go unnoticed; domestic enterprises have demanded a balance between protection for Chinese business interests and incentives for introduction of foreign capital.⁵⁰

42. Dyer, *supra* note 1 (noting foreign direct investment influx between 2001 and 2005).

43. Baston & Fong, *supra* note 3.

44. Clay Chandler, *China Takes a Break*, FORTUNE, Oct. 16, 2006, at 8; James T. Areddy, *Shanghai Probe Hasn't Finished*, WALL ST. J., Sept. 27, 2006, at A8 ("Analysts attributed Mr. Chen's downfall in part to the fact that he pursued development policies out of step with those pushed by Beijing.").

45. Steven R. Weisman, *Paulson Says China Hurts Itself With Economic Policies*, N.Y. TIMES, Sept. 14, 2006, at C3. U.S. Senators Charles Schumer and Lindsay Graham have indicated that they will pursue legislation taxing U.S. imports from China if Beijing does not take action to unfix the rate of the RMB that they say is "artificially low." *Id.*

46. *See generally id.* (discussing U.S. Treasury Secretary Henry Paulson's observation that the same Chinese protectionism that was preventing China from opening up to competition was causing reactionary protectionism in the U.S. and may ultimately lead to backlash from other economic stakeholders in the Chinese economy).

47. Weitseng Chen, *Legal Implications of a Rising China: WTO: Time's Up for Chinese Banks — China's Banking Reform and Non-Performing Loan Disposal*, 7 CHI. J. INT'L L. 239 (2006). (stating that China has to open its banking market to foreign competition and is engaging in banking reform); JINGLIAN WU, UNDERSTANDING AND INTERPRETING CHINESE ECONOMIC REFORM 319 (2005)

48. WU, *supra* note 47, at 320; Understanding the WTO, *supra* note 5.

49. WU, *supra* note 47, at 307.

50. *Id.*; Baston & Fong, *supra* note 3.

B. ECONOMIC NATIONALISM

Some investors worry that once China fulfills most of its obligations to the WTO at the end of 2006, it will take an increasingly protective stance through regulation, shielding domestic firms from competition from and acquisition by foreign groups with further roadblocks and ambiguous regulatory hurdles.⁵¹ Such protective measures have already been explicitly requested by some industry groups.⁵²

1. Government Actions Towards Economic Nationalism

Keeping the RMB low compared to the U.S. dollar allows Chinese exports to be marketed abroad at artificially low prices and keeps imports into China relatively more expensive than domestically produced products.⁵³ Non-Chinese businesses worry that, once the Chinese market is fully open to foreign products, those goods imported into China will be prohibitively expensive for the Chinese consumer because of the RMB's low value.⁵⁴ This would enable domestic Chinese firms to maintain a large market share in consumer industries. While the value of the RMB is set by Beijing,⁵⁵ national ministries as well as local economic development regulators have a hand in foreign investment regulation.⁵⁶

Chen Laingyu was removed as the Secretary of Shanghai's Communist Party, the highest official role in Shanghai in September 2006. Beijing cited a pension scandal as the reason for his termination.⁵⁷ However, Mr. Chen's removal is considered to be a message from Beijing that local officials will no longer be allowed to approve foreign investment projects at the rate achieved by Shanghai's local government.⁵⁸ Indeed, Shanghai is the center of Chinese operations for over 120 foreign companies, all approved by local administrators.⁵⁹ While Mr. Chen did not set foreign investment policy in his role, his removal suggests that Beijing will not tolerate local officials deviating from the national foreign investment policy.⁶⁰ Two weeks after Mr. Chen's dismissal, the Ministry of Commerce issued its first Five-Year

51. Tao Jingzhou, *Why China Must Turn Away from Economic Nationalism*, FIN. TIMES, Nov. 15, 2006, at 15.

52. *Id.*

53. Weisman, *supra* note 45.

54. *Id.*

55. *Id.*

56. See discussion *infra* Part IV.

57. Chandler, *supra* note 44; Areddy, *supra* note 44.

58. James T. Areddy, *China Sacks Shanghai Official—Beijing Pushes to Tighten Control, Consolidate Power Amid Corruption Scandal*, WALL ST. J., Sept. 26, 2006, at A8.

59. *Id.*

60. *Id.*

Plan on Commerce, featuring a plan to centralize foreign investment policy and remove it from the hands of local officials.⁶¹

2. Private Businesses' Requests for Protection

Some industry sectors have asked for protection from foreign investment or from the entrance of foreign firms into the Chinese market.⁶² Retailers have successfully lobbied for a rule restricting the expansion of large-scale chain stores.⁶³ Soybean processors have asked for restrictions on the expansion of foreign firms in the industry.⁶⁴ Chinese auto-makers have received a boost in the form of vague regulations demanding that foreign firms with manufacturing plants in China also make vehicles under local brand names.⁶⁵ The Chinese bearings industry has publicly opposed the potential acquisition of Luoyang Bearing Group by Schaeffler, a German bearings manufacturer.⁶⁶ A cement industry group asked regulators to review any foreign acquisition of a cement firm in excess of \$100 million U.S. dollars.⁶⁷ Members of the telecom industry asked the Ministry of Information for enhanced rules banning domestic telecom agencies from selling or leasing their licenses to foreign firms.⁶⁸ Chinese regulators have considered steel a special strategic industry.⁶⁹ In 2005 Beijing announced that foreign firms cannot purchase controlling shares of domestic steel companies.⁷⁰ In this announcement, regulators revealed their plans to continue architecting the steel industry even after opening the market according to WTO obligations.⁷¹ These concessions to the industry groups illustrate the nimble and responsive style of Chinese economic regulators when presented with requests. Though the noted examples are small-scale and industry-specific, they begin a precedent that could allow broader protections if translated to a larger scale.

61. *Local Officials May Face Less Pressure on Foreign Investment Invitation*, XINHUA ECON. NEWS SERVICE (BEIJING), Oct. 11, 2006, available at <http://www.lexis.com> (last visited Nov. 19, 2007).

62. Baston & Fong, *supra* note 3.

63. *Id.*; *China Drafting Rules to Regulate Large-Scale Shopping Outlets*, NEWS GUANGDONG, July 17, 2006, available at <http://www.newsgd.com/business/laws/200607170045.htm>. The Ministry of Commerce drafted a rule restricting both domestic and foreign "big box" retailers from building stores over 10,000 square feet without undergoing a rigorous approval process. *Id.*

64. Baston & Fong, *supra* note 3.

65. *Id.*

66. *Id.*

67. *Id.*

68. *Rules to Hurt*, *supra* note 11.

69. Shu-Ching Chen, *No Steel for Foreigners in China*, DAILY DEAL, July 21, 2005.

70. *Id.*

71. *Id.*; Sanchanta, *supra* note 28. The plan proposed consolidation, a more efficient coastal relocation of the production locations, and mergers that would give the top-10 producers a 50 percent share by 2010 and a 70 percent share by 2020.

C. CASE STUDY: CARLYLE GROUP'S ATTEMPTED ACQUISITION OF XUGONG MACHINERY

Carlyle's attempted play for Xugong Machinery and the unorthodox approval process thus far is an example of the unpredictable regulatory climate hindering the influx of foreign capital. Xugong Group Construction Machinery Co. is China's leading construction-equipment machinery maker.⁷² The local government of Xuzhou started a public auction process to sell Xugong in 2004; a deal giving Carlyle an 85 percent stake for \$375 million U.S. (3 billion RMB) was announced in November 2005.⁷³ That deal had not been approved by October 2006.⁷⁴ While the proposal was languishing, industry protections and national rules governing foreign acquisition were introduced, codifying concern over the strong market position of foreign firms.⁷⁵ Even without regulatory precedent, the 85 percent proposal was stalled in the approval queue as a handful of government ministries offered opinions.⁷⁶ An unprecedented meeting was held between several ministries of the Chinese government specifically to discuss the buyout of Xugong.⁷⁷ Since the proposal, the machinery industry has lobbied for and received specific protection.⁷⁸ In June 2006, a government document declared that the heavy machinery industry would receive special protection as a "pillar" of the domestic economy, and the rule includes a provision for extra scrutiny of foreign acquisitions.⁷⁹ In October 2006 Carlyle revised their agreement with Xugong, shrinking the sale to \$230 million U.S. for a 50 percent share. The remaining 50 percent will stay in control of the Xuzhou government.⁸⁰

It seems counterintuitive that 2006 brought calls for restrictive regulation from Beijing and Chinese industry groups after foreign investment had helped the Chinese economy grow so much in the last decade.⁸¹ However, the shift to restrictive regulation probably occurred in 2006 because the deadline was approaching for completion of China's WTO obligations.⁸² The pace of foreign investment between 2001 and 2006 was rapid and continued even without a predictable legal framework for

72. Shu-Ching Chen, *China Slows Foreign Industrial Acquisition*, DAILY DEAL, July 3, 2006.

73. *Id.*

74. Andrew Baston & Laura Santani, *Carlyle Scales Back Planned Stake in China Firm*, WALL ST. J., Oct. 18, 2006, at A12.

75. *Id.*

76. *Id.*

77. *Beijing Holds Meeting to Discuss Carlyle-Xugong Deal*, CHINA KNOWLEDGE NEWSWIRE, Aug. 3, 2006, available at <http://www.chinaknowledge.com/news/news-detail.aspx?id=3883&cat=general>.

78. Baston & Fong, *supra* note 3.

79. *Id.*

80. Baston & Santani, *supra* note 74.

81. Baston & Fong, *supra* note 3.

82. Understanding the WTO, *supra* note 5.

foreign investors.⁸³ The rate of transactions also increased significantly between 2001 and 2005 along with the price of individual deals.⁸⁴ A timeline of investment in the retail banking sector demonstrates this: in 2003, Citigroup's \$72 million U.S. investment in Shanghai Pudong Development Bank was a landmark.⁸⁵ By 2004 that investment was overshadowed by the \$1.75 billion U.S. share of the Bank of Communications that Hong Kong Singapore Banking Corporation (HSBC) purchased.⁸⁶ The year 2005 saw even more deals in the banking sector, with Bank of America taking a \$2.5 billion U.S. position in China Construction Bank⁸⁷ alongside Temasek's \$2.4 billion U.S. position in the same bank.⁸⁸ The Industrial and Commercial Bank of China (ICBC) sold a 10 percent position to Goldman Sachs and other investors for \$3.5 billion later in 2005.⁸⁹

If Chinese regulators decided to restrict foreign transactions only after looking on as European⁹⁰ and American investors took stakes in their formerly state-owned banks, they made an effective decision. Withholding approval from acquisitions and tightening regulations has already resulted in a decline in foreign investment. The January to August period in 2006 saw a 2.1 percent decrease in foreign investment compared to the same months in 2005, and the pace continued to slow as the 2006 Regulations were announced.⁹¹ In August 2006 China received 8.5 percent less foreign investment than August 2005.⁹²

83. There is some speculation that foreign investors are so bullish about Chinese investment that they will not be deterred by any recent regulation, as evidenced by the pace of investment thus far, even without solid protections in place for foreign investors. Kate Linebaugh, *Record China IPO Could Have Been Even Bigger — ICBC Offering Highlights Global Investors' Appetite*, WALL ST. J., Oct. 21, 2006, at B3. If this were the case, then foreign investment would continue in sectors that allow it, so that the problem of foreign control would not be quelled, but industry-specific protections would keep foreign capital away from the sectors that need it most to compete.

84. Jirak, *supra* note 40, at 345–46 (outlining the 2003, 2004, and 2005 private equity investments in the banking sector).

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*

90. HSBC is a British corporation. About HSBC, <http://www.hsbc.com/1/2/about-hsbc> (last visited Nov. 19, 2007).

91. *After Years of Courting Investment, Beijing May be Losing its Ardor for Capital*, FORTUNE, Oct. 16, 2006, at 16.

92. *Id.*

III. RECENT HISTORY OF CHINESE REGULATION OF FOREIGN INVESTMENT AND 2006 REGULATIONS

September 2006 brought significant Ministry of Commerce regulations on foreign investment.⁹³ The 2006 Regulations introduced a mandatory anti-monopoly probe if either party has large assets, high revenue in China, or a significant market share,⁹⁴ and special scrutiny for transactions concerning “key industries” or “national economic security.”⁹⁵ The 2006 Regulations have been touted as the “most far-reaching legislation governing foreign takeovers” to date⁹⁶ because they are the first such rules intended to be applied evenly across industry groups.⁹⁷ The 2006 Regulations came at the tail end of a period of regulatory relaxation for foreign investors.⁹⁸ However, proposed transactions that trigger provisions in the 2006 Regulations will face much more intense scrutiny from the Ministry of Commerce than any prior regulation imposed.⁹⁹ Those provisions allowing intensified scrutiny, and the bevy of more specific regulations in the past two years, signify an effort by Chinese policymakers to slow the rate of foreign investment through greater regulation than in the past. As of February 2007, the United States had requested that the WTO Dispute Settlement Body look into the Chinese regulations as well as the system of taxes on foreign investors.¹⁰⁰ No result was reached in the WTO, and most of the threats against Chinese regulators have come in the form of warnings or local legislation.¹⁰¹

A. REGULATORY BACKGROUND AND STRUCTURAL OPTIONS FOR FOREIGN INVESTORS

Foreign investors can be grateful for at least one aspect of the post-WTO reforms: the potential for simplified structural options.¹⁰² By not

93. 2006 Regulations, *supra* note 19.

94. *Id.* at art. 51.

95. *Id.* at art. 12.

96. Shu-Ching Chen, *China Issues New M&A Rules Requiring Anti-Monopoly Probes*, DAILY DEAL, Aug. 14, 2006.

97. *Id.*

98. *Id.*

99. 2006 Regulations, *supra* note 19, at art. 51.

100. Request for Consultations by the United States, *China—Certain Measures Granting Refunds, Reductions or Exemptions From Taxes and Other Payments*, WT/DS358/1 (Feb. 7, 2007).

101. *China Trade Policies Draw a Warning from Europe*, N. Y. TIMES, Oct. 25, 2006, at C4; Weisman, *supra* note 45 (discussing threat of U.S. legislation).

102. See generally Jessica Zoe Renwald, *Foreign Investment Law in the People's Republic of China: What to Expect From Enterprise Establishment to Dispute Resolution*, 16 IND. INT'L & COMP. L. REV. 453 (2006) (discussing the relative ease of direct investment compared to the WOFE structures that were previously the only ways for foreign investment to be involved in China). Although Renwald refers to entities owned entirely by foreign investors as Wholly

allowing mergers and acquisitions in the past, Chinese regulators have demanded that foreign operators use joint ventures and other mechanisms to tap the Chinese market.¹⁰³ Even those regulations were changing every few months through the end of 2005.

Often, investors in Chinese companies own shares in an offshore company and not the Chinese company directly.¹⁰⁴ These wholly owned foreign entities (WOFEs), many of which are based in the Cayman Islands,¹⁰⁵ are structured to allow investors to avoid Chinese taxes while they are invested.¹⁰⁶ Because investment in WOFEs is structured as shares of the foreign holding company, it offers investors the appealing prospect of liquidity by allowing investment exits through US or other stock exchanges.¹⁰⁷ In 2002 the WOFE form constituted 65 percent of all foreign investment in China.¹⁰⁸ Some of the most famous successful exits from venture capital investments in China were listed on U.S. exchanges through the WOFE format.¹⁰⁹ In January and April 2005 the State Administration for Foreign Exchange (SAFE) issued Circulars designed to rein in Chinese residents who had avoided taxes by owning Chinese investments through offshore entities.¹¹⁰ Circular 11 in January¹¹¹ and Circular 29 in April¹¹² forbid any Chinese citizen or resident foreigner from starting or owning shares in an offshore company without government approval.¹¹³ As far as the private equity and venture capital community could see in August 2005, SAFE was not approving any proposed offshore investments by Chinese residents.¹¹⁴ The head of a public bank noted that, because of the fear of investing offshore and uncertainty about the standards for approval, venture

Foreign Owned Entities (WFOE's), a more widely used translation and abbreviation is "WOFEs" (pronounced woof-ees). *Id.*; Jerry Borrell, *New Laws Slow Chinese Deal Making*, VENTURE CAP. J., Aug. 1, 2005, available at <http://www.ventureeconomics.com/vcj/protected/1122124806489.html>.

103. Renwald, *supra* note 102 (discussing history of permitted mechanisms for foreign investors).

104. Borrell, *supra* note 102.

105. *Id.*

106. *Id.*

107. *Id.*

108. WU, *supra* note 47, at 301.

109. Borrell, *supra* note 102. Ctrip.com, Shanda Interactive and Sina.com are listed on NYSE and Nasdaq, and were publicly offered when they existed as Chinese WOFEs. *Id.*

110. *Id.* "Circular" is the translated term for regulations issued by an administrative agency.

111. SAFE Circular No. 11, *Circular on Certain Issues Relating to Improvement of Foreign Exchange Administration for Acquisitions with Foreign Capital* (Jan. 24, 2005), available at http://www.fdi.gov.cn/pub/FDI_EN/Laws/ForeignExchangeAdministration/default.htm.

112. SAFE Circular No. 29, *Circular on Issues Relating to Registration Related to Mergers and Acquisitions by Foreign Investors* (Apr. 8, 2005), available at http://www.fdi.gov.cn/pub/FDI_EN/Laws/ForeignExchangeAdministration/default.htm.

113. *Id.*; SAFE Circular No. 11, *supra* note 111; Borrell, *supra* note 102 (discussing the 2005 circulars).

114. Borrell, *supra* note 102.

capital funding for offshore entities had almost ceased after SAFE Circulars 11 and 29 were issued.¹¹⁵ In the period following those Circulars, private equity groups and their portfolio companies arranged financing based on unsupported agreements, and hoped that legal agreements and financing would materialize once the approval process got off the ground.¹¹⁶ In response to unrest about the uncertain state of equity transactions, SAFE issued Circular 75 on October 21, 2005, regarding Issues Relating to Financing through Offshore Special Purpose Vehicles by Domestic Residents and Round Trip Investment.¹¹⁷ Circular 75 upheld the authority of SAFE to approve transactions, but also eliminated the provision for Ministry of Commerce approval.¹¹⁸

While transactions including offshore companies were being regulated in bits and pieces, domestic venture capital transactions were aided by national sweeping regulation designed to smooth the acquisition process. In November 2005 the National Development and Reform Commission announced that domestic venture capital would be regulated by a uniform set of regulations designed to make Chinese investors more competitive in the domestic venture capital landscape dominated by non-Chinese investors.¹¹⁹ Previously, domestic venture capital regulations varied by province.¹²⁰ The November 2005 rules helped investors avoid being double-taxed and announced government help through seed capital and incentive systems that award investment in certain industries.¹²¹

The year-to-year policy changes,¹²² including the formation of SAFE, contributed to a generally unpredictable climate for foreign investment. The 2006 Regulations on mergers and acquisitions by foreign investors were a similar surprise. Although the timing conveniently coincided with pending transactions that the government had been stalling, the tone of the Regulations was a marked contrast to the trend toward de-regulation that foreign investors had enjoyed since China's WTO accession agreement.

115. *Id.*

116. *Id.*

117. SAFE Circular No.75, *Circular of State Administration of Foreign Exchange on Relevant Issues Concerning Foreign Exchange Administration of Financing and Return Investments Undertaken by Domestic Residents through Overseas Special-Purpose Vehicles* (Oct. 21, 2005), available at http://www.fdi.gov.cn/pub/FDI_EN/Laws/ForeignExchangeAdministration/default.htm.

118. *Id.*; SAFE Circular No. 11, *supra* note 111.

119. Shu-Ching Chen, *New China Rules Seen as VC Boost*, DAILY DEAL, Nov. 16, 2005.

120. *Id.*

121. *Id.* The rules also came with restrictions barring margin financing and making it more difficult to invest in real estate.

122. *Id.*

B. SEPTEMBER 2006 ANTI-MONOPOLY PROBE

Foreign acquisitions of Chinese-owned companies after September 8, 2006 must undergo an anti-monopoly probe if either party has assets over 3 billion RMB (about \$404 million U.S. dollars in November, 2007), revenue inside China exceeding 1.5 billion RMB (\$202 million U.S. dollars), or a Chinese market share over 20 percent.¹²³ It is worth noting that a foreign acquiring company meeting these criteria will trigger the probe regardless of the size of the Chinese target. The probe will also be triggered if the foreign party has acquired more than ten related companies in China during the year.¹²⁴ If none of those requirements are met, a relevant industry group, competing Chinese enterprise, or government department may petition the Ministry of Commerce for a hearing to determine whether the transaction could be anti-competitive.¹²⁵ The Ministry then has 90 days to decide if a hearing is necessary, and then can begin evaluating the transaction for approval.¹²⁶

The 2006 Regulations also introduced a few special classes of Chinese corporations, the acquisitions of which will require special approval from the Ministry of Commerce.¹²⁷ Transfer of a controlling interest in a Chinese company with a “famous brand name” or one in a “key industry” with an actual or potential effect on “national economic security” is included in this provision.¹²⁸ The terms “famous brand name,” “national economic security” and “key industry” are not defined in the 2006 Regulations.¹²⁹ This allows for substantial discretion by the administrators who decide which transactions trigger the provision. The 2006 Regulations do not offer guidelines and reporting standards for transacting companies to present their financial information or assessment of whether the transaction will affect a “key industry” or “national economic security.” To date no request for clarification or interpretation has been made to the National People’s Congress (NPC).

The lack of guidelines may lead to uneven application of the regulation because it requires that transacting firms police themselves when determining whether they will trigger the anti-monopoly probe. Firms will not know whether to complete the probe or what type of inquiry will satisfy the regulation. The requirement on companies with a market share of 20

123. 2006 Regulations, *supra* note 19, at art. 51; Chen, *supra* note 96. Conversion is at 7.4255 RMB to 1 USD. *DataBank: Currencies*, N. Y. TIMES, Nov. 18, 2005, § 3, at 15.

124. 2006 Regulations, *supra* note 19, at art. 51.

125. *Id.*; 2006 Regulations, *supra* note 19, at art. 52.

126. 2006 Regulations, *supra* note 19, at art. 52.

127. *Id.* at art. 12.

128. *Id.*

129. *See* 2006 Regulations, *supra* note 19.

percent¹³⁰ will be problematic for manufacturing companies that contribute products to several sectors. Furthermore, the benchmark of what is or is not a monopoly will vary between industries because the 2006 Regulations do not provide a clear definition of “famous brand name.”¹³¹ As there is no timeline or standard for the reporting and approval processes, prospective acquisitions could be stalled indefinitely.

IV. THE CHINESE LEGAL CLIMATE FOR FOREIGN INVESTORS

While China's problems with adopting the rule of law¹³² have not impeded hungry investors thus far,¹³³ how the 2006 Regulations affect domestic businesses and foreign investors will be a significant indicator of the sustainability of China's post-WTO accession open marketplace. Recent announcements indicate that regulators understand that the legal implications for foreign investors could be clearer,¹³⁴ but the process of truly centralizing the regulation of foreign investment in all industries and sectors may be too ambitious to expect consolidation in the near future.¹³⁵

Since Deng Xiaoping's commitment to open China to the outside world in 1978,¹³⁶ China's legal regime has evolved from the dictatorship it was during Mao Zedong's life, but not yet to the point of operating within the rule of law.¹³⁷ “Rule of law” is a term generally used to describe legal systems where law has achieved the status necessary to impose “meaningful restraints on the State and individual members of the ruling elite.”¹³⁸ Besides lacking the authority that many western nations ascribe to their bodies of law, China's body of law has been hallmarked by ambiguity.¹³⁹ While that was helpful to administrative ministries as they worked around

130. Chen, *supra* note 96.

131. This may have more to do with the uneven application of Chinese trademark and patent law than just the blurry language of the regulation.

132. See generally Rohit Sachdev, *Comparing the Legal Foundations of Foreign Direct Investment in India and China: Law and the Rule of Law in the Indian Foreign Direct Investment Context*, 2006 COLUM. BUS. L. REV. 167 (2006) (arguing that China's lack of the rule of law makes it a better climate for protecting foreign investor's interests than India's system based on the rule of law).

133. Dyer, *supra* note 1.

134. See generally *Local Officials*, *supra* note 61 (discussing announced plans for a more precise system for local governments to analyze proposed foreign investments).

135. *Id.*

136. Friedman, *supra* note 9. In 1978 Deng Xiaoping adopted the “open door” policy, a series of reforms designed to speed up the growth of China's economy through the use of foreign capital. *Id.*

137. See generally Randall Peerenboom, *Let One Hundred Flowers Bloom, One Hundred Schools Contend: Debating Rule of Law in China*, 23 MICH. J. INT'L L. 471, 525 (2002) (explaining that China is still in the transition towards rule of law).

138. *Id.* at 472.

139. Renwald, *supra* note 102, at 456.

regulation to bolster state-owned businesses,¹⁴⁰ the system of subjective regulations interpreted for each individual transaction would be impractical when the volume of foreign businesses operating in China increases, as it is expected to after WTO accession is completed.¹⁴¹ The stalling of the Xugong, Shangdong and Guangdong deals may have already demonstrated that wrangling approval from all the relevant ministries and agencies is time consuming and nearly impossible.¹⁴²

The history of the People's Republic of China is brief¹⁴³ and still in flux as the single-party communist government modernizes a body of law that has historically been an "ideological instrument of politics."¹⁴⁴ Chinese law comes from a variety of central, administrative, and provincial sources.¹⁴⁵ The most unique and troublesome source for recent investors has been the state council's authority to issue tentative laws to control unprecedented situations.¹⁴⁶ The NPC is the main body of lawmakers and their power in the central Chinese government is almost entirely unchecked.¹⁴⁷ Members of the NPC elect the president of China, the head judicial leader, the heads of other departments and ministries, and enact laws.¹⁴⁸ The NPC itself is a 3,000-member body made of delegates chosen from the provincial congresses.¹⁴⁹ Mechanisms for the selection of those provincial delegates and the composition of the NPC's internal Standing Committee ensure that the membership of the NPC consists of approved Communist Party members.¹⁵⁰ Although the NPC is empowered to administer regulations itself,¹⁵¹ it also elects the State Council, which oversees the ministries, commissions, bureaus, and local governments that make up most of China's administrative regulators.¹⁵² These ministries and other bureaucratic bodies are granted the power to create administrative rulings as well.¹⁵³ The Ministry of Commerce, which set many of the regulations on foreign investment, is included in those ranks.¹⁵⁴

140. Austan Goolsbee, *In the New China, Banks Still Cling to Old Ways*, N.Y. TIMES, Oct. 12, 2006, at C3.

141. *Id.*; Baston & Fong, *supra* note 3.

142. *See supra* Part I.

143. Friedman, *supra* note 9, at 478. The Communist Revolution in 1949 sparked the formation of the law-making bodies that exist today.

144. Eric Orts, *The Rule of Law in China*, 34 VAND. J. TRANSNAT'L L. 43, 57 (2001).

145. Zhonguo Renmin Ginghegu Xianfa [P.R.C. Constitution] (1982), *available at* <http://english.people.com.cn/constitution/constitution.html>.

146. Renwald, *supra* note 102, at 459.

147. *Id.* at 456–57.

148. *Id.*

149. *Id.* at 457.

150. *Id.*

151. P.R.C. Constitution, *supra* note 145.

152. *Id.*

153. *Id.*

154. *Id.*; 2006 Regulations, *supra* note 19.

While the NPC serves as the root of power in the Chinese government, many avenues exist through which regulation may be handed down. This affects foreign investors when the approval of proposed transactions is delayed by the wide variety of policy-setting bodies that have the authority to speak on the transactions. The provision in the 2006 Regulations allowing a third party to call a hearing questioning a proposed foreign acquisition¹⁵⁵ will certainly draw many more concerned private and bureaucratic parties into the approval process, and possibly result in even further delays.

V. CHINESE BUSINESSES WILL NEED FOREIGN CAPITAL AND EXPERTISE TO COMPETE EFFECTIVELY WITH THE FOREIGN FIRMS THAT ARE EXPECTED TO ENTER CHINA'S MARKETPLACE

While the regulations against foreign investment may not be an immediate death knell for them, domestic Chinese firms could certainly benefit from injections of expertise and capital while international firms are circling the 1.3 billion-person market, looking for a way to capitalize on it.¹⁵⁶ In March 2007, the U.S. Undersecretary of Commerce for International Trade, Frank Lavin, noted that the health of China's domestic businesses would be aided by investment from foreign firms: "The controversy shouldn't be Carlyle-Xugong . . . I think China needs 100 Carlyle Groups to come in and buy 100 Xugongs."¹⁵⁷ Foreign investment would offer enhanced technology and more sophisticated management and marketing strategy to any sector, but the consumer financial services industry offers a ripe example. The domestic Chinese market for consumer banking is enormous, and the Chinese firms occupying the market have underperformed.¹⁵⁸ This makes it an attractive market for successful and established foreign banks, like Citigroup, which have adopted a philosophy of "if you can't buy 'em, join 'em" as they carve out a market share on their own after their attempts to invest in Chinese banks were rebuffed.¹⁵⁹ If Chinese banks are not prepared to compete, they risk not only losing ground

155. 2006 Regulations, *supra* note 19, at art. 52.

156. THE WORLD FACTBOOK, *supra* note 16, at 114. See Part II for discussion of foreign transactions pending in 2006.

157. Reuters, *US Official Warns China to Open Markets*, FINANCIALTIMES.COM, Mar. 19, 2007, <http://www.ft.com/cms/s/0de47ae0-ddac-11db-8d42-000b5df10621.html> (last visited Nov. 19, 2007).

158. *Battle for Rare Prize*, *supra* note 33; Wendy Dobson & Anil K. Kashyap, *The Contradiction in China's Gradualist Banking Reforms* (Initiative on Global Fin. Mkts., Working Paper No. 4, 2006), available at <http://faculty.chicagogsb.edu/anil.kashyap/research/Contradictionpercent20inpercent20China.pdf>; see *infra* notes 181–86 and accompanying text.

159. *Citigroup's China Focus*, WALL ST. J., Mar. 30, 2006, at A3.

at home, but ultimately failing to gain a significant share in the consumer banking market abroad.

The banking industry is particularly affected by the recent regulatory developments because China's largest banks were owned and run by the government until 2005 and 2006.¹⁶⁰ The WTO obligations call for China to allow established foreign retail banks to open on the ground in China and market directly to Chinese consumers by the end of 2006.¹⁶¹ However, this can benefit the existing Chinese banks by offering expertise, particularly related to the limited scope of retail consumer products that have not been offered by the government-owned Big Four banks in the past.¹⁶² The number of proposed acquisitions in the retail banking market suggests that foreign banks prefer to make that connection by acquiring or joining with existing banks instead of forging ahead alone to break ground on completely new branches.¹⁶³ The WTO obligations allow foreign banks to establish their own freestanding businesses in China, and if they are forced to do so without merging with or acquiring a Chinese bank, they will certainly offer the retail products popularized in western markets. Chinese banks will not be prepared to compete with them unless foreign expertise is employed in their product development management.

Although the Big Four domestic Chinese banks have completed public offerings, there is some concern that Beijing will continue to manage the banking industry.¹⁶⁴ Indeed, Beijing exhibited anxiety about the impending entrance of foreign lenders as far back as early 2005, when the vice-chairman of the China Banking Regulatory Commission announced at the inaugural China Financial Reform Forum that "we need to focus on having an appropriate level of protection for Chinese banks."¹⁶⁵ At that point there was an implicit rule banning multinational banks from taking stakes in more than two Chinese banks, and in October 2006 the only foreign banks granted commercial-banking licenses were Citigroup Inc. and HSBC.¹⁶⁶

So far, government management of the banks has led to poor performance, allowing government officials to award loans at their personal

160. See generally Dobson & Kashyap, *supra* note 158; Shu-Ching Chen, *Beijing Moves to Protect Local Banks*, DAILY DEAL, Apr. 28, 2005. The Big Four went public in 2005 and 2006.

161. Hong Kong Trade Development Council, *supra* note 6. (stating that commitments must be met within 5 years of accession, which began December 11, 2005).

162. Jirak, *supra* note 40, at 351. The Big Four are the specialized banks that received the commercial lending business separated from the People's Bank of China in 1986; they are the Agricultural Bank of China, the Bank of China, China Construction Bank, and the Industrial and Commercial Bank of China. *Id.*

163. Chen, *supra* note 160; *Battle for Rare Prize*, *supra* note 33; *Moving the Market: Morgan Stanley Expands in China with Bank Deal*, WALL ST. J., Oct. 3, 2006, at C3.

164. Austan Goolsbee, *In the New China, Banks Still Cling to Old Ways*, N.Y. TIMES, Oct. 12, 2006, at C3.

165. Chen, *supra* note 160.

166. *Id.*; *Moving the Market*, *supra* note 163.

discretion to non-creditworthy recipients or without securing collateral.¹⁶⁷ However, government bail-outs have kept the bad loans from affecting the IPO prospects of at least one large bank, the ICBC.¹⁶⁸ There, the percentage of non-performing loans was reduced from 34 percent to 5 percent in the last year when the bad loans were removed from ICBC's books and shuttled to separate asset management companies.¹⁶⁹

ICBC has also benefited from the overall growth in the Chinese banking market, where deposits and personal and corporate loans have experienced double-digit increases each year since 2001.¹⁷⁰ Since Chinese law has kept deposit rates low and lending rates higher, ICBC's profits doubled between 2004 and 2006.¹⁷¹ ICBC's public offering earned \$21.9 billion U.S., but it drew \$350 billion U.S. in demand.¹⁷² While that figure is exciting, it is probably more an indicator of foreign investor excitement about claiming a stake in a large Chinese offering than the health of ICBC.¹⁷³ To illustrate the increase in excitement, compare Goldman Sachs' 5.8 percent share of ICBC, for which they paid \$2.6 billion U.S. in April 2006,¹⁷⁴ to the end of 2001, when all foreign investment in the Chinese banking and insurance industries totaled only \$1.4 billion U.S.¹⁷⁵

The Chinese banking market does warrant such zeal by investors; it is growing even faster than the country's economy, paced by the rise in personal wealth in China.¹⁷⁶ The excitement over the industry's growth and jealousy by investors who were not invited to ICBC's offering have incited foreign investment in other banks as well, some with even less attractive portfolios than ICBC.¹⁷⁷

In late 2006, Morgan Stanley planned to acquire the Nan Tung bank, a one-branch operation dealing only with non-Chinese currencies.¹⁷⁸ Guangdong Development Bank in southern China may appear generally unattractive with \$4.5 billion U.S. in bad loans, but it spurred a bidding war between Citigroup and Societe Generale, the French bank.¹⁷⁹ Retail banks with such poor performance as Guangdong and such small market share as

167. Goolsbee, *supra* note 164.

168. *Id.*

169. *Id.*

170. *A Dragon Stirs; China's Biggest Bank*, THE ECONOMIST, Oct. 14, 2006, at 78.

171. *Id.*

172. Linebaugh, *supra* note 83. The demand for IPO shares probably also can be attributed to Goldman Sachs' marketing expertise and reputation for involvement in profitable IPOs.

173. *Id.*

174. *A Dragon Stirs*, *supra* note 170.

175. WU, *supra* note 47, at 304 (citing National Bureau of Statistics, China Statistical Yearbook (Zhongguo Tongji Nianjian) Beijing, China Statistics Press, 2003).

176. *A Dragon Stirs*, *supra* note 170.

177. *Id.*

178. *Id.*; *Moving the Market*, *supra* note 163; *A Dragon Stirs*, *supra* note 170.

179. *Battle for Rare Prize*, *supra* note 33.

Nan Tung would not normally be courted by multinationals. However, because the approval process for licensing in China is so ambiguous and local, the licensing that small banks have already obtained is attractive to foreign firms who are uncertain that they would be granted licenses as new entrants to the banking market. Guangdong also offers 501 existing branches and all the local and municipal licenses to operate them.¹⁸⁰ However, other potential foreign investors watched from the sidelines in 2006 as big private transactions, like the bid for Guangdong, waited in limbo for approval from Chinese authorities.¹⁸¹ Chinese regulators seemed perfectly happy with the slowdown, even indicating that protecting the domestic banking industry's market share starts with keeping foreign investors out of indigenous banks.¹⁸²

Despite the growth in the market for banking in China, experts believe that the sustainability of the domestic banking industry could benefit from an increased role for foreign entrants, and that fear over harm to existing indigenous banks (particularly the Big Four) is unwarranted.¹⁸³ The presence of foreign banks was not threatening the market share of Chinese banks by the time of the 2006 Regulations. Further, a future increase in foreign bank outlets has the potential to help the domestic banking industry take advantage of consumer banking products that the Chinese market has not yet been exposed to. In 2006, foreign banks operating in China were not occupying a significant share of the domestic retail market.¹⁸⁴ A 2005 survey of foreign banks by PriceWaterhouseCoopers showed that foreign banks operating in mainland China drew on a mostly non-Chinese customer base.¹⁸⁵ Experience in Japan indicates that foreign banks will not steal away Chinese banking customers as they enter.¹⁸⁶ When foreign banks first entered the market in Japan, domestic customers were not quick to switch their savings or borrowing to new banks.¹⁸⁷

The foreign banks surveyed anticipated growth in retail banking because Chinese customers have not been exposed to many products that have been successful in western markets.¹⁸⁸ Credit cards, mortgages and investment vehicles have not been popularized by the current Big Four players in Chinese retail banking because they do not have the expertise to

180. *Id.*

181. Chandler, *supra* note 44. *See also supra* Part II.C. (2006 foreign investment numbers are lower than those in 2005).

182. Chen, *supra* note 160.

183. Dobson & Kashyap, *supra* note 158.

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.*

develop and offer such products.¹⁸⁹ Foreign entrants who have already developed retail products and have experience tailoring and marketing them may be better equipped to educate Chinese consumers and popularize the products first.¹⁹⁰ Morgan Stanley's Nan Tung acquisition is a good example of the pathway that foreign investors must take to make inroads into Chinese retail banking. It is a very small holding, but the commercial-banking license is not currently available to foreign banks and is a necessary prerequisite to introducing and popularizing retail products and services such as credit cards and investment instruments in the Chinese market.¹⁹¹

VII. CONCLUSION

The sentiment from Chinese firms and industry groups requesting protection is understandable as the post-WTO open market will expose them to competition not only from foreign firms on their own soil, but also from the Chinese firms already backed by foreign capital or traded on public exchanges. However, the Chinese government has reacted by holding up foreign acquisitions and mandating time-consuming and vague reporting requirements through the 2006 Regulations. Such a reaction has merely quelled public unrest at the foreign economic presence and has not contributed to a legal regime that will foster efficient and competitive Chinese businesses in the open market. The health of Chinese enterprises will not be ensured just by slowing the flow of foreign capital and foreign acquisitions. As China's WTO accession has brought its market into the open world economy, self-seclusion for Chinese businesses is no longer possible to sustain.¹⁹² Chinese private firms and the remaining state-owned enterprises will only suffer from excessive protection as they are closed off from the benefits of foreign management and capital. The problems will be particularly ironic and damaging for key industries, like banking, that have historically been hampered by inefficiency while leaving huge domestic Chinese markets untapped.

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189. Dobson & Kashyap, *supra* note 158.

190. *Id.* "The foreign banks might well do the Big Five a favor by helping familiarize customers with some of these products and by creating standards; . . . the Big Five could be better off letting foreigners set up the credit derivatives market before entering, rather than trying to trail blaze." *Id.* The Big Five refers to the Big Four plus another formerly state-owned bank not discussed in this paper. The terms are used by the press interchangeably to refer to large domestic banks.

191. *Moving the Market*, *supra* note 163.

192. WU, *supra* note 47, at 309.

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