

COMMUNICATION FROM THE UNITED STATES

The following communication, dated 22 September 2006, is being circulated at the request of the Delegation of the United States.

**TRANSITIONAL REVIEW MECHANISM PURSUANT TO PARAGRAPH 18
OF THE PROTOCOL ON THE ACCESSION OF THE PEOPLE'S
REPUBLIC OF CHINA ("CHINA")**

Questions From the United States to China
Concerning Trade-Related Investment Measures

I. AUTOMOBILE INDUSTRIAL POLICY

1. In connection with last year's transitional review before this Committee, the United States addressed Article 47 of China's automobile industrial policy, published on 1 June 2004, and entitled "Development Policy of the Automobile Industry", which states that a new automobile production plant requires a minimum investment of RMB 2 billion, of which owned capital should not be less than RMB 800 million. According to this article, the new plant should also include an R&D facility, investment in which should not be less than RMB 500 million. Article 47 additionally requires the establishment of an R&D facility in connection with new automobile engine manufacturing. The United States explained that, in its WTO accession agreement, China committed not to condition the right of investment on the conduct of research and development. The United States cited paragraph 7.3 of China's Protocol of Accession ("China shall, upon accession, comply with the TRIMs Agreement, without recourse to the provisions of Article 5 of the TRIMs Agreement ... Without prejudice to the relevant provisions of this Protocol, China shall ensure that the distribution of import licences, quotas, tariff-rate quotas, or any other means of approval for importation, the right of importation or investment by national and sub-national authorities, is not conditioned on: whether competing domestic suppliers of such products exist; or performance requirements of any kind, such as local content, offsets, the transfer of technology, export performance or *the conduct of research and development in China.*") and paragraph 203 of the accompanying Working Party Report ("The allocation, permission or rights for investment will not be conditional upon performance requirements set by national or sub-national authorities or subject to secondary conditions covering, for example, *the conduct of research*, the provision of offsets or other forms of industrial compensation including specified types or volumes of business opportunities, the use of local inputs or the transfer of technology.")

2. The United States asked China to explain whether Article 47 was consistent with China's commitments in paragraph 7.3 of China's Protocol of Accession and paragraph 203 of China's Working Party Report not to condition the right of investment by mandating the conduct of research and development in China. In response, the representative from China did not address that question. Instead, the representative from China stated only that "setting up an R&D facility itself did not constitute a mandatory requirement on transfer of technology ... [and] [t]hus ... was not against [China's] WTO commitments."

- (a) Please explain how Article 47 complies with China's commitments in paragraph 7.3 of China's Protocol of Accession and paragraph 203 of China's Working Party Report not to condition the right of investment by mandating the conduct of research and development in China – an issue explicitly separate from the issue of technology transfer, according to paragraph 7.3 of China's Protocol of Accession and paragraph 203 of China's Working Party Report.

3. In connection with China's Trade Policy Review, held on 19 and 21 April 2006, the United States submitted written questions addressing the fact that new investment projects in the automotive sector require, *inter alia*, a technology transfer agreement. The United States then asked China to explain, taking into account the commitments that China made in paragraph 7.3 of Part I of its Protocol of Accession and paragraph 203 of the accompanying Working Party Report not to condition investment on the transfer of technology, how it justifies this condition. To date, China has not responded to this question. The United States anticipates that China will submit its Trade Policy Review response prior to this Committee's 17 October 2006 meeting, when China's Transitional Review Mechanism is on the agenda. The United States may then ask follow-up questions in connection with China's upcoming transitional review. In the event that China does not submit its Trade Policy Review response prior to this Committee's 17 October 2006 meeting, the United States would ask that China provide its response during the portion of that meeting devoted to the Transitional Review Mechanism.

II. STEEL POLICY

4. In connection with last year's transitional review before this Committee, the United States addressed Article 23 of China's steel industrial policy, released by the National Development and Reform Commission on 8 July 2005, which mandates certain requirements as conditions for investments. These include requirements for certain production levels in the previous year, self-financing of 40 per cent or above, modern technology and management, strong supply and distribution networks, transportation, and water, mineral and power resources. Furthermore, these requirements appear to apply only to domestic enterprises seeking to operate in cross-regional domestic steel operations, while foreign enterprises must meet these requirements for any investment in China. In addition, domestic enterprises only need to meet a 5 million ton previous year quantity threshold for investments in common steel and a 0.5 million ton previous year quantity threshold for investments in special high-alloy steel. The corresponding thresholds for foreign enterprises are 10 million tons and 1 million tons. Article 23 also does not allow foreign enterprises to invest in new business sites, but limits participation to reform or relocation of existing enterprises and to non-controlling stakes. The United States asked China to explain why there is a need for such discrepancies in the treatment of foreign enterprises and domestic enterprises. However, China did not respond to this question. Please provide the requested explanation during the portion of this Committee's 17 October 2006 meeting devoted to the Transitional Review Mechanism.

5. In connection with last year's transitional review before this Committee, the United States also noted that the steel industrial policy places other restrictions on foreign investment, such as by requiring that foreign investors possess proprietary technology/intellectual property in the processing of steel. Given that foreign investors are not allowed to have a controlling share in steel and iron

enterprises, this requirement would seem to constitute a *de facto* technology transfer requirement. The United States then asked China to explain how these restrictions are consistent with the commitments made by China in paragraph 7.3 of its Protocol of Accession and paragraph 203 of its Working Party Report. However, China did not respond to this question. Please provide the requested explanation during the portion of this Committee's 17 October 2006 meeting devoted to the Transitional Review Mechanism.

III. STATE COUNCIL OPINIONS

6. Over the past year, the United States and U.S. industry have become concerned about new restrictions on investment being proposed and implemented by China. Often, these restrictions are accompanied by other problematic industrial policies, such as the increased use of subsidies, preferences for using domestic rather than imported goods, or the development of China-specific standards.

7. In June 2006, China publicly issued the *State Council Opinions on the Revitalization of the Industrial Machinery Manufacturing Industries* (the *State Council Opinions*). The *State Council Opinions* identify 16 types of equipment manufacturing as the focus of the new initiative, including, *inter alia*, large equipment for clean and efficient power generation, critical semiconductor manufacturing equipment, civilian aircraft and aircraft engines, pollution control equipment, textiles machinery and large excavators. Policy supports for the initiative include preferential import duties of parts and material needed for R&D (vs. finished machinery), encouragement for procuring domestically manufactured new major technical equipment, a dedicated fund to facilitate capital market financing for domestic firms, and strict review of imports. The *State Council Opinions* discuss new controls on foreign investment in these sectors, including new approval requirements when foreign entities seek majority ownership or control and the strengthening of the management of equipment and machinery imports, as well as a number of other initiatives designed to promote, develop and expand the market share of domestic companies in these sectors in China.

8. In the United States' experience, sustained economic growth and development of globally competitive companies is best achieved by relying on market mechanisms and resisting domestic pressures to raise barriers to trade and to protect domestic companies against foreign competition. Government intervention often stymies development. In addition, particularly at a time of large and rising trade and economic imbalances, introducing new investment restrictions intended to protect the development of strategic industries or specific sectors inevitably leads to further bilateral trade frictions and can give rise to WTO concerns.

- (a) Please describe the legal effect of the *State Council Opinions*.
- (b) Please clarify the full scope and intent of the *State Council Opinions*. What kinds of specific policies are being planned to support the development of the selected industries?
- (c) Does China have plans to expand the policies set forth in the *State Council Opinions* to include other sectors in the future? The United States notes that press reports indicate that the financial services, energy and petrochemicals sectors, among others, are under consideration. Please explain.
- (d) Please describe the extent to which China has begun to implement the *State Council Opinions*. What is the status of any proposed implementing regulations?

IV. M&A REGULATIONS

9. In August 2006, new regulations on mergers and acquisitions (M&A regulations) were jointly issued by the Ministry of Commerce (MOFCOM), the State-owned Assets Supervision and Administration Commission (SASAC), the State Administration of Taxation (SAT), the State Administration of Industry and Commerce (SAIC), the China Securities Regulatory Commission (CSRC) and the State Administration of Foreign Exchange (SAFE). No opportunity was provided for public comment on a draft of these regulations. Instead, the regulations were issued in final form, effective one month later. The regulations strengthen MOFCOM's supervisory role over foreign investment, in part by requiring MOFCOM's approval of M&A transactions that it believes impact state economic security or involve famous Chinese brands. The regulations also place MOFCOM in the role of determining if the domestic acquisition target has been appropriately valued.

- (a) Please explain why China chose not to circulate a draft of the M&A regulations for public comment.
- (b) When does China plan on issuing implementing rules for the M&A regulations? Will an opportunity be provided for public comment on a draft of these implementing rules?
- (c) Article 12 of the M&A regulations calls for MOFCOM's approval of any deal involving a "major industry", having "impact on the state economic security" or concerning "famous trademarks or traditional Chinese brands". This language is very broad and appears to require MOFCOM approval on most foreign investment transactions. Please explain what the quoted terms mean. Does China intend to define these terms in the implementing rules?
- (d) Article 14 of the M&A regulations requires that MOFCOM approve the valuation of any merger or acquisition. What qualifications and experience will be required of those who determine the appropriate valuation? On what basis will they determine the value?
- (e) Article 30 of the M&A regulations requires an "acquisition consultant" be hired to complete a stock swap-based deal. Article 31 sets forth general guidelines as to who will be able to qualify as such a consultant. These guidelines include the requirements that the acquisition consultant have a "good reputation", no "significant" criminal record and the "capability to conduct" the investigation. Does China intend to define these terms or otherwise provide more specificity regarding the necessary qualifications for an acquisition consultant in the implementing rules?
- (f) Chapter 5 of the M&A regulations requires MOFCOM approval for any M&A transaction that meets specific criteria or involves "very large market share" or "other important factors" that affect competition. Does China intend to define the quoted terms in the implementing rules? What are the other applicable criteria?
- (g) Some provisions in Chapter 5 of the M&A regulations address competition policy concerns, such as market share. Will these provisions remain in place after China issues its Anti-Monopoly Law? Please explain.

10. Does China have any plans to draft a new law on mergers and acquisitions? If so, does China intend to circulate a draft of that law for public comment? Please explain.

V. FOREIGN INVESTMENT CATALOGUE

11. In November 2004, the National Development and Reform Commission (NDRC) and the Ministry of Commerce issued a revised *Catalogue for the Guidance of Foreign Investment Industries*. This catalogue became effective in January 2005. Does China have any current plans to revise this catalogue? Please explain.
