The first Australia-China Investment Relationship Conference was conceived around the investment laws and regulatory regimes in Australia and China, the financial systems in both countries, and the governance and regulation of corporate and government entities in both countries. Focusing upon these critical aspects of the relationship begins as an exercise in comparative law but given the currency and urgency of the issues compels researchers to find solutions to the sticking points in law, governance and policy.
THE AUSTRALIA-CHINA INVESTMENT RELATIONSHIP
Law, Governance and Policy

EDITED BY
Geoffrey Nicoll, Gerard Brennan and Jane Golley
CONTENTS

The Australia-China Investment Relationship

vi • Foreword
Peter Drysdale

xii • Acknowledgements

xiv • Editors and contributors

INTRODUCTION

xxii • Australia's thirst for capital and the unique character of Chinese investment
Gerard Brennan and Geoffrey Nicoll

PART I: Overview of the Relationship
3 • CHAPTER 1: The Australia-China relationship
Peter Rowe
15 • CHAPTER 2: Chinese investment in an economic context
Ken Waller
25 • CHAPTER 3: China's 'Go Global' strategy – the dilemma and the way forward
Kong Qingjiang

PART II: Foreign Investment in Australia
39 • CHAPTER 4: The Australian foreign investment regime
Malcom Brennan
65 • CHAPTER 5: Recent Australian transactions
Nicola Wakefield Evans
85 • CHAPTER 6: Chinese investment in Australia: reflections and observations
Xiang Gao

PART III: Foreign Investment in China
99 • CHAPTER 7: The legal challenges of FDI in China
Che Hu
111 • CHAPTER 8: QFIs: A door opens for foreign investors
Zhu Weiyi

PART IV: Issues for Corporate Law and Governance
127 • CHAPTER 9: Corporate governance in Chinese companies
Roman Tomasic
147 • CHAPTER 10: The governance of SOEs in China
Jenny Fu
171 • CHAPTER 11: The independence of the Chinese Auditor General
Monir Mir, Ian Maclean and Haiwei Fan

PART V: The Future of the Relationship
183 • CHAPTER 12: Taxation issues and investment incentives
John McLaren
195 • CHAPTER 13: Business relationship development and management in China
Rebecca Yang, Patrick Zou and Rob Leslie-Carter
213 • CHAPTER 14: Conclusions and issues for further research
Geoffrey Nicoll
Foreword

Chinese direct investment abroad has grown dramatically over the past decade since the government opened up capital controls through its 'go global' strategy, to allow major state-owned enterprises to invest abroad. This policy change was designed to strengthen the capacity of Chinese enterprises in building their competitiveness in manufacturing, through the acquisition of assets that brought in technology, research capabilities and resource security, and through the acquisition of resource provinces that could be developed to boost international supplies to serve China's voracious appetite for industrial raw materials and energy.

Under these strategies, China has become a major new source of international direct investment, with an annual outflow of around US$77 billion in 2012. The destinations of this direct investment are spread right around the world. They include both developed countries, in which technology and research and development-rich corporate assets have been purchased, and developing economies, in which resource acquisition is the principal focus. Australia, as a resource abundant developed country, has naturally been a particular target of Chinese interest. Indeed, Australia has been the largest single ultimate destination for Chinese direct investment over the past half-decade or so.

The speed and scale of the growth of Chinese overseas direct investment has excited both interest and anxieties, as rounds of foreign investment from whatever source tend to do. While Australia has become home to a large amount of new Chinese direct investment, suggesting its relative openness to this new investment source, its reception has not been without controversy. The anxieties that accompanied the expansion of Chinese investment in Australia have been mirrored in many other countries and have shaped policy responses to it, to some extent or other, around the world.
There is no multilateral regime that yet governs international flows of
direct foreign investment, in the way that the WTO broadly governs in-
ternational trade. The global investment regime comprises the patchwork
of national regulatory regimes and what exists in the way of bilateral or
regional treaties and agreements governing the treatment of direct investment
flows. As new players in the overseas direct investment market, Chi-
nese firms therefore face a number of particular challenges: dealing with
the multitude of investment environments in different countries; having
very little in the way of an international framework of bilateral invest-
ment arrangements within which they could operate with confidence;
and, perhaps most significantly, having their origins overwhelmingly in
the state-owned sector in the political economy of a one-party state.

China is certainly different from other large sources of direct investment.
The speed with which Chinese overseas direct investment has grown is
unmatched, meaning that the capacity to analyze and understand its im-
 pact is still limited. It is the first time that a country with China’s mix of
political and economic institutions has become a large source of foreign
direct investment, with the major role envisaged for state-owned firms
extending the privileged position they enjoy in the domestic economy.
Finally, the interplay between economic exchange and strategic concerns
is commonly perceived to have no analogue in past experience.

The appropriate response to the growth of Chinese overseas direct invest-
ment may therefore depend in part on how long it retains its exceptional
Chinese character. If the Chinese reform program becomes more and
more comprehensive, the differences between Chinese economic institu-
tions and western ones may sooner rather than later narrow drastically,
with state-owned firms losing their central position. If, on the other hand,
the reforms do not dislodge state-owned firms from their central position,
questions will continue to be raised about their privileged position. How
should western governments respond to investment from Chinese state-
owned firms? Are state-owned firms unfairly powerful because of the
explicit and implicit support they receive from the Chinese government,
unduly reducing competition and compromising competitive neutrality?
Could they be a drag on host economies, as such firms tend to underper-
form relative to their private competitors. Could Chinese state-owned
firms be used as a tool for the Chinese government in pursuing non-com-
mercial objectives?

These are some of the questions that have been raised in response to the
growth of Chinese investment and shaped the policy responses to it, lead-
ing to automatic review of investment proposals under revised guidelines
in Australia or rejection of projects in North America under the US na-
tional security test.

This book had its origins in an Australian - Chinese collaborative research
program which brought together work on a number of the legal and insti-
tutional aspects affecting the experience with Chinese investment in Aus-
tralia. The book helps to clarify issues at both the Australian and Chinese
end of investment transactions and policymaking processes. It begins the
important process of demystifying what has been going on at each end
of the relationship for those at the other end. The result is a powerful
testament to the importance of careful analysis and research as a positive
influence in the development of policy thinking and, for the conception of
the project and its timely execution Gerard Brennan, Geoff Nicoll and Jane
Golley deserve congratulations and warm encouragement.

PETER DRYSDALE
The Australian National University, Canberra
18 August 2013
Acknowledgments

This book is based on papers that were presented at the first Australia-China Investment Relationship Conference held at the University of Canberra on 30 and 31 July 2012.

We would like to acknowledge and thank the Faculty of Business, Government and Law at the University of Canberra and our co-hosts, the College of Comparative Law at the University of Political Science and Law, Beijing for their assistance and participation in the conference. We acknowledge particularly the vital contributions of four eminent Chinese scholars from this university – Professors Xiang Gao, Kong Qingjiang, Che Hu and Zhu Weiyi – to a sophisticated academic discussion on critical aspects of law and policy associated with the developing Australia-China investment relationship.

We would also like to acknowledge and thank the major sponsor of the event, King & Wood Mallesons, the international law firm without whose financial assistance the conference would not have taken place. We also received valuable personal assistance from members of their Beijing, Canberra and Sydney offices. Lawyers from the Canberra and Sydney offices presented papers at the conference.

The Australian APEC Study Centre at RMIT and the American Society of International Law were co-sponsors of the conference and we also record our thanks to these two organisations.

As the body of this publication consists of papers prepared for and presented at the conference, special thanks are due to the distinguished authors of those papers for their contributions and participation in the conference.

Adjunct Professor Gerard Brennan and Dr Geoffrey Nicoll of the School of Law, University of Canberra, shouldered the burden of organising the conference and together with Dr Jane Golley of the Australian Centre on China
in the World (CIW) at The Australian National University have worked to prepare and edit this book for publication. They would like to thank CIW for its generous financial support and for converting the manuscript into its published form.

Editors and Contributors

Gerard Brennan (LLB Hons, Melbourne; LLM, University of London) is an Adjunct Professor in the Law School, Faculty of Business, Government and Law, University of Canberra. He was formerly the Legal Adviser to the Department of Foreign Affairs. He was the Australian Representative to the Sixth Committee of the United Nations General Assembly and the Deputy Leader of the Australian Delegation to the Third United Nations Conference on the Law of the Sea. He is co-author with Geoffrey Nicoll and Keni Josifoski of The New Mercantilism? Direct investment by state-owned enterprises in Australian owned companies.

Malcolm Brennan (BEc, LLB, ANU) is a special counsel in the Canberra office of King & Wood Mallesons where he specialises in advising on Australia’s foreign investment regime. He is an expert in the application of Australia’s foreign investment regime comprising the Foreign Acquisitions and Takeovers Act 1975 and Australia’s Foreign Investment Policy and the impact the regime has on proposed investments into Australia. For more than 25 years he has advised on the application of Australia’s foreign investment regime in relation to many major transactions and developments. As a result of his wide experience he has a unique understanding of the issues and sensitivities surrounding foreign investment in Australia.

Haiwei Fan (BSc, Tsinghua; Grad Dip. Professional Accounting, Griffith; MCom, Charles Sturt; CPA) is a Lecturer of Accounting in the School of Information Systems and Accounting at the Faculty of Business, Government and Law at the University of Canberra (UC). She has a strong teaching and research background in universities both in Australia and in China. For more than 20 years at UC she has been teaching financial and management accounting and corporate finance to both undergraduate and postgraduate students. Before joining UC she was a Deputy Director of the Management Research Centre at the China Textile University.

Jenny Fu (MLeg, LLB, UC) is an Assistant Professor at the Law School in the Faculty of Business, Government and Law at the University of Canberra. She teaches corporations law and is currently completing her PhD at the ANU on the governance of listed SOEs in China.
Jane Golley (BEc, ANU; Mphil, Dphil Economics, University of Oxford) is an economist focused on a range of Chinese transition and development issues. She worked in the Asia section of the Australian Commonwealth Treasury before spending eight years in Oxford undertaking postgraduate study and teaching economics. She returned to the ANU in 2003 and became Associate Director of the Australian Centre on China in the World in 2011. She is presently working on various aspects of China’s demographic change and economic performance.

Kevin Hobgood-Brown Appointed 15 October 2007 for three years, reappointed 1 November 2010 for three years. Kevin is the Managing Director of Riverstone Advisory, a Sydney-based corporate advisory firm. He is the Immediate-Past Chairman of the Australia China Business Council and has served on the Board of Directors of the ACBC since 1999. He is a member of the Global Council of the Asia Society and of the Advisory Board of the China Studies Centre of the University of Sydney. He taught on the law faculty of Beijing University from 1983-1987. Kevin has over 25 years of management and legal experience in the Asia Pacific region and has been based in Sydney since 1996.

Che Hu (JD Cum Laude, PhD, Hawai‘i) is an Associate Professor at the College of Comparative Law at the China University of Political Science and Law in Beijing. He teaches corporate and commercial law and his research focuses upon comparative studies of China’s company law and foreign investment law. He is admitted to the Bar of Hawaii.

John Larum (BCom, MEc, GAICD) is a company director and economic consultant. He worked with UBS for fourteen years including positions as Chief Economist in Australia and CEO of the Asset Management Division. He was president of China business for UBS Asset Management, working with UBS funds management joint venture in China. He is a contributor to the Lowy Institute for International Policy with published papers on ‘Australian investment in China’ (2010) and ‘Chinese perspectives on investing in Australia’ (2011).

Rob Leslie-Carter is a Director of Arup in London. He has worked around the world with Arup for more than twenty years, and spent the past ten years based in Australia where he was Arup’s Sydney Office Leader and Regional Leader for Arup’s Project Management Group. Rob has led landmark projects including the Stirling Prize-winning Laban Building in Deptford, and the Beijing National Aquatics Centre (the ‘Water Cube’). A chartered civil engineer by profession, Rob also has an MBA from Imperial College specialising in project management and entrepreneurship. Having relocated to London at the end of last year, Rob is leading the commercial property business within Arup’s Project Management Group – currently APM’s Project Management Company of the Year.

Ian Maclean (BSc Hons, UNSW; PhD, ANU; Grad Dip. Professional Accounting, CCAE; MAIP, CPA) is an Adjunct Associate Professor in the Faculty of Business, Government and Law, University of Canberra. He has taught in a range of capacities at the University of Canberra for almost three decades, mainly in the areas of finance, strategic management and management accounting. Dr Maclean’s university career intertwined with a career in the Australian Public Service, in which he was for several years a performance audit manager in the Australian National Audit Office. Dr Maclean has had a long interest in Asia, particularly China, and recently stepped down as president of the Association for Learning Mandarin in Australia.

John McLaren (LLB, Tasmania; MBA, LLM, Monash; PhD, RMIT) is a Senior Lecturer in the Faculty of Business at the University of Wollongong. He teaches Australian taxation law, Hong Kong taxation law and international taxation law. He is the joint editor of the Journal of Australian Taxation and has published in the area of tax havens and the taxation of mineral resources. He is a barrister and solicitor of the High Court of Australia.

Monir Mir (BCom Hons, MCom, Dhaka; MBA, Leuven; PhD, Wollongong; FCPA; FCMA; CA) is a Professor of Accounting in the School of Information Systems and Accounting in the Faculty of Business, Government and Law. He teaches in the area of management accounting. Monir’s research has been published in leading
international journals including The Accounting, Auditing and Accountability Journal, The Financial Accountability and Management Journal and The International Journal of Public Sector Management. His current research focuses on social, environmental and political aspects of accounting; critical analysis of the role of accounting technologies in public sector reform initiatives, accounting in developing countries, and accounting education. He is a member of the ACT Divisional Council and ACT Divisional Management Accounting Committee of CPA Australia.

Geoffrey Nicoll (BA, LLB, ANU; PhD, Sydney) is a Senior Lecturer in the Law School at the Faculty of Business, Government and Law, University of Canberra. He is a member of the Corporations and Markets Advisory Committee (CAMAC) and an Executive Member of the Business Law Section of the Law Council of Australia. He has published widely in corporations and securities law, corporate governance and institutional investment. He is a co-author of Public Sector Governance in Australia. He was a co-convenor of the First Sino-Australian Law Deans' Conference in 2006 and maintains his strong interest in the evolution of China's corporations and securities laws.

Peter Rowe (BA, Sydney) is head of the North Asia Division covering China, Korea and Japan in the Department of Foreign Affairs and Trade (DFAT). He has had three postings in Seoul since the 1980s, his most recent from 2006 to 2009 as ambassador. He was also accredited to Pyongyang and Ulanbator. Peter had earlier postings in Peking, Wellington, Jakarta and Colombo, where he served as High Commissioner from 1999 to 2002. Peter worked in the Office of National Assessments (ONA) from 1986 to 1991 with responsibility for Chinese and Korean issues.

Xiang Gao (BA, BFSU; LLM, CUPL; LLM, PhD, UNSW) is Professor of Law and Dean of the College of Comparative Law of China University of Political Science and Law (CUPL), the Director for the Centre of International Banking Law & Practice and the Director of the Australian Law Centre at CUPL, the Editor-in-Chief for the Journal of Comparative Law in the PRC, and the Chairman of the Beijing Society of Comparative Law. He is an arbitrator for the China International Economic & Trade Arbitration Commission and a member of the Legal Advisory Council for the Institute of International Banking Law and Practice in the United States. He was a Senior Lecturer in the Faculty of Law of the University of Canberra, and a judge of the Supreme People's Court of the PRC. Professor Gao specialises in commercial law with an emphasis on international trade law, international banking and finance law.

Kong Qingjiang is a Professor of Law and the Executive Deputy Dean of the Faculty of International Law at the China University of Political Science and Law in Beijing. Specialising in international economic law, WTO law and related China issues, he has published about 30 articles with international journals and four books including: China–EU Trade Disputes and their Legal Management, WTO, Internationalisation of Intellectual Property Rights Regime in China and China and the World Trade Organisation: A legal perspective. He teaches international economic law, international trade law, international law on intellectual property rights and related subjects.

Roman Tomasic (MA LLB, Sydney; PhD, UNSW; SJD, Wisconsin) is Professor of Law, School of Law, University of South Australia, and Visiting Professor of Company Law at Durham University; before returning to Australia in 2012, he worked as Chair of Company Law at Durham University and has had visiting professorial appointments at the University of Hong Kong, the International Islamic University, Malaysia, and in the China University of Politics and Law in Beijing. He has had extensive experience working on commercial law reform in China with GTZ and the Finance and Economic Committee of the NPC. He has recently been working on corporate governance and corporate reorganisation in China and in 2012 worked with the World Bank and the PRC National Judges College training judges in regard to China’s new Enterprise Bankruptcy Law. He has also recently worked on an international project with the Law Institute of the Chinese Academy of Social Sciences examining the use of gatekeepers and stakeholder theory in corporate governance.
Nicola Wakefield Evans (BJuris, LLB, NSW) is a Partner of King & Wood Mallesons’ Sydney office. She specialises in mergers and acquisitions, capital markets, projects, infrastructure and corporate governance. Nicola is a non-executive director of Toll Holdings Limited, Australia’s largest transport and logistics company. She has recently returned to Sydney where she is now head of KWM’s China practice in Australia after spending four years in the Hong Kong office of KWM where she was the Managing Partner International. In her general practice, she has been involved in significant transactions in the energy and resources, financial services, airports, private equity, media, technology and communications sectors.

Ken Waller (BSc Econ, London) is currently the Chair of the Financial Services Advisory Board at the Australian APEC Study Centre and is Director of the centre’s financial services programs. He spent nearly 30 years at the Australian Treasury, during which time his positions included Minister (Financial) at the Australian Embassy in Beijing and Treasury Minister at the High Commission, London. He joined the Colonial Group in 1998 as Group Economic Advisor and, following the acquisition of Colonial by CBA in 2000, was appointed Group Economic Advisor to the Commonwealth Bank of Australia, a position he held until July 2006. He has worked with the APEC Business Advisory Council (ABAC) since 2000 and was also senior advisor to the ABAC Australia Secretariat. Ken is also an honorary Professor of Economics at Zhongnan University of Finance and Economics, Wuhan, China.

Nofel Wahid (BEc Hons/BCom, MAppEc, Monash) is a Research Analyst at the Australian APEC Study Centre at RMIT University, where he undertakes policy research and analysis to design and deliver the APEC Study Centre’s training and capacity-building programs. Prior to his current role, Nofel worked as a financial markets analyst at the Australian Treasury where he monitored and analysed developments in international financial markets, with a special focus on macrofinancial policy issues.

Zhu Weiyi (BA, Nanjing; JD, Columbia) teaches securities law in the College of Comparative Law and China–EU School of Law at the China University of Political Science and Law in Beijing. Professor Zhu has worked as a legal adviser and research fellow at the China Securities Regulatory Commission and was instrumental in drafting major laws for the Chinese capital market. He has also worked for the Department of Laws and Treaties in the Ministry of Foreign Affairs and United Nations Development Organisation in Vienna and has published extensively in the field of securities law and capital markets. He is an arbitrator at the Beijing Arbitration Commission and a member of the New York Bar.

Rebecca Jing Yang is a Lecturer in Construction Management at Deakin University. She is an expert in stakeholder management and organisational network analysis (ONA). Her current research interests focus on sustainable building development including comparative studies between Australia and China. Her PhD research was focused on stakeholder management in construction projects, which has led to the publication of many papers in international journals and conferences. Prior to her academic career, Rebecca worked as a quantity surveyor in China Construction (South Pacific) Development Pte Ltd.

Patrick XW Zou (PhD, UNSW) is the Professorial Chair of Building and Construction Management and a Fellow of the ANZSOG Institute for Governance at the University of Canberra. Prior to joining UC, Dr Zou was Associate Professor and Program Director of Construction Management and Property at the University of New South Wales (UNSW), where he obtained his PhD in civil engineering and served in various capacities. Patrick is a Supervisory Chair of Construction Management at the College of Civil Engineering Hunan University and Guest Professor in Shenzhen University. He is an internationally recognised, award-winning researcher and teacher in risk management, including theoretical development and practical applications, with a focus on construction business and management and China context.
INTRODUCTION
Gerard Brennan and Geoffrey Nicoll

Australia’s thirst for capital and the unique character of Chinese investment

A number of current issues in the Australia-China investment relationship are examined in this book. Foreign investment is not a new phenomenon in Australia. Since its settlement, Australia has relied on foreign direct investment (FDI) for the development of its resources, both mineral and agricultural, and its industries. In the early years of Australia’s development investment came from countries such as the United Kingdom and the United States. In the 1960s and 1970s much of the investment came from Japan. In all of those cases the investors were companies similar to those established under Australian law and governed by similar rules.
What is new in more recent years is the substantial inflow of FDI from China, which has emerged as a major participant in the global economy and a capital-exporting country. Australia is a major destination for foreign investment from China, taking the number one spot in 2012. Unlike earlier investment in Australia, however, much of the investment from China has been undertaken by state-owned enterprises (SOEs). This type of investment has generated a great deal of media attention in Australia and has raised some concerns among Australian policymakers. Although Anglo-American corporations ultimately derive legitimacy and authority from the State, the growth and regulation of markets for the securities of large public companies have tended to distance such corporations from the immediate influence of the State and governments. The regulation and governance of Chinese SOEs have not yet enabled this degree of independence to emerge clearly. Nor has the regulation of markets in China reached this level of sophistication.

It is not unusual for a host country such as Australia to have an ambivalent attitude towards FDI. On the one hand, FDI is seen as making an essential contribution to the development of the host country. On the other, however, FDI also introduces the prospect of foreign interest in, and possibly ownership or control of, major corporations. As these corporations are politically and socially responsible for their actions, and an integral part of society itself, FDI may also cause concern for the host country’s sovereignty. Australia has long been a net capital-importing country and has experienced this ambivalence at different times. It was last seen in relation to Japanese investment in Australia in the 1960s.

The present scale of investment by China in Australia, and in other countries around the world, has raised a number of new concerns. First, China is a growing world power, moving rapidly along the path from ‘developing country’ status to that of a highly developed influential country, albeit with a number of domestic issues to resolve. Second, the dominant position of the Party in most aspects of Chinese life and business raises the potential for unknown political influences upon investment policy, the financial system and the governance of large SOEs. Third, Chinese law and regulation relevant to corporations and securities, markets and the operation of the financial system are all in a state of transition or evolution. And fourth, Chinese SOEs appear to be corporate entities that remain significantly under the control of the Chinese government.

The Australia-China investment relationship

The first Australia-China Investment Relationship Conference was held at the University of Canberra on 30–31 July 2012. The conference was in fact the product of several years of collaboration by researchers at the University of Canberra and the China University of Political Science and Law (CUPL) in Beijing. This collaboration was motivated by a concern for the way in which the relationship was developing and the view that further research would provide better understanding of and solutions to particularly difficult issues of law and policy.

Since 2008 several cases of investments made by Chinese SOEs in Australian companies have attracted a great deal of public attention. Accordingly, the conference took place in the context of widespread public interest and media coverage of Chinese FDI in Australia. Some of the cases discussed in this book were for some time high-profile media cases that led to tensions between the Australian and Chinese governments. In the Rio Tinto case, for example, Rio Tinto executive Stern Hu was sentenced to a prison term in China. Other cases raised issues of directors’ duties and corporate governance.

The objective of the conference was to provide a forum for discussion of the critical legal issues central to improving understanding in both
Australia and China about each other’s FDI policy in the belief that this approach might facilitate investment flows and also improve the overall Australia-China relationship.

The authors of the chapters in this book were asked to present papers on key aspects of the relationship that are to be the subject of continuing research. The approach has already borne fruit, requiring Australian researchers to consider Chinese perspectives on central issues. In considering China’s Go Global campaign in Chapter 2, for example, Professor Kong highlights the fierce competition among SOEs and emphasises the difficulties they face in obtaining state consent to make foreign investments abroad. As hoped, the same approach is also highlighting those areas crying out for further research and dialogue, such as the development of the Chinese financial system and the encouragement of institutional investment addressed in Chapter 8.

The first Australia-China Investment Relationship Conference was conceived around the investment laws and regulatory regimes in Australia and China, the financial systems in both countries, and the governance and regulation of corporate and government entities in both countries. Focusing upon these critical aspects of the relationship begins as an exercise in comparative law, but given the currency and urgency of the issues, compels researchers to find solutions to the sticking points in law, policy and practice. The book is divided into five parts. These five parts explore the broader political and economic contexts of the investment relationship (Part I), the law and policy regime governing FDI into Australia (Part II), the law and policy regime governing investment into China (considering particularly the evolution of the financial system and securities markets) (Part III), issues in corporate law and governance in Australia and China (Part IV) and emerging issues in the evolution of the relationship (Part V). Some brief notes on each chapter are set out below to guide the reader.

Structure of the book

Part I Overview of the relationship

Part I comprises three chapters that deal with the broader Australia-China relationship and the economic forces at work in moulding the investment relationship in that context. In Chapter 1, Peter Rowe provides an overview of the current political and diplomatic relationship between Australia and China. In 2012, Australia and China celebrated the fortieth anniversary of diplomatic relations and Australia is working with China both bilaterally and with multilateral organisations to improve world and regional stability and prosperity. Since the conference was held in 2012, Australia has been elected to the UN Security Council and this will provide another avenue for Australia to work with China, as one of the permanent members of the Security Council.

In Chapter 2, Ken Waller highlights weaknesses in the global economy and its adverse impacts on China’s recent economic performance, which was slower than expected. Nevertheless, the Chinese economy is expected to rebound in the second half of 2013, with a strong medium to long-term economic outlook. The strong outlook is predicated on the continuation of policy reforms that aim to promote greater investment flows into and out of China, as well as increasing market discipline within the Chinese financial system. The Chinese economy is also in the midst of a structural transformation that will see internal demand and consumption play an increasingly important role in driving economic growth, relative to its previous reliance on an external demand-driven growth model. This structural rebalancing is partly in response to major demographic shifts already afoot in China, and managing and responding to those changes with appropriate policy and regulatory regimes will have an important bearing on how successfully China is able to continue its remarkable economic re-emergence.
Chapter 3 turns to China’s ‘Go Global’ strategy as the foundation for directing and expanding China’s overseas direct investment (ODI). In this chapter, Kong Qingjiang considers the diverse reasons driving the strategy and the central direction given to the targets for China’s foreign investment. While the Go Global strategy has led to some uncertainty among countries receiving this investment, the policy has not been clear in its application in China either. For example, the consent required of Chinese agencies by SOEs seeking to invest overseas appears to be complex and confusing. Professor Kong considers the role of ‘favoured SOEs’ to Chinese ODI within the strategy and the ‘predicaments’ that have arisen when they have invested in the United States and Australia respectively. He speculates that the Go Global strategy may in time give way to negotiated bilateral investment treaties (BITs).

**Part II Foreign investment in Australia**

Part II of the book comprises three chapters that consider the investment regime in Australia and its operation in practice. In Chapter 4, Malcolm Brennan outlines the key aspects of the Australian investment regime, noting the important roles played by both law and government policy. He considers the treatment of foreign individuals and entities as investors, the assessment of applications and some statistics with respect to foreign investment. The lack of a clear definition of the national interest test provides flexibility in an open regime and allows for a case-by-case analysis; however, the approach also means that foreign investors need to examine the rules and policy relating to FDI and to take care in structuring proposed transactions. In Chapter 5, Nicola Wakefield Evans reviews the successful and unsuccessful acquisitions of Australian companies and businesses by Chinese investors in Australia in recent times. These transactions suggest that Chinese investors are developing a refined awareness of the Australian legal and regulatory environment when going abroad to seek new business opportunities. As Chinese investors become more familiar with the Australian business environment, new levels of sophistication in launching takeovers of Australian corporations should be anticipated. For investing Chinese entities in the future it may be important to weigh the relative merits of full ownership of an Australian company (assuming all the risk of operating without local experience) and joint-venture arrangements (giving less control, but providing a more experienced local partner).

In Chapter 6, Xiang Gao provides empirical evidence of the experiences reported by SOE executives investing in Australia and dealing with the Australian investment regime. His conclusion, despite initial misgivings about the way in which Australian policy may have been applied unevenly to SOEs investing in Australia, is that the SOEs themselves generally understand the concerns of the Australian Government and still see business benefits in investing in Australia within the rules.

**Part III Foreign investment in China**

Part III of the book comprises two chapters that consider the challenges embedded in the broader legal system when foreigners seek to invest in China. In Chapter 7, Professor Che Hu considers the legal framework for foreign investment in China, particularly the role of the Catalogue of Industries for Guiding Foreign Investment (the Catalogue). Professor Hu considers other important challenges for foreign investors embedded within the Chinese legal system. Importantly, he considers the value of alternative business forms that might be utilised in investing in China. This consideration points to a less formal investment relationship in which different legal forms might be utilised more effectively to meet new investment opportunities.

In Chapter 8, Professor Zhu Weiyi addresses the legal issues associated with China’s desire to attract passive long-term capital and deepen the market for China’s local securities markets. Associated with this desire is the need to develop China’s capital markets, the financial system and pro-
Introduction

Gerard Brennan and Geoffrey Nicoll

There are two major new taxes in Australia that have been the subject of heated discussion: the Rent Resources Tax and the Carbon Tax. The former seeks to address the difficult issue of how best to ensure that the wealth generated through mining in Australia, largely the result of Chinese investment, is to be preserved and distributed for the national benefit. The latter addresses the question of how Australia might contribute to global problems of pollution and global warming through the imposition of a suitable carbon tax. The chapter concludes that neither of these taxes is likely to significantly deter Chinese investment in the future.

In Chapter 13, Rebecca Yang, Patrick Zou and Rob Leslie-Carter look to the future of the relationship in a consideration of more flexible and less formal partnership arrangements directed to developing investment opportunities to the full. They consider the range of individual business relationships involved in the construction of the Beijing National Aquatics Centre (the ‘Water Cube’) for the Beijing Olympics 2008, foreshadowing the development of such partnerships in the future. The more this happens, the more developed the financial and legal infrastructure must be to facilitate the partnerships and arbitrate any disputes that may arise.

It is anticipated that these and other aspects of the Australia-China investment relationship will come more clearly into focus as researchers in both countries continue to consider the key aspects of the investment relationship that have been opened for research and discussion in this book.

Finally, in Chapter 14, Geoffrey Nicoll reviews the analysis and conclusions of all authors to suggest the areas requiring continuing, collaborative research. In considering the three key aspects of the investment relationship central to this research, he concludes that further co-operative work on the evolution of the financial systems in both China and Australia would be a most beneficial starting point.
The wider relationship and areas of cooperation

Investment between Australia and China – the focus of this book – is only one part of the overall relationship. Before addressing that, it is necessary to reflect on how far the relationship has come and the shape of the relationship today. In 2012, Australia and China celebrated their fortieth anniversary of diplomatic relations. Fifty years ago, the Australian Government seized the opportunity of China’s decision to emerge from isolation and engage with the world to initiate a solid political relationship with a key player in its region. Achieving strong political relations has been one of the highest priorities of Australian governments since that normalisation in 1972. Looking back, the great prescience and judgment in that decision are notable. China’s economic rise and growing influence make it an important partner for Australia in addressing every important global and regional issue.
Building on the efforts of those who have come before us over the past four decades, Australia strives to maintain a comprehensive, constructive and cooperative relationship with China. Australia and China already share an extensive network of dialogue mechanisms covering most of our bilateral interests. Australia is working with China, both bilaterally and through regional bodies, on shared interests in regional stability and prosperity. In the East Asian Summit (EAS), for example, Australia and China have committed to improving education delivery across the region through the development of an EAS Education Cooperation Action Plan.

Globally, Australia works closely with China across the entirety of the G20 agenda. Australia and China have collaborated on climate change for nearly a decade, including work on developing carbon markets, and Australia has worked closely with China for many years in the Asia-Pacific Economic Cooperation (APEC) group. Business links are expanding, while people-to-people links are increasing as Chinese people have more disposable income. Mandarin is now Australia’s second-most widely spoken language. More than 120,000 Chinese students enrolled in Australian institutions last year alone. Record numbers of Chinese tourists are visiting Australia.

The year of Chinese culture in Australia has just concluded. This followed the year of Australian culture in China in 2010–2011. Celebrations to mark the fortieth anniversary of diplomatic relations with China reflect the multifaceted nature of the relationship. The anniversary program currently lists more than eighty different events and initiatives hosted by government, business, educational and cultural organisations – including the Australia-China Investment Relationship Conference. Other events range from Australia-China business weeks in leading cities through to the Sydney Symphony Orchestra China Tour. At the political level, the relationship is assisted by a comprehensive program of high-level visits and activities. And the fortieth anniversary provides an opportunity to strengthen the bilateral relationship even further.

On the ground, Australia’s diplomatic network in China is one of its most extensive anywhere in the world. It has expanded further in 2013 with the opening of Australia’s new consulate in the dynamic inland city of Chengdu.

Australia’s growing diplomatic presence and regular reciprocal visits at the highest levels of government provide a strong platform for enhancing political and strategic engagement – something that will be vital as China’s significance to Australia’s national interest grows.

Australia-China bilateral economic relationship

The economic component of the bilateral relationship has been central to the overall relationship. There are strong complementarities between the economies of Australia and China. China has relied on Australia’s mineral and energy exports to build its cities and infrastructure. Australia has benefitted from China’s demand for these resources – and increasingly, for Australia’s agricultural and services exports. Unlike most other developed economies, Australia maintains a merchandise trade surplus with China.

Admittedly, the economic relationship is narrowly focused on trade and investment in resources; however, Australia has been actively addressing that issue, in particular with Trade Minister Dr Craig Emerson’s initiatives to broaden our economic relationship with China. These have included

- launching the Australia-China Services Sector Promotion Forum in May this year
- initiating, with Chinese Commerce Minister, Chen Deming, a joint agricultural study on cooperation in agricultural investment and technology to help address growing global food security concerns.
Australia-China bilateral investment relationship

The issue of foreign investment is part of the broader environment of the Australia-China relationship. Investment is already a crucial part of the relationship and all the trends point towards even greater prominence in the future. Given this, it is essential that the dynamics of the investment relationship today and the plan to deepen those investment links as part of a broadening relationship are clear and well understood.

Australia as a destination for FDI

A stranger to Australia, observing the occasional prominence of the debate over FDI, might mistakenly conclude that Australia lacks an abiding consensus on the role of foreign investment in its economy. Yet since the earliest European settlement, Australia has been a capital-hungry country that has accepted large foreign inflows. More than that, it has embraced foreign investment. And it has relied on it to provide the capital its economy needs to put its abundant natural resources and capabilities to their best and most productive use. This was true when Australia rode on the sheep’s back. It is true of the mining boom of the present time. And it will be true in years to come as Australia extends its strengths in services and agriculture in response to the opportunities in its region in the Asian Century.

For this reason, Australia’s strong reputation as a stable, efficient, productive destination for FDI is as valuable a resource as its mineral wealth and its ingenuity. In these circumstances, it is not surprising that the Australian Government, major political parties, business and the broader community maintain a steadfast commitment to an open investment environment. Similarly, given Australia’s growing trade and other economic links, it should come as no surprise that investment inflows from China have accelerated rapidly over recent years. This has been seen before with Australia’s largest trading partners – chronologically, the United Kingdom, the United States and Japan. And now Australia is seeing a rapid acceleration in investment from China, which has consistently been among its top three sources of proposed investment in recent years.

Far from being a cause for concern, this is part of an established and advantageous pattern of strong investment inflows complementing Australia’s largest trading links. What would be a cause for concern is if Australia were not seeing the kind of rapid inflow it has from China – especially given the rapid flow of Chinese capital to other countries right around the world. FDI from China has grown from around A$550 million at end of 2006 to some A$13.4 billion by the end of last year. This amounts to a 24-fold increase in just five years. All the same, despite the dizzying figures involved in recent years, China’s overall stock of investment in Australia remains low. The process is only just starting. At around 2.6 per cent of total stock, China is Australia’s ninth-largest source of FDI, still far below the contribution of traditional partners like the United Kingdom, the United States and Japan, but also others like the Netherlands and Switzerland. Chinese investment is likely to remain strong over the coming years (as seen in Chapter 3), contributing a growing share of Australia’s overall FDI. As China’s contribution increases, it is natural to expect a prominent debate about the appropriate role of Chinese investment in the Australian economy.

Debate surrounding escalating sources of investment is nothing exceptional. Historically, similar waves of concern and sensitivity accompanied the rapid acceleration in investment from the United Kingdom, the United States and Japan. Now, as then, it is perfectly legitimate for the public to demand that investment is in the national interest. As with investment in the past, the case is strong for Chinese investment in the national interest. One need only look to the role of Chinese investment in the mining sector – or in the development of new export industries like liquefied natural gas (LNG) – to understand the immense potential for productive use of China’s huge capital reserves in Australia.
Investment in the national interest: managing tensions

In all of this there are some clear realities. First, Australia welcomes foreign investment, including from China. Second, to the extent that Australia has an issue with Chinese investment, the issue is not that it has too much, it is that Australia wants more. Third, for a variety of reasons, not all individual investment proposals will meet Australia’s national interest objectives. Understanding these realities, and mindful of the immense benefits of FDI for access to capital, jobs, living standards and productivity, the question is this: how does Australia encourage further investment inflows while ensuring that investments from China and elsewhere are in the national interest? The answer is by doing what Australia already does.

The operation of the Foreign Investment Review Board (FIRB) is a major part of what Australia already does (as discussed in detail in Chapter 4). Importantly, the FIRB plays a legitimate role in screening investment proposals on the basis of national interest. It also fulfils the vital function of giving confidence to the Australian public that foreign investment is being managed in accordance with Australia’s economic, social, environmental and security interests. These roles are crucial to the long-run sustainability of foreign investment relationships – something that is clearly in the interest of parties on both sides. In a difficult, complex environment, the FIRB is performing its role with distinction. It is also taking an active approach to improving the openness, timeliness and transparency of its decisions, and its accessibility to potential Chinese investors.

The consistent feedback received from Chinese investors – both private and state-owned – is that they are increasingly comfortable and satisfied with FIRB processes, reinforcing Australia’s attractiveness as an investment destination. The figures accord with this. Between 2003 and 2010, Australia was the single-largest recipient of verifiable, genuine Chinese FDI. In July 2012, new FIRB Chairman, Brian Wilson, met his Chinese counterparts as part of the Deputy Prime Minister’s visit to China – a strong indication of the FIRB’s growing engagement with China.

Deputy Prime Minister and Treasurer, Wayne Swan, also visited Hong Kong and China to explore opportunities for Australia’s participation in renminbi (RMB) internationalisation – a development that will pave the way for even greater trade and investment flows. The visit included an announcement of a new high-level dialogue between senior business leaders from Australia and Hong Kong on RMB trade and investment, starting in Sydney next year. The Deputy Prime Minister and People’s Bank of China Governor, Zhou Xiaochuan, also agreed to talk further on the next steps to achieve direct convertibility between the Australian dollar and the RMB. These outcomes are clear examples of the joint progress the Australian and Chinese governments are making to promote deeper investment and other linkages.

Chinese investors: behaviour

As well as taking its own active approach to increasing dialogue on investment, the Australian Government also emphasises the importance of engagement by Chinese firms to ensure the long-term viability of the investment relationship. Part of the FIRB’s message to potential investors has been the importance of early and effective engagement with relevant Australian authorities. The door is always open. Rigorous planning is also crucial to ensure that prospects for commercially successful investment are strong. So too is a willingness to engage closely with the Australian public – both nationally and at the local level, where investments can have a direct impact on local communities.

Through this engagement and planning, Chinese investors can achieve strong commercial outcomes that will benefit both countries, and can help to contribute to a public rapport to ensure a positive long-term in-
investment environment. Australia expects all companies – whether foreign or domestically owned – to respect its laws and maintain the highest standard of corporate conduct. Understanding and adapting to Australian laws are critical to the success of investment in Australia.

**SOE investment**

This advice applies equally to both private firms and government-related or state-owned entities seeking to invest in Australia. Of course, the issue of SOEs has attracted particular attention in the public discussion of Chinese investment into Australia. Given the prominence of SOEs domestically in China, and the presence of leading SOEs at the forefront of China’s international investments, increased activity by Chinese firms abroad inevitably raises sensitive issues about how SOE investment should be perceived and treated. This is true in Australia and elsewhere around the world, in advanced and developing economies. The issue of the conduct of Chinese SOEs is not just a question for Australia, or any other recipient economy. Fundamentally, it is a question for China itself.

After all, the evolving relationship between China’s government, SOEs and other enterprises in key industries will be crucial not only for China’s international investments, but also for China’s domestic economic rebalancing and economic growth. Equally, the issue of state ownership or government-related funds is far from unique to China. The growing global role of sovereign wealth funds (SWFs) from various countries, and of state-backed enterprises from large emerging economies, means that the international investment environment has changed markedly.

As the Australian Trade Minister, Craig Emerson, pointed out in June 2012, some of the world’s largest corporations – including industry leaders in the resources sectors so vital to Australia’s economy – are state owned. These include the world’s thirteen-largest oil companies and its largest natural gas corporations. Some of these companies – including Malaysia’s Petronas, and Sinopec and others from China – are making a vital contribution to Queensland’s emerging LNG industry through investments there. Add to that the thousands of jobs and billions of dollars of exports that these projects will sustain.

Given the increasing role of SWFs and SOEs, it is increasingly important that a capital-hungry country like Australia does not unnecessarily exclude itself from this growing source of investment. Critically, Australia’s foreign investment screening arrangements provide a comprehensive and rigorous assessment of SWF and SOE investments. With appropriate systems in place, Australia should be confident in its ability to distinguish between investments that are and are not consistent with its national interest.

It is entirely legitimate and appropriate to review investments made by foreign government entities as a matter of policy, to ensure that all investments are in the national interest. This is Australia’s policy, and the policy of many other countries. The crucial thing is that this screening focuses on the national interest case of investment itself, rather than unfairly discriminating against or arbitrarily restricting access by a particular source or class of investors.

On this front, Australia’s record is strong. Of literally hundreds of business investment applications in recent years from Chinese firms (both public and private), not a single one has been rejected. Very few – a handful – have had their approval made subject to conditions. The government assessed that the vast majority of investment proposals – public and private, from China and elsewhere – were in the national interest. There is no conflict between the screening of proposals by government-related entities and greater investment links with China.
Agricultural investment

Another industry that has been at the forefront of the Chinese investment debate is agriculture. As with many things in the broader debate about investment, the allegation that Chinese or other foreign investors are buying up the farm does not match the reality. Based on an Australian Bureau of Statistics study, the share of foreign ownership of Australian farmland increased from 5.9 per cent in 1984 to 6 per cent in 2011. That is one-tenth of a percentage point in one-quarter of a century.

To increase transparency around this issue, the Australian Government announced in June 2012 the creation of a working group to help develop a foreign ownership register for agricultural land. Such a register could help to provide a more comprehensive picture on the nature of foreign agricultural holdings; but the government’s initiatives in agricultural investment go beyond issues of transparency. Australia and China have worked together on a landmark joint study on strengthening agricultural investment and technological cooperation. The study, released in 2012, assesses how Australia and China can work together to make the agricultural sector more productive.

The study examines how Australia can access Chinese capital to create jobs and revitalise rural communities. This carries with it major opportunities for market-driven regional development. Agriculture is a clear example of the potential that exists for Australia to embrace foreign investment to expand productive capacity and ensure its iconic industries are well placed to adapt to changing global patterns of demand.

Future directions

Growing interest in agricultural investment is also a reminder that the profile of Chinese investment in Australia will change over time. This is particularly so as China’s own institutional and business structures evolve in line with domestic economic reform and rebalancing. Progress towards a consumption-driven, services-oriented economy – accompanied by a liberalisation of currency and capital controls and financial markets – will change the type of business Chinese firms seek to do abroad. These domestic changes will also create major opportunities for investment into China, including by Australia.

This raises its own issues, including China’s own foreign investment review environment, which remains much more restrictive than Australia’s. These investment issues – in both directions – are part of the robust and productive dialogue that exists between Australia and China as the economic relationship continues to broaden. It is in the mutual interest of both countries to expand investment ties, and genuine progress has been made on encouraging closer cooperation and collaboration on these issues. In the investment space, this is not simply a matter of investment screening processes. In Australia, it also encompasses other important issues such as how infrastructure gaps, labour shortages and other challenges in the domestic economy are approached. In China, it encompasses questions of regulatory reform and financial-sector development, and of how Australian expertise in services, agriculture and other industries can contribute to China’s domestic economic restructuring. In turn, as important as investment is, it is only part of a broad-ranging economic relationship that is becoming more diverse every day.
The current economic environment

China’s economic growth has moderated in recent months, with gross domestic product (GDP) growth in the March quarter 2013 slowing to 7.7 per cent through the year since the March quarter 2012. This was lower than expected, with market analysts expecting growth to be 8 per cent or higher. The slowdown in GDP growth has been attributed to weak industrial production, which grew by 8.9 per cent in the March quarter – a notably lower outcome than expectations of 10 per cent growth.

China’s slowing industrial production and weakening economic performance are symptomatic of both internal and external factors adversely impacting the Chinese economy. Europe’s economic struggles in the aftermath of the Eurozone sovereign debt crisis have had a notable impact on external demand for China’s exports, with the growth in export volumes slowing from 9.5 per cent in 2011 to 6.7 per cent in 2012. This
Chinese investment in an economic context

Ken Waller

than total funds raised in the previous year. This follows CNOOC’s recent US$15 billion takeover of Canadian oil company Nexen and, more generally, US$34 billion of overseas acquisitions by major SOEs in 2012.

Market analysts believe this rise in overseas investments by Chinese enterprises – at a time when global commodity prices have moderated – is in response to expectations of continued high growth in energy consumption stemming from a positive medium to long-term outlook for the Chinese economy. Increases in Chinese investments overseas are not, however, just limited to the energy sector. More generally, the increase in foreign lending by Chinese resident financial institutions is estimated to have doubled to US$270 billion in 2012, with Chinese banks constituting a large share of that increase. Foreign assets of Chinese banks have increased from just less than US$40 billion in 2011 to approximately US$500 billion at the end of 2012.

Capital flows

Capital flows into China are also expected to increase in line with the improving economic outlook. The International Institute of Finance forecasts that total net capital flows into China will rise to US$313 billion in 2013, after falling from US$370 billion in 2011 to US$301 billion in 2012. Most notably, net inflows into China through private banking channels are expected to rise from US$82 billion in 2012 to US$89 billion.

Increased capital inflows have contributed to the appreciation of the renminbi, which has gained more than 4 per cent since mid 2012. Although this partly reflects the fundamental strengths of the Chinese economy relative to other major economies, it has also been attributed to loose monetary policy settings in advanced economies. Sustained quantitative easing in the United States, and more recently Japan,
has encouraged interest rate arbitrage that has led to higher capital flows into faster-growing economies, such as China, in search of higher yields.

The Chinese Government has responded to these market developments, especially increased foreign currency lending by banks within China, by introducing macro-prudential controls. Recently, the State Administration of Foreign Exchange (SAFE) announced a new policy requiring both Chinese and foreign banks with foreign currency loans of more than 75 per cent of deposits to reduce their loan-to-deposit ratios to levels to be set on a case-by-case basis.

These measures are designed to discourage foreign capital inflows being intermediated through the banking system, where total foreign currency loans are greater than deposits, especially in domestic Chinese banks. Data from the People’s Bank of China (PBoC) indicate that total foreign currency loans in the Chinese banking system were US$754 billion at end-March 2013, while total deposits were US$442 billion.

**Shadow risks**

The significant gap between the foreign currency loans and deposits of Chinese banks reflects an aspect of broader concerns about total credit levels within the Chinese financial system, as well as the composition of that lending, especially within the shadow financial system.

Total credit in the Chinese financial system stood at approximately 190 per cent of GDP at the end of 2012, having grown by 23 per cent through the year following a contraction of 8.5 per cent in 2011. Market analysts have attributed most of the growth in total credit to the increased use of off-balance sheet lending instruments by both banks and non-bank financial institutions. Shadow lending – as this market segment is often referred to – has increased rapidly in recent years from being quite negligible in 2009 to approximately one-third of total credit-to-GDP in 2012, which puts the size of the shadow financial system at more than 50 per cent of GDP.

Although this growth in shadow finance reflects, to a certain extent, greater financial deepening in China, concerns have also been raised about its contribution to real economic output. Market analysis indicates that a 1 per cent increase in credit is expected to raise Chinese nominal output by only 0.3 per cent. There is some evidence of this arising from a recent survey conducted by Nomura, which shows that 20 per cent of the total financing raised by 370 of the largest urban construction debt issuances in 2012 was used in repaying existing debt.

This is indicative of rising leverage within the Chinese financial system with implications for financial stability, especially if economic performance continues to underwhelm for an extended period. Furthermore, market concerns about this rising tide of financial leverage across the system might precipitate a sudden and sharp loss of confidence, and possibly a credit crisis, if inflation rises unexpectedly, raising expectations of higher interest rates.

**Policy reforms**

Despite concerns about unexpected interest rate hikes and SAFE’s recent regulations on foreign currency lending, there is an unmistakeable trend towards greater policy reforms aimed at liberalising the Chinese financial sector and introducing greater market discipline. The Chinese central bank (the PBoC) has been at the forefront of a comprehensive set of policy reforms, ranging from widening the daily trading
band of the renminbi to greater liberalisation of market interest rates by relaxing statutory controls on money supply through reserve requirements and fixed deposit and lending rates.

Most recently, the Australian and Chinese governments announced an agreement to allow full convertibility between the Chinese renminbi and the Australian dollar, which makes the Australian dollar the third currency – after the US dollar and Japanese yen – to be fully convertible with the renminbi. This agreement is expected to lead to significant benefits to bilateral trade between Australia and China by lowering transactions costs and removing hedging risks associated with trade financing through intermediate transactions involving the US dollar.

In January 2013, the PBoC announced plans to start daily liquidity operations through the use of repurchase (repo) and reverse repurchase (reverse repo) agreements in an attempt to allow market forces to play a more dominant role in short-term liquidity management and in the setting of benchmark interest rates.

Other major policy reforms by the China Securities Regulatory Commission (CSRC) and SAFE have eased regulations to the Qualified Foreign Institutional Investor (QFII) regime in 2012.

The QFII regime specifies rules and regulations that apply to foreign institutional investors looking to invest in China’s capital market. The regime was initiated in 2003 to attract long-term portfolio investment into China’s capital markets, and has been widely used by global investors looking to gain exposure to China. A pilot program in 2012 allowed QFIIs to buy renminbi-denominated shares and fixed-income securities with offshore Chinese currency (that is, renminbi financing obtained in Hong Kong), a program that has come to be known as RQFII.

Table 2.1 QFII regime reforms in 2012

<table>
<thead>
<tr>
<th>Asset management: institutions, insurance companies, other institutions like foundations, sovereign funds, pension funds, etc</th>
<th>Circular 2006</th>
<th>Provision 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Experience requirements: above 5 years; Latest year securities assets under management/possessed: above USD 5 billion</td>
<td>Experience requirements: above 2 years; Latest year securities assets under management/possessed: above USD 5 million</td>
<td></td>
</tr>
<tr>
<td>Securities firms</td>
<td>Experience requirements: above 30 years; Paid-in capital: minimum USD 1 billion; Latest year securities assets under management: above USD 10 billion</td>
<td>Experience requirements: above 5 years; Latest year securities assets under management/possessed: above USD 5 billion</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>Experience requirements latest year ranked within world’s top 100; Latest year securities assets under management: above USD 10 billion</td>
<td>Experience requirements: above 10 years; Tier 1 capital above USD 300 million; Latest year securities assets under management: above USD 5 billion</td>
</tr>
</tbody>
</table>

These reforms indicate a notable trend towards the liberalisation of China’s financial system in order to make capital markets more liquid and deeper, which will improve market pricing and lower transaction costs. These anticipated improvements in capital-market quality are also expected to mitigate some of the risks arising from the growth of the shadow banking system. This is expected to happen largely as a result of greater competition posed by efficient, often foreign, capital-market participants equipped to undertake market-based intermediation compared with banks, which have until now relied on off-balance sheet activity to bypass regulations in search of higher margins and fees.

More liquid and deeper financial markets, complemented by the use of cutting-edge information technology (IT) and skilled finance profession-
als, are also expected to lead to greater product choice and better, more affordable financial services for savers and investors, both domestic and foreign. The reforms are important to promote financial-market development in China, which is one of the key elements of enabling the transition from external demand-driven growth to internal consumption-based drivers of economic growth.

**China’s long-term economic outlook**

Economic growth was overwhelmingly driven by investment financed through high local savings, but excessive debt finance has led to domestic imbalances and lower returns on capital. Overcoming those imbalances will now require structural reforms aimed at increasing the consumption of social services to deliver better living standards through higher educational attainment, improved health outcomes and more smoothed retirement incomes.

This is especially important given the demographic transition under way in China. China’s working-age population is expected to peak at close to one billion in the latter half of this decade, and start decreasing towards the end of the 2020s. More importantly, China’s dependency ratio is expected to rise from a low of approximately 40 per cent around 2020 to more than 60 per cent in 2050. The majority of that increase in dependency will arise from retirees in need of social services such as health care. Meeting that demand for social services will require effective financing and provisioning of such services, away from the previous focus on fixed-asset accumulation.

In addition to the need for structural rebalancing, there are concerns about environmental degradation and sustainable development in China. The government is undertaking policy measures to reduce carbon intensity and to promote green growth by committing, in the current Five-Year Plan, to establish a national carbon emissions trading system by 2015. This will follow a number of pilot provincial emissions trading schemes (ETSs) that are scheduled to begin in the fiscal year 2013-14.

Sustainable development through investment in green technologies is an important socioeconomic objective, with China already a market leader in the production of solar panels and in the promotion of green technologies. China’s continued transformation and rise as an economic powerhouse will be multifaceted and not just dependant on one set of factor endowments or policy levers.

**Implications for Australia**

China’s future economic outlook is profoundly important to Australia. China is Australia’s largest trading partner. In 2011–12, two-way trade in goods and services was close to A$130 billion, making China the largest destination for Australian exports and the largest source of imports. More specifically, Australian exports to China grew by nearly 19 per cent to A$77 billion in 2011-12, with iron ore and coal alone accounting for nearly A$50 billion in exports.

The importance of the bilateral economic relationship is not just one-way. Australia is China’s fifth-largest export market.

Not surprisingly, then, China’s recent economic slowdown has adversely impacted Australia’s economic performance, with Australia’s terms of trade falling from record highs due to moderating commodity prices as a result of waning Chinese demand. This has lowered Australia’s nominal GDP growth to below trend levels and is impacting on business and
consumer confidence. The recent slowdown may also be reflected in reduced flows of Chinese investment overseas, although this tendency will be offset to some extent by the appreciation of the renminbi.

Notwithstanding the short-term dynamics, China’s medium to long-term economic outlook is strong and will provide sustained economic benefits to both economies. There will be a further deepening of the economic relationship as China’s structural transformation, partly due to changing demographics, creates demand for services such as aged care and retirement income products, which Australia’s service providers can capitalise on to diversify their business operations into China, and Asia more generally. China’s policy reforms aimed at promoting greater portfolio investment inflows will also aid that process of structural rebalancing.

Bilateral ties will be strengthened following the recent agreement allowing full convertibility between the renminbi and the Australian dollar. This is expected to have a notable impact on bilateral trade by lowering transaction costs and removing hedging risks arising from financing trade through US dollar transactions. Overall, the economic relationship between the two economies is strong and is expected to continue strengthening, despite concerns over the relatively weak short-term economic outlook.

CHAPTER 3
CHINA’S GO GLOBAL STRATEGY: THE DILEMMA AND THE WAY FORWARD
Kong Qingjiang

The strategy

This chapter examines the history of China’s Go Global strategy and highlights the reasons some ambivalence may have emerged within China in the application of the strategy in practice. By extension, this ambivalence may also explain why the strategy has given rise to some uncertainties and misconceptions in countries to which Chinese overseas direct investment (ODI) has been directed.

The Go Global Strategy was initiated in 1999 by the Chinese Government to increase China’s ODI. It was later promulgated as part of the Outline of the Tenth Five-Year-Plan (2001–05) in 2001 and reiterated in the Eleventh Five-Year-Plan (2006–10) and the Twelfth Five-Year-Plan (2011–15), and in the Reports of the Sixteenth, Seventeenth and Eighteenth Party Congresses in 2002, 2007 and 2012 respectively.
In addition to promoting Chinese ODI, the programs launched so far by the Chinese Government have the following goals in mind: a) to convert China’s huge foreign exchange reserves into less risky tangible assets; b) to pursue product diversification; c) to improve the level and quality of the projects; d) to expand financial channels with respect to the national market; and e) to promote brand recognition of Chinese companies in overseas markets.

Since the launch of the Go Global Strategy, Chinese ODI has increased significantly, especially by SOEs. According to China’s Ministry of Commerce (MOFCOM), China’s ODI increased 8.5 per cent year-on-year to US$74.65 billion in 2011, ranking sixth worldwide. In 2012, Chinese investors invested US$77.22 billion in 4,425 enterprises in 141 countries and regions – up by 28.6 per cent year-on-year. MOFCOM predicts that ODI for 2011-15 is expected to register double-digit annual growth to reach US$560 billion, matching the figure for China’s inward-bound FDI.

Apart from seeking to achieve the objectives of the Go Global Strategy, the rise of China’s ODI can be explained variously by: a) China’s acceptance of the need to appreciate the RMB; b) the need to acquire energy, raw materials and natural resources; c) the competition for larger market share and the need to avoid barriers in foreign markets; and d) the response to government support.¹

Government support has come in the form of information and guidance. For example, in July 2004, October 2005 and January 2007 the National Development and Reform Commission (NDRC), the Ministry of Foreign Affairs (MOFA) and MOFCOM jointly issued the Guiding Catalogue of Countries and Industries for Overseas Investment. This catalogue sets out a list of preferred industry sectors in 68 countries shaped both by Beijing’s impressions of previous endeavours and by perceived prospects for future success. Investments in ‘preferred’ sectors benefit from a broad range of incentives, which include priority access to financing and foreign exchange, tax concessions and preferential customs treatment. MOFCOM is also establishing an information bank for Chinese enterprises that intend to expand overseas.

The regulatory framework for ODI

China controls the inflow of FDI by way of a variety of regulatory tools, among which industrial policy and case-by-case screening are probably the most effective. The same is true for the ODI of Chinese enterprises. The regulatory framework for ODI is primarily represented by the Administrative Measures on Overseas Investment, issued by MOFCOM in March 2009, and is characterised by case-by-case approvals for each proposed ODI project, greenfield investment or merger and acquisition.

In name, the MOFCOM has the only competence to determine whether or not to approve a proposed ODI project. In practice, however, diversified government agencies at different levels are involved in the approval process. First of all, the NDRC or its local counterpart (depending on the amount of the investor’s proposed ODI and the investor’s affiliation) must give their approval. A prerequisite for the issuance of this approval is a letter from the bank to extend the facility to the prospective investor.

Following this approval, MOFCOM or its local counterpart will examine and determine whether or not to approve the proposed ODI project. Thereafter, the approved proposed investor shall register its investment with the State Administration of Foreign Exchange (SAFE) or its local counterpart. Where the ODI is to be made by financial institutions, such investments are subject to prior approval by China’s Banking Regulatory Commission and the SAFE. Similarly, ODI investments to be made by insurance companies are subject to the prior approval of the China Insur-
The favoured position of SOEs in ODI

According to a survey on ODI by the China Council for the Promotion of International Trade (CCPIT), among the surveyed Chinese enterprises making ODI investments, private enterprises account for 57.7 per cent of the total ODI figure, state-owned enterprises for 22.7 per cent, Sino–foreign joint ventures for 10.7 per cent, wholly foreign-funded enterprises for 5.8 per cent and collective-owned enterprises for 3.1 per cent. These figures might suggest that the SOEs are more regulated than private enterprises because SASAC is involved, or are more cautious about making ODI attempts. In fact, most ODI projects have been completed by the SOEs rather than by private companies. A closer consideration of the figures provides clearer explanations as to why SOEs are favoured in making ODI.

According to the CCPIT survey, 72.8 per cent of the enterprises surveyed had obtained various kinds and degrees of assistance from governments at various levels during their ‘going-global’ process. This proportion differs for enterprises with different types of ownership. For example, 83.1 per cent of SOEs obtained various forms of assistance in various degrees from different levels of government during their going-global process, while 70.1 per cent of private firms received that assistance – 13 per cent lower than SOEs.

A number of other factors favour SOEs in making ODI. First, SOEs are able to retain a larger portion or even the whole of their after-tax profits. They can accumulate large sums of disposable money for ODI. Second, SOEs are also favoured by banks in accessing loans. Financing SOEs through state-owned or controlled commercial banks remains the most convenient way of accessing loans, because they are favoured or ultimately backed by the government. It is not uncommon for banks to be encouraged by the government to extend finance to SOEs. Third, SOEs are controlled by the State and are therefore likely to follow a government policy like the Go Global strategy, such that the requirement of SASAC approval may not necessarily pose a barrier to their ODI. And fourth, SOEs, particularly large ones, are better informed than private companies about the regulatory framework for ODI. Accordingly, the cumbersome regulatory framework may prove less discouraging to SOEs than it is to private companies.
Scrutiny of SOEs abroad

Most of China’s major overseas targets, such as the United States, the European Union, Japan and Australia, are advanced economies. They share in common a relatively liberal investment regime, which is characterised by a general openness to investment; however, without exception, broad authorities are delegated to government agencies to take action focused on the protection of national security or national interests. These concerns are presenting a major challenge for Chinese firms, both private and state-owned, in these destination countries, as revealed by a brief discussion of the regulatory environments for foreign investment in the United States and Australia. (The Australian regime is discussed in greater detail in Chapter 4.)

According to US law, the Committee for Foreign Investment in the United States (CFIUS) reviews, and occasionally recommends rejection of, foreign investments into the United States on national security grounds. Upon recommendation by CFIUS, the President may block mergers, acquisitions and takeovers that threaten US ‘national security’, provided

- the threat cannot be mitigated
- provisions of law other than the Exon-Florio Amendment and IEEPA do not provide adequate and appropriate authority for the President to protect national security.

National security scrutiny is triggered only if a foreign person acquires control over a US business and there is a nexus to US national security. In the United States, approximately 10 to 15 per cent of all FDI investment proposals are blocked.

There are factors listed in law and regulations that may help determine what is included within the national security reference. These include securing the defence industrial base, protecting critical technologies, protecting critical infrastructure (including energy assets), assuring the government and defence supply chain, and compliance with important US national security policies (counter-terrorism, nonproliferation, export controls). There has, however, not yet been a clear-cut and precise definition of the core concept of national security. In practice, additional factors are taken into consideration in determining national security concerns. These include

- US Government customers and/or access to US Government systems
- classified contracts
- proximity to sensitive assets
- law enforcement interests (for example, in data or telecom networks)
- competition (other sources of supply)
- compliance record of US company
- reputation of home country
- investor’s reputation, including for compliance
- management, including current or past ties to foreign military
- commitment/ties to US market
- business in other countries (for example, Iran)
- financing.

Interestingly, regulation is not mandatory. It requires only ‘voluntary’ joint filing by the foreign investors and the US company in question. Moreover, the regulation does not differentiate foreign entities as private or state-owned investors. In practice, however, there is a strong tendency to investigate foreign government-controlled enterprises.

Notably also, greenfield investments are not covered although joint ventures may be subject to review if the US company contribution is a business or line of business.

In Australia, a foreign investment may be rejected if it is deemed to be contrary to the national interest. The Foreign Acquisitions and Takeovers
Unlike in the United States, Australian regulation of ODI by SOEs is mandatory and covers all ODI investments made by SOEs. Moreover, in contrast with the US notion of ‘national security’, the Australian ‘national interest’ concept is ready to be used as a convenient tool to deny ODI by Chinese SOEs. As a result, Chinese SOEs have experienced more predicaments in Australia than in the United States in their ODI attempts.

Both the CIFUS of the United States and Australia’s FIRB are designed to protect their respective countries from foreign investments that are perceived to encroach on national interests, however defined. Seemingly to empower the authorities to deal with foreign influence, however, key concepts such as national security, control and foreign entities are deliberately vaguely and loosely defined, thus leaving room for interference in the economic policymaking process. Moreover, the political response in the name of national security to the surge of Chinese ODI has been far from sure-footed and often appears as a national politically populist one.

A bilateral approach to replace the Go Global strategy

The predicaments that Chinese SOEs are experiencing raise policy questions about whether their investments need to be treated in host countries differently from private investment. They are also causing China to reassess the investment climates in its major ODI destinations. Nevertheless, a reassessment does not make much sense if the follow-up action is limited to protesting against the ODI’s host country or retreating from ODI.

For China, retreating from ODI is tantamount to abandoning its Go Global strategy. This cannot be an advisable option in the long run. Should protests be made against such maltreatment? With no binding international agreements.
legal framework to govern domestic regulatory framework for FDI, China is not in a position to help its investors when they encounter predicaments resulting from the host country’s domestic regulatory framework.

Without the multilateral legal obligations on the admission of FDI, bilateral investment treaties (BITs) or free-trade agreements (FTAs) through their investment chapters are now playing an important role in binding nations with regard to FDI; however, the existing BITs are limited to providing a favourable environment for FDI. For example, there is a BIT between China and Australia; but this BIT is not instrumental for helping solve the predicament Chinese SOEs encounter in Australia. The reason appears to be that existing BITs are mostly intended to protect the position of host countries receiving FDI; they do not focus on the investors’ access to the market of host countries.

As China has become an expanding source of ODI, it is now entering a second round of BITs with other countries. In this round, BITs will aim not only to accord adequate protection for incoming FDI, but also to focus on the access of ODI to the host country’s market.

As part of the high-profile Strategic Economic Dialogue (SED) on 18 June 2008, China and the United States agreed to negotiate a BIT. If adopted, the China-US BIT will rank among the most liberalised bilateral investment pacts. The high standards adopted in this BIT will have implications for the negotiation of other Chinese BITs. A reasonable prediction is that China will follow suit or at least be willing to consider high-standard models when it is to negotiate BITs with other partners while calculating its national interests therein.

Australia is the largest single ultimate destination for Chinese ODI. Given the strong economic complementarities that exist between the two countries, it will not be surprising if Australia remains one of largest destinations for China’s ODI in the coming years. Whether Australia and China pursue the proposed China–Australia BIT or instead opt to have an investment chapter in their ongoing FTA negotiations, it is likely that the China–US BIT will be considered a blueprint. That being the case, a set of high-standard investment provisions is to be expected so as to accord national treatment to investment from the other country at the pre-establishment stage. The proposed China–Australia BIT or ongoing FTA could mandate routine consultations between Chinese and Australian authorities on the issues that are arising. This would help to facilitate scrutiny of competition, corporate governance and financial transparency issues related to investment by SOEs.

It would also be the best way to dispel the uncertainty and policy confusion that now pervades China’s ODI in Australia.

Notes


PART II
FOREIGN INVESTMENT IN AUSTRALIA

CHAPTER 4
THE AUSTRALIAN FOREIGN INVESTMENT REGIME
Malcolm Brennan

The regime

Foreign investment in Australia is regulated principally under federal legislation, including the Foreign Acquisitions and Takeovers Act 1975 (hereinafter FATA), and by the Australian Federal Government’s Foreign Investment Policy (hereinafter, the Policy).

It is a jurisdiction not simply based in legislation and relies heavily on a policy approach. The Policy purports to have legislation-like operation. This makes the process complex and difficult for investors and advisers alike to understand. The Policy is not law and certainly is not able to be read in the same way as a statute.

The Policy is published on the Foreign Investment Review Board (FIRB) web site, www.firb.gov.au The Policy is amended from time to time and is designed to assist foreign investors in determining whether their pro-
It is compulsory for a foreign person to notify the Treasurer of a proposal to acquire a substantial shareholding (that is, 15 per cent or more) in an Australian corporation valued at A$244 million or more (A$1.062 billion where the acquirer is a US investor in a non-sensitive sector) or listed Australian non-residential property trust or listed Australian urban land corporation. The thresholds are those that apply for the calendar year 2012. The thresholds are indexed on an annual basis.

An offshore acquisition by a foreign person of an interest of 15 per cent or more in a foreign target with Australian assets may fall within the scope of the FATA. If the foreign target holds assets in Australia of A$244 million or more (A$1.062 billion where the acquirer is a US investor in a non-sensitive sector) where the Australian assets are less than 50 per cent of the total assets then the foreign target is a prescribed corporation for the purposes of the FATA and the Policy. If the Australian assets are 50 per cent or more of the corporation’s global assets, the threshold changes to A$244 million (or A$1.062 billion for US investors in a non-sensitive sector) for the global assets. As a result, if the Australian Treasurer considers the proposal to be contrary to Australia’s national interest, he may make orders in respect to the proposal including prohibition or divestment orders.

In circumstances where the Treasurer’s powers may be active, voluntary notification under Section 25 of the FATA and receipt of a statement of no objections are recommended to deactivate the Treasurer’s power with respect to the proposed transaction.

The national interest test

The test applied by the Treasurer in determining whether to provide a ‘statement of no objections’ to a proposal within the scope of the regime is whether the proposal is contrary to the national interest. Proposals
Ultimately the test is determined by community attitudes of the day. It is a heavily political concept and one that in the wrong hands can cause enormous international damage to Australia and adversely impact investment flows. Care needs always to be taken to appear to be even-handed and ensuring the national interest is not adversely impacted.

**What is a foreign person?**

Many terms used in the foreign investment regime have meanings much broader than the usual understanding of the words. ‘Foreign person’ is an example. Under the regime, a foreign person is broadly defined and includes

- a natural person not ordinarily resident in Australia
- a corporation in which a natural person not ordinarily resident in Australia or a foreign corporation holds a controlling interest (15 per cent or more held solely or together with associates)
- a corporation in which two or more persons, each of whom is either a natural person not ordinarily resident in Australia or a foreign corporation, hold an aggregate controlling interest (40 per cent or more including associated holdings)
- the trustee of a trust estate in which a natural person not ordinarily resident in Australia or a foreign corporation holds a substantial interest (15 per cent or more held solely or together with associates)
- the trustee of a trust estate in which two or more persons, each of whom is either a natural person not ordinarily resident in Australia or a foreign corporation, hold an aggregate substantial interest (40 per cent or more including associated holdings).

As a result, a foreign person includes an Australian corporation that has foreign ownership. It is a common misconception that the regime may be bypassed by simply incorporating an Australian acquisition vehicle.
Acquisitions by foreign government-related entities

Proposals without any notifiable acquisitions under the FATA may nevertheless be notifiable to the Treasurer under the Policy. In particular, the Policy provides that prior approval and therefore notice are required to be given by foreign governments or their related entities, irrespective of size, in respect to

- direct investments
- acquisitions of interests in Australian urban land
- the establishment of new businesses.

A foreign government-related entity is defined by the Policy to include: a body politic of a foreign country; companies or other entities in which foreign governments, their agencies or related entities have more than a 15 per cent interest; or companies or entities that are otherwise controlled by foreign governments, their agencies or related entities.

A definition of ‘direct investment’ is provided in the Policy. The effect of that definition is that a purely passive investment by a foreign government-related entity where an interest of less than 10 per cent is acquired (and without any control elements) will not be considered to be a direct investment for the purposes of the Policy and notice is not required. Where there is any control element acquired, or the investment can be used to influence the target, or if the interest is acquired as preliminary to a takeover bid, notification must be made under the Policy irrespective of the percentage interest acquired. Further, the Policy explicitly states that a security interest is a direct investment.

The Policy has been in operation alongside the FATA since the commencement of the FATA in 1975. For all that time the Policy has consistently been applied to treat foreign government-related investment with greater scrutiny. The Policy application in this way has been the same through successive Liberal and Labor governments.

In recent times, attention has been drawn to the foreign investment regime in its application to Chinese Government-related investment in the resources sector in particular. No new policy as such was required to deal with the various investment proposals; however, Treasurer Swan saw fit to provide some transparency around the treatment of proposals under the Policy and issued the Foreign Government Investment Guidelines, which broadly require foreign government-related investors to address

- whether operations are independent from the foreign government
- whether an investor is subject to and adheres to the law and observes common standards of business behaviour
- whether the proposal could hinder competition or lead to undue concentration or control
- the impact on Australian Government revenue or other policies
- any impact on Australia’s national security
- the impact on the operations and directions of an Australian business as well as its contribution to the Australian economy and broader community.

The flexibility of the national interest test not having a definition and the regime not being precedent based allow for true case-by-case assessment; however, some direction can be obtained from recently announced approvals. The key factors to be considered include

- the diversity of ownership of Australian resources
- the appropriate separation of commercial operation of resources and their customers' interests
- development according to market-based principles
- the geographic location of assets – national security issues if they are proximate to an Australian Defence Force site
- the aggregation of assets in a concentrated area
- the retention of Australian management and other Australian connection to the assets
the maintenance of Australia as a reliable supplier.

The core concern is that any proposal by a foreign government-related entity is made on a commercial basis with understood and clear, predictable outcomes. It cannot be one made for a strategic government objective.

**Other foreign ownership restrictions**

In addition to the thresholds applicable under the FATA, the Policy reflects foreign ownership restrictions applicable under other Commonwealth legislation. Sensitive industry sectors with specific foreign ownership limits are outlined below. These sectors correspond generally to industry sectors often excluded from foreign investment in other countries – for example, the catalogue in China would exclude foreign investment in most of the same areas.

**Australian urban land**

Under the FATA, all proposals to acquire interests in Australian urban land are compulsorily notifiable regardless of the value of the transaction (save for specific exemptions provided under the FATA and the Foreign Acquisitions and Takeovers Regulations).

‘Australian urban land’ is broadly defined (in essence, all land not used for primary production purposes) and covers far more than the natural meaning of the words might suggest. Land that is vacant, semi-rural or even crown bushland is regarded as Australian urban land. For land not to be ‘urban land’, there must be a business of primary production being carried out on the land.

Interests in Australian urban land include leasehold and freehold interests, interests in land-rich companies and trusts and interests in profit-sharing arrangements relating to the use of Australian urban land.

The FATA defines an interest in Australian urban land to include

- a legal or equitable interest in Australian urban land, other than an interest under a lease or licence or in a unit in a unit trust estate
- an interest in a share in a company that owns Australian urban land, being a share that entitles the holder to a right to occupy a dwelling of a kind known as a flat or home unit situated on the land
- an interest as lessee or licensee in a lease or licence giving rights to occupy Australian urban land where the term of the lease or licence (including any extension) is reasonably likely, at the time the interest is acquired, to exceed five years
- an interest in an arrangement involving the sharing of profits or income from the use of, or dealings in, Australian urban land
- an interest in a share in an Australian urban land corporation (AULC)
- an interest in a unit in an Australian urban land trust estate (AULTE)
- if the trustee of an Australian urban land trust estate is a corporation, an interest in a share in that corporation.

An AULC is defined as a corporation where the value of its assets (or interests) in Australian urban land exceeds 50 per cent of the value of its total assets. Similarly, an AULTE is defined as a trust where the value of its interests in Australian urban land exceeds 50 per cent of the value of its total assets. The mere acquisition of a single share of an AULC, or a single unit in an AULTE, is a compulsorily notifiable event. There is an exemption for acquisitions of less than 15 per cent in a listed AULC or AULTE if the listing is on the Australian Securities Exchange and certain conditions are satisfied.
Acquisition by foreign persons of interests in residential real estate

**Developed residential real estate** (including hobby farms and rural residential blocks) that have been previously owned or occupied are considered sensitive, and proposed acquisitions by foreign persons based overseas are not normally approved except in particular, narrowly defined circumstances. (This includes an interest in a timeshare scheme, unless the interest of the foreign person and any associates in the aggregate is not greater than four weeks in any year.)

Foreign persons who are temporary residents, however, are exempt from notification of proposed acquisitions of established residential real estate for their own residence, new residential real estate and vacant residential land (for development); however, temporary residents may not purchase more than one established dwelling.

Proposals by foreign-owned companies to acquire second-hand dwellings for the purpose of providing housing for their Australian-based staff are normally approved subject to the condition that the company undertakes to sell or rent the property if it is expected to remain vacant for six months or more.

**Existing residential real estate** for redevelopment is considered on a case-by-case basis subject to various conditions, including

- the proposal must provide for an increase in the housing stock – that is, an increase in the number of dwellings (or the property must be beyond its economic life)
- the existing residence cannot be rented out prior to demolition and redevelopment
- the existing dwelling must be demolished and continuous substantial construction of the new dwellings must commence within 24 months.

**Vacant residential land for development acquisitions** (including house and land packages where construction has not commenced) is normally approved subject to the condition that continuous substantial construction commences within 24 months. With the acquisition of more than a single block of vacant land, an additional condition will apply that at least 50 per cent of the greater acquisition cost or current market value must be spent on redevelopment of the site.

**New dwellings** either off-the-plan or newly completed are normally approved provided they have not been sold or occupied for more than twelve months. (This includes dwellings that are part of a redevelopment, as discussed above.)

It comes as a surprise to many that the bulk of the FIRB’s work is in the residential land area with more than 90 per cent of applications in this category. Relevantly, China ranks as number one for country-of-origin of applications. The 2010/11 FIRB Annual Report notes Chinese applications totalled 5,033 of 10,865 applications considered. The bulk of these applicants are students acquiring temporary residences.

**Other real estate investments**

Aside from acquisitions in residential real estate, several types of acquisition will be considered to be acquisitions of interests in Australian urban land, which, unless there is an available exemption, will require prior FIRB approval.

Such acquisitions include

- the acquisition of non-residential vacant land for development (standard conditions will apply in any FIRB approval – including a five-year commencement of development condition)
The Australian foreign investment regime

Malcolm Brennan

Rural land

Under the FATA, certain acquisitions of rural land are notifiable. As of 1 January 2012, the thresholds attracting operation of the FATA in the rural sector are

- A$244 million for general investors
- A$1.062 billion for prescribed investors (US investors and soon to include New Zealand investors).

It must be noted, however, that these thresholds may be amended following the government’s release of the Foreign Investment and Australian Agriculture Report and the Senate inquiry into the national interest test – which provided its final report in June 2013. The report was commissioned to ‘consider the role and history of foreign investment in the development of agriculture in Australia, the extent of foreign ownership of Australian agricultural land and the factors driving foreign investment in Australian agriculture’.

The report considered investment by foreign governments and their related entities. It addressed public concern associated with this type of investment, including not operating solely on commercial principles, and the channelling of production through non-market avenues to home country customers.

In response to the report, the government issued a statement regarding foreign investment in rural land. This statement now forms part of the Policy. Noting the need for foreign investment in Australia’s rural industry, the Policy expressly declares that:

Without foreign capital inflows, investment in Australia would be limited, resulting in lower food production with potentially higher food prices, as well as lower employment, lower incomes in the sector and lower government revenue. Foreign investment in agriculture supports...
agricultural production, job creation and contributes to the prosperity of
rural communities and the broader Australian economy.

Further changes to this sector are likely following the release in June
2013 of the Senate inquiry into the national interest test.

**New business (foreign government-related entities only)**

The Policy provides that proposals by foreign government-related enti-
ties to establish new businesses require prior approval and therefore
should be notified to the Treasurer.

A new business includes the following

- the establishment of a business by foreign government interests not al-
  ready operating in Australia
- the establishment of a new hotel or tourist facility, a new mining or raw
  materials processing project, and a new project in the agricultural, pas-
  toral, forestry or fishing sectors even if the foreign government interest
  is already operating a similar business in Australia
- the diversification of a foreign government interest already operating in
  Australia into an activity not previously undertaken by it in Australia.

FIRB approval should be sought once the feasibility of the new business
has been confirmed and details of the proposed business are available.
The details required to successfully process a new business application
include information on the total investment proposed, what type of busi-
ness is being commenced, the structure of the business, the likely em-
ployment opportunities resulting from the new business, what products
or services will be provided and if the new business satisfies other regu-
latory requirements.

This aspect of the Policy previously applied to all foreign investors; how-
ever, the rule was relaxed in 2009 and now only applies to foreign gov-
ernment-related entities. It often comes as a surprise to foreign govern-
ment-related entities in the resources sector that not only do they need
FIRB approval for the acquisition of the mining tenement (even if from a
state government) but also further FIRB approval is required for a new
mine under the new business head of the Policy.

**Telecommunications**

Prior approval is required for foreign involvement in the establishment
of new entrants to the telecommunications sector or investment in ex-
isting businesses in the telecommunications sector. Proposals above the
notification thresholds will be dealt with on a case-by-case basis and
will normally be approved unless judged contrary to the national inter-
est.

Aggregate foreign ownership of Telstra is restricted to 35 per cent of the
privatised equity (including instalment receipts), and individual foreign
investors are only allowed to acquire a holding of no more than 5 per
cent of the privatised equity.

**Shipping**

The *Shipping Registration Act 1981* requires that, for a ship to be regis-
tered in Australia, it must be majority Australian owned (that is, owned
by an Australian citizen, a body corporate established by or under law of
the Commonwealth or of a state or territory of Australia), unless the ship
is designated as chartered by an Australian operator.
Civil aviation

Domestic services
Foreign persons (including foreign airlines) can generally expect approval to acquire up to 100 per cent of the equity in an Australian domestic airline (other than Qantas), unless this is contrary to the national interest.

International services
Foreign persons may acquire up to 49 per cent of the equity in an Australian international carrier (other than Qantas) individually or in aggregate, provided the proposal is not contrary to the national interest. In the case of Qantas, total foreign ownership is restricted to a maximum of 49 per cent in aggregate, with individual holdings limited to 25 per cent and aggregate ownership by foreign airlines limited to 35 per cent. A number of national interest criteria must also be satisfied, relating to the nationality of board members and operational location of the enterprise.

Airports
Foreign investment proposals for acquisitions of interests in Australian airports are subject to case-by-case examination in accordance with the standard notification requirements. In relation to the airports previously owned by the Commonwealth, the Airports Act 1996 (Cwlth) stipulates a 49 per cent foreign ownership limit. There is also a 5 per cent limit on ownership by airlines of airport-operator companies for those airports. Additionally, there is a 15 per cent limit on cross-ownership for Sydney (including Sydney West), Melbourne, Brisbane and Perth airports.

Media
The Policy provides that all foreign persons, including US investors, need to notify the government and receive prior approval to make investments of 5 per cent or more in the media sector, regardless of the value of the investment. Such investments will include equity interests as well as purely economic interests such as swaps.

Banking and insurance
Foreign investment in the banking sector must be consistent with the Banking Act 1959 (Cwlth), the Financial Sector (Shareholdings) Act 1998 (Cwlth) (hereinafter FSSA) and banking policy, including prudential requirements. The FSSA covers financial-sector companies, which includes banks, authorised deposit-taking institutions, authorised insurance companies and holding companies of all such entities.

Essentially, the FSSA prohibits the acquisition of a stake in a financial-sector company in excess of 15 per cent without the Treasurer’s approval. Under the FSSA, notice is required where a 15 per cent or more voting interest is proposed to be acquired in a ‘financial sector company’. A holding of a 15 per cent or more voting interest in the absence of the Treasurer’s approval is an ‘unacceptable shareholding situation’.

A financial-sector company is defined to be an authorised deposit-taking institution, an authorised insurer or a holding company of either. There is no dollar threshold.

Any proposed foreign takeover or acquisition of an Australian financial-sector company will be considered on a case-by-case basis and judged on its merits. Acquisitions of interests by US investors in financial-sector companies as defined by the FSSA are exempt from the FATA (but the FSSA continues to apply).

The government will permit the issue of new banking authorities to foreign-owned banks where the Australian Prudential Regulation Author-
Dispelling misconceptions and myths

This section examines and dispels six common myths about Australia’s foreign investment regime. These myths are

1. that the FIRB is the decision-maker
2. that Chinese investment is not welcome
3. that Treasurer Swan created the Policy requirement for foreign government notification in 2008
4. that there is a 49 per cent limit for foreign government investment
5. that the FIRB is a roadblock to investment
6. that notice is required once the 40 per cent threshold is reached.

Myth number one: ‘The FIRB is the decision-maker’

There is a common belief that the FIRB is the ultimate decision-maker when it comes to assessing applications under either the FATA or the Policy; however, this is not the case.

The FIRB is an advisory board whose main functions include

• examining proposals and assessing them against the requirements of the regime
• making recommendations to Treasury on each proposal
• advising the government on foreign investment matters generally
• monitoring and ensuring compliance with the Policy.

The FIRB advises the Treasurer and it is the Treasurer who is ultimately responsible for making a final decision on each application.

As noted above, the FIRB is an administrative body with no statutory existence but its role is confirmed by the Policy. Further, all decisions by the Treasurer relating to a foreign investment proposal are underpinned by analysis and recommendation by the FIRB.
Myth number two: ‘Chinese investment is not welcome’

In the midst of tabloid reporting and ‘shock-jock’ journalism that has whipped up public concern about Asian investors ‘buying up big’ in resource-rich nations, there has developed a misconception that foreign investment, and particularly investment from China, is unwelcome in Australia. Historically, Australia has welcomed, and in fact relied upon, foreign investment and this position has not changed.

Over recent months, the government has been at pains to assure foreign, and especially Asian, investors that the FIRB process is not a roadblock to investment in Australia and that investment from China is very much welcomed.

Openness to investment from China is reflected in the FIRB’s Annual Report for 2010/11. Between 2008 and 2011, China was consistently ranked in the top three sources of proposed investment by value. Over the previous five years, Chinese investment has increased substantially, with the Australian Government approving more than A$70 billion worth of Chinese investment during this time. As noted above, China ranks number one in terms of applications.

Whilst the Federal Opposition Leader has been quoted negatively in respect to the acquisition of Australian businesses by state-owned enterprises, his speech does note ‘that dozens of investments are approved often with conditions’. This may signal that the current process will continue under an Abbott government with conditions being applied to approvals to ensure proposals remain consistent with the national interest.

Myth number three: ‘Treasurer Swan created the policy requirement for foreign government notification in 2008’

The requirement for notification by foreign government-related entities of their investments with an Australian connection was not established under the current government or by Treasurer Swan. In fact, the requirement, in different iterations, has been in place for more than 30 years.

Both the Policy and the FATA were introduced in 1975 when the government of the time made a commitment to formalise Australia’s foreign investment policy.

Since their introduction in 1975, both the Policy and the FATA have gone through a number of changes. Originally the Policy was far more restrictive than it is today and included a net economic benefit test and a minimum level of Australian equity participation in some industry sectors such as mining.

The Policy has always required notification by foreign government-related entities of their investments. In recent times, the Swan guidelines and the definitions of a ‘foreign government-related entity’ and ‘direct investment’ have provided transparency to the regime. Unfortunately, the intent to provide transparency was misread as a new approach to foreign government investment and in particular Chinese investment. Treasurer Swan’s press release did note that the Policy has been in place through successive governments; however, this was missed by most commentators.

Myth number four: ‘49 per cent limit for foreign government investment’

This myth originally has the form of a 49 per cent limit on greenfield investment and a 15 per cent limit on major miners. There is no such limit. As outlined above, the only hard 49 per cent aggregate limit on foreign ownership is in the aviation sector. The foreign investment regime does not impose such a limit.
The myth arose following poor reporting of a response to a question put to a former FIRB executive member, Patrick Colmer, at an Australia-China Business Council lunch in late September 2009. When asked what the FIRB’s comfort levels are, Colmer responded that up to 15 per cent in major miners and up to 49 per cent in greenfield projects did not normally give rise for concern. These remarks were reported as signalling a change in approach and became the myth that there are hard limits, which is not the case.

All matters are assessed on a case-by-case basis. Proposals involving substantial interests, even up to 100 per cent, are approved and are subject to appropriate scrutiny.

**Myth number five: ‘the FIRB is a roadblock to investment’**

It is commonly believed that the FIRB is a significant roadblock to investment and that a large proportion of applications are rejected; however, a quick look at the 2010/11 FIRB Annual Report setting out the statistics for recent approvals addresses this myth.

In 2010/11, some 10,293 applications were approved and there were only 43 rejections out of 10,865 applications considered (the remainder were withdrawn or considered exempt). Of the 43 rejected, 42 were in the real estate sector. In 2011 the sole business proposal to be rejected was the proposed A$8.4 billion takeover of the Australian Securities Exchange by the Singapore Stock Exchange. That rejection was not based on foreign government-related entity concerns. The previous commercial proposal rejected was the Shell bid for Woodside ten years earlier.

The FIRB’s approval proportion is 99.9 per cent. Whilst some matters may be subject to conditions to ensure consistency with the national interest, the vast majority of commercial proposals are approved on an unconditional basis. The comments of Tony Abbott perhaps signal a change to more conditional approvals, but we will need to see the final policy position of the likely incoming government.

**Myth number six: ‘Notice is required once the 40 per cent threshold is reached’**

Under the FATA, an entity will be considered a ‘foreign person’ when 40 per cent or more is owned by two or more foreign persons in aggregate. For example, if an entity is 38 per cent owned by foreign persons (in aggregate), an acquisition of a 3 per cent interest in the entity by a new foreign investor will result in that entity becoming a foreign person for the purposes of the foreign investment regime.

There is a common belief that (using the example above), the new foreign investor acquiring the 3 per cent interest will be required to submit a FIRB application for that acquisition; however, this is not the case. The consequence of the transaction in terms of the FIRB, is that the target entity will, following the additional investment, become a foreign person under the FATA. As a result, that entity will now be subject to the FATA in respect to future activities that it undertakes.

The investor acquiring the 3 per cent interest is not under any obligation to acquire FIRB approval for the transaction, assuming no other requirements under the foreign investment regime need to be satisfied. The notification requirement applies where a substantial interest – 15 per cent or more – is acquired. There is no obligation to notify of an aggregate substantial interest coming into existence.
**Conclusion**

There have been many misunderstandings of Australia’s FDI policy as the discussion relating to the various myths shows. Australia’s FDI policy is open and seeks to facilitate FDI; however, it is necessary that foreign investors consider the rules and the policy that apply to the proposed investment. Contrary to some suggestions, the rules are well established, going back to the 1992 booklet mentioned earlier. The policy is also well established and available on the FIRB’s web site.

The lack of a definition in the national interest test provides flexibility and allows for a true case-by-case analysis. This approach means that foreign investors need not only examine the rules and the Policy relating to FDI but they also need to take care in structuring a proposed transaction. A checklist of factors to be considered in this regard is set out in Table 4.1 on the following page.

**Table 4.1 Checklist of factors to consider in structuring transactions**

<table>
<thead>
<tr>
<th>Factor</th>
<th>Other Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Degree of State ownership</td>
<td></td>
</tr>
<tr>
<td>Governance structures in place – how management/board appointed</td>
<td></td>
</tr>
<tr>
<td>Industry structure in Australia for target</td>
<td>Ensuring diversity of ownership in the industry</td>
</tr>
<tr>
<td></td>
<td>Objective that Australia is a reliable supplier to its trading partners</td>
</tr>
<tr>
<td></td>
<td>Query if any national security issues</td>
</tr>
<tr>
<td>Is the acquirer a customer of target</td>
<td>Ability to influence/be involved in/have access to pricing information</td>
</tr>
<tr>
<td>Degree of ownership of target</td>
<td>15% / 50% /100% are the main trigger points for regulatory scrutiny</td>
</tr>
<tr>
<td></td>
<td>Commitment to return target to Australian ownership over time is attractive to the Treasurer</td>
</tr>
<tr>
<td></td>
<td>Size of transaction</td>
</tr>
<tr>
<td>Target board composition</td>
<td>Minority/majority board representation</td>
</tr>
<tr>
<td></td>
<td>Chairman casting vote</td>
</tr>
<tr>
<td></td>
<td>Composition of sub-committees</td>
</tr>
<tr>
<td>Target management arrangements</td>
<td>Will Australian management be maintained</td>
</tr>
<tr>
<td></td>
<td>Degree of involvement in management</td>
</tr>
<tr>
<td></td>
<td>Commitment to maintaining management activities/head office in Australia</td>
</tr>
<tr>
<td>Business activities</td>
<td>Commitment to develop resources</td>
</tr>
<tr>
<td></td>
<td>Development according to market based principles</td>
</tr>
<tr>
<td></td>
<td>Commitment to Australian employees</td>
</tr>
</tbody>
</table>
Introduction

This chapter reviews a number of Chinese investments in Australian companies over the period 2003-2012. The chapter seeks to provide readers firstly with a clearer idea of the full extent of Chinese investment directly into Australian corporations and secondly, with some insights into the different forms that such investment takes. The Chinese investments reviewed here range from the provision of finance and participation in joint ventures and partnership agreements to the acquisition of major shareholdings in public listed companies. The acquisition of major shareholdings may result in seats on the board, or ownership and control of a target company.
With corporate control may come also the control of significant corporate assets. The chapter provides a basic outline of the structure of both successful and unsuccessful transactions to date. The objective of this review of transactions is to reach some conclusions as to what has worked and what investors might learn from past mistakes in negotiating and structuring future transactions.

**Review of successful transactions by Chinese companies investing in Australia**

**Joint ventures and partnerships between Australian and Chinese companies**

**GCL Projects joint venture with Linc Energy**

GCL Projects Limited (GCL) is to form a joint venture with Linc Energy Limited (ASX: LNC) to commercialise underground coal gasification to gas to liquids in China with the first multi-gasifier project. GCL is a subsidiary of Golden Concord Holdings Limited, which has interests in power generation, and coal and poly-silicon production. One of its other subsidiaries is GCL-Poly Energy Holdings Limited, which is listed on the Hong Kong Stock Exchange. LNC will hold 33 per cent of the joint venture and GCL will hold 67 per cent.

LNC is the global leader in underground coal gasification. GCL will provide US$15 million in working capital to the joint venture in three equal instalments over the first three years of the joint venture, and have the principal obligation to arrange CAPEX funding of the commercial projects the joint venture undertakes in China via debt and other structures. LNC will have minimal balance sheet exposure whilst maintaining ownership of 33 per cent of the commercial projects.

GCL has also agreed to subscribe for an approximate 5 per cent interest in LNC for A$120 million, constituted by a 2.5 per cent first tranche on execution of the joint-venture contract suite and a further 2.5 per cent tranche on the successful completion and commissioning of operations at the first site in China.

LNC will grant an exclusive licence to the joint venture for the use of its intellectual property (IP) in China. It will continue to hold and control the core IP and knowhow, with IP developed by the joint venture to be jointly owned by the joint venture and LNC having exclusive use of the jointly owned IP outside China.

**China United Coalbed Methane Corporation Limited – CSIRO**

In April 2011, China United Coalbed Methane Corporation Limited (CUCBM) announced an A$10 million partnership with the Australian Government’s Commonwealth Scientific and Industrial Research Organisation (CSIRO).

The partnership will investigate the development of low-emission coal technology – specifically, the underground storage of carbon dioxide and methane extraction. The partnership allows CSIRO to expand its project-demonstration work in China, and to utilise CUCBM’s drilling expertise. CUCBM is a state-owned Chinese company working on exploring and developing coal-bed methane production. The project will be demonstrated in Shanxi Province, China.
Takeovers subject to FIRB and Chinese regulatory approval

Zijin Mining Group – Norton Gold Fields

This unsolicited takeover proposal was announced in April 2012. The proposal is subject to a number of conditions including due diligence investigations, FIRB approval, Chinese regulatory approvals and Zijin achieving at least a 50.1 per cent minimum relevant interest in Norton’s shares.

Under the proposal, the shareholders of Norton Gold Fields Limited (ASX: NGF) are to receive a total of A$0.27 per share comprising an offer price from Zijin Mining Group Company Limited of A$0.25 cash per share and a special dividend of A$0.02 per share. Zijin is currently in the process of a takeover of all remaining shares from existing shareholders of NGF.

Zijin is China’s largest gold producer; it produced around 2.2 million ounces of gold in 2010 and holds interests across other commodities including copper, lead, zinc, iron ore and tungsten. Zijin currently holds a 16.98 per cent share in Norton. Norton is a mid-tier, unhedged gold producer with annual production in excess of 150,000 ounces. Norton holds mining and exploration leases in Western Australia’s Goldfields region, with an extensive tenement package spanning an area of 693 sq km.

Acquisitions of Australian Land

White Horse Group – Lindeman Island

In April 2012, White Horse (Australia) Holdings Proprietary Limited (White Horse) purchased Lindeman Island for A$12 million. This sale represented the first Queensland island asset to be acquired by an entity with direct links to the Chinese market. It also represented a significant drop in the purchase price originally paid for the investment by its previous owners, Club Med. Club Med shut the resort island in January 2012 due to poor visitor numbers. White Horse has announced that its intention is that the Lindeman Island development will be run by a professional resort management company.

White Horse has strong ties to the White Horse Group, one of China’s best-known advertising and media companies. Since 2009, the White Horse Group has invested in the Chinese real estate market and overseas mining projects. Lindeman Island is a 584 ha leasehold island located on the Great Barrier Reef approximately 40 minutes by air from Cairns International Airport.

Compulsory downstream acquisition of an Australian company

Taurus Minerals – Kalahari Minerals

Taurus Minerals (Taurus), a subsidiary of the state-owned entity China Guangdong Nuclear Power Holding (CGNPC), has announced an unconditional cash offer to acquire all the shares of UK-listed company Kalahari Minerals. Kalahari has interests in uranium, gold and copper in Namibia. The acquisition of Kalahari was only the second acquisition of a UK-listed company by a Chinese state-owned enterprise. The deal is valued at A$937 million. When this acquisition became unconditional it triggered Taurus’s takeover of Extract Resources (below), in which Kalahari held a 42.5 per cent stake. Regulatory authorities in China, the United Kingdom and Australia have all indicated their approval of these transactions.

Taurus Minerals – Extract Resources

This transaction followed on from the announcement of the takeover by Taurus of the UK-listed company Kalahari Minerals plc. Kalahari Minerals held 42.5 per cent of the Australian company Extract Resources.
Under the *Australian Corporations Act*, Taurus was required in these circumstances to make a separate ‘downstream’ takeover offer to all shareholders of Extract Resources. The total value of the deal was A$2.2 billion.

Taurus announced an offer to acquire the Australian-owned Extract Resources (ASX: EXT) at A$8.65 per share. This increased Taurus’s shareholding from its current 42.74 per cent to more than 90 per cent. On 29 March 2012, Taurus issued a notice of compulsory acquisition of Extract Resources and subsequently the shares were suspended from quotation. Extract Resources has rights over the world’s fourth-largest uranium deposit, located in Namibia. The Namibian Government has given its approval.

Taurus sought relief from the Australian Securities and Investments Commission (ASIC), which required Taurus to proceed with an off-market takeover offer to all shareholders of Extract Resources within four weeks of Taurus having received acceptances of the Kalahari offer in respect of more than 50 per cent of the voting rights in Kalahari.

**Acquisitions via a scheme of arrangement and Australian subsidiary**

**Yanzhou Coal – Felix Resources Limited**

Chinese Shandong-based Yanzhou Coal Mining Company Limited (SEHK: 1171) entered into a binding Scheme Implementation Agreement dated 13 August 2009 with Brisbane-based Felix Resources Limited (ASX: FLX), agreeing to acquire 100 per cent of Felix shares. The Felix directors unanimously recommended the scheme to Felix shareholders. Upon completion of the scheme, Felix shareholders were entitled to receive a cash payment of A$16.95 for each Felix share held and cash dividends totalling A$1 per share.

The requisite regulatory and shareholders approvals were obtained from the FIRB and from the relevant Chinese agencies. The FIRB gave conditional approval and required Yanzhou Coal to give the following undertakings:

- that the company would operate Australian mines via its wholly owned subsidiary Yancoal Australia
- that Yanzhou would list Yancoal Australia on the ASX by 2012 and reduce its holding to 70 per cent or less
- that Yanzhou would ensure Yancoal’s CEO and CFO principally reside in Australia
- that Yanzhou would hold a majority of Yancoal’s board meetings in Australia
- that coal extracted from Australian mines would be marketed on arm’s-length terms in line with international benchmarks.

**Yanzhou Coal – Premier Coal (from Wesfarmers)**

In September 2011, Yanzhou Coal announced plans to acquire all the shares of Australian company Premier Coal, a subsidiary of Wesfarmers. The deal was valued at A$296.8 million. The Premier Coal mine in Western Australia annually produces around 3.5 million t of coal, and is one of the few major coalmines in Western Australia. This interest is only managed by Yancoal Australia on behalf of Yanzhou Coal and is not owned by Yancoal Australia.

The FIRB required an undertaking from Yanzhou Coal that its economic ownership of Premier Coal be reduced to less than 70 per cent by the end of 2013.
Yanzhou Coal – Syntech Resources

Yanzhou Coal acquired Syntech Resources Proprietary Limited in August 2011, in a deal valued at US$202.5 million. For this price, Yanzhou acquired large thermal coal exploration and production assets. The coal is sold to electricity-generating companies in the Asian region. These consist of coal resources valued at A$1 billion. Again, this interest is only managed by Yancoal Australia on behalf of Yanzhou Coal.

The FIRB required an undertaking from Yanzhou Coal that its economic ownership of Syntech Resources is reduced to less than 70 per cent by the end of 2013.

Yanzhou Coal – Ashton Project

Yanzhou Coal, through Yancoal Australia, acquired a further 30 per cent stake in the Ashton Coal Project in August 2011, in a deal valued at US$250 million. This added to the 60 per cent stake Yanzhou already had as a result of its 2009 takeover of Felix Resources, taking its total stake to 90 per cent. The Ashton Coal Mine is now owned by the listed company Yancoal Australia.

The Ashton Coal Project is a NSW coalmine producing more than 6 million t of coal per year.

Yanzhou Coal – Gloucester Coal

Gloucester Coal (ASX: GCL) and Yanzhou Coal proposed a scheme of arrangement to merge Gloucester Coal with Yanzhou Coal’s Australian subsidiary Yancoal Australia. Under the merger proposal, Gloucester Coal shareholders will hold 22 per cent of Yancoal and Yanzhou Coal will hold the remaining 78 per cent. The scheme became legally effective on 27 June 2012. Gloucester Coal had a market value of A$1.43 billion, but the deal is estimated to be worth at least A$2 billion. The implied offer was A$10.16 per share. Gloucester Coal delisted from the ASX on 11 July 2012, and Yancoal Australia was subsequently listed on the ASX on 28 June 2012. This transaction created Australia’s largest listed pure-play coal company and resulted in the first large Chinese state-controlled company listed on the ASX.

Yancoal Australia plans to sell 25 million t of coal per year by 2016.

Supply contracts, financing arrangements and joint ventures

China National Offshore Oil Company (CNOOC) – Exoma Energy

In 2010, China National Offshore Oil Corporation (CNOOC) made an A$50 million strategic investment in Exoma Energy’s (ASX: EXE) Queensland coal seam gas (CSG) and shale gas projects, acquiring a 50 per cent interest in a joint venture on all five of Exoma’s large Central Queensland tenements. Exoma granted CNOOC an option to acquire 86.6 million shares at 31.5 cents per share.

An aggressive coal seam gas and shale gas exploration program is planned for Exoma’s 26,840 sq km of acreage with Gas In Place.

The total amount of the deal was estimated to be A$78 million.

New Energy Investment (CNOOC) – Altona Energy

New Energy Investment, a wholly owned subsidiary of CNOOC, entered into a joint venture with Altona Energy to complete a feasibility study into the proposed commercialisation of the Arckaringa coal-to-liquids and power project in South Australia. The joint venture is valued at A$40 million and was announced in June 2009 and executed in October 2010. Altona Energy is listed on the London Stock Exchange.
**China National Offshore Oil Corporation (CNOOC) – BG Group**

In March 2010, China National Offshore Oil Corporation (CNOOC) signed a liquefied natural gas (LNG) sales contract with BG Group Limited for the supply of 3.6 million t per annum of LNG over a 20-year period. Under the contract, CNOOC is to be supplied with LNG manufactured at the Queensland Curtis LNG Facility in Queensland. In addition, BG Group may also supply CNOOC from BG Group’s global LNG portfolio.

**Anshan Iron & Steel – Gindalbie Metals Limited**

A share placement was proposed by Anshan Iron & Steel Group Corporation (Ansteel), comprising 190.7 million shares at A$0.85 per share in November 2008. The total consideration paid was A$162.1 million. Ansteel increased its total shareholding from 12.6 per cent to 36.28 per cent. The issue price represented a 105 per cent premium to the closing price of Gindalbie (ASX: GBG) shares on 31 October 2008.

This share placement received Gindalbie shareholders’ approval in February 2009 and was completed in July 2009.

**Chinese bank finance for Karara Mining Limited**

China Development Bank (CDB), Bank of China (BOC), Agricultural Bank of China (ABC) and Industrial and Commercial Bank of China (ICBC) are participating banks in a twelve-year, US$1.39 billion loan facility for the Karara Iron Ore Project in Western Australia. The Karara Iron Ore Project is being developed by Karara Mining Limited, a 50/50 joint venture between Gindalbie Metals Limited and Ansteel.

The facility is secured against the Karara Project and the shareholders’ shares in Karara Mining Limited and, during the construction phase of the project, is severally guaranteed by Gindalbie (ASX: GBG) and its joint-venture partner, Ansteel. Ansteel is China’s second-largest steel producer and the biggest iron ore miner.

**Acquisition of OZ Minerals by China Minmetals**

Possibly the best publicised successful acquisition of an Australian company by a Chinese investor was the acquisition of OZ Minerals by China Minmetals. The acquisition has been judged a significant business success story. In Chapter 6, Gao records the reflections of senior China Minmetals executives on this transaction.

In February 2009, China Minmetals Non-ferrous Metals Company Limited and OZ Minerals Limited (ASX: OZL) entered into a Scheme Implementation Agreement for the proposed acquisition through a scheme of arrangement of a 100 per cent stake in OZ Minerals by Minmetals at a cash price of 82.5 cents per share.

FIRB approval was, however, not initially granted to Minmetals for the 100 per cent acquisition of OZ Minerals on Australia’s national interest grounds, as the proposed transaction included the ‘Prominent Hill’ mine located in the Woomera Prohibited Area in South Australia. This is an example of the application of the national interest test considered in Chapter 4. For some reflections by Chinalco executives on this transaction and the FIRB process, see Chapter 6. An interim order was issued on Minmetals’ FIRB application on 23 March 2009.

Following the issue of the interim order, several alternative proposals were considered before the original proposal was amended to provide for the acquisition by Minmetals of certain assets of OZ Minerals amounting to A$1.75 billion. The revised proposal excluded assets associated with the Prominent Hill mine. FIRB approval for the revised proposal was granted on 23 April 2009. The sale of assets to Minmetals was completed on 17 June 2009.
A difficult case: Chinalco’s shareholding in Rio Tinto plc

In February 2008, the acquisition on the London exchange of a 12 per cent shareholding in Rio Tinto plc by the Chinese SOE Chinalco (the Aluminium Corporation of China) attracted a great deal of international publicity. Chinalco and US-based Alcoa purchased about 12 per cent of outstanding shares in Rio Tinto plc in the open market for more than US$14 billion in February 2008. At the time, it was the largest foreign investment made by a Chinese entity. The shares were purchased from a number of investors in Rio Tinto at US$118 per share, around a 20 per cent premium to Rio Tinto’s closing price on 31 January 2008. Approximately one-third of the company’s global assets are located in Australia and 40 per cent of the company’s revenues derive from those assets.

For Chinalco, the acquisition was strategically successful in that it thwarted a possible takeover of Rio Tinto by BHP Limited. This takeover might have presented difficulties for Chinalco through consolidating the market power of two very significant global suppliers. The acquisition was also successful in relationship-building in that it led to Chinalco undertaking a long-term joint venture with Rio Tinto in Guinea. At the same time, the Chinalco acquisition in Rio Tinto plc also demonstrated very publicly the complications arising from a share acquisition on the UK market that might potentially affect dealings in the company’s Australian assets and thus, in the application of the FATA by the FIRB.

In the middle of 2008, a voluntary application was made to the FIRB seeking the Australian Treasurer’s approval for Chinalco increasing its shareholding in Rio Tinto through the acquisition of convertible bonds to 14.9 per cent. The need for approval by the Australian Treasurer arose from the unusual complexities in this proposal. The initial 12 per cent acquisition of shares in Rio Tinto plc (the UK arm of Rio Tinto listed on the London and New York stock exchanges) was made on the London exchange; however, the company’s Australian arm, Rio Tinto Limited, was listed on the Australian Stock Exchange and significant mining assets are located in Australia. Chinalco’s direct acquisition in Rio Tinto plc, and its proposed acquisition of convertible bonds in Rio Tinto Limited, meant that cross-voting by each arm of Rio Tinto on decisions about Australian assets was likely to be complicated. Further, Chinalco was pressing for two seats on the Rio Tinto board at the time, enabling Chinalco to influence Rio Tinto’s decisions on its Australian assets.

On 24 August 2008, the Australian Treasurer announced his approval of an investment by Chinalco of up to 14.99 per cent in Rio Tinto on the basis of enforceable undertakings by Chinalco not to seek board positions.

In February 2009, Chinalco announced that, subject to regulatory approvals, it would enter into a strategic partnership with Rio Tinto Limited. The proposed deal included the sale of US$12.3 billion of Rio’s assets and Chinalco paying US$7.2 billion for convertible bonds that, once converted to shares, would increase its stake in Rio Tinto from 9.3 per cent to 18.3 per cent. In March 2009, the Treasurer issued an interim order extending the review period for 90 days; however, on 5 June 2009, Rio Tinto terminated its agreement with Chinalco and five days later Chinalco withdrew its application from the FIRB.

Review of unsuccessful transactions

There have been a number of unsuccessful transactions that are also worth reviewing so that similar transactions might be better formulated or structured in the future. Some transactions have not succeeded because of commercial considerations. The proposed CRM/UMC investment in RIM Capital Limited, the Bright Food Group’s attempted takeover of CSR Limited and Sinochem’s offer for Nufarm all appear to be examples of transactions that did not proceed for largely commercial reasons.
In other cases, however, it is possible to see that Chinese investors may have encountered difficulties in understanding and complying with the Australian legal and regulatory regimes. The proposed takeover of Lynas Corporation Limited by CNMC may have been such a case. In this case, the additional undertakings required by the FIRB would have required CNMC to reduce its proposed ownership to less than 50 per cent and the number of proposed CNMC board positions to less than half of the board. CNMC was not prepared to do this.

On other occasions, difficulties have arisen for Chinese investors in obtaining timely approval in China for offshore investments, delaying investments that are subject to regulatory approval conditions. The same conditions may not be required of investors from other jurisdictions. This seemed, in part, one of the difficulties for the Zijin Mining Group in completing its pre-bid offer to major shareholder Xstrata, when seeking to complete an implementation agreement to acquire shares in Indophil Resources NL.

Finally, some problems have also arisen because of language and cultural issues. Language barriers and lack of experience may give rise to difficulties in negotiating deals. In implementing deals problems have arisen because there is often no pre-existing relationship between the Chinese acquirer and Australian targets. There may also be no real cross-cultural integration strategies, or strategies to manage expatriate and foreign staff.

**Bright Food Group – CSR Limited**

China’s state-owned Bright Food Group attempted to takeover the sugar and renewable energy business of Australian company CSR (ASX: CSR). The proposed deal was worth A$1.65 billion, but the transaction did not proceed. Despite determination from the Bright Food Group, CSR opposed the takeover and refused engagement.

The sugar and renewable energy business of CSR (Sucrogen) was ultimately acquired by Wilmar Foods from Singapore for A$100 million more than the offer made by Bright Foods.

**Zijin Mining Group – Indophil Resources**

Zijin Mining Group Company Limited (Zijin) executed a definitive implementation agreement with Indophil Resources NL (ASX: IRN) to acquire all of the issued shares in IRN for A$1.28 per share. The offer valued IRN’s share capital at approximately A$545 million.

Zijin also entered into a pre-bid acceptance deed with IRN’s largest shareholder, Xstrata, in respect of Xstrata’s 19.9 per cent shareholding. The offer was subject to conditions including Zijin obtaining at least 90 per cent interest in IRN’s shares and the completion of the acquisition by IRN of the 3.27 per cent operating interests in Sagittarius Mines Incorporated held by Alsons Corporation.

On 12 July 2010, the period of the offer expired with several unfulfilled and unwaived conditions, including the failure to receive Chinese regulatory approval. Zijin had extended the offer three times.

**CRM/UMC – RIM Capital Limited**

China Railway Materials Commercial Corporation Group (CRM) and United Minerals Corporation NL (ASX: UMC) jointly agreed to make a direct A$27.2 million equity investment into RIM Capital Limited (ASX: RMC).

This investment was subject to CRM and UMC entering into a long-term iron ore off-take agreement covering 3 million t per annum for ten years of future production from UMC’s railway project in Western Australia and also Chinese and Australian regulatory approvals.
Sinochem – Nufarm

Sinochem, one of China’s largest corporations, attempted a takeover bid against Australian agrichemicals operator Nufarm Limited in September 2009. The bid, valued at A$2.8 billion, did not proceed. Nufarm brought an abrupt end to a year of informal and formal takeover negotiations with Sinochem at the end of 2009. Nufarm subsequently received a partial offer from Japanese company Sumitomo, which it accepted. Sumitomo now owns a 23 per cent interest in Nufarm.

CNMC – Lynas Corporation Limited

China Nonferrous Metal Mining Group Company Limited proposed to acquire 700 million shares, representing a 51.6 per cent stake in Australian rare earths miner Lynas Corporation Limited (ASX: LYC) for A$252 million at A$0.36 per share, announced on 1 May 2009.

CNMC and Lynas entered into a binding heads of agreement whereby CNMC would provide full funding for the Lynas rare earths project. The total capital provision to Lynas was to be more than A$500 million. The Lynas board was to expand to eight directors to include four directors appointed by CNMC.

CNMC terminated the deal on 24 September 2009 as a result of additional undertakings sought by the FIRB, which included reducing the proposed percentage ownership to be held by CNMC to below 50 per cent and reducing the number of board director positions to be held by CNMC to less than half of the board.

Huawei Technologies – NBN

In late 2011, Huawei was advised by the Australian Government that it should not tender to the National Broadband Network (NBN) as it would not be successful. The Australian Government stated that in blocking the awarding of any NBN contracts to Huawei it was acting on advice from Australian security services to protect the integrity of a key national communications network.

The decision does not mean that Huawei or other Chinese vendors are excluded from the Australian market. Quite the opposite; Huawei has been very successful recently in winning key contracts with other telecommunications providers in Australia. And the Australian Government has not legislated to ban this development; however, the decision has shown that in making determinations, national security issues may be an influential factor for the Australian Government.

Conclusion

The cases outlined above suggest that there are some identifiable reasons for investment transactions not succeeding. Dealing with a different legal and regulatory landscape in Australia may partly explain unsuccessful transactions; however, language and cultural differences play a part in understanding and negotiating new deal structures. Moreover, problems understandably arise in the implementation of deals if there is no pre-existing relationship with Australian targets and there are no strategies for dealing with cross-cultural integration and the management of expatriate staff. These are areas in which improvement seems
achievable. They are also areas that are fundamental to improved continuing investment relations between Chinese and Australian investors.

In many major transactions, Chinese SOEs and their subsidiaries have shown themselves adept in Australian and international market techniques and practices. They have demonstrated sophistication in seeking out and acquiring influential or controlling shareholdings in small Australian companies, which are then used as vehicles to acquire stakes in much larger companies. Chinese SOEs may use subsidiaries domiciled in the United States or Hong Kong to acquire shareholdings in Australian companies. They may use private equity funds and other collective investment vehicles to avoid negative media coverage. The various acquisitions by Yanzhou Coal and its Australian representative company (Yancoal) suggest a sophisticated understanding of the FIRB’s conditional undertakings.

The cases reviewed in this chapter also provide some sense of the ways in which FIRB approvals may incorporate conditions that have an impact upon the structuring of transactions. These conditions may serve to diversify ownership, separate the commercial resources operation and the interests of the investing customer or take account of sensitive geographical locations and national security issues. When imposed, such conditions have reflected the considerations required to be taken into account by the Treasurer in applying the national interest test.
CHAPTER 6

CHINESE INVESTMENT IN AUSTRALIA: REFLECTIONS AND OBSERVATIONS

Xiang Gao

Backdrop

The steady flow of media commentary regarding Chinese investment in Australia in recent years highlights what a sensitive issue it has become for Australian politicians, public servants and citizens.

On 5 July 2012, the Australian Financial Review reported that cables released by the Wikileaks web site in 2011 had strained relations between China and Australia when US diplomats reported that Australia’s ‘new foreign investment guidelines target China’. The US diplomatic cables said the guidelines signalled ‘a stricter policy aimed squarely at China’s growing influence in Australia’s resources sector’.1
On 27 July 2012, The Business Spectator reported:

In a stroke of pure economic genius, Liberal leader Tony Abbott used news of China’s biggest foreign investment acquisition this week to tell an audience in Beijing that he wasn’t too keen on current levels of Chinese foreign investment. Abbott said any future Coalition government would increase scrutiny on Chinese state-owned companies seeking to control businesses in Australia. Which is a great idea, as it’s well known that everyone in Australia hates money.²

It is against the backdrop of news reports such as these that this chapter investigates what Chinese investors think about the Australian investment environment, based on the author’s interviews with a number of Chinese investors in June and July 2012. Among these, China Minmetals Non-Ferrous Metals Company Limited and CITIC Pacific are typical. While the former represents a successful story, the latter represents those that have been problematic.

### China Minmetals Non-Ferrous Metals Company Limited (Minmetals)

#### Facts about the Minmetals investment

In February 2009, Minmetals entered into an agreement with OZ Minerals under which Minmetals proposed to acquire OZ Minerals for A$2.6 billion. On 27 February 2009, the Treasurer announced that he would not approve the acquisition due to concerns over Australia’s national security interest associated with Prominent Hill, which is located within the Woomera Prohibited Area. Minmetals revised its proposal to acquire all of OZ Minerals’ assets other than Prominent Hill and certain other assets, for A$1.2 billion (later increased to A$1.4 billion). On 23 April 2009, the Treasurer approved Minmetals’ acquisition proposal, conditional on Minmetals providing legally enforceable undertakings.

The Australian company Minmetals Resources Limited (MMG) was formed on 17 June 2009. MMG is being run by the original management team. Andrew Michelmore was appointed as an Executive Director and the CEO of the company in December 2010. He has been the Managing Director and CEO of MMG since its formation in June 2009. He joined MMG after his tenure concluded as the CEO of Zinifex Limited (Zinifex) and then OZ Minerals Limited (OZ Minerals). David Lamont was appointed as an Executive Director and the CFO of the company in December 2010. He joined MMG as the CFO on its formation in June 2009 and was the CFO of OZ Minerals from October 2008.

The six undertakings imposed on Minmetals by the Treasurer’s conditional approval were

1. to operate the acquired mines as a separate business with commercial objectives
2. to operate the mines using companies incorporated, headquartered and managed in Australia under a predominantly Australian management team
3. to price all off-takes on arm’s-length terms by a sales team headquartered in Australia, with reference to international observable benchmarks and in line with market practice
4. to maintain or increase production and employment at Century, Rosebery and Golden Grove mines, pursue growth in Century and Rosebery mines, re-open Avebury mine and develop Dugald River, subject to economic conditions
5. to comply with Australian industrial relations laws and honour employee entitlements
6. to maintain and increase levels of Indigenous employment in its local operations and honour agreements with Indigenous Australian communities.

The Business Spectator reported:

In a stroke of pure economic genius, Liberal leader Tony Abbott used news of China’s biggest foreign investment acquisition this week to tell an audience in Beijing that he wasn’t too keen on current levels of Chinese foreign investment. Abbott said any future Coalition government would increase scrutiny on Chinese state-owned companies seeking to control businesses in Australia. Which is a great idea, as it’s well known that everyone in Australia hates money.²

It is against the backdrop of news reports such as these that this chapter investigates what Chinese investors think about the Australian investment environment, based on the author’s interviews with a number of Chinese investors in June and July 2012. Among these, China Minmetals Non-Ferrous Metals Company Limited and CITIC Pacific are typical. While the former represents a successful story, the latter represents those that have been problematic.

### China Minmetals Non-Ferrous Metals Company Limited (Minmetals)

#### Facts about the Minmetals investment

In February 2009, Minmetals entered into an agreement with OZ Minerals under which Minmetals proposed to acquire OZ Minerals for A$2.6 billion. On 27 February 2009, the Treasurer announced that he would not approve the acquisition due to concerns over Australia’s national security interest associated with Prominent Hill, which is located within the Woomera Prohibited Area. Minmetals revised its proposal to acquire all of OZ Minerals’ assets other than Prominent Hill and certain other assets, for A$1.2 billion (later increased to A$1.4 billion). On 23 April 2009, the Treasurer approved Minmetals’ acquisition proposal, conditional on Minmetals providing legally enforceable undertakings.

The Australian company Minmetals Resources Limited (MMG) was formed on 17 June 2009. MMG is being run by the original management team. Andrew Michelmore was appointed as an Executive Director and the CEO of the company in December 2010. He has been the Managing Director and CEO of MMG since its formation in June 2009. He joined MMG after his tenure concluded as the CEO of Zinifex Limited (Zinifex) and then OZ Minerals Limited (OZ Minerals). David Lamont was appointed as an Executive Director and the CFO of the company in December 2010. He joined MMG as the CFO on its formation in June 2009 and was the CFO of OZ Minerals from October 2008.

The six undertakings imposed on Minmetals by the Treasurer’s conditional approval were

1. to operate the acquired mines as a separate business with commercial objectives
2. to operate the mines using companies incorporated, headquartered and managed in Australia under a predominantly Australian management team
3. to price all off-takes on arm’s-length terms by a sales team headquartered in Australia, with reference to international observable benchmarks and in line with market practice
4. to maintain or increase production and employment at Century, Rosebery and Golden Grove mines, pursue growth in Century and Rosebery mines, re-open Avebury mine and develop Dugald River, subject to economic conditions
5. to comply with Australian industrial relations laws and honour employee entitlements
6. to maintain and increase levels of Indigenous employment in its local operations and honour agreements with Indigenous Australian communities.
Minmetals agreed to these conditions and provided the undertakings. MMG confirmed that the Chinese group got an extremely good deal, helped in part by OZ’s nervous banking syndicate forcing the garage sale of OZ mining assets in the first place. MMG reported that its profit after tax in the December half from the assets picked up from OZ was US$180.7 million. That suggests that on an annualised basis, Minmetals paid less than four times earnings for the basket of mining assets. This deal was rated as the 2009 Best M&A Deal/Best Cross Border M&A Deal by the magazine Finance Asia.

Interviews with Minmetals’ executives

MQ1: Can you briefly tell us about your investment in Australia?

- We acquired OZ Minerals in 2009. We have not only acquired the assets of the company, but also retained its original local management team.
- Now the company is run by our Australian colleagues. We are only performing the role of a major shareholder, exercising our rights as a shareholder. We have no direct management of the company.
- We are happy with the deal and its current operation.

MQ2: Have you experienced any problems in the approval process?

- We relied upon our local staff and friends to deal with the approval process.
- When the application was first made, a copper mine was included; however, the Australian Government did not approve this due to its concern that the mine was located within a military prohibited area.
- When the application was rejected, we spent days and nights carefully evaluating the remaining assets, taking all the circumstances into account to see how long we might have to lose money, when we could break even and when we could make a profit.

- We finally formed the view that it was still commercially worthwhile to do the deal.
- It just luckily turned out to be a good deal for us because metals prices quickly recovered.

MQ3: What do you think of the Australian Government’s disapproval of the acquisition of the copper mine?

- We later learned that the so-called military prohibited area was very large; however, when the decision was made by the Australian Government, we respected it.
- The Australian Government is very cautious when it approves foreign investment projects; however, since the government does not only deal with us in that way, we can understand its approach.
- After all, as ours was a big transaction, it was easy to understand the government’s caution.

MQ4: What do you think of the FIRB’s approval process?

- Normally 30 days are needed for FIRB to approve. It can be extended to ninety days. It is a bit long for a commercial investment, as it not only increases the cost but also the uncertainty.
- Australia has more restrictions on SOE investment than other countries. It requires that all investments by SOEs, whether big or small, be approved by FIRB.
- Canada also has restrictions over investments by SOEs, but only over those above certain levels, which makes Canada’s investment environment more attractive, particularly with smaller amounts.

MQ5: There are suggestions that Chinese SOEs invest for political purposes and not on commercial terms. What do you think?
• We have always been investing in purely commercial terms, which can be demonstrated by the following facts.

• When investing in OZ Minerals, we had undertaken lots of our own research over its value. If we had the government’s backing, the decision would not have been that difficult.

• MMG offered to acquire Equinox on 4 April 2011 for CAD 6.3 billion (Canadian dollars), but revoked the offer on 26 April 2011, when Barrick Gold offered CAD 7.3 billion for that company. MMG had had Equinox on its radar for some time because of its valued copper assets, acquisition of which would lead Minmetals to be one of the world’s major players in the field, and there was no funding problem for us.

• SOEs have fierce competition among themselves, buying Australian iron ore by Chinese steel mills and exporting rare earths are good examples.

• SOEs are assessed by the State-owned Assets Supervision and Administration Commission (SASAC) on their financial performance, rather than assets acquired.

• Those SOEs that lost money on their investments in Australia have to bear the responsibilities themselves, having not received any support from SASAC or any other organisation.

In this connection it is noted that Sinosteel Chairman, Huang Tianwen, one of China’s biggest investors in Australia, has been dumped from his post by the Chinese Government after a string of financial irregularities and bad investments. One figure under the microscope is the US$1.4 billion paid for Australia’s Midwest Corporation, which lost RMB 92.81 million in 2009.

Mr Huang has been replaced with Jia Baojun, according to Jiang Zhigang, an official at the SASAC. The long-expected move to push out Mr Huang, aged 56, well ahead of his retirement age, comes only months after Sinosteel renegotiated its Channar joint venture with Rio Tinto and a few weeks after Mr Huang dined with Julia Gillard.

**MQ6: Why are Chinese SOEs misunderstood by outsiders?**

• Improper communication with the outside world, in particular with the media. For example, when the Chinese Government says ‘go global’, it is only to encourage Chinese enterprises to internationalise themselves or compete internationally, but has no political purpose such as grabbing resources by disregarding the cost.

• When some of the Chinese enterprises and media use the words, they say they are following China’s ‘going-out strategy’, which is easy for other people to misunderstand.

**MQ7: Why are some Chinese investors not doing well in Australia?**

• Generally speaking, they are inexperienced.

• The grade of minerals in China is normally not high. While some of them are treated as high quality in China, they may be regarded as something worthless outside China.

• When some Chinese investors find something outside China that is of higher grade, they treat it as treasure, and are willing to pay higher prices without knowing that the cost and expenses involved with its exploration and development are very high; they don’t know that some of the assets they regard highly are unwanted by their international competitors.

• They have bought something they should not have touched, but their inexperienced dealings can lead foreign competitors, government and the public to think that the motivation of the Chinese enterprises is problematic, non-commercial and political – just to grab the resources without calculating the cost.

**MQ8: Is there anything else that may affect your investment in Australia?**

• The mining tax and the carbon tax. The former affects us less, but the latter does have a big effect.
The unpredictability of those taxes is also likely to affect foreign investment in Australia.

CITIC Pacific

Facts about the CITIC Pacific investment

On 3 April 2006, CITIC Pacific, headed by Larry Rong, bought Mineralogy Sino-Iron and Balmoral Iron for US$415 million and devoted US$2.5 billion more in capital spending. CITIC Managing Director, Henry Fan, told reporters that the first mine should start up in 2009.

The initial construction contract for the project was signed with the contractor Metallurgical Corp of China (MCC) in January 2007, with an estimated value of US$1.1 billion. This increased to US$1.75 billion in August 2007 and US$2.59 billion in May 2010, due to tight labour-market conditions and higher costs for equipment and other items.

On 30 December 2010, CITIC Pacific said it would pay an extra US$822 million to MCC, further inflating the construction cost of its Sino Iron project by nearly one-third to US$3.41 billion. On 8 March 2012, the budget for the project almost tripled from the initial US$2.5 billion estimated to US$7.1 billion. There is every possibility that the cost will increase in the future. It cost the job of its former chairman, Larry Rong, who resigned on 8 April 2009, when his bet against the Australian dollar went sour and resulted in a loss of HKD 15.5 billion (US$1.9 billion).

Most importantly, the initial projected production date was pushed back several times from early 2009 to the second half of 2012.

Interviews with CITIC Pacific’s Executives

CPQ1: What do you think of the FIRB’s approval process?

• FIRB has lots of procedural rules. An investor must meet the requirements of those rules.
• If the rules raise a question, a clear explanation is needed with sufficient documents.
• Of course, the rules are stricter when they deal with SOEs; however, it is hard to say that they are discriminating against Chinese SOEs. The FIRB is set up to protect the Australian national interest. It is easy to understand if you are in that position.

CPQ2: What difficulties have you met in the course of your investment?

• In Australia, it is easy to get approval for foreign investment, but strict requirements must be met in the course of the investment.
• There are many things that need to be approved with strict and draconian conditions, which have created lots of obstacles for the construction of the project. For example, it was originally planned that underground water would be used, but it was not allowed after the application was made. We had to find water from somewhere else, which increased the cost. Another example is that there are strict restrictions on the use of foreign workers.
• Therefore, very careful due diligence is needed before the investment decision is made.
• We hope that the Chinese Government can help us with regard to migrant policies.

CPQ3: Why are some Chinese investors not doing well in Australia?

• The risk for inflation of the budget is very high.
• In some places, the infrastructure is very poor, which makes it very hard for your project to proceed.
• After all, it is because they are inexperienced. There is a huge difference
between China and Australia in terms of developing costs, environmental protection and so on. If no sufficient due diligence has been done, many problems may arise.

**CPQ4: What do you think of Australia’s investment environment?**

- Generally speaking, it is good because the laws are clear.
- But to protect the local workers, Australia has a minimum requirement for paying foreign workers, who are principally high-tech professionals.
- Moreover, there are many laws and regulations for the protection of the environment. Violating these laws may lead to the stoppage of production by the government.

**Conclusions**

In the context of some of the negative press surrounding Chinese investment in Australia at the time of these interviews, it was somewhat surprising to the author that these interviews revealed a fairly positive impression of Australia’s investment environment. This was reflected in the fact that executives of both Chinese companies clearly understood that all foreign investors, whether SOEs or not, are expected to operate under the Australian legal and regulatory systems, which they did not find problematic because they were investing on purely commercial terms. They also appeared to be generally satisfied with the Australian legal environment, despite some of the concerns stated in the background above.

There are, however, some misunderstandings in Australia regarding Chinese investment. The reasons for such misunderstandings are

- improper communication with the outside world from the Chinese side
- some Chinese investors are inexperienced in relation to the transactions they seek to enter
- huge volumes of Chinese investments are coming too quickly
- differences of cultures and political systems.

There is a need for more and proper communications between the two countries concerning investment. There is also a need for strong leaders with great vision rather than populists relying on short-term political rhetoric.

**Notes**

PART III

Foreign Investment in China
Challenges embedded in the general legal system

China’s legal system is not a product of 5,000 years of development but of 30 years of effort to establish a modern legal system. The Chinese Government deserves credit for creating a modern legal infrastructure that has facilitated the country’s colossal social and economic transformation in the past few decades. In late 1970s, as China commenced economic reform, the legal system was essentially re-created. Many major legal codes were enacted in the 1980s, while the 1990s saw a significant expansion of business and commercial laws that were designed to enhance China’s business climate. Before and after accession to the World Trade Organisation (WTO) in 2001, China carried out a major project to improve the transparency of laws and to repeal ones that were inconsistent with the WTO’s mandate. This was no small project at a time when law schools and legal professionals were in short supply.
Because of the relatively short time in which China’s legal system has developed, many Chinese laws have been written broadly without explicit details. There are often gaps when it comes to the application and interpretation of the law. This creates uncertainty, which translates into risks that investors try to avoid or reduce. Every year, AmCham China runs a member survey titled ‘Business Climate Survey’ whose results shed light on how the member companies of AmCham China perceive the economic and regulatory situation they face in China. In 2012, inconsistent regulatory interpretation/unclear laws was the second-highest business challenge (behind management-level human resources constraints). A transparent legal system levels the playing field for business entities and fosters competition. When insufficient details are provided, there can be differences or even abuse of discretion in interpretation.

China spans a large territory with many differences across regions. This makes it necessary to give provincial and local governments a significant amount of discretion in setting rules for their locality. At the national level, China has the National People’s Congress, the State Council, the Supreme People’s Court and the Supreme People’s Procurator. The National People’s Congress (hereinafter NPC) has the power to amend the Constitution and supervise its enforcement. It also enacts and amends basic laws such as the Criminal Procedure Law and Property Law. The power of the NPC Standing Committee is almost as broad as the NPC itself in law-making, with the exception of revision of the Constitution and voting on basic laws. The State Council – the Central Government – can enact administrative measures. The ministries and commissions of the State Council can issue ministry regulations.

Under the Central Government, China has 23 provinces, five autonomous regions (Xinjiang, Tibet, Inner Mongolia, Ningxia and Guangxi), four municipalities directly under the Central Government (Beijing, Shanghai, Tianjin and Chongqing) and two special administrative regions (Hong Kong and Macau). Each province can be further divided into cities, counties and townships. The local people’s congresses of provinces, municipalities and certain cities have power to enact local regulations. Local people’s governments of provinces, municipalities and certain cities can also issue local administrative rules.

The generality of the laws provides flexibility for the executive branch at various levels to apply the law to specific situations, but the risk of losing clarity and consistency in their application also arises. The cultural impact on the laws as drafted is also clearly visible in the text of legal codes. Some provisions are aspirational rather than practical and suitable for enforcement. In practice, people conveniently ignore such provisions in legal planning but they are nevertheless black-letter laws that go through the same legislative process as regular laws and carry the full force of binding law. This discrepancy between aspirational provisions and black-letter laws can be confusing for investors more accustomed to a legal culture in which any action that deviates from the stated legal standard has real consequences.

There are numerous other areas that challenge foreign investors in China, including licensing requirements, intellectual property rights (IPR) protection, contract enforcement and dispute resolution in the court system. While licensing requirements are less cumbersome and more reasonable today than they were three decades ago (when in extreme cases more than 100 approvals were required for a project to start), there are still many procedures to go through today, which can be daunting and time-consuming. This can affect the overall investment return if the duration of acquiring necessary approvals is not taken into consideration.

Likewise, while China has made some progress in protecting IPR, serious concerns remain. This is despite the existence of laws on the protection of trademarks, copyrights and patents, each of which has been revised more
China’s legal framework for foreign investment

Just like any other country, China has a set of rules that regulates how the social elements interact with each other. Unlike many other countries, China’s regulatory regime sets many boundaries on how to do business, making no exception for foreign-invested enterprises. While foreign investment is encouraged, foreign investors need to follow the all-encompassing rules that determine which industries foreign investors can enter and the business form they can assume.

Not all industries are equally accessible for foreign investors. Investment is encouraged in some industries but prohibited in others. In 2002, the State Council promulgated a revised version of the Provisions of Guiding the Direction of Foreign Investment. It stipulates that there are four categories of industries in which foreign investments are encouraged, allowed, restricted or forbidden.

In 2012, a new version of the Catalogue of Industries for Guiding Foreign Investment (hereinafter the Catalogue) became effective. The new industrial policies as reflected in the Catalogue continue to observe the principle of active, rational and effective utilisation of foreign investment. The Catalogue serves the purpose of directing capital into industries preferred by the government while there are certain restrictions or even prohibitions where the government sees a need for doing so. For example, foreign investment is encouraged for the construction and operation of ecological environmental protection projects such as the planting of trees and grasses to combat desertification and soil erosion. Foreign investment is restricted for construction and operation of pipeline networks for gas, heat, water supply and sewage in cities with populations of more than 0.5 million (with Chinese parties as the controlling shareholders). Foreign investment is prohibited for exploration, mining and selection of rare earth elements.
In general, the government encourages foreign investment in new and high-technology industries, infrastructure and associated peripheral projects. Multinational companies are encouraged to invest in China.

**Choice of corporate and alternative business structures**

For certain industries, foreign investors cannot assume the preferred business form for the business. For example, if the Catalogue mandates joint equity ownership with Chinese partners, foreign investors cannot set up a wholly owned entity.

Although China has three basic business association forms (sole proprietors, partnerships and corporations), foreign-invested enterprises (FIEs) are commonly referred to by the legal terms that are given in the FDI legislation. This classification is a remnant of the ownership-denominated system in the early years of the reform. The system is still alive today for SOEs, privately owned enterprises and FIEs.

There are a few basic business forms a foreign investor can choose when investing in China. FDI is about equity ownership in an entity. It usually involves one of the three major business vehicles made available for FDI – namely, equity joint ventures (EJVs), contractual joint ventures (CJVs) and wholly foreign-owned enterprises (WFOEs). Each of these vehicles can usually be established as a legal person and a limited liability company.

EJVs and CJVs are subject to their own set of laws and regulations. EJVs are governed by the Equity Joint Venture Law and by the Equity Joint Venture Law Implementing Regulations. CJVs are governed by the Contractual Joint Venture Law and by the Contractual Joint Venture Law Implementing Rules. EJVs tend to be preferred because of the perception that they provide more predictability and certainty.

WFOEs allow foreign investors to maintain complete ownership of the enterprise and to operate the business independently. They also enable easier protection of intellectual property and other proprietary information. WFOEs are governed by the Wholly Foreign-Owned Enterprise Law and the Wholly Foreign-Owned Enterprise Law Implementing Rules. While joint ventures were the prevailing investment vehicle in the 1980s, WFOEs have become the dominant form in recent years.

Foreign investors can also use a holding company to centralise the ownership and management of China-based operations. There must be substantial existing foreign investments in the operation and the minimum asset value requirements must be met before a holding company can be established.

Since 1 March 2010, foreign investors have been able to set up a foreign-invested partnership (FIP) in China either by themselves or by partnering with domestic individuals or entities. FIPs are governed by the Partnership Enterprise Law issued in 2007, and are also subject to the Catalogue of Industries for Guiding Foreign Investment. FIPs can register directly with the State Administration of Industry and Commerce or its local branches for a business licence without prior approval from the Ministry of Commerce or its local counterparts. The Partnership Enterprise Law provides that partnerships are exempt from income tax at the enterprise level.

One option that does not involve equity in an entity is a representative office. This does not take a lot of money and it is possible to set up numerous representative offices in different cities in China. Though a representative office is not supposed to engage in direct business operations, it is allowed to carry out market research and act as a liaison between the home office and the contacts in China.
The evolving Company Law remains another challenge. The word ‘corporation’ is probably a better term here than ‘company’ since the latter is not a legal term. Nevertheless, gongsi, the Chinese word for a corporation, is commonly translated as ‘company’. China’s Company Law was enacted in 1993 after the major FIE laws were enacted; however, under China’s Company Law, limited liability companies and joint-stock limited companies invested by foreign investors shall be governed by it. Where there are otherwise different provisions in any law regarding foreign investment, such provisions shall prevail.

The minimum amount of registered capital of a limited liability company is RMB 30,000 (RMB 100,000 for a one-person limited liability company and RMB 5 million for a joint-stock limited company). A shareholder may make capital contributions in currency, in kind or intellectual property right, land-use right or other non-monetary properties that may be assessed on the basis of currency and may be transferred according to law. With the development of the modern corporate system in China, the Company Law in China continues to evolve. The company law was revised in 1999, 2004 and 2005. These new revisions add provisions that are yet to be fully litigated and tested in practice.

China is trying to create a legal structure that encourages foreign investment but at the same time it is working on reducing the unfair treatment of non-FIEs. For example, the unification of enterprise income tax to 25 per cent under the new Enterprise Income Tax Law that became effective in 2008 creates the same income tax rate for both FIEs and non-FIEs. In the future, FIEs may see more unification in the legal environment.

New laws on mergers and acquisitions

In 2011, the State Council launched a security review system for mergers and acquisitions (M&A) of domestic enterprises by foreign investors, which could terminate a proposed transaction or demand that measures such as transfer of equity or assets be taken if a foreign investor’s merger or acquisition of a domestic enterprise has a potential major impact on national security. The new security review system, together with the existing laws that include Provisions on Foreign Investors’ Merger with and Acquisition of Domestic Enterprises, Certain Provisions on Change of the Equity Interests of the Investors of a Foreign-Invested Enterprise and the Interim Provisions on Investment Made by Foreign-Invested Enterprises in China, provide a framework for M&A to be made by foreign investors. The exact ambit of the new security review system is yet to be defined.

China’s law on anti-monopoly, which became effective in 2008, also plays a role in merger and acquisition transactions.

Conclusion

To invest in China is not a right, but a privilege. This statement defines the legal challenges faced by foreign investors, as they need to ascertain which business activities are categorised as allowed and which are prohibited, and the proper forms to engage in those that are allowed. It is not always easy to accomplish that. There are also many challenges for foreign investors that extend beyond the subsystem of foreign investment into the overall legal regime. Other challenges arise from the delicate balance that Chinese policymakers want to keep between encouraging FDI and guarding economic policy and national interests.

It is not the intention of policymakers to purposely set roadblocks for foreign investment. On the contrary, FIE laws are promulgated to promote the inflow of foreign capital. China attracts a huge amount of FDI inflow, which
indicates that the economic prospects still outweigh the legal challenges in many cases; however, addressing the challenges that continue to make life difficult for foreign investors will lead to more and sustained investment in the longer term. Also, with the declining emphasis on the demarcation of capital ownership, China aims to create a unified enterprise law system that is based on the principles of fair competition and equal treatment for all investment sources. This means that in the future FIEs will face fewer restrictions but at the same time will lose some of the benefits that the existing regulatory framework provides.
Qualified Foreign Institutional Investors: an introduction

This chapter considers the recent opening of the door to foreign institutional investors, enabling them to invest in Chinese stocks through their status as Qualified Foreign Institutional Investors (QFIIs), which is emerging as an alternative to FDI through the investment vehicles described in Chapter 7: joint ventures, corporations and partnerships. The present chapter examines the legal framework now evolving to encourage portfolio investment by institutional investors in domestic Chinese stocks.

QFII is a status granted to a foreign institutional investor with a licence to buy domestic stocks. As of 15 June 2012, 147 QFIIs with a combined quota of US$27.36 billion had been approved. Introduced in 2002, the QFII program has become the major channel for foreign investors to access China’s growing domestic market for A-shares in Shanghai and Shenzhen. A-shares
are denominated in renminbi and are almost entirely owned by domestic investors. As of the end of 2011, China’s stock market ranked third in the world, with 2,342 listed companies and a total capitalisation of RMB 21.48 trillion.

Some Chinese companies have also issued H-shares and red chips, which are traded on the Hong Kong Stock Exchange. These shares are freely accessible to international investors. The market for H-shares and red chips is, however, much smaller than the domestic market for A-shares, which accounts for more than 76 per cent of Chinese market capitalisation. By comparison, the H-share market has fewer than 200 issues and is heavily concentrated in energy, telecoms and financial services.

On 10 June 2012, at the Sixth China International Private Equity Forum in Tianjin, Dai Xionglong, Chairman of the Council of the Social Security Fund, revealed that his fund would invest RMB 30 billion in the stock market by the end of 2012 and RMB 50 billion by the end of 2013. The National Social Security Fund opened sixteen A-share accounts in 2012. According to Dai, pension funds managed by local governments and insurance companies will also increase their holdings in private equity funds. The theory is that the National Social Security Fund might invest in the Chinese market in a manner similar to pension funds in the United States, which account for 40 per cent of the capital of venture capital companies and private equity funds there. The SAFE Investment Company, CIC and FSSF, collectively managing US$2.352 billion, ranked third, fifth and eleventh among the SWFs investing in the Chinese domestic market.

QFIIs may thus provide an attractive way for foreigners to invest in A-shares. If so, they will also increase liquidity in China’s A-share market and, China hopes, reveal the tricks of international finance to their Chinese hosts in an easy way.

The legal and regulatory landscape for QFIIs

The QFII scheme is jointly policed by the China Securities Regulatory Commission (CSRC), the People’s Bank of China (PBoC) and the State Administration of Foreign Exchange (SAFE), with the CSRC as the lead regulator. These agencies are responsible for accounts, currency quotas and licences.

Most regulations covering QFIIs are made by the CSRC alone or by the CSRC in collaboration with the PBoC and SAFE. Such regulations include: the Administration Methods of Securities Investment by QFII (2006) (‘The Administration Methods’), the Notice on the Implementation of the Administration Methods of Securities Investment by QFII (2006) (‘The Implementation Notice’), the Notice on the Issues Related to the Registrations and Settlements of the Transactions by QFII (2003), the Guidance on the Inspectors of QFII (2008) and the Guideline of Participation of Stock Index Futures (2011) (‘The Guideline’). All of the regulators are under the State Council with a view to making the regulatory regime uniform as prescribed by the Securities Law.

The Administration Methods, first issued in 2002, form the seminal legal instrument dealing with the qualifications of a QFII and custodian banks, and with their settlements, investment operations, capital controls and supervision. The Implementation Notice requires a QFII to appoint an internal inspector who, in terms of his or her functions, resembles the chief compliance officer of a major American investment bank.

The Guideline allows QFIIs to trade ‘financial future contracts’, a Chinese term especially coined for derivatives, on the China Financial Future Exchange. Three futures brokerage firms have been allowed as a concession to lobbying by QFIIs. These firms are only to invest in financial futures contracts for hedging purposes and must report to the regulator on a continuing basis. A central clearing house for financial futures contracts has been established.
QFIIs and derivative forms of the QFII

Ingenious foreign bankers, with the help of their lawyers, have found ways to circumvent the limits imposed on them by the Chinese Government. For example, hedge funds borrow their brokers’ QFII allowance. If there is no allowance to spare, they may leverage that allowance via the sort of complex synthetic trades that China has tried to avoid.

Alternatively, foreign funds can partner with a Chinese financial firm in setting up a trust company. A trust company is a unique financial institution in the PRC, which acts as a securities firm, asset management firm or private equity firm.

QFIIs: a popular vehicle for foreign investors

Under the Implementation Notice, QFIIs are permitted to invest in renminbi-denominated financial products such as stocks, bonds and warrants that are traded on stock exchanges; fixed-income products in the interbank bond market; securities investment funds; stock index futures; and other financial instruments with approval from the CSRC. Trading in stock index futures is a new business opened for QFIIs under the Administrative Methods of 2012. On 25 January 2012, approval was granted to the first group of QFIIs able to trade in stock index futures.

The regulation of QFIIs has been progressively liberalised. The ceiling on the combined stake able to be held by several QFIIs in any listed company in China’s domestic A-share market has been raised from 20 per cent to 30 per cent under the 2012 Implementation Notice. In addition, the interbank bond market and stock index futures businesses were formally opened to QFIIs under the 2012 Implementation Notice. In Hong Kong, while attending the 2013 Asia Finance Forum, Guo Shuqing, Chairman of the CSRC, announced to an international audience that QFIIs would be given more latitude in the areas in which they invest and the ways they invest.
QFIIs are allowed to trade stock index futures. This is still a state-of-the-art business for China’s capital market and has occurred barely one year after a group of select Chinese institutional investors had obtained permission to engage in such trading. The Chinese regulator has been in many respects exceptionally accommodative of foreign investors’ requests. There may be some irony here in the fact that QFIIs are supposedly exemplars of long-term investment yet they are allowed to trade derivatives, an activity that can be considered either hedging or speculation with a thin line in between.

Under the Administration Methods, Article 8, a QFII shall hold no more than 10 per cent equity in any listed Chinese company. This limit, however, has been circumvented by some QFIIs in an ingenious way. Through its own QFII, a foreign bank that is already a shareholder of a listed Chinese urban commercial bank can increase its equity in the Chinese bank beyond the 10 per cent cap to become a controlling shareholder. Some foreign banks have succeeded in doing this.

In July 2012, an announcement was made on identifying the ‘beneficiary’ for the purposes of compliance with the terms of a tax treaty. According to this announcement, taxes on the profits remitted by foreign companies will be reduced by up to 50 per cent after rules on withholding taxes were relaxed to encourage more investment. The move will also apply to dividends paid by listed Chinese companies to foreign shareholders through the QIFF schemes.

**RQFII (or QDII): twin of the QFII**

The Renminbi Qualified Foreign Institutional Investors (RQFII), also referred to as Qualified Domestic Institutional Investors (QDII), refers to the domestic market activities of a fund management company or securities company incorporated in Mainland China. Hong Kong subsidiaries of China’s fund management companies and securities firms have launched funds managed by RQFII. Such subsidiaries are QFIIs in terms of their legal status.

On 16 December 2011, the CSRC issued the Methods of Pilot Investments in Mainland China by RMB Qualified Institutional Investors owned by Investment Fund Management and Securities Firms (the ‘RQFII Methods’) and the Implementation Regulations (the ‘RQFII Implementation Regulations’). The RQFII Methods apply to institutional investors incorporated in Hong Kong, Macao or Taiwan. Although not yet a competitor for the QFII, these domestic operators may be expected to be encouraged in the future.

The RQFII Methods apply to the market activities of renminbi investments in securities issued within Mainland China by the Hong Kong subsidiary of a fund management company or securities company incorporated in Mainland China. Such a subsidiary is a QIFF in terms of its legal status. Under the Administration Methods, Article 36, an institutional investor incorporated in the Hong Kong Special Administration Zone, the Macao Special Administration Zone or the Taiwan Region is treated as a QFII with respect to its securities investments in Mainland China.

As the subsidiary of a parent incorporated in Mainland China, a RQFII is not, however, really ‘foreign’ in terms of its ultimate ownership. Indeed, RQFIIs are commonly dubbed QDII (or Qualified Domestic Institutional Investors) in the Chinese press. Mainland Chinese securities firms and asset management firms have set up subsidiaries, branches or offices in Hong Kong, ostensibly in response to the government’s outward-bound investment (OBI) strategies. This has also provided them with a convenient way to circumvent legal prohibitions on more exotic businesses like hedging. Seventy per cent of QDIIs’ assets are located in Hong Kong. Developments in this area were officially affirmed in 2008 with the introduction of the Regulations Establishing Institutions by Securities Investment Management Companies in Hong Kong, issued by the CSRC.
Frustrations and pitfalls for QFIIs

The A-share market is heavily regulated and still relatively closed to international capital flows. The major causes for concern for Western investors include the government’s unduly intrusive role, standards of corporate governance and the regularity of accounting policies. A closer examination shows, however, that the government’s role has been largely benign, and often favourable to foreign investors. Admittedly, there are some frustrations for QFIIs. These include the very crowded field of QFII regulators, the regulatory restraints imposed upon QFIIs and the intrusion of the government in their activities; however, the lack of an effective dispute resolution system to resolve disputes concerning the trading of securities remains the most significant obstacle to the confidence of QFIIs trading in the Chinese domestic market.

The QFII scheme is crowded with regulators. Apart from the CSRC, the PBoC and SAFE, other government agencies also intervene as opportunities arise. For example, any tax break or preferential treatment accorded to QFIIs is decided by the State Administration of Taxation (SAT). In July 2012, SAT issued an announcement on identifying ‘beneficiaries’ for the purpose of a tax treaty (‘the Announcement’). According to the Announcement, taxes on the profits remitted by foreign companies will be reduced up to 50 per cent after rules on withholding taxes were relaxed to encourage more investment in the domestic market. The move will also apply to dividends paid by listed Chinese companies to foreign shareholders through the QFII schemes.

Another regulatory restraint on QFIIs is that they cannot remit money without approval from SAFE. The equity investments by a QFII must meet the proportional requirement imposed by the CSRC or any other requirements imposed by any other government agency.

Many potential foreign investors in China seem to harbour deep suspicions against the Chinese Government. The distrust is misplaced. In practice, the mandarins responsible for financial markets, and the government agencies under their leadership, have been embraced by some major foreign financial firms. For example, Guo Shuqing, in an effort to promote market practice shortly after he had been appointed Chairman of the CSRC, proposed that the procedure for the examination and approval of QFIIs should be replaced with the registration procedure utilised in the United States. He had to reverse his position quickly due to strong opposition from many quarters. To the surprise of many people, the most vocal voice of dissent came from leading American investment banks.

For thousands of years throughout Chinese history, the mandarins have exerted control over all aspects of Chinese society and business. The control of the mandarins is not limited by the government, and the removal of formal government control will not undermine their informal control. While foreigners may complain about the excessive amount of government control over the system, in a freewheeling Chinese capital market, foreign investment banks would likely fare the worst. Less familiar with the Chinese culture and more restricted by their company’s internal rules and their home country’s anti-corruption laws (such as the Foreign Corrupt Practices Act [1977] in the United States), foreign financial firms are likely to be no match for Chinese firms, whether state-owned or private, in lubricating relationships with mandarins.

The lack of dispute resolution mechanisms available to QFIIs

Chinese courts have been extremely reluctant to accept lawsuits filed by investors regarding securities investment disputes, whether they are individuals or institutions. The People’s Supreme Court has established a so-called ‘procedure prior to lawsuits’ with respect to civil claims involving securities investments. In this regard, the Supreme Court issued the Notice on the Issues Related to Tort Claims Arising out of False Statements in the Securities Market (‘the Notice’) in 2002 and the Regulations of Civil Claims Arising
QFIIs – a door opens for foreign investors

Similarly, arbitration is an option available to investors like QFIIs for dispute resolution. Although way behind their American counterparts in terms of caseloads, the China International Economic and Trade Arbitration Commission (CIETAC) and Beijing Arbitration Commission, two reputable Chinese arbitration commissions based in Beijing, are well equipped to entertain securities investment disputes. In 2011, CIETAC accepted and adjudicated a dispute between an investor and a securities fund company.¹⁰

Conclusion

Foreigners complain about the crowded field of regulators, the regulatory restraints imposed on QFIIs and the intrusion of government in their activities. In spite of these objections, QFIIs are surviving and thriving. The CRSC reports that securities firms, enterprise annuity funds, the National Social Security Fund, securities investment funds, trust companies, QFIIs and insurance companies are all institutional investors currently active in China’s securities market. Among these institutions, QFIIs rank third in their performance.¹¹

Chinese investors embrace the risks of the market in the hope of making big profits. Foreign investors are in reality shielded from many of these risks through the oversight of mandarins and regulated investments in QFIIs. Thus there are seemingly irreconcilable contradictions and conflicts of interest at work in China’s capital market. In this respect it shares much in common with other capital markets around the world, which are sometimes likened to gambling houses.
Notes

10 Zhonguomaozongcaizidi (Cietac No.), No. 0152, 2010.
PART IV

Issues for Corporate Law and Governance
The opening up of the Chinese economy has seen a dramatic rise in foreign direct investment into China, with cumulative inflows reaching US$1.3 trillion by 2012, the year in which China became world’s number one destination for FDI. A relatively recent parallel process has been the rise of Chinese own direct investment into foreign markets, which has served to make China’s globalisation a two-way process.

According to Peter Nolan, since the late 1970s, ‘a consistently stated goal of China’s industrial policy has been to construct globally powerful companies that can compete on the global level playing field’. One component of this goal has been the decade-long directive of the Chinese Government for Chinese firms to ‘go global’, which was renewed by Premier, Wen Jiabao, in his work report to the Fifth Session of the Eleventh National People’s Congress held in March 2012. There has been a massive and varied response to this
Corporate governance is one of the major challenges facing Chinese firms trying to establish themselves in global markets. When they enter foreign markets, Chinese enterprises are likely to bring their corporate governance practices with them. This chapter brings together the available information to examine the distinctive governance features of corporations operating within China and the difficulties that Chinese companies have found in responding to the corporate governance requirements of foreign countries when listing abroad.

Chinese corporate governance practices: the role of the State

The pervasive role of the State within individual Chinese companies is fundamental to understanding China’s corporate governance practices both at home and abroad.

At the national level, the State-owned Assets Supervision and Administration Commission (SASAC), established in 2003, holds shares in companies for the National Government. On behalf of the National Government, in 2010 SASAC supervised 121 SOEs that were regarded as important; these SOEs in turn controlled 194 companies listed on the Mainland and 57 Hong Kong-listed companies. Despite this oversight role, SASAC’s power is limited in a number of ways. Unlike a parent company, SASAC is not the owner of the companies in which it holds shares. Its weaker position is illustrated by the difficulties it has had in persuading investee companies to pay significant dividends, and by its incapacity to appoint key office-holders in the companies in which it holds shares. This is a power that is exercised by the Communist Party. As noted by Walter and Howie: ‘The Party is able to ensure its control over China’s most powerful business groups by having the power to appoint their top management.’

Because the State in China is somewhat fragmented, (its various agents operating at the national, provincial and local levels), public company shares may be held by different state agencies and may be used in different ways. This can result in conflicting obligations to the State within the one company. For example, at the national level, SASAC tends to operate in a fairly remote or arm’s-length fashion. In contrast, at the provincial level there may be greater interference in the affairs of the company so as to preserve local employment security and economic growth.

In her longitudinal study of the first nine Mainland companies to list on the Hong Kong Stock Exchange, de Jonge finds that little real change has occurred in the nature of such practices, with the Chinese State playing a critical role in major Chinese companies. In particular, she argues that in
China, ‘the defining feature of the equity market must surely be the pervasive presence of the state on both sides of the fence’, warning that ‘while protection of minority shareholder interests has improved under recent reforms, it is the State, through a variety of personal allegiances and connections, which remains a dominant presence on the board of most publicly listed Chinese corporations, including those listed in Hong Kong’.

De Jonge also notes that:

[S]tate involvement in business decision making is neither singular nor homogenous. Rather, diverse and disparate versions of the State exist, potentially representing power elites at the local, regional and central government levels, respectively. While tensions exist within each level between diverse departmental aims and interests, the more obvious and influential tensions so far as the nine firms examined are concerned are those between regional (provincial) governments on the one hand, and the national central government on the other.

In addition to the tensions between corporate obligations to different state interests, there are other conflicting forces at work within large Chinese companies. Nolan has noted that unlike major foreign large firms, many Chinese conglomerates reflect conflicting rivalries within the group. There is an ambiguous relationship, for example, between Chinese listed companies and their parent companies. Nolan made a comparison of Chinese and foreign oil companies and noted that:

The global giants have a strong ‘one company’ corporate identity and culture. Within PetroChina and Sinopec there exist powerful entities that over the years have developed strong independent corporate identities and ambitions. They struggled for autonomy in business management and aspired to become independent competitive companies.

Nolan suggests that these rivalries and conflicting interests must affect the capacity of large Chinese companies to react quickly and decisively to long-term economic opportunities and threats.

Much has been written about corporate governance in large Chinese companies. It is not the purpose of this chapter to review this literature as this would be a massive task and has already been done elsewhere by both Western and Chinese authors. Instead, the purpose is to clarify some of the key features of corporate governance patterns in Chinese global companies.

Although China may have copied Western corporate laws, stock market rules and corporate governance codes, the local meaning of these transplants is inevitably different due to the dominance of the State in large listed companies both as a shareholder and as the regulator. As Tam and Yu express the problem: ‘The dominance of the state as direct and indirect owner holding two-thirds of issued shares in over 80 per cent of the country’s listed companies has compounded the governance issues that a public company will normally have to address.’

They add that where concentrated share ownership is high, as in China, ‘the major governance problems are generally centred around the issue of state ownership, insider control and the weak enforcement of law and regulations’.

Chinese companies that have listed on China’s stock exchanges have made more of an effort to adopt new corporate governance rules. This is especially so in regard to the top listed companies. The split-share reform scheme, for example, has to some extent added greater fluidity to the share register of major listed companies; however, the State remains in the dominant position as the holder of non-circulating shares and this dominance continues to condition the governance of these companies.
This continuing influence is reflected in the State's block holding on the share register of large Chinese companies and in the fact that the State remains a major source of funding. The outside control of companies through transactions on the stock exchange is less significant as stock exchanges are less important as sources of finance than in Western countries such as the United States. In China, state-controlled banks have served as the principal source of financing for state-owned enterprises; however, they have not sought to actively monitor and control governance functions inside these companies, as happens in Japan and Germany. A massive amount of bank lending to companies took place in China in 2009 in response to the global financial crisis – further reinforcing government influence in the support of such lending.

State ownership reflects an insider model of corporate governance

A distinction is made in the corporate governance literature between ‘outsider’ and ‘insider’ models of corporate governance. Many of China’s formal mechanisms (such as its stock exchanges and corporate law and securities rules) mimic institutions found in outsider control systems; however, China’s stock market does not actually operate as an ‘outsider market’ due to the strong block-holding position of the State. This means the nature of regulation and governance will be more akin to what Kanda has described as an insider control model. This creates something of a mismatch.

Like German and Japanese firms, which are also taken to represent insider models of corporate governance, large Chinese companies will generally be more sensitive than Anglo-American firms to employee concerns as distinct from those of shareholders. These concerns are reflected in supervisory boards that seek to reflect employee inputs, maintaining stability in employment and by the Chinese concern for maintaining employee harmony. The use of the supervisory board in corporate governance has been a characteristic of social democracies in European countries, reflecting the sensitivity in these countries to the interests of employees. Roe summarises this sensitivity as follows:

Social democracies [such as in Continental Europe] historically favoured incumbent employees. They favoured them directly by insisting that firms not lay off employees; when managers are not tied tightly to shareholders, they would not strongly resist such pressures … True, such governments also sought to stabilize employment in firms with dominant stockholders. But dominant stockholders, with their money on the line, can oftentimes resist the government’s actions more vigorously or more surreptitiously.

In China, however, such supervisory boards are largely ineffective and operate quite differently from the system of co-determination in Germany, upon which they are modelled.

Macro-politics linked to the microstructure of the Chinese corporation

Roe argues that patterns of corporate governance are built into a politics that links the macro-politics of the nation to the microstructure of the firm. The relationship between ownership patterns, management power and employee protection will therefore vary in different corporate governance systems.

Clarke notes that the linkage between macro-politics and the company’s microstructure has affected the application of both the Company Law and the Corporate Governance Codes in China. It has also meant that companies sometimes serve public or political purposes rather than value or wealth maximisation. For example, the corporatisation of Chinese companies under the 1993 Companies Law was primarily aimed at dealing with govern-
ment problems such as the reform of SOEs. Corporatisation also served the purpose of providing some equity capital to state-controlled entities, thus reducing the amount that had to be provided by the State. Non-legal institutions (such as large shareholders, banks, debt markets and equity markets) were also important means of advancing corporate governance ideas in China; however, these developments did not imply that there would be less state control of companies or that minority shareholder protection would be a primary focus.

Similarly, the effect of block-holder control of a company by the State means that the focus on protecting minority shareholder interests is much less important than it would be in companies with widely dispersed shareholders. The fact that the party organisation is an important institution within any significant Chinese company has created ‘strange bedfellows’ in corporate structures. The party organisation provides a parallel and often overlapping structure within Chinese listed companies, which can reduce statutory governance mechanisms such as the board of directors and the general meeting to being little more than rubber stamps. Company insiders tended to dominate the composition of the board, with the chairman often also occupying the position of CEO and being appointed by the supervising government department.

Lack of independence within the board

In 2001, the CSRC issued Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies, from which time independent directors must comprise at least one-third of listed company boards with the purpose of protecting minority shareholder interests; however, these ‘independent’ directors are in practice nominated by the large shareholders and so are unlikely to pose a challenge to the dominance of company insiders on the board. The concept of ‘independence’ is not well understood in this context. In one internal assessment, the independent director system was seen as promising, but deficient. Thus Shen and Jia note that ‘it is unrealistic to count on independent directors to completely prevent exploitation by controlling shareholders and management, especially when listed corporations have not yet solved their share structuring problems, and China has yet to formulate a sound legal environment’.

Clarke also reviewed research on independent directors in China and found that there was no evidence to show that independent directors actually improved performance in Chinese companies. As he observed, ‘to date there does not appear to be any strong empirical support for the view that independent directors in China enhance corporate performance’. Independent directors sit awkwardly on their respective boards in terms of their background and experience. Not surprisingly, they have often been referred to as being decorative or akin to ‘beautiful vases’. As Clarke explained, ‘the numbers appear to bear out the common stereotype of independent directors as perhaps well-meaning but ultimately ineffectual academics and celebrities brought onto boards for their prestige value and perhaps to satisfy the CSRC, but for little else’.

Inability of the stock market to discipline corporate governance practice

China has sought to use stock markets to improve corporate governance in Chinese companies. Wei notes that, in theory, the stock price is an indicator of the degree to which a company is well managed, and that where a company’s stock price is low, this serves as a signal to the market and may lead to a takeover of the poorly performing company, which would displace the old management team with a more efficient team. The Chinese stock market has, however, in recent years seen periods of considerable volatility in share prices, which has been attributed to a lack of efficiency within Chinese stock markets and the existence of serious breaches of legal rules in regard to insider trading, misleading disclosure and market manipulation.
Wei argues that one of the main causes of this volatility has been ‘poor corporate governance’; however, the signalling impact of share prices has not operated in China as theory might suggest. Wei notes that ‘share prices do not necessarily reflect the economic efficiency or performance of listed companies’, and instead concludes that China’s experience in recent decades ‘has shown that establishment of a securities market does not necessarily guarantee good corporate governance in listed companies’. Some believe that the standard of corporate governance in Chinese companies might be improved through their listing on foreign stock exchanges. This issue, and the underlying question of whether Western law and practice can be successfully transplanted in Chinese firms, is discussed in the following sections.

**Difficulties transplanting corporate law and corporate governance**

The early 1993 Company Law sought to corporatise SOEs and to increase their efficiency and profitability. Subsequently, revisions were made to the Company Law, with a new law proclaimed in 2005. This 2005 Company Law demonstrated a greater concern for corporate governance issues, such as shareholder protection and the duties of directors.

In particular, the 2005 Company Law provided for a director’s duty of loyalty. The 1993 Company Law had provided some comparable duties, such as in Article 59, requiring directors to ‘perform their duties faithfully and uphold the interests of the company’. The 2003 Investment Fund Law also relied upon the concept of fiduciary duties as it provided that a fund manager has a fiduciary duty to act in good faith and with due diligence when managing fund assets. A major problem that has emerged with respect to the 2003 Investment Fund Law, however, is the conflict of interest between fund managers and the fund manager’s major shareholders. The affiliation of fund managers with securities companies adds a further range of possible conflicts of interest. Similarly, the CSRC in 2002 followed American law and issued various Takeover Measures, which imposed what have been described as ‘fiduciary duties’ or a duty of good faith (changxin yiwu) on both the buyer and the seller of shares in the target company. Thus, Article 148 now provides that

> Directors, supervisors and senior managers of a company shall observe laws, administrative regulations and the company’s articles of association and shall assume the duties of loyalty and diligence to the company. Directors, supervisors and senior managers of a company shall not take advantage of their functions and powers to accept bribes or collect other illicit earnings, and shall not take illegal possession of the property of the company.

This Article restates some parts of Article 59 of the 1993 Company Law. Article 149 goes on to prohibit directors and senior managers from doing various acts, such as the misappropriation of the company’s property.

It has been argued that Article 20 of the 2005 Company Law actually introduces a fiduciary duty owed by the controlling shareholder to the minority shareholders – the controlling shareholder is prohibited from causing loss to the company or from abusing the independent status of the company. Article 21 imposes a liability to pay compensation where a person violates the duties in Article 20 (which may be compared with Article 63 of the 1993 Company Law). Also, Article 152 gives any shareholder the right to bring action against any person who has contravened the lawful rights of the company. There is some debate, however, as to whether provisions such as Article 20 actually create a fiduciary duty.

It has also been argued that the actual meaning of transplanted provisions such as these may have been lost in translation, such as when the duty...
of good faith has been interpreted by Chinese academics to constitute a fiduciary duty. Clarke also notes that the enforcement of rights does not fit well into the Chinese legal system because of the dominant position of the State. He notes that policymakers introducing new Western-style laws ‘fail to appreciate the sheer pervasiveness with which the norms and practices of the state-owned economy continue to permeate many realms of Chinese society’. This makes transplantation extremely difficult. Clarke adds that another cause of misunderstanding comes from the fact that transplantation of corporate law into China fails to take into account that Western company law often assumes that the State will play a limited role in the life of a corporation. Chinese law does not reflect this assumption. One Chinese scholar, Chao Xi, also points to the ‘inherent difficulty in specifying the meaning of fiduciary duty’ when attempts are made to transplant it, so that any attempt ‘can at best be partial’. Added to this, according to Xi, is the lack of consensus in China on the fiduciary duties standards that should be formulated and adopted in China to deal with the extensive pattern of ‘looting’ and ‘tunnelling’ behaviour by controllers of Chinese companies.

**Chinese corporate governance in times of crisis**

A closer study of governance practices in leading Chinese listed companies in times of crisis is instructive as to their acceptance and resilience in practice. It has been argued, for example, that the Asian Financial Crisis in 1997–98 exposed major weaknesses in Chinese listed companies operating outside Mainland China. Chinese companies operating in Hong Kong incurred massive debts, with the most visible illustration of this the experience of the Guangdong International Trust and Investment Corp (GITIC) and Guangdong Enterprises (GDE). Nolan observes that:

Prior to the crisis both companies had been regarded as model institutions by international lenders, but GITIC’s bankruptcy and GDE’s restructuring allowed the outside world to look closely for the first time inside large Chinese companies. The investigations revealed a comprehensive failure in corporate governance, including disastrous lending practices: a large fraction of their loans had been made to firms and institutions that were unable or unwilling to repay their debts. A substantial part of their investments were highly speculative, including heavy participation in the property boom in Guangdong province and in Hong Kong.

These failures saw the Chinese Government reconstruct China’s main banks so as to reduce their bad debt positions by setting up asset management companies to take over and dispose of these bad debts, and by introducing more rigorous corporate governance practices. This period also saw the China Securities Regulatory Commission (CSRC) issue a Code of Corporate Governance for Listed Companies in China in 2001 modelled on the OECD Principles of Corporate Governance.

Around this time a number of other corporate governance-related rules were issued by the CSRC including the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (2001); Opinions on Strengthening Work on Monitoring and Regulating Listed Companies (2000); Implementing the System of Interview Discussion with Board Chairmen of Listed Companies (2001); Regulations on Strengthening Protection of Shareholder Rights of the General Public (2004); and the Administrative Rules on Stock Incentives in Listed Companies (Trial) (2005). A new Securities Law was also enacted in 2005.

Let us then turn to examine the extent to which large Chinese corporations have absorbed the corporate governance practices of foreign strategic investors when they have invested in China and adopted foreign corporate governance practices when listing on markets overseas.
Although the Chinese market has not been open to listings by major foreign corporations, some indication of the willingness to adopt foreign corporate governance practices is seen in the influence of early ‘strategic’ investors investing in Chinese corporations. For some time China has encouraged large foreign companies to become strategic investors in large publicly held Chinese companies as a way of introducing new technologies and management expertise into Chinese companies. One of the earliest of these strategic investors was the US brewer Anheuser-Busch, which until recently held a substantial 27 per cent of the shares in Tsingtao Brewery; it sold 19.9 per cent to the Japanese brewer Asahi Breweries in 2009. Whether these foreign strategic investors had a significant impact on Chinese corporate governance practices is questionable, however, given that the controlling interest has in most cases remained with the State.

For Chinese companies going global, the reverse issue is whether the direct listing of Chinese companies on foreign exchanges is likely to bring about improvements in their corporate governance practices. Chinese authorities have for some time been conscious of the need to control the process of cross-listing. One of the main reasons companies list on foreign stock exchanges is to obtain cheaper capital and to raise the visibility of the issuer. It has been argued that when companies from a weak corporate governance environment make the decision to cross-list on a foreign stock exchange, this creates a legal and regulatory bonding whereby the foreign firms commit themselves to abide by higher corporate governance standards, such as stronger minority shareholder protection laws; however, this proposition does not often hold true. For example, Coffee notes that American stock exchanges often waive the need for foreign firms listing in the United States to comply with domestic corporate governance requirements.20

Licht also has noted that cross-listed foreign issuers in the United States are not required by the Securities and Exchange Commission to disclose matters such as the remuneration of company officers, the options they hold and their material transactions. He also suggested that trading on inside information was easier for these foreign firms.21 Another study also provides evidence that there are few enforcement actions taken in foreign jurisdictions against foreign firms that list there and breach local rules, although it is possible that the risk of prosecution may deter some foreign firms seeking to cross-list in the first place.22

In her study of the first nine Mainland companies to list on the Hong Kong Stock Exchange, de Jonge found that these firms had not adapted their corporate governance structures to comply with the dominant ‘outsider control’ system that is to be found in Hong Kong and in Anglo-American-type stock exchanges; instead they remained faithful to the broadly ‘insider control’ model that exists in China. As de Jonge observed, over time, these nine firms ‘remain stubbornly the same in the way they actually operate on a day-to-day basis, despite ostensible compliance with regulatory requirements aimed at promoting shareholder protection and market efficiency in ‘outsider systems’. This can be explained by the persistence of block-holder control of shares in these companies by the Chinese State.

In another case, in Singapore, corporate governance patterns in Chinese companies were again on public display. This concerned the collapse of China Aviation Oil (CAO), a subsidiary of a Mainland Chinese company, China Aviation Oil Supply Corporation (CAOSC). After an initial public offering of CAO shares, a 75 per cent stake in the company was transferred to CAOHC, a Chinese Government-controlled, state-owned holding company, which then gained control of CAO. In 2001 CAO was regarded as a leading company listed on the Singapore Stock Exchange. But in 2004 the company announced that it had suffered a loss of US$550 million from trading oil derivatives and sought bankruptcy protection after it had amassed significant losses from betting against the market in the belief that oil prices would fall. When CAO turned to CAOSC for assistance to cover its losses, the parent company decided to sell a 15 per cent stake in CAO on the market.
by way of a share placement; this sale raised SGD 185 million, which was provided to CAO as a loan to allow it to meet a margin call. CAOSC made this transfer when it became aware of the financial problems being suffered by CAO – that is, whilst in possession of material price-sensitive information about CAO. This sale took place about a month before CAO filed for bankruptcy. Once it filed for bankruptcy, the Singaporean authorities commenced an investigation into the share trade and CAOSC admitted civil liability for trading on inside information and paid a civil penalty of SGD 8 million. What is interesting is that penalties were imposed both on the local controllers of CAO and on the board members of the Chinese holding company. The latter’s penalties would have required the approval of the Chinese authorities, but the imposition of penalties by Singapore allowed it to show that it had an effective legal system, even though more of the response to the failure of CAO proved to be administrative in nature.

We can only speculate regarding the impact of cross-listing upon other Chinese companies; however, it is clear that patterns of corporate governance that exist in large public companies in China are likely to remain intact once they or their subsidiaries ‘go global’ through cross-listing on a foreign stock exchange. It is certainly something that will be important in countries such as Australia, which have seen such a large number of Chinese companies entering the local market. Understanding how they will behave will be greatly assisted by a better understanding of patterns of corporate governance that have developed in these kinds of companies in China.

Conclusion

The Go Global strategy might have been expected to consolidate the transposition of corporate governance practice and to hasten some convergence between Chinese and Anglo-American corporate governance practice; however, this does not seem to have happened. The earliest belief that American corporate block stockholders might modify corporate governance practice in Chinese companies was unable to dent the pre-eminent influence of the State in these companies. So too, the listing of Chinese companies on foreign stock exchanges does not seem to have resulted in these companies absorbing more refined principles of Anglo-American corporate law and governance.

The effect of ‘path dependency’ is such that the prospect of a significant convergence between the Chinese and Anglo-American corporate governance models is not high. As Shi has noted, this is because China’s governance models have been heavily influenced by local social, economic, political and legal traditions. Consequently, Shi adds: ‘China needs its own corporate governance model and supplementary corporate governance mechanisms that best suit the complex and changing nature of Chinese companies, which may not necessarily track international models.’ As a result, China’s SOEs ‘carry with them the historical and political burden of the path that led to their creation: a socialist economy in transition from a planned to a market economy’. 23

Evidence of this is found in the fact that legal concepts such as the fiduciary duties of company officers and obligations to minority shareholders have still not yet found a comfortable place in Chinese corporate law. Nor have important corporate governance practices, such as the augmented role for independent directors, been readily adopted. The fundamental reason for this appears to be the dominant and pervasive influence of the State, whether in domestic Chinese companies or in foreign-listed Chinese companies as a block stockholder.
Notes


23. Shi, Political Determinants of Corporate Governance in China, p. 130.
Instead of ‘a way-station on the road to liberal capitalism’, China has been increasingly viewed as an example of ‘state-led capitalism’ or its short form, ‘state capitalism’.1 Despite differences in the specific terms used, the various characterisations highlight a system that bears some resemblance to the post–World War II state-led economies (such as Japan, South Korea, Taiwan and France prior to the late 1980s) in which the State plays a ‘significant and visible’ role in promoting economic growth through association with or intervention in businesses.2

China’s form of state capitalism, however, may be distinguished from the former postwar state-led model in two important respects. The first is the unprecedented size and scale of state ownership in large domestic enterprises. Despite the rapidly growing private sector, state-owned enterprises (SOEs), especially those affiliated with the Central Government (Central
state-led model of corporate governance, which was developed based on the experiences of the postwar state-led economies several decades ago, have any application to China? In particular, does it describe state–manager relations in Chinese state-controlled listed companies today? China introduced major reforms to its decade-old Company Law and Securities Law in October 2005. With the adoption of many concepts and principles from the Anglo-American jurisdictions, the 2005 amendments were widely commended as having significantly modernised or Westernised the Chinese systems of corporate law and corporate governance. There has been, however, little discussion of state–manager relations in the listed SOEs from the perspective of the Chinese form of state-led economic development.

Recent literature has also highlighted a second feature of the Chinese form of state-led capitalism. This is the remarkable ability of the party-state to combine administrative with market-based means to achieve policy goals. Indeed, the combination of political objectives with enterprise profit-seeking goals in the Chinese State has led Bremmer to define state capitalism as ‘a system in which the state functions as the leading economic actor and uses markets primarily for political gain’.  

How might the rise of state capitalism in China impact on state–manager relations, as a fundamental aspect of corporate governance, in state-controlled listed companies? The nexus between state-led economies and a state-led model of corporate governance has been illustrated by comparative corporate governance researchers such as Hansmann and Kraakman as well as a number of capitalism theorists.  

maximising financial return to shareholders, corporate governance in a state-led economy is often an instrument of the State to promote rapid economic development through intervening in the affairs of large companies. Therefore, state control and/or direction of managers is a typical feature of corporate governance in the state-led model, along with other features such as high levels of employee protection to elicit long-term employee commitments, the muted voice of outsider minority shareholders, and poor protection of other non-shareholder stakeholders (the former state-led model).

...
The governance of SOEs in China

Jenny Fu

Where the State is the controlling shareholder, another avenue for the State to influence the affairs of a listed company was the company’s senior management, especially the chair of the board of directors (commonly referred to in China as the ‘chairman’). The position of the chairman under the 1993 Company Law was very similar to a top manager in a traditional SOE. The chairman was given a broad range of powers and responsibilities under the 1993 Law. These included convening and presiding over shareholders and board meetings and examining the implementation of board resolutions. The chairman was the only director to whom the board might delegate part of its functions and powers outside board meetings (Art. 120[1]). Further, as the statutory company ‘legal representative’, the chairman had the sole power to represent the company in executing contracts and undertaking legal proceedings (Art. 113[2]). The political leadership role of the chairman in the company was often reinforced by their concurrent appointment as the company’s party secretary. Indeed, the extensive powers and responsibilities associated with this position often led the chairman to overstep the general manager to become a company’s real chief executive officer.

One consequence of the 1993 Company Law’s preservation of state control over corporatised SOEs was lax internal control. The concentration of powers in the general meeting and the chairmen inevitably limited the role of the board of directors and the board of supervisors. The supervisory board, which was made up of shareholder (generally the controlling shareholders) and employee representatives, lacked both monitoring powers and independence from the company management. Further, the concentration of powers in the general meeting (essentially the control-
ling shareholder or parent SOEs) and the chairman as a party-government appointee further contributed to the lax external monitoring environment on the exercise of powers by those corporate controllers. This was particularly so with the overlapping roles of the State as a corporate controller, a regulator of the stock market and an adjudicator of securities-related disputes.

With the lax internal and external monitoring environments, the problem of insider control of listed SOEs by their top executives, particularly the chairman, and parent SOEs became rather prevalent. Substantial risks associated with this model resulted in several major corporate scandals involving listed SOEs. These included the 2004 China Aviation Oil saga, which led to the collapse of a Singapore-listed subsidiary. In another case, a former chairman of Sinopec was sentenced to a suspended death penalty for taking bribes of RMB 196 million (approximately A$32 million).

As the China Securities Regulatory Commission (CSRC) took on the leading role of promoting good corporate governance, it sought to introduce some checks and balances into the governance of listed companies by borrowing from Anglo-American experiences. For example, the CSRC required all listed companies to have at least one-third independent directors, with at least one of them an accounting professional. The CSRC also issued the Code of Corporate Governance for Listed Companies, which recommends that specialised board subcommittees (such as the audit committee, the nomination committee, and the remuneration and appraisal committee) be adopted in all listed companies; however, these reform measures did not alter the basic state-centric governance structure established under the 1993 Company Law. The independent directors did not play a major role in the governance of listed SOEs. This was, in part, due to their lack of independence from the parent SOEs and/or the management of listed companies to whom they owed their appointment.

With economic globalisation and competition and pluralisation of interests within Chinese society, this state-led model of governance of listed SOEs faced increasing criticism from the public. Economic globalisation has been widely regarded as one of the key challenges faced by all forms of state-led economies. In the area of corporate governance, since globalisation increases the free movement of capital, governments are under increasing pressure to conform to certain international standards of corporate governance – namely, Anglo-American standards.

Since the 2000s, China has faced unprecedented challenges from globalisation and competition. China’s WTO accession in 2001 was viewed by Chinese policymakers as an instrument for furthering economic reform and development; however, with WTO accession, the challenges faced by Chinese policymakers were imminent and multifaceted. On the one hand, the Chinese Government had to improve its market access through not only reducing trade barriers and opening important service sectors (such as banking and finance industries) to foreign businesses, but also by altering the regulatory framework to meet international standards and practices. On the other hand, poor corporate governance of SOEs meant that they were poorly adapted to international competition, especially from multinational corporations. Indeed, despite their surging accounting profits and international profile, the average efficiency of the SOEs has continued to lag behind the Chinese private sector. A disproportionate share of the SOE profits continued to be made by less than ten giant groups in state monopoly sectors such as petrochemicals and telecommunications. The lack of efficiency of the state sector has led various commentators to continue to associate the improved financial positions of the SOEs with their monopoly status and government policy support.

Economic globalisation aside, diversification of interests within Chinese society has become an additional challenge faced by Chinese policy makers in maintaining state control of large firms. Similar to the former East
As a result of these growing criticisms, Chinese policymakers have resorted to further reform of the SOEs, including corporate governance, to improve their efficiency and public image. Extensive changes have been introduced in China’s post-2005 regulation of state–manager relations. As discussed below, various market-based mechanisms based on Anglo-American corporate governance have been introduced to reform state–manager relations at the level not only of listed companies, but also of their parent SOEs. While some of the mechanisms have sought to place more checks and balances on the exercise of power by top corporate executives, others provide them with extra incentives to maximise the financial performance of their companies (which ultimately coincides with the economic-oriented goals of the State). Still other reforms have been introduced to enlist market-based institutions, such as external directors, institutional investors and foreign stock market regulators to monitor and discipline managers. The participation of these outside forces will presumably help to mitigate the problem of weak legal enforcement against corporate misbehaviour on the Chinese stock market.

**Post-2005 governance reforms**

**Regulatory changes to state–manager relations within listed SOEs**

Like the corporate structure under the 1993 PRC Company Law, the hierarchical structure has not been altered by the 2005 Company Law and has continued to serve as a conduit for state intervention in corporate affairs. The new Company Law and the subsequent regulatory reforms have, however, made attempts to improve the accountability of managers, including the chairman, by readjusting the power distribution among different corporate organs and putting in place more checks and balances in the exercise of management powers. Many of the changes introduced in this respect post 2005 are not unfamiliar to scholars acquainted with Anglo-American corporate governance.

First, some changes were introduced by the new Company Law to strengthen the role of the board of directors in executive decision-making. Under the 1993 Company Law, it was impossible for the board to meet and pass resolutions when the chairman had neither convened a board meeting nor designated the deputy chairman or another director to do so. The new
Company Law makes it clear where the chairman fails to perform any of their responsibilities, including those to convene and chair a board meeting, such responsibilities shall be performed by the deputy chairman, or otherwise, a director nominated by more than half of the directors (Art. 110[2]). Furthermore, the new Company Law gives the power to requisition interim board meetings to a much wider range of corporate actors, including shareholders with at least 10 per cent shareholding in the company (Art. 111[2]). To ensure all directors enjoy equal decision-making power, the new Law also specifies the principle of one director one vote over board resolutions (Art. 112[2]). As another effort to strengthen the role of the board, the new Company Law has broadly endorsed the system of independent directors for listed companies first introduced by the CSRC, and designated the State Council to make detailed rules in the relevant area (Art. 123).

Second, as a corollary to the strengthened role of the board, the powers of the chairman in management decision-making have been curtailed. For example, the provision under the 1993 Company Law that gave the board of directors the power to delegate part of its functions to the chairman has been deleted. The revised Company Law allows companies to appoint their legal representatives from a much broader range of executives including the chairmen, executive directors and the general managers (Art. 13). Consequently, the old provision that granted the chairman the sole authority to sign the shares and corporate bonds has been removed.

Third, the powers of the supervisory board in monitoring directors have been expanded under the new Company Law. In relation to information gathering, in addition to their routine powers to inspect company financial affairs and audit directors’ meetings, the supervisory board has been given the power to make inquiries and suggestions at the meetings of boards of directors (Art. 55[1]). The revised Company Law also grants the supervisory board the power to investigate any irregularities in company operations.

In so doing, it may seek help from professional advisors such as accountants, with expenses covered by the company (Art. 55[2]). Where a director or senior manager fails to rectify alleged wrongdoing upon request, the supervisory board has more options at its disposal under the new Company Law. These include convening and presiding over an extraordinary general meeting to report its findings to the shareholders (Art. 119[1]), proposing the general meeting to remove the wrongdoer (Art. 54[2]) or, at the request of shareholder(s) with at least 1 per cent of the shareholding in the company for 180 consecutive days, bring a derivative action on behalf of the company against the wrongdoer (Art. 152[1]).

Fourth, further to strengthening the roles of the board of directors and board of supervisors, the new Company Law has imposed more stringent duties on the members of both boards and senior managers. The 1993 Company Law required directors, supervisors and the general manager to ‘perform their functions and responsibilities loyally’ but omitted a director’s duty of care and diligence. This extremely weak regime of directors’ duties has been considered by some Chinese legislators as contributing to the problem of insider control in listed companies. Under a new chapter (Chapter Six) entitled ‘Qualifications and duties of directors, supervisors and senior managers’, the revised Company Law specifically subjects directors, supervisors and senior managers to the duties of care and diligence, as well as the duty of loyalty (Art. 148[1]). The new Company Law also expands the types of conduct that would constitute a breach of a director’s duty of loyalty under the 1993 Law. Thus, various conflict-of-interest situations under the Anglo-American jurisdictions – for example, usurping corporate opportunity and accepting secret commissions – have been included (Art. 149). This revamped directors’ duty regime has been further reinforced with the introduction of a number of Anglo-American-style shareholders’ rights and remedies.
Reforms at parent SOE/corporate group level

State-manager relations in listed companies cannot be isolated from their state-owned parents. This is especially so given that most state-controlled listed companies in China are dominated by their state-controlled parent companies, with the top executives of the listed companies often overlapping with those of the parent companies. As discussed below, market-oriented reforms at the level of listed companies have been complemented by reforms at the parent SOE level.

China’s post-2005 corporate governance reform at the parent SOE level cannot be separated from the emergence of the SASAC as a powerful regulator of and state shareholder in these large companies. The creation of the SASAC in 2003 strengthened the role of the State as an investor and provided a leading government agency to further reform the state sector. The corporatisation reform from the early 1990s helped to improve the efficiency of the SOEs through designating the state shareholding agencies; however, in part due to the lack of delineation of the rights and responsibilities among different central and local government shareholders and other agencies involved in the management of the SOEs, the fragmentation of both shareholders and their rights and obligations over the incorporated enterprises persisted. As no one agency assumed the ultimate responsibility for the enterprise bottom line, improvement in the overall performance of the SOEs was quite limited. At the sixteenth National Party Congress in late 2002, the Party put forward two guiding principles for further reforming management of state-owned assets in industrial and commercial SOEs. The first was the separation of state investor functions among different levels of government to ‘give full play to the initiative of both the Central and local authorities’. Hence, the Central Government would retain its state investor functions over SOEs that ‘have bearing on the national economic lifeline and state security and enterprises in such fields as important infrastructures and natural resources’, and hand over all other enterprises – usually the less strategic or less profitable ones – to governments at provin-
Lying at the heart of the ‘standardised board’ is the introduction of SASAC-nominated external directors onto the boards of directors in the Central SOEs. The standardised Central SOE board has seven to thirteen directors with the majority being external directors. SASAC has also set out detailed rules concerning the desirable mixture of skills among the external directors. For example, the majority of outside directors should have experience in managing large enterprises, and at least one of them should have an accounting background. Appointment of foreign external directors is also stressed for companies with substantial business operations overseas. The board should also establish several sub-board committees, including the nomination committee, the remuneration and evaluation committee and the audit committee, to act as advisory bodies to the board. While it is required that the majority of the nomination committee is filled by external directors, the last two committees shall only be filled by external directors.

To further reduce power concentration, SASAC has also required the standardised board to display a clear separation of the role of the chairman from that of the general manager and the role of the board from managers involved in the company’s day-to-day operations. The chairman must be responsible for the oversight of the proper functioning of the board, and the general manager for the organisation of day-to-day business operations. The two positions are required to be separated where possible. To separate the role of the board from senior managers, managers other than the general manager (such as the deputy general manager and chief accountant) should not be directors. To further empower the standardised boards, SASAC has delegated them the power to appoint, evaluate and remunerate some of their senior managerial roles, including the general manager, chief accountant and the board secretary.

When SASAC was first created, there was considerable public suspicion about its ability to rein in and extend its reform agenda to the Central SOEs. This was mainly due to the political power and influence of the large SOE leaders. These leaders are appointed by the Organisational Department of the Central Party Committee and are often politically influential and well-connected figures within the party framework. Within a few years, however, SASAC has emerged as a strong Central Government regulator through taking over many powers from other central political authorities (such as some personnel appointment powers from the Party Organisational Department) as well as creating new powers for itself, such as the power to collect dividends from the central SOEs and approve their budgets and major investment plans. This significant surge in SASAC powers paved the way for a new state-led approach to the reform of state–manager relations in large listed SOEs that combines state and market forces.

SASAC has undertaken several reforms to turn gigantic traditional SOEs into modern large corporations since the mid 2000s. First, SASAC has undertaken the important step of introducing the so-called ‘standardised board’ reform to strengthen the effectiveness of the boards of parent SOEs. SASAC initiated a pilot program in June 2004 and selected seven Central SOEs to participate in an experiment of the ‘standardised board’. By the end of 2011, 42 of the 121 SASAC-controlled SOEs had undergone the reform.

Consequently, the SASAC was established under the State Council in 2003 to consolidate Central Government control over the then 196 large SOEs previously administered by various ministries. For enterprises in the financial sector that fall outside SASAC’s purview, Central Huijin Investment Limited (which was merged into China Investment Corporation, China’s largest sovereign investment fund, in 2007) was established to hold state shares in major financial institutions including the four largest Chinese commercial banks.
In addition to the standardised board reform, SASAC has paid considerable attention to improving managerial incentives by introducing performance evaluation of SOE managers and strengthening managerial responsibility for preserving enterprise assets. Under the new schemes, senior executives, including the chairman, are required to enter into three-year performance contracts with SASAC. The contracts outline both annual and three-year targets. Profit-based performance indicators, such as annual profits and return on equity, are the key components. In its evaluation of SOE executives at the end of each year and the three-year period, SASAC scores the performance of each executive on a 100-point scale and assigns a grade from A to E accordingly. The grades received by the executives are further tied to their incentive pay. To strengthen managers’ responsibility for preserving state assets vested in their enterprises, SASAC released the Interim Measures for Pursuing Liability for Loss of Assets to Central Government-affiliated SOEs in 2008 (the ‘Interim Measures’). The Interim Measures specify various administrative penalties that may be imposed on SOE managers where they have neglected their duties thereby causing a loss to enterprise assets. Such penalties range from fines and dismissal to disqualification from managing an enterprise for a specific period and permanent disqualification.

Concerning the governance of parent SOEs, another even bolder step undertaken by SASAC has been the promotion of full listing of these large parent SOEs on domestic and overseas stock markets. This strategy was adopted by SASAC with the Singaporean Temasek model in mind. If successful, this strategy could potentially transform SASAC from an owner-manager of the Central SOEs to a state financial holding institution, similar to Temasek, which holds major shareholdings in large listed companies.

SASAC and other commentators have identified at least two advantages of the full listing of SOEs. First, the integration of the main business of the corporate group into the listed companies will help the latter achieve greater economies of scale and synergies in business operations. As the capacity of these companies expands, their international competitiveness may also be enhanced. Second, full listing would lead to better liquidity of state-owned assets, therefore providing SASAC with greater flexibility in the operation of state-owned assets.

Corporate governance, nevertheless, plays a dominant role. This is especially so as SASAC has combined full listing with listing SOEs on overseas, including Hong Kong, stock markets. According to Shao Ning, Deputy Director of SASAC, these enterprises will be forced to undergo thorough restructuring when they list overseas. They will also be brought under the close scrutiny of foreign regulators and a much more sophisticated international investment community. All these factors will contribute to better corporate governance.

SASAC has set itself the target of achieving the ‘full marketisation’ of Central SOEs within ten to fifteen years. This is not an easy task. By the end of 2011, 40 of the 117 SASAC-controlled Central SOEs had listed all, or substantial amounts, of their main business on the stock market; however, few of these corporate groups have realised the listing of their parent SOEs. A ‘shell parent company’ that has no functions to perform except for holding shares in its listed subsidiary may not be conducive to management efficiency. SASAC has therefore been undertaking research to resolve the ‘shell parent company’ issue. There seems to be no legal obstacle for SASAC to hold shares directly in listed companies. This solution, however, requires that the overlapping roles of SASAC as a state shareholder and a regulator of state-owned assets be first addressed. Given the large number of Central SOEs, it has also been suggested that several state-asset management companies be established under SASAC to hold state shares in the listed SOEs. If either option proceeds, there is a prospect that the Chinese state-controlled listed companies will become ‘parentless’ companies under SASAC’s direct control, or will be indirectly controlled through its investment arm. The
potential integration between the unlisted parent SOEs and their listed subsidiaries also means that the standardised board reform that is currently pursued by SASAC is only a transitional phase.

The above review of post-2005 legal and regulatory changes within Chinese listed SOEs and their parent companies shows that in an effort to improve the governance of listed SOEs, Chinese policymakers have become far more receptive to Western principles and structures of corporate governance. Consequently, many mechanisms from advanced market economies have been utilised to solve the old problems associated with the governance of Chinese listed companies (especially the problem of insider control by senior executives and parent SOEs) as well as to respond to international and domestic pressures for change imposed on these large companies. The introduction of these wide-ranging market-based mechanisms inevitably leads state–manager relations in the listed SOEs to shift away from the Chinese traditional state-led model that largely relied upon administrative control and supervision of enterprises. Viewed in isolation, these market-based changes may well suggest that the regulation of state–manager relations in China is moving towards the Anglo-American outsider-based model. Nevertheless, as the examination of the continuities in China’s post-2005 regulation of state–manager relations below will suggest, strong state involvement in the affairs of the listed SOEs has remained despite the various market-oriented reforms discussed above.

Post-2005 regulation of state–manager relations: what has not changed?

First, the ultimate control of the Party/government over the parent SOEs has not changed and has, arguably, been strengthened by various market-based reforms introduced by the SASAC. From the outset, in addition to ownership links, the Chinese system of ‘party management of cadres’ has remained a central instrument for the party-state to retain control over these large enterprises. Among the 121 SASAC-administrated Central SOEs, the top three leadership positions – namely, the chairman, the party secretary and the general manager – in 53 of the largest Central SOEs are still appointed and evaluated by the Organisational Department of the Central Party Committee. For the remaining 68 Central SOEs, as noted earlier, SASAC has authorised those with a standardised board structure to appoint some of their senior management positions such as the general manager and the deputy general manager. SASAC, however, retains its power over the appointment, evaluation and remuneration of the top two leadership positions in these enterprises – namely, the chairman and the party secretary. Moreover, SASAC also appoints, evaluates and decides the remuneration of other directors, including external directors and supervisors in these Central SOEs. Personnel decisions in local SOEs at provincial, municipal and county levels are managed by the local branches of the Organisation Department of the Party Central Committee and the local equivalents of SASAC.

With personnel decisions in the Central SOEs continuing to be controlled by SASAC and the Party, the various market-based incentives and constraints that SASAC has introduced into these enterprises have, arguably, strengthened the party-state’s control over these companies. This is because these SOEs executives have incentives to adhere to the policy goals of the Party and the SASAC.

Often SASAC has other decision-making powers over the parent SOEs, due to its role as their sole shareholder. These include the power to decide on matters such as mergers, split-ups, changes in a company’s registered capital, as well as the issuance of corporate bonds. SASAC also has the power
to approve Central SOEs’ investments that fall outside their core business as defined by SASAC. Furthermore, in an effort to strengthen the supervision of the implementation of China’s Go Global strategy, the Central Government has conferred on SASAC broad powers to administer outbound foreign direct investment by central SOEs. Under the Interim Measures for Supervision and Administration of Foreign Investment by Central Enterprises (the ‘Interim Measures’) released by SASAC in March 2012, SASAC is responsible for overseeing the establishment of an internal foreign investment management system within all Central SOEs and the compilation of annual investment plans by these enterprises. Foreign investment projects that fall under a Central SOE’s core business (as defined by SASAC) must be included in its annual investment plans and lodged with SASAC for record-keeping. Projects that fall outside the core business must be submitted to SASAC for approval. The boards of Central SOEs are also required to be responsible to SASAC, implement SASAC decisions, accept its guidance and maintain transparency in board operations to SASAC. As a side note, the Interim Measures also require Central SOEs to ‘avoid vicious competition’ in pursuing their respective overseas investment projects.

How does SASAC’s control of the parent SOEs translate into its control over the listed companies? In addition to controlling state shareholding in both the parent SOEs and the listed companies, the overlapping top executives in the listed companies and their state-owned parents hold the key. In a survey of 109 listed companies controlled by the Central SOEs in 2010, 80 per cent of the chairmen’s roles in these companies were held by senior executives of the companies’ state-owned parents. In addition, 35 per cent of other non-independent directors in the listed companies coincided with senior executives in the listed companies’ state-owned parents.

As long as the State retains controlling shareholding in listed companies, the overall listing of the SOEs is unlikely to weaken SASAC’s control over these companies to any significant extent. Most of the Huijin-controlled companies, including China’s four largest commercial banks, have fully listed their parent SOEs. Yet the executive directors of these companies, such as the chairman and the bank president, remain appointed by the Party’s Organisational Department, while most of the non-executive directors (except for independent directors) of these companies are nominated by Huijin.

Last but not least, so long as the State retains controlling shareholding in the listed SOEs, the channels for state involvement in the management of these companies have not been removed by the 2005 Company Law. Under the 2005 Company Law, the presence of the Party in Chinese companies has been retained and even strengthened. The 1993 Company Law, echoing a relevant provision in the Constitution of the Chinese Communist Party, provided that a grassroots organisation of the Party shall be established in all companies and carry out its activities according to the Party’s Constitution (Art. 17). Article 19 of the new Law, while retaining this provision, goes further to require that ‘companies shall provide necessary conditions to assist the activities of the Chinese Communist Party’. This addition followed the release of a joint circular by the Organisational Department of the Central Party Committee and the SASAC in 2004, which called for establishing the Party’s ‘core political’ status in Central SOEs.

**Conclusion**

This chapter has reviewed China’s post-2005 developments in the regulation of state–manager relations in large state-controlled listed companies. By examining the changes and continuities, the chapter has shown the emergence of a new state-led approach to the regulation of state–manager relations in these companies. On the one hand, this approach has significantly moved away from the pre-2005 state-led model by applying extensive market-based governance mechanisms to both listed companies...
and their state-owned parents. On the other hand, this approach has been adopted to strengthen, rather than weaken, the effectiveness of state control over these large enterprises. This new state-led model contradicts a popular prediction that Chinese corporate governance is converging with the Anglo-American model. It cannot, however, be separated from China’s efforts to maintain its state-led model of economic development amid international and domestic pressures for change, particularly economic globalisation, the pluralisation of interests within Chinese society and the poor governance of the SOEs.

As the chapter by Tomasic suggests, Chinese policymakers will continue to face the battle between retaining ultimate state control over the country’s large SOEs and improving their management efficiency. Many of the problems in Chinese corporate governance will not be easily resolved. This is especially so as the overlapping role of the State as a market player, regulator and adjudicator of securities-related disputes has remained largely unchanged. Nevertheless, as long as this new approach to state–manager relations continues to serve state policy goals, it is unlikely to be subject to significant changes in the near future.

Notes
Investment and public sector audits

The investment relationship between Australia and China is of obvious importance. Greater investment in both directions serves to deepen and strengthen the complementary economic relationship between our two countries. Investment requires a deeper relationship than mere trade: it requires a long-term relationship in which at least one party is comfortable operating in the other’s business environment. The business environments in Australia and China have many points of difference. It is therefore not surprising that there have been some difficulties in the investment relationship, including in the recent past. Chinalco and Huawei are Chinese companies that have been denied the opportunity to make substantial investments in Australia. Conversely, some Australian companies have had less than happy experiences in China. One of the aims of this book is to identify the sources of the difficulties and seek to find appropriate frameworks and regulatory arrangements that can reduce the roadblocks and facilitate strengthening the investment relationship to our countries’ mutual advantage.
This chapter starts from the premise that many of the Chinese entities that seek to engage in investment relationships with Australia, and indeed the rest of the world, are SOEs. In any potential investment relationship, it is important for each party to be satisfied as to the competence and intentions of the other party. In almost every case, an important component of ‘competence’ relates to the financial position and performance of the parties. It is likely that potential investors would find challenges in understanding the financial position and performance of Chinese SOEs.

The work of the Chinese National Audit Office may be able to provide some assistance in this regard. The instant reaction of most Westerners is that Chinese Government auditors say what the Communist Party tells them to, and the financial statements they sign, and the corresponding representations by SOE management, can neither be trusted nor relied upon. Such reactions are essentially reflections on the perceived independence of the Chinese Government auditors.

The research team at the University of Canberra has recently commenced a research program to investigate the independence of the Chinese Auditor-General and the Chinese National Audit Office (CNAO), which supports him. The motivation for this study has its origins in two extended visits by CNAO officers to the University of Canberra to undertake training in advanced audit methods. These visits involved around 50 CNAO staff and some eight months of full-time study at the University of Canberra.

The aim is to understand what ‘independence’ means in the context of public sector audit in China.

**The Chinese Auditor-General: institutional arrangements**

The institutional arrangements for the Chinese Auditor-General and the CNAO are a work in progress. In reviewing these arrangements it is therefore important to be aware of recent developments. From 1949 until 1982, there was effectively no audit in China. It was only with China’s reawakening that the need for audit was recognised.

Since 1982, China has acquired, in quick order

- an audit function
- public sector audit
- an Auditor-General
- a National Audit Office to assist the Auditor-General
- an embedded position and function for the Auditor-General in the national Constitution, and establishing the Auditor-General as a member of the State Council
- an Audit Law
- audit standards
- audit procedures.

Much of this documentation has been examined and the detail seems to be much what you would expect to see in almost any country for an audit office. The elephant in the room is the fact the Auditor-General is a member of the State Council (the equivalent body in Australia is Cabinet) and reports to the Premier.

There has been a concomitant change in aspects of the operation of the Chinese Auditor-General. These include the Chinese Auditor-General giving press conferences on his audits, making the annual report to the National People’s Congress public and making summaries of audit reports publicly available.
An assessment of the Auditor-General’s independence

Critical comparison with Australia

‘Independence’ is a slippery concept, and the research program first sought to compare the independence of China’s Auditor-General with that of Australia’s. Australia was chosen for two reasons:

1. Australia’s Auditor-General operates within a framework that is typical of Western government systems based on Westminster-style parliaments
2. a system of numerically rating the independence of the auditors-general within Australia has been developed; this rating system has not been published, but it has been given an airing in at least one seminar at The Australian National University.

The rating system looks at independence from ten criteria. Each of these criteria is rated with a score that reflects their relative importance to independence as adjudged by Ken Coghill, who was formerly a speaker in the Lower House of the Victorian Parliament. The scoring is organised so that the maximum possible score is 100.

Coghill’s rating for the Australian Auditor-General was 83. The ratings for the states and territories were lower than this, ranging down to the thirties. When we applied the same scoring to the Chinese Auditor-General, the rating was 37.5. The obvious conclusion is that the Chinese Auditor-General is not independent according to Western standards of independence; however, we are also acutely aware that some of the criteria do not apply in China, so that the comparison was not really fair.

Consideration of international standards

Other criteria were then sought, including those without a scoring system. The best ones we have identified are those of the International Organisation of Supreme Audit Institutions (INTOSAI). INTOSAI is an independent body that operates under the auspices of the United Nations, and comprises the auditors-general of UN member states. INTOSAI regards the independence of auditors-general as critical to their effectiveness. In 1977 it set out a statement on the independence of auditors-general, and reduced this statement in 2007 to a set of core principles.

When these principles were applied to the Chinese Auditor-General, the office came out rather better, but still failed the crucial test of independence: the Chinese Auditor-General reports to the Chinese Premier (the head of the Chinese Government), and it is through the Premier that the Auditor-General reports to the National People’s Congress.

Assessing the CNAO’s claims to effectiveness

Discussions were held with senior officers of the Chinese National Audit Office and with two auditees, one of which was a subsidiary corporation of an SOE. A common theme in the discussions was that while the Chinese Auditor-General was not independent, he was effective. ‘Independence’ was stated to be ‘an input to the audit process. CNAO is interested in outcomes.’

The evidence for the effectiveness of the CNAO is quite broad and includes the following.

- The ‘audit storm’: the public reaction in China when the Auditor-General’s 2004 report to the National People’s Congress was made public and revealed widespread corruption. The then Auditor-General, Li Jinhua, was voted ‘Person of the Year’ in a vote run by a major newspaper in China.
- The fact that summaries of audit reports are made public on the CNAO website. These summaries have also been translated into English.
- The recent provision for ‘economic responsibility’ audits whereby senior public servants, including those in SOEs and the Chinese Communist Party,
can be held individually to account for their use of public funds under their control. There are reports that some 160,000 of these audits have been conducted, and about 4 per cent of them have revealed financial misbehaviour of some sort. CNAO claims that some very senior people have been subject to these audits, including provincial governors and members of the State Council. The CNAO newspaper has also reported on the numbers of people who have been punished within their organisations, through the court system or by the Party as a result of economic responsibility audits.

- A presentation of this research was made at an ANZSOG Institute of Governance seminar held in June 2012 at the University of Canberra. At this seminar, one comment was that many SOEs have recently set up subsidiaries as private sector enterprises in order to avoid public sector audit scrutiny. The suggestion that audit activity is causing organisations to change their behaviour is an indication of audit effectiveness.

Two areas in which the CNAO has persuaded the international public sector audit community of its merits deserve mention: first, the Chinese Auditor-General has been elected to the UN Board of Auditors. The board is responsible for auditing the United Nations. And second, World Bank projects in China are now audited by CNAO on behalf of the bank.

An example of an audit report

Funds and projects in support of Xinjiang’s development in 2011

This is the summary of an audit report placed on the English version of the CNAO web site on 20 April 2012.² The following is a precis of the summary. In 2011, some 3,212 projects supporting development in Xinjiang Province were jointly funded by the Central Government, five Central Government SOEs (China National Petroleum Corporation, China Petrochemical Corporation, State Grid Corporation of China, China Huaneng Group and Shenhua Group Corporation Limited) and nineteen provinces and municipalities, with planned investment of RMB 132 billion.

The CNAO and its subsidiary offices in Xinjiang Province deployed more than 540 auditors to audit 762 projects with a total investment of RMB 316 billion. (The projects audited evidently covered investment across several years.)

The audit report summary provides details of

- joint funding partners who had not provided funds when required
- misappropriation of funds to other purposes – for example, Xinjiang Power Transmission and Distribution Engineering Company and its affiliated Fifth Branch Company misused RMB 8 million for a reception and bonuses by falsely issuing invoices for materials and transport
- projects started before all relevant approvals had been obtained, resulting in the need to reroute a highway when oilfields were discovered
- 1,194 contracts either failed to invite tenders or improperly determined the winner; construction contracts were awarded to enterprises that lacked the engineering qualifications to undertake the work; one case mentioned was of an SOE that won a construction contract and then subcontracted to a private enterprise that lacked the relevant qualifications; the SOE claimed a management fee of 3 per cent or RMB 9 million (this could be an example of an SOE setting up a private enterprise beyond the reach of the CNAO, along the lines of the fourth dash point in the paragraph above on effectiveness)
- improper supervision of quality, including 51 faked work acceptance records and identifying poor and possibly dangerous construction work
- poor investment control when projects ran over budget.
Conclusion

The CNAO and the Chinese Auditor-General are not independent in terms of Western standards. The CNAO does not operate in a democracy but in a unitary government, where the executive, the legislature and the judiciary are not separated but are all under the control of the Communist Party. In such a unitary system, independence as understood in the Western democratic tradition simply does not make sense.

The Chinese Auditor-General and the CNAO operate in a way more like an internal auditor to the entire Chinese Government than as an external auditor. In addition, the CNAO has certain powers that Western auditors do not possess, such as economic responsibility audits. CNAO is working to strengthen transparency and accountability in public life in China.

When an investment relationship is contemplated, the parties will generally wish to undertake some form of due diligence on each other. The question is whether and how the CNAO might facilitate such investigations. The CNAO is having some impact on public sector business culture in China, although the extent of the effect is difficult to gauge. The CNAO is nevertheless trying to improve transparency and accountability in the public sector in China. As such, it deserves to be encouraged, studied more and understood better in the West.

How might the work of the CNAO facilitate the Australia-China investment relationship? This is primarily a task for future research, for policymakers and legislators; however, it is suggested that parties negotiating with SOEs require, at an early stage of negotiation, disclosure of all instances of adverse findings by CNAO and perhaps by other organisations such as SASAC. As international relationships are highly prized in China, a condition of this nature may encourage SOE senior management to be more vigilant in discouraging inappropriate behaviour within their organisations. Such an outcome would serve the interests of the parties negotiating with SOEs, and the CNAO. It would also benefit China more broadly as it implements its Go Global strategy for SOEs with ever more vigour and resources.

Notes

2. The discussions with officers of the Chinese National Audit Office were held under the auspices of the China Audit Society, whose assistance in facilitating the discussions we gratefully acknowledge.
3. CNAO Audit Report, No. 8 of 2012, online at: http://www.cnao.gov.cn/main/articleshow_ArtID_1227.htm
PART V

The Future of the Relationship
The concept of a rent resources tax and the Henry Review

The recent imposition of a Mineral Resource Rent Tax (MRRT) on profit generated from iron ore, coal and gas from coal seams, and a new Petroleum Resource Rent Tax (PRRT) on onshore oil and gas deposits and the carbon tax have been the subject of heated debate in Australia. Taxing resource rents and unimproved land values are examples of the taxation of economic rents. The government has adopted one small part of such a tax (namely, an MRRT on minerals), and to date has rejected two other aspects of such a tax, a land tax and a bequest duty, while accepting that at some time in the future it may be appropriate to look at a business-level expenditure tax or cash-flow tax – that is, a tax on the economic rents of business.
Economic rent is that return over and above the return necessary for the activity to take place. One of the best explanations of the concept of ‘economic rent’ in the MRRT context is the following definition provided by Ross Garnaut and Anthony Clunies Ross:

Economic rent is the excess of total revenue derived from some activity over the sum of the supply prices of all capital, labour, and other ‘sacrificial’ inputs necessary to undertake the activity ... In essence, it refers to the reward that a landowner could derive by virtue simply of being a landowner and without exerting any effort or making any sacrifice.1

According to Garnaut and Clunies Ross, the philosophical basis for the imposition of a rent tax is fourfold: first, that the minerals belong to the State and the rent tax is the price for extracting state-owned assets; second, the collection of economic rents may result in a large amount of revenue being collected without distorting production; third, that mining companies are very large and usually involve some degree of foreign ownership; and fourth, that from an equity perspective a higher rate of tax can be justified.

Mineral resources are non-renewable and the State has only one opportunity to maximise its return for the Australian community.

The renewed interest in a resource rent tax (RRT) on mining was the initiative of Dr Ken Henry and the members of the review into ‘Australia’s Future Tax System’, now commonly referred to as the ‘Henry Tax Review’. The review recommended the introduction of an RRT for all mineral and petroleum resources except brown coal to replace the previous system that allowed the states to collect revenue based on the value of the resource being sold and the volume of output. The Henry Tax Review applies the general logic of economic rent to the specifics of minerals. The following passage from the review provides an excellent explanation:

The finite supply of non-renewable resources allows their owners to earn above-normal profits (economic rents) from exploitation. Rents exist where the proceeds from the sale of resources exceed the cost of exploration and extraction, including a required rate of return to compensate factors of production (labour and capital). In most other sectors of the economy, the existence of economic rents would attract new firms, increasing supply and decreasing prices and reducing the value of the rent. However, economic rents can persist in the resource sector because of the finite supply of non-renewable resources. These rents are referred to as resource rent.

Dr Henry and his review panel recommended the replacement of state-based royalties with a uniform resource rent tax collected by the Australian Government. In turn the Australian Government would negotiate the allocation of the revenue between the state and territory governments. The Henry Review contended that by abolishing royalties, mining companies would not have to comply with and administer two tax systems and that a resource rent tax would promote more efficient production.

Henry examines the various options for taxing mineral and petroleum resources. There are two versions of a resource rent tax (RRT) that are referred to in Chapter C of the report as well as the literature on this area of taxation.

The first version is a ‘Brown Tax’, which is based on the work by the American economist E. Cary Brown. The second version is what is known as the Garnaut and Clunies Ross rent tax. Both versions of the rent tax are similar except the ‘Brown Tax’ requires the State to recompense the mining company for expenses incurred in the exploration and early production phases where there are negative cash flows. The payment required by the State is equal to the product of the tax rate and the value of negative cash flow. In other words, the mining project is paid compensation by the State based
on the losses incurred in the project up to that point. This would mean that
governments bear some of the risk of the project and this may be substan-
tial with very large projects that are non-productive. In some instances it
may create sovereign risk for the State.

The second version, the Garnaut and Clunies Ross model, is similar ex-
cept negative cash flows are carried forward until such time as the pro-
ject becomes cash positive. In order to compensate the project, the losses
are carried forward with an uplift factor. For example, under the PRRT in
Australia, the uplift factor is the long-term bond rate plus 15 per cent for
exploration expenditure or 5 per cent for project development and oper-
ating expenditure. The Australian Government has accepted the Garnaut
and Clunies Ross model and this is acknowledged in the MRRT Explanatory
Memorandum.

The Australian PRRT and MRRT

In 1984, the Hawke Labor Government introduced a petroleum resource
rent tax (PRRT), based on the Garnaut and Clunies Ross model, in order to
remedy the state-based taxation system of imposing royalties on resource
production output. The Act was effective from 15 January 1984, even
though the legislation was not passed by Parliament until 1987. The Act
applied retrospectively to exploration permits awarded on or after 1 July 1984
and recognised expenditure incurred on or after 1 July 1979. The PRRT was
imposed on oil companies with the enactment of the Petroleum Resource
Rent Tax Act 1987 (Cwlth) and the Petroleum Resource Rent Tax Assessment
Act 1987 (Cwlth). The PRRT raised in excess of an additional A$1 billion a
year in revenue over and above the normal company tax on income. The
Federal Government was not able to extend the rent tax to onshore petro-
leum production in lieu of state royalties because the state governments of
Western Australian and Queensland objected.

On 2 November 2011, the Australian Government introduced a raft of bills
into Parliament for the imposition of a Mineral Resource Rent Tax (MRRT)
on profit generated from iron ore, coal and gas from coal seams, and a
new petroleum resource rent tax (PRRT) on onshore oil and gas deposits.
As a result of this review, the government announced on 2 May 2010 that
it would introduce a ‘Resource Super Profits Tax’ on mining to not only
generate additional revenue but to also compensate a reduction in the rate
of company tax to ultimately 28 per cent. While the reduction in the rate of
company tax did not eventuate, the MRRT was introduced as law. The gov-
ernment also increased the Superannuation Guarantee Charge to 12 per
cent to be gradually increased over the next seven years.

The final raft of legislation creating the MRRT and amending the PRRT was
introduced into Parliament on 2 November 2011. The object of the MRRT
Bill is stated in Sections 1–10 as follows

The object of this Act is to ensure that the Australian community re-
ceives an adequate return for its taxable resources, having regard to:
   a) the inherent value of the resources; and
   b) the non-renewable nature of the resources; and
   c) the extent to which the resources are subject to Commonwealth,
       State and Territory royalties.

This Act does this by taxing above normal profits made by miners (also
known as economic rents) that are reasonably attributable to the resources
in the form and place they were in when extracted.

A ‘taxable resource’ is defined in Division 20 of the Bill as coal, iron ore and
coal seam gas. The MRRT is based on taxing projects, similar to the PRRT.
Mining projects that do not generate resource profits of more than A$50
million in a given year will not be subject to the MRRT. This is designed
to reduce the compliance costs for small mining companies. The MRRT is
imposed at a rate of 30 per cent. The profit or loss calculation is based on the assessable receipts less deductible expenditure less the carry forward losses with an uplift factor of the long-term bond rate plus 7 per cent.

The MRRT will be a deductible expense when calculating taxable income for income tax purposes. This is the current situation under the PRRT where the PRRT is a deduction against assessable income pursuant to Subsections 40-750 and 40-751 of the Income Tax Assessment Act 1997 (Cwlth). Royalties paid to the states and the Northern Territory will be credited against any MRRT liability and any excess royalty payments will be uplifted and applied against future MRRT liabilities. Any excess royalty payments will not be refundable. The MRRT will apply to iron ore, coal and petroleum projects. It will also apply to coal seam methane or technologies that will convert coal into petroleum products. It will not apply to other minerals. The MRRT will apply from 1 July 2012 but the market value of assets acquired for projects after 1 May 2010 will be included in the expenditure calculation for the MRRT.

The MRRT was expected to generate revenue of A$3.7 billion in 2012–13, A$4 billion in 2013–14 and A$3.4 billion in 2014–15; however, the amount of revenue generated from the tax was considerably lower due to a reduction in the price obtained by the mining companies for their iron ore, coal and coal seam gas, and because mining companies have been able to claim deductions for their earlier investment in infrastructure associated with their mining projects. While this situation has drawn criticism, it merely demonstrates that a rent tax only taxes super profits due to high commodity prices.

The Australian carbon tax

The Clean Energy Act 2011, Clean Energy (Household Assistance Amendments) Act 2011, Steel Transformation Plan Act 2011 and Australian Renewable Energy Agency Act 2011 and 17 related bills introduced a carbon tax in Australia with effect from 1 July 2012. These laws provide support to low and middle-income households as a result of energy companies increasing their prices as a direct result of the carbon tax. The government hopes that these reforms will reduce pollution while allowing the economy to grow. The Clean Energy laws, now commonly known as the ‘carbon tax’, were designed to assist in moving towards the following goals:

- a carbon price of A$23 per tonne to be applied to around 500 of the nation’s biggest polluters from 1 July 2012
- the transition of the carbon price to a flexible price cap-and-trade emissions trading scheme on 1 July 2015, linking Australia to international carbon markets, including the market in China
- an increase in the tax-free threshold from 1 July 2012 from A$6,000 to A$18,200, effectively reducing income tax for the low income earner
- an increased payment for pensioners, equivalent to a 1.7 per cent increase in the maximum rate of the pension
- the introduction of the Jobs and Competitiveness Program to support the emissions-intensive trade-exposed industries and help them to reduce their carbon and energy intensity
- the introduction of the A$300 million Steel Transformation Plan to support the Australian steel industry
- the introduction of the Energy Security Fund to provide assistance to the most emissions-intensive coal-fired generators, to support energy security and to help transition to cleaner energy
- the establishment of an independent Climate Change Authority on 1 July 2012 to advise on pollution caps and climate change policies, taking into account Australia’s legislated reduction target of 80 per cent below 2000 levels by 2050.
The government expects reductions by 2050 of 90 per cent of expected waste emissions, 76 per cent of expected electricity emissions, 62 per cent of expected fugitive emissions and 53 per cent of expected industrial process emissions. The first household assistance payments were made in May and June 2012 to help households with higher energy charges as a result of the impact of a carbon price.

**Position of the People’s Republic of China on carbon pollution**

With a population of 1.3 billion people, China is the world’s most populous country and contributes around 20 per cent of the world’s greenhouse gas emissions, making it the largest emitter of carbon pollution. While its per capita emissions remain quite low (close to one-fifth of Australia’s), China has already taken a number of steps to reduce its carbon pollution and create a cleaner energy future. Under the *UN Framework Convention on Climate Change*, China has pledged to lower its carbon emissions per unit of GDP by 40 to 45 per cent by 2020 based on 2005 levels. China has also pledged to increase the percentage of non-fossil fuels in primary energy consumption by around 15 per cent by 2020. Other pledges include a 40 million ha increase in forest coverage and an increase in forest stock volume by 1.3 billion cu m by 2020 based on 2005 levels.

China announced in its Twelfth Five-Year Plan (2011–15) that it would introduce emissions trading progressively, commencing in a number of key cities and provinces. The cities of Beijing, Shanghai, Tianjin and Chongqing, the provinces of Guangdong and Hubei and the Shenzhen Special Administrative Region, which together cover more than 200 million people, are preparing emissions trading schemes to start from 2013, with the first pilot scheme in Shenzhen launched in June. The Chinese Government aims to work towards national emissions trading between 2016 and 2020, during the period of the Thirteenth Five-Year Plan (2016–20).

China is the largest investor in renewable energy, with US$52 billion invested during 2011. China is the world’s leading producer of wind turbines and solar modules, and has the largest amount of renewable power capacity in the world. In particular, China leads the world in the amount of installed hydropower, wind, solar hot water and geothermal direct heat capacity. China is also installing new high-efficiency power stations, and since 2005 has retired over 70 GW of smaller inefficient power plants, which is more than Australia’s total electricity generation capacity of around 51 GW. China has introduced performance standards to reduce energy use in lighting products, commercial equipment, industrial equipment, traffic tools, office equipment and home appliances. China has expanded its regulatory program targeting the highest energy-consuming enterprises, with the program now effectively covering 10,000 enterprises. Each enterprise is required to develop energy efficiency action plans and meet specified energy targets.

**Resource rent taxes in other countries**

Both the United Kingdom and Norway impose an RRT on petroleum profits derived from the North Sea on the ‘Continental Shelf’. The United Kingdom introduced a petroleum resource tax when the North Shelf was first developed in 1975. Since then it has been amended and altered a number of times.² The United Kingdom and Norway abolished royalties based on the value of oil and gas extracted in 2002 and 1986 respectively. The reason given for abolishing royalties was that it was a regressive tax as it applied to gross revenue and acted as a disincentive to exploration and production. The United Kingdom applies a petroleum rent tax (PRT) at the rate of 50 per cent as well as the normal company income tax. Norway applies a special petroleum tax (SPT) at 50 per cent and the normal company tax on income. The UK Government imposed a supplementary charge of a further 10 per cent in 2002 and in 2005 increased the rate to 20 per cent.
on the company income. The PRT is, however, deductible for income tax purposes. Norway does not allow the SPT to be deductible for income tax purposes and the effective marginal tax rate on the income of the company is 78 per cent.

The UK system is complicated by the fact that the PRT is based on the development of the oil fields and especially those fields given development consent before 1993 and those given consent after 1993. In the former case, fields that received permission before 1993 are taxed on their income at a company tax rate of 50 per cent and a PRT at the rate of 50 per cent, whereas the later fields are subject only to a company tax rate of 50 per cent. In 2002 the UK Government introduced a 50 per cent supplementary charge on the same basis as company tax but there was no deduction for financing costs against the supplementary charge. The royalty was abolished on older fields that had received development consent before 1983 in an attempt to encourage fuller exploitation of reserves from those fields. In 2005, in light of an increase in oil prices, the UK Government doubled the supplementary charge to 50 per cent. This means that in the United Kingdom oil and gas are taxed at the highest rate of any industry: for fields given approval after 1983, a company tax rate of 30 per cent and the supplementary charge of 50 per cent. For those fields given approval prior to 1983, the marginal rate of tax is 75 per cent and they are also liable to company tax at the rate of 50 per cent.

Given the range of extra taxes imposed on mining and petroleum projects by different nations, the introduction of an MRRT in Australia should not deter investment by Chinese investors. The fact that a PRRT has been in existence in Australia since 1988 should have provided comfort for the Government that a resource rent tax would gain acceptance by the mining companies and foreign investors alike.

Conclusions

Future generations of Australian taxpayers will eventually judge the manner in which the nation’s non-renewable mineral resources have been exploited and the return that was extracted for the benefit of Australians both now and into the future. Australia’s resource rent taxes have been designed to provide the mining companies with a return on labour and a return on capital equivalent to the long-term bond rate and an uplift factor. They are ‘efficient’ taxes and as such do not impact on the profitability of the investor. In fact, if rent taxes are well structured and designed then they should not have any impact on the required return for an investor. Furthermore, if the profitability of each mine is not achieving this level of return then a resource rent tax is not paid to the Australian Government. This is now the case in Australia, where low mineral resource prices have reduced profits and hence the mineral resource rent tax payable.

The carbon tax is basically a domestic arrangement aimed at reducing pollution in Australia. It does not directly affect iron ore mining companies or even coalmining companies as most of the coal is exported. The only foreign investors that would be affected would be those investing in coal-burning electricity generators. On the other hand, the introduction of a carbon tax has highlighted the opportunities that investment in renewable energy sources provides, including investment from China. Furthermore, the fact that China leads the world in the manufacture of alternative energy sources and is already introducing an emissions trading scheme of its own suggests that the Australian carbon tax should not have any adverse effect on investment from China. In sum, the negative perceptions about the impact of Australia’s resource rent and carbon taxes are misplaced.
CHAPTER 13
BUSINESS RELATIONSHIP DEVELOPMENT AND MANAGEMENT IN CHINA
Rebecca Yang, Patrick Zou and Rob Leslie-Carter

Business in the Asian Century

The Australian Government’s White Paper on Australia in the Asian Century, released in October 2012, is based on the premise that the transformation of the Asian region into the world’s economic powerhouse is not only unstoppable, it is gathering pace. Asia’s extraordinary ascent has already changed the Australian economy, society and strategic environment. Within a few years, Asia will be the world’s largest producer of goods and services, as well as the largest consumer market and the home of the majority of the world’s middle class. The White Paper notes that thriving in the Asian century requires the Australian nation to have a clear plan to seize the economic opportunities and manage the strategic challenges that will arise, by taking a farsighted approach focused on fairness. To do so, Australians must be Asia-literate and Asia-capable, with a thorough understanding of Asian cultures and languages. These capabilities are needed to build stronger connections and partnerships across the region. Australia’s
commercial success in the region requires that highly innovative, competitive Australian firms and institutions develop collaborative relationships with others in the region. Australian firms need new business models and new mind-sets to operate and connect with Asian markets.

Against this backdrop, this chapter discusses several important issues relating to Australian firms developing and managing their business relationships in China, in the context of urban planning, architecture, civil engineering and construction. The chapter examines the Chinese business environment, in terms of *guanxi*, business opportunities, risks and strategies, in a case study of the successful partnerships established to manage the ‘Water Cube’ for the Beijing Olympic Games in 2008.

**Case study: the ‘Water Cube’ (Beijing National Aquatics Centre)**

China has become the largest construction market in the world, and more and more international companies have entered into China providing design, project management and consulting services. Because the competition is so strong, surviving in the market is the main issue that concerns international companies. Resources, capabilities, long-term strategies and relationships with other parties are also considered to be critical. Ling, Low, Wang and Egbelakin suggested that to implement a superior project management practice in China, international companies should increase their financial strength to overcome the ‘blank’ period before they are able to make a profit, prepare high-quality contracts as early as possible, reduce language barriers to avoid misunderstandings, employ a qualified workforce and have more face-to-face than written communication. Likewise, Gunhan and Arditi stated that a good track record, project management capability, a broad international network and advantages in technology, materials and equipment are the most important strengths of international construction companies.

The Beijing 2008 Olympic Games provided many opportunities for international architecture, engineering and construction firms to demonstrate their ability in international design and project management; however, there were many challenges for the design and construction of these projects, because of new technologies, new materials and innovative designs adopted in the Olympic projects, the complexity of design and construction, as well as the diverse cultural backgrounds of the project teams. The management of the design of the ‘Water Cube’ provides an example of a successful, complex international project, highlighting the challenges and strategies for achieving success. It also documents the lessons learned, which could be useful to future management in international construction projects and business in general.

**Project objectives: what the client wanted**

The Water Cube showcases China’s determination to establish itself as a leading destination for world sporting events. The requirements for the Water Cube included a 50 m competition pool, a 33 m diving pool and a 50 m warm-up pool. The main pool hall was to have 17,000 seats and the whole facility had to accommodate everything required for an Olympic operational overlay. Following the games, the main pool hall was to be reduced to 7,000 seats with other facilities added in order to make the Aquatic Centre a viable long-term legacy. The Beijing Municipal Government expected to build the best Olympic swimming venue that would then become a popular and well-used leisure and training facility after the games. The venue was to cost no more than US$100 million before the Olympics and US$10 million for its post-Olympics conversion. The construction was to start before the end of 2003 and to be completed at least six months prior to the commencement of the Olympics on 8 August 2008, to allow a sufficient period for trial competitive events.
Managing the ‘Water Cube’ design partnerships

The Beijing ‘Water Cube’ Aquatic Centre has its project management roots in Australia. In 2003, Arup, PTW Architects and China Construction Design International (CCDI), in partnership, won an international design competition. The Water Cube was the result of an international design competition with ten shortlisted participants, judged by a panel of architects, engineers and pre-eminent Chinese academics. The Arup/PTW/CCDI design was selected as the winner from the competition both by the international jury and by the Chinese people. Arup’s project managers led a team of more than 100 engineers and specialists, spread across 20 disciplines and four countries. This team was responsible for leading and coordinating the Water Cube’s project design process, managing the internal and the external interfaces and the dynamics of team leadership, and establishing a communication strategy and a risk management strategy, which focused on the complex and dynamic nature of the Chinese market and ‘the management of difference’ between Chinese and Australian stakeholders.

A testament to the success of this project management was that the design was delivered from competition stage through to a fully approved scheme in just twelve weeks, and that the Water Cube was officially opened on time and on budget. This was only achievable by establishing and maintaining clarity of the design vision, and full and transparent collaboration between Arup, PTW and CCDI.

Responding to the client’s wishes and the Chinese culture

In responding to the clients’ wants and needs, the Arup/PTW/CCDI team agreed from the outset that the Water Cube Aquatic Centre design should portray the way in which humanity relates to water. The building would sit alongside the National Stadium in Yin-Yang harmony, a key concept in Chinese culture. The Water Cube Aquatic Centre would seek to portray the harmonious coexistence of humans and nature, which in Chinese culture is life’s ultimate blessing. The team also agreed on a flat ceiling to signify peace and stability. It was decided that a cube-shaped concept would appeal to the typical Chinese way of understanding beauty – a subtle, thought-provoking design representing the beauty and serenity of calm, untroubled water. The Water Cube concept was inspired partly by its neighbour, the Bird’s Nest (National Stadium), with the two opposing shapes sitting together in Yin-Yang harmony. The Water Cube is blue against the stadium’s red, water versus fire, square versus round, male versus female, Earth versus Heaven, as pictured in Figure 13.1.
Communicating the vision and turning it into reality

The structural innovation, based on the formation of soap bubbles, is unique. Furthermore, the Water Cube is an insulated greenhouse to maximise the use of ‘carbon-free’ solar energy for both heating and lighting. The use of ethylene tetrafluoroethylene (ETFE, a kind of plastic) in lieu of glass creates a superior acoustic environment, reduces the weight of material supported by the structure, improves seismic performance, and is self-cleaning and recyclable. The roof collects and reuses all rainwater that falls on the building. The building is the result of integrating the technical requirements of all the relevant engineering disciplines, not the result of a single dominant one. These innovations all reflected Beijing’s ‘Green Games’ principle.

The management of the project had to deal with major timing issues, most notably delivering the physical venue design well in advance of knowing who would operate the Water Cube before and after the games, and how they might want to reconfigure the building. There were no easy answers to these issues, which involved a real understanding of how Olympic events would be operated, how many operational streams would be linked, how to balance the needs of various stakeholders and how the venue sits within the wider Olympic organisational framework. Recognising the scale and complexity of the challenge, the project management team led a two-day workshop with key design team members to produce a nine-step road-map for the project, as shown in Figure 13.2. Establishing these key project management strategies and their rapid and successful implementation were fundamental in shaping the success of the Water Cube design.

The binding threads in the success of the Water Cube project were the quality and depth of communication, both internally and externally. As well as day-to-day team communication and information management processes, the communication strategy established the project’s vision and key messages, and how these would be integrated into the daily life of the project. The strategy produced by Arup’s project management team went beyond planning the formal methods of communication, encompassing the need for continuous incorporation of lessons learnt in dealing with stakeholders in a different location (that is, Beijing), and with a different culture and language. In doing so, it provided a vehicle for relationship management and stakeholder engagement.
At the project implementation plan workshop, Arup’s project management team focused initially on the need to articulate and communicate a very clear project vision for the Water Cube design. This was intended to have multiple benefits. Most simply, the vision would provide improved clarity and autonomy to the design team members. This would help achieve a quality outcome in a very short period, by allowing parallel streams of activity to converge quickly and accurately. It was also hoped that having a robust vision would greatly help achieve alignment and buy-in from other project stakeholders. The workshop resulted in eight threads.

1. Site plan and urban design: sitting opposite the National Stadium in Yin-Yang harmony, the two sites separated by a protected historical axis to Beijing’s Forbidden City. Red versus blue, fire versus water, round versus square, female versus male, Heaven versus Earth.

2. A building full of water made from bubbles – a perfectly pure combination of form and function.

3. A building harnessing the benefits of nature – the bio-mimicry of bubbles and the translation of theoretical physics into a unique building form, portraying the harmonious coexistence of humans and nature.

4. A big blue ‘green’ building – that technically performs well in terms of heat, light, sound, structure and water, so function is not sacrificed in the name of art. Instead art is made from function.

5. A 3-D world: the giant strides made in 3-D design and analysis technology, without which this project simply could not have been fully conceived or documented.

6. Next technology: the use of high-tech materials to minimise energy consumption (for example, ETFE).

7. Spiritually uplifting inside and outside: the square shape of the building reflects the Chinese philosophies of the square representing the Earth, and circles representing Heaven.

8. Total, equitable and transparent partnership between Arup, PTW and CCDI.

These eight threads were initially used as a guide to brief the Arup team and the design partners. They proved invaluable in discussions with external stakeholders and Beijing local approval authorities, who were able to buy into the overall vision and understand how they could contribute to achieving that vision. An example is when the price of glass dropped sufficiently for the Arup project management team to ask whether the design should replace the roof with glass rather than ETFE. The Mayor of Beijing, already aware of the eight threads of the project, killed the idea by saying, ‘I’ve promised a box of bubbles and we shall deliver a box of bubbles’, meaning that the ETFE concept was not to be replaced.

Leadership and team performance

The Arup project management team identified the key issues for the team and leadership: first, due to the short time frames available to progress the design from competition stage through to a fully approved scheme, the Arup project management team needed to mobilise quickly, and with the right people. To achieve this, the project management team engaged selected engineers and specialists in a series of formal and informal briefings about the Water Cube project and the potential opportunities for team members. By generating a sense of excitement and anticipation, they were able to lock-in the key team members even before the competition winner was formally confirmed.

Second, due to the innovative design concepts and materials proposed for the Water Cube, the management team would need to include a high proportion of analysts and programmers, capable of developing the new analytical approaches and techniques required to realise the project. The Arup project management team focused on providing these people with a safe environment in which they could experiment (and fail), and on protecting them from the administration distractions that occur in a project of this scale.
Third, to remove potential pinch points from specific key staff becoming overloaded, and to allow technical staff more freedom, Arup’s project management team established semi-independent teams with their own leadership, to progress in parallel streams. These four teams were design, product research, stakeholder engagement and commercial issues such as scope, contract and fees. For example, Arup established clean interfaces that would allow the finalisation of the structural geometry and research into the ETFE facade performance to proceed without holding up the general spacial planning of the building. The leadership for key stakeholder meetings and for commercial negotiations were separated, so that one did not compromise the other. On the back of the success of the Water Cube, the model of having specialist project managers providing leadership, whilst giving freedom to technical staff to add more value to the design process, has since become standard Arup practice on all major projects.

Innovative and lean processes for success

Developing the necessary tools: The Water Cube project was a catalyst for the establishment of a range of bespoke project management planning and monitoring tools needed to deliver such a large multidisciplinary project, across different offices, and with a program that demanded reporting, monitoring and action to happen in real time. A range of management tools was developed for the Water Cube and has since been developed further through internal funding and applied to major Arup projects in the Australasian region. These include simple protocols for shared servers and email filing between multiple offices, safety in design and construction sequencing, and complex programming applications that interface with Arup’s global cost-monitoring system to provide detailed forecasting and performance reporting capabilities. Following from the success of the Water Cube project management, there is now a dedicated Systems Development and Integration team that services both internal major projects and external clients.

Interface management: Arup’s project management team had the challenge of coordinating between 20 specialist Arup engineering disciplines, ensuring they were properly coordinated, and that the complex interfaces of the Water Cube were properly understood and documented; they introduced an interface management strategy, which divided component parts of the Water Cube into volumes defined by physical and time boundaries, described in a project volume register. At the very start of the design process, Arup’s project management team identified volumes and assigned owners. An interface occurred when anything touched or crossed a boundary. Initially all high and low-level interfaces were identified and captured on a register, and regular interface management and coordination meetings were held involving all parties.

This principle worked very well internally, and was quickly expanded to include external interfaces where Arup required information from another team or a second or third party – for example, interior designers and utility suppliers from off-site. Examples of organisational interfaces included the development of details by Chinese design partner CCDI based on Arup scheme designs, or interfaces between civil engineering and architectural landscaping documentation. The management of interfaces became one of the most important functions of Arup’s project management team. Given the short time frame, the elimination of mistakes at interfaces meant the documentation handed over to Chinese design partners for detailing was more robust and generated fewer queries.
Lessons learned

The Water Cube project has acted as a bridge for cultural exchanges and has deepened the understanding, trust and friendship among the project team members and stakeholders from Australia and China. This was only achievable by establishing and maintaining absolute clarity of the design vision, communicating that vision to project stakeholders with differing cultural expectations, and the outstanding collaboration between Arup, PTW and CCDI. For Arup’s project management team, a major challenge – greater than the technical aspects of the Water Cube and ultimately far more rewarding – was learning and understanding the business culture and context in China. As a follow-up to Arup implementation plan workshops, Arup held some specific internal sessions with Chinese team members to agree early on the ‘management of difference’. To this end, there are several key lessons learned, as discussed in this section.

Managing cultural differences and risks

Managing cultural differences, especially for those companies with a traditional Western cultural background, is an important issue for international business, particularly in the Chinese context. Different cultures may have significant differences in management styles and capacities. Understanding organisational and national cultures, cross-cultural communication, negotiation and dispute resolution is most important for the management process in China, where personal relationships are very important and teamwork is preferred for making decisions. For the Water Cube project, managing both internal and external communication, as well as handling the relationship with all parties involved in the project were critical to its success.

For cross-cultural management in China, one of the most important issues is *guanxi*, which refers to relationships or social connections based on mutual interests and benefits. In general, *guanxi* and Western ‘relationship marketing’ share some basic characteristics, such as mutual understanding, but they have quite different underlying mechanisms. In contrast with relationship marketing, *guanxi* works at a personal level on the basis of
friendship, and affection is a measure of the level of emotional commitment and the closeness of the parties involved. Indeed, according to Buder and Huang, in China there is no such thing as a purely business relationship. Instead, to be successful in business, one must blend formal relationships with personal ones, and guanxi refers to the delicate art of building and nurturing such ties. In China’s old school of doing business, it can carry a negative connotation of favouritism and cronyism. But the same word also conveys deep and lasting relationships that can only be built over time.

Managing key risks is also critical for achieving business objectives in China. International companies should prepare high-quality contracts as early as possible, control language-barrier risks to avoid misunderstandings, have more face-to-face than written communication, and minimise and manage the risks of specific differences in norms, practices and expectations. The complex and dynamic nature of the Chinese market meant that the risks associated with delivering the Water Cube could not be underestimated. Beijing’s lack of regulatory transparency, regional differences and a relationship-based business culture were among the factors we identified that made China a challenging business environment.

The Arup project management team looked at a diverse range of risks, trying to understand and plan an approach to the project in the unfamiliar context of China’s legal, social, cultural, economical and technological environments. Other than the commercial risk of delayed payment, the key risks identified were social – how China’s business culture might affect the relationships and dynamics within the international Water Cube team, and with the external stakeholders involved in approving the design concept. Relationship-building is fundamental in Chinese business, so understanding guanxi and how to authentically cultivate and manage it were vital to the project management. Other important factors in the approach included emphasising Arup’s international reputation and the depth and diversity of its activities and locations.

The Arup team also planned to ensure all interactions with Chinese stakeholders provided them with the highest possible quality of service, in terms of both the material and the staff directly involved with them. For example, Arup deliberately involved well-respected senior engineers from its Beijing and Hong Kong offices at key stages of the approvals process. Their influence and local knowledge of Chinese legislation, coupled with Arup’s involvement in other high-profile Olympic projects in Beijing, were leveraged to convince some conservative authorities to accept a range of innovative approaches to the engineering design that didn’t follow the prescriptive rules of the Chinese Building Codes. This was the number one risk in the early stages of the project.

Another example was in commercial negotiations. For Arup, the project was a financial success in that it made an acceptable profit despite the considerable risks of working on such a fast-tracked project, with international partners and stakeholders, on a project involving such groundbreaking design techniques and materials. This was largely because during contract negotiations Arup clearly defined the scope of services and the interfaces with the Chinese design partners, and was robust in contract negotiations.

**Ownership of intellectual property**

An ongoing challenge during the contract negotiations was the inclusion of standard clauses to protect intellectual property and copyright over design ideas and documentation. At the implementation plan workshop, Arup’s project managers presented the benefits of embracing a very clear and simple policy that Arup collaborate with the Chinese design partners totally and with complete transparency. Arup believed it was fundamental to establishing and maintaining trust and respect at the start of the project and to developing good guanxi. In design terms, this involved accepting that the concepts and analytical approaches that Arup developed
would become an important knowledge legacy to help their Chinese design partner develop their capabilities. In practical terms, it meant that the handovers from Arup to CCDI were genuinely open.

Another legacy that Arup has championed is that of a totally shared ownership of the Water Cube concept. The philosophy that resonated with all stakeholders during the project was that the box of bubbles concept for the Water Cube was generated by equally integrating the requirements of Arup’s engineering, PTW’s spacial planning and the Chinese cultural influences on architecture from CCDI. It was not the result of any single dominant party. With such an iconic building, this was and remains a powerful statement in terms of the outstanding collaboration established between Arup, PTW and CCDI.

Conclusion

This chapter has highlighted several key issues for international firms undertaking business in China using a case study in which key management strategies and lessons were presented. China’s culture is built on trust, relationships and mutual respect. Trust takes a long time to build, but there are many ways to break trust: by showing disrespect, by failing to provide favours in exchange for favours received, by not following the protocols, by condescension, coercion or by dwelling on controversial issues. Ultimately, success in doing business in China is all about fostering good guanxi, as China is a relationship-based business culture.

It is important that foreign companies first develop long-term business goals that are informed by their strengths and weaknesses together with their capabilities in seizing opportunities and managing risks. Once the long-term goals are set, and the decision is made to enter the Chinese market, it is necessary to learn the protocols, culture, political and social systems and to forge a trust relationship in China. A key principle to remember is ‘contribute first and benefit later’ because business guanxi in China and its development are not overnight matters but require time and effort to demonstrate commitment and develop trust.

Following the establishment of a business or partnership, it is important to nurture and hire local talent and leaders. Many Chinese are now educated overseas with bicultural and bilingual backgrounds, and hiring these people will help to minimise cultural risks. Playing by the Chinese market rules and being flexible and open to local needs and practices is important too, as this will help add value to the local economic development and fulfil corporate social responsibility.

Given that China is on the rise to become the world’s largest economic powerhouse, with its unique political, social and cultural systems, one could expect that the Australian Government and business sectors might plan more in this context – a suggestion made in the White Paper. Australia-China business relationships are a ‘two-way street’ and each country should constantly learn from the other to foster and maintain long-term, win–win business guanxi for all parties and stakeholders.

Notes


The research undertaken for this book reveals a number of issues that are important for the future of the Australia-China investment relationship. In broad terms there are clear benefits in greater investment flows between Australia and China. Improved investment flows promote economic growth. They encourage the development of infrastructure, the market and financial systems and they foster understanding of the law and the regulation of commercial and government-related entities. Perhaps the most important and the most challenging long-term goal in fostering closer working relations between businesspeople and organisations in Australia and China will be the closer integration of the financial systems of both countries.
The chapters of the book have been organised specifically to encourage further discussion and collaborative research with respect to a number of academic and practical sticking points that have emerged in the Australia-China investment relationship. These tensions were considered generally by Nicoll, Brennan and Josifoski in 2012 in an article for the *Australian Business Law Review*. They relate to the three following areas of interest:

- the law and policy applicable to FDI into Australia and China, and the ODI emanating from each country
- differences in the laws governing the operation and regulation of the market, financial institutions and financial systems in Australia and China
- differences in the law, regulation and governance of investing corporate and government-related entities, such as SOEs, in both countries.

It is clear that there is some way to go in resolving the many issues emerging in these areas. Some sensitive issues in the relationship will require further discussion and analysis. Several such issues came to prominence in 2008 when the Chinese SOE Chinalco acquired a substantial interest in Rio Tinto. The same issues have since been continuously debated in the media. Continuing collaborative research by academic lawyers and practitioners in Australia and China, directed to the immediate problems in law and policy, has the potential to greatly ease the tensions in the relationship.

**Bridging the gap**

It was unfortunately not possible for the commentary and discussion in the last session of the conference – titled ‘Bridging the Gap’ – to find a satisfactory place in the concluding chapters of this book. The session, facilitated by John Larum and Kevin Hobgood-Brown, was nevertheless extremely valuable. In this session, John Larum outlined the attributes of a sound investment relationship, emphasising particularly the need to build trust. He suggested that despite the very strong trade and investment flows reported in the economic data in Chapter 2, there remained a serious problem in engendering greater levels of trust between Australia and China. Referring to the 2012 Lowy Institute poll, Larum noted the anxieties reportedly felt in Australia about Chinese investment. Similar concerns were reported again recently in the 2013 Lowy poll.

Certainly, societal and cultural norms play a vital role in filling gaps in the relationship; however, these norms are likely to fall short of what is required in a comprehensive commercial regulatory framework for the relationship. This may be illustrated by reference to the important Chinese concept of *guanxi*. Yang, Zou and Leslie-Carter explained that the concept encompasses the human elements in a business relationship that are critical to building enduring friendships, business associations and trust. These are the elements often missing in the Western formulation of ‘good business relations’ or the requirements of contract law. There is, however, an important duality inherent in the concept of *guanxi*. While the concept emphasises the human aspects of any business relationship, it may also be at odds with the distinct responsibilities of public officers, company directors and others acting in a country in which constitutional powers and authority are governed by the law. In the exchange of favours central to *guanxi* lie the seeds for cronyism, conflicts of interest and the erosion of the rule of law.

In the context of investment and business between Australia and China, the most immediate Australian concerns are likely to relate to blurred lines between the role of the Chinese State and the business of private
commercial entities. The significance of these blurred lines seems clearest in the constitution, regulation and governance of Chinese SOEs. They are equally relevant, however, to the operation of the market and the financial institutions relied upon to monitor the governance and performance of commercial corporations. They also pervade the resolution of commercial disputes before the courts and the exercise of the powers of public officers, courts and regulators.

The very different roles envisaged for the State and the judiciary in China and Australia are evident in many chapters of this book. The hand of the State is apparent in the governance of Chinese SOEs – a style of governance that may be directed more to improving their efficiency and performance than it is to their self-regulation and governance (as discussed in the chapters by Tomasic and Fu). The hand of the State is also evident in the catalogue guiding Chinese ODI and the investments of Chinese SOEs abroad (as seen in the chapter by Kong). Taken together, these influences of the State suggest that China may not yet be able to rely as comfortably upon the market and the independent regulation of private business entities as can Western jurisdictions. They also suggest the difficulties that may be presented to China’s trading and financial partners in opening mature, self-regulated Western markets to direct investment by SOEs from China.

The tensions in these areas suggest the continuing importance of maintaining ‘reciprocity’ as a guiding principle in the development of the investment relationship between China and Australia. Anxieties and misunderstandings are sure to continue in both countries. The speed of China’s rise to enormous economic power and international influence may have raised fears for the unknown in Australia. China’s own concerns, too, may reflect suspicions born of many years of international isolation. The understandings that bind Western democratic countries have not been forged in isolation, but through a common historical experience. It is this experience that has helped build trust and confidence within Western capital markets over many years. This same level of trust may not yet have evolved in Australia’s relationship with China.

**Investment law and policy**

The basic tools of law and policy used to regulate FDI into both Australia and China are strikingly similar. Many countries in the world utilise both broad guidelines to direct or prohibit investment into different industries or sectors and the right to reject particular investments because they are contrary to the ‘national interest’ (as in Australia) or ‘national security’ (as in the United States). The use of these tools is mainly a matter of emphasis. The fact that the essential tools are the same, however, has not quelled cries of unfairness and partisanship in their application in practice.

In China, the Catalogue of Industries for Guiding Foreign Investment (the Catalogue) provides a clear indication of those industries into which FDI is prohibited. Australia too provides some industry guidance, but the FATA relies more upon the application of a ‘national interest’ test to guide the Treasurer in deciding whether to approve, or not approve, particular investments. While the national interest may seem a movable standard to foreign investors, the underlying principles and policy applied are consistent. The test is in principle a more liberal one than a strict catalogue approach because it provides the opportunity to examine the merits of each investment proposal rather than imposing a blanket exclusion of certain investments.

With respect to Chinese investment into Australia, the terminology used by Malcolm Brennan to dispel myths surrounding Australia’s foreign investment policy provides a very fruitful foundation for future discus-
sion. It reveals some of the misunderstandings about the way in which Australia’s foreign investment regime is perceived and conducted. Nevertheless, there remain areas of concern in China for the regime, articulated by Professors Gao and Kong. Professor Kong refers to the ‘predica-
ment’ that China faces in Australia as a host country.

Areas of particular concern for Chinese investors have included the treatment of SOEs under the FATA and the length of time taken to process applications under the FATA. In some respects the two issues are related. The definition and status of investing SOEs remain a fundamental issue that may affect the speed and efficacy of the approval process. China maintains strenuously that its SOEs should be considered commercial entities but the issue is not straightforward. SOEs are clearly fiercely competitive within China, and may be generally managed in a manner indistinguishable from major Western corporations. Nevertheless, the perception of the governments of other countries that SOEs are controlled by the Chinese Government may affect their legal character and status in those other countries.

The national interest test provides a flexible yet open approach to foreign investment from China, but it can be misinterpreted. It relies upon a set of predictable precedents developing over time. Perhaps one lesson from recent applications by Chinese SOEs has been that the Treasurer, acting on the advice of the FIRB, bears the onerous responsibility of applying the test consistently and publicly. At the time of writing, some commentators are calling for the powers of the FIRB to be clarified and for its decisions to be judicially reviewed; however, there remain some significant obstacles and objections to adopting this course, as the approval of certain investment proposals may always be political decisions that are not suitable for judicial review.

China prefers to rely upon the Catalogue to direct inward-bound FDI. While this has the benefit of clarity, the Catalogue excludes foreign investment into China in industry sectors without review. While there are restrictions on foreign investment into similar Australian sectors, Malcolm Brennan notes that such investments may be made through the acquisition of shares in Australian corporations operating in those industries. Australian companies are unable to invest directly in the shares of any companies listed on the A-share markets in China, or to gain control of those companies. Foreign institutional investors must first qualify for QFII status in order to do this. Although not framed in terms of safeguarding China’s national interest, the lines drawn in these areas are essentially political lines.

China continues to press Australia not to review acquisitions below the A$1 billion threshold in line with Australia’s approach to investment from the United States, but to date Australia has rejected this push.

So far as China’s ODI is concerned, the expressed intention of the Go Global strategy has been to acquire information, experience, expertise and technology from abroad. While these objectives are readily accepted among China’s trading partners seeking to encourage investment flows, the scale of China’s investment and its desire for control of certain corporations and their assets on world markets have given rise to unease. Unlike Australia, China also utilises a catalogue to direct its ODI as well as incoming FDI. Although all countries provide assistance to their nationals investing abroad, the existence of the Catalogue for Chinese ODI reinforces concerns among countries receiving Chinese investment for the national strategies pursued by the Government in encouraging ODI. Professor Kong notes that the Go Global strategy may have also created obstacles within China for SOEs seeking to invest globally, since the regulatory approvals required of them have presented bureaucratic difficulties.
Conclusions and issues for further research

Geoffrey Nicoll

A fundamental difficulty remains in defining the precise status and character of Chinese SOEs as government-related entities or commercial corporations when investing in Australia. China insists that its SOEs should be treated as commercial entities for the purposes of the FATA, but the issue is a difficult one. The FATA requires entities associated with foreign governments to notify the Australian Treasury of their investments. These definitional difficulties are compounded if it becomes necessary to consider whether Australia’s ‘national interest’ has been affected by the company’s activities, or whether company directors have complied with their legal duties to an Australian company under Australian law.

Corporate and SOE governance

Corporate governance in China is another point at which lines may be blurred between the role of the State and the business of private commercial entities. We have seen above that the issue is important to defining the status of SOEs as investors for the purposes of the FATA; however, the difficulties in defining the character of SOEs also point to further difficulties in assessing the effectiveness of their regulation and governance in a closed or ‘insider’ governance framework.

In Australia, commercial corporations listed on the market are subject to market assessments of their performance, supported by ASIC regulation and backed by independent legal enforcement. Their compliance with the
self-regulatory ASX Corporate Governance Principles is important to market assessments of performance. This is the kind of ‘outsider’ monitoring that is largely foreign to Chinese SOEs, however competitive they might otherwise be. Subsidiaries of SOEs listed in Hong Kong and elsewhere may be more aware of these restraints on their governance but, as Tomasic pointed out, the evidence suggests that SOE subsidiaries listing overseas may be expected to follow the governance ‘path’ of their parent SOEs. China and Australia stand at different stages of development in these areas.

Tomasic notes that Western companies holding strategic investments in Chinese companies through block shareholdings have historically had only very limited influence upon the governance of those companies. Such shareholders might have been expected to have had some educative impact upon Chinese companies seeking to go global, yet this does not appear to have occurred and the influence of the State has prevailed. As noted above, the more recent experience of Chinese companies listing in foreign jurisdictions also suggests that these companies have been reluctant to adopt international corporate governance practice. In many respects, Chinese listed companies operating abroad appear to have adhered to their established domestic ‘pathways’ instead.

In her examination of trends in the governance of Chinese SOEs and their subsidiaries, Fu also concludes that despite many apparent movements towards adopting the language of Western corporate governance, the changes in corporate governance that have been introduced are actually likely to strengthen, rather than weaken, the control exerted by the State in corporate governance in China.

The currently available evidence seems to suggest that China’s corporate governance regime is unlikely to converge with Western ideas of corporate governance. The reason for this is the influence exerted by the State in different capacities on SOEs in different stages of corporatisation. Some commentators suggest that the State may emerge from this era as an arm’s-length owner (although there is a possible conflict in the role of the State as regulator). Others suggest that the deep linkages between macroeconomic policy and microeconomic firm management in China are unlikely to be broken. Given the historical evolution of Chinese SOEs, it is difficult to see the State emerging as an anonymous arm’s-length owner and capital provider to SOEs in the same way that a QFII might provide patient portfolio investment to the market.

Whichever view of the future relationship between the State and SOEs proves correct, the dominant role assumed by the State in China seems sure to continue. This is reflected in the SASAC ownership of SOE shares and in its control of listed SOE subsidiaries since the 2005 reforms. It is also reflected in the state or SOE ownership of large block shareholdings in their foreign listed subsidiaries. It is true that the State may fulfil some of the same valuable functions fulfilled by large block shareholders in Western companies. It may, for example, improve the efficiency of SOE management and maintain the stability of the market; however, unknowns remain as to the capacity of the State to enforce the legal responsibilities of directors or to protect the rights of minority shareholders. As noted above, the full extent to which the State might pursue macroeconomic, international and domestic policies through its influence upon internal corporate management and governance remains difficult to judge.

For the moment, suspicions as to the influence of the State upon corporate management and governance are outweighed by the enthusiasm of China’s embrace of the market and corporate governance. For the present it should be concluded that China is adopting the sensibly cautious policy of developing corporate governance slowly within SOEs with a view to testing the real value of Western corporate governance principles, while also learning more of the operation of the market through the listing of SOE subsidiaries on developed overseas markets.
The move toward the introduction of many Western principles of corporate governance and market rules is a bold one and must be applauded. The difficulty lies in the fact that corporate governance in Western countries has become a complex mix of voluntary rules and self-regulation, coupled with market and corporate regulation – all within a secure legal system. These supporting mechanisms for good corporate governance can’t yet be assumed or relied upon in China. Whether or not the Western concept of corporate governance can or will ever be adopted in SOEs remains a difficult question. Whatever else may be said, this is a difficult issue that is likely to require close collaborative effort, evolving over a substantial period.

Issues for further research

Because of the scale and importance of Chinese SOE investment abroad, and because of the length of time that it is likely to take to harmonise Chinese and Western concepts of corporate governance, China’s trading and financial partners and their international markets will need to consider their policy responses to China’s progress in adopting principles of corporate governance. Otherwise, difficulties are likely to be encountered in approving and monitoring investments by Chinese SOEs and other corporate entities. One response might be to encourage more institutional and portfolio investment into both countries, and to postpone direct corporate investment until principles of corporate governance in each country become clearer and the financial systems of both countries are more closely integrated.

There are a number of other consequences of these conclusions. If China’s move towards the adoption of more recognisable international principles of corporate governance continues so slowly, smaller market-driven economies such as Australia may need to consider alternative business structures to undertake large-scale projects. These structures may need negotiated joint ventures or partnerships in collaboration with government. In the longer term, the traditional role of the market as a pricing mechanism and as a market for corporate control may even need to be re-examined. Political philosophers such as Michael Sandel at Harvard University have begun to ask interesting questions as to the efficiency and effectiveness of the market in assessing the worth of commodities with different moral values. If the potential implications of these questions and their relevance to market efficiency are not well understood, the real value of the shares of private corporations sold on an internationally accessible market may be lost.

Professor Che has canvassed the possible use of alternative investment vehicles, more suitably tailored for particular projects. Joint ventures and other commercial or government partnerships may find a clearer place in undertaking major projects. Negotiated projects may need to consider political aspects, and not just the commercial benefits. There may need to be more government-to-government consultation in reaching agreement on these projects. These considerations tend to drive us toward a bilateral investment treaty as Kong suggests.

What appears clear is that any movement in China towards Western-style corporate governance will at the least take time. The Chinese State seems sure to continue to play a central role in the activities of SOEs and their related corporate entities. These circumstances require investment policy adjustments in Western countries such as Australia, in which China is a major investor.
Financial systems and markets

Perhaps the most challenging tasks in the longer term for the future of the Australia-China investment relationship lie in the development of the financial systems of each country.

It is clear from the analysis above that issues arising in the application of investment law and corporate governance are often interlinked. Difficulties in the application of the national interest test, for example, rest upon the status of investing SOEs as government-related entities or commercial corporations. In turn, the governance of investing corporations in Australia rests upon the monitoring of corporate performance by the market, rather than the State. These connections ultimately tend to link questions of corporate governance and the application of the FATA to the financial system.

The ultimate importance of the financial system to issues in investment law and corporate governance is likely to become even clearer in the future. At the time of writing, for example, China is grappling with the problems of ‘shadow banking’ by non-bank institutions and interbank lending. These problems reflect in some measure the privileged position enjoyed by SOEs for some time in obtaining lead bank finance. Once again, this tends to lead us back to questions that must be asked about the status that should be accorded to SOEs investing outside China.

The supervening challenge for both Australia and China in improving their investment relationship is to provide an integrated financial framework within which entities investing in either country might operate comfortably and effectively. While the full development of the Chinese financial system is likely to take considerable time, some comments relevant to the development of the capital market, banks and other financial institutions and products should be made to complete this consideration of the investment relationship between the two countries. Once again, the financial systems in Australia and China stand at quite different stages of development.

The starting point is to consider the very different roles played by the market in Australia and China. As we have seen, the market in Australia plays an active and integral role in monitoring corporate performance. The ASX Principles of Corporate Governance set the standards for corporate and board behaviour. The market is a finely tuned and delicate mechanism, which has developed sophisticated rules governing the regulation of corporate disclosure, insider trading and other market misbehaviour. It is because such a refined set of market rules has evolved over time that the ASX Limited has been able to structure itself as a self-regulating corporate entity, listed and able to raise capital on its own market. Importantly, the Australian market is not merely a market for raising capital. It is also a market for corporate ownership and control.

Since the ASX Corporate Governance Council comprises twenty-eight market representative bodies, the ASX Principles reflect the broad expectations of all participants in the market. In China, by contrast, corporate governance in SOEs and their listed subsidiaries is apt to be seen through the eyes of the State. As we have seen in the case of SOEs, the State may tend to use corporate governance as a tool for improving management efficiency and performance, rather than as a means for encouraging corporate self-regulation and social responsibility. While Chinese investors have encountered difficulties investing directly in Australian companies, Australian investors have no direct access to the domestic A-share market in China. The limited access they do have is through their recognised status as Qualified Foreign Institutional Investors (QFIs) receiving a quota from the Government.

In these circumstances the opportunity arises to consider much more seriously the role of institutional investment in supporting and integrating the two markets. Given the differences considered in the previous paragraph, the encouragement of institutional and portfolio investment in the market of each country might seem the next logical step forward in this area.
Clearly, the development of investment in the Chinese domestic market by both foreign and domestic institutions is seen to be a matter of great importance to China. China has granted significant investment quotas to QFIIs wishing to invest in the domestic share market. Professor Zhu has outlined the legal framework for this. Alongside the admission of foreign institutional investors to the Chinese domestic market, new domestic institutions are also developing at a rapid pace. Dai Xionglong, the Chairman of the National Security Fund, has committed his fund to the investment of RMB 50 billion in the domestic share market by the end of 2013. Other emerging domestic funds such as those of the SAFE Investment Company, CIC and FSSF are all proposing similar investments in the domestic market.

Issues arising for the future

It is this encouragement of institutional investment that perhaps underlines more than any other the commitment of the Chinese Government to building a major international capital market in China. Ideally, this should be investment passing in both directions. China’s large institutional investors might in time consider investing in the Australian market. This may provide a stronger force for market stability in both countries.

China’s approach to encouraging QFIIs also provides a good example of the reasons the principle of reciprocity should continue to underlie the investment relationship with Australia. All governments seek to ensure stability and deepen the base of their domestic capital markets. QFIIs, like any institutional investor, represent a sensible approach to this in China. The approach might serve to develop the relationship while more immediate obstacles, such as the difficulties confronting SOEs investing directly in Australian companies and the lack of access by foreign companies to the Chinese domestic market, are addressed.

**Conclusion**

In the main, the issues considered in this book reflect the difficulties faced by Australia, as a small developed democratic country, seeking to maintain close economic ties with a rapidly developing international economic and political powerhouse. On the evidence here, the practical concerns may be, first, the length of time it takes China to develop a sophisticated market and regulatory regime for corporations, and second, the policy responses that Australia must adopt in the interim to safeguard its own interests.

More is needed to ensure that Australian public policy and administration keep pace with the scale of Chinese investment. There are questions as to whether direct investment in operating corporations provides the most appropriate way to steer worthwhile investment projects. There are questions as to whether these investment decisions ought to be left to the market and questions as to whether corporations or joint ventures and partnerships provide the most appropriate investment vehicles. There are further questions as to whether major investments in infrastructure, special projects and ‘pillar’ industries should not be underwritten by governments in bilateral investment treaties.

In the absence of a bilateral agreement between Australia and China, much more is needed on the part of the Australian Government to keep pace with investment on such a scale from a powerful trading and financial partner such as China. Upon the evidence, the reform of the administration of SOE parent groups within China and their listing amount to a massive and sophisticated merger of public administration and private corporate enterprise. Australia may need to learn from the high level of coordination achieved in China through the better integration of its own public–private relationships.
Notes
