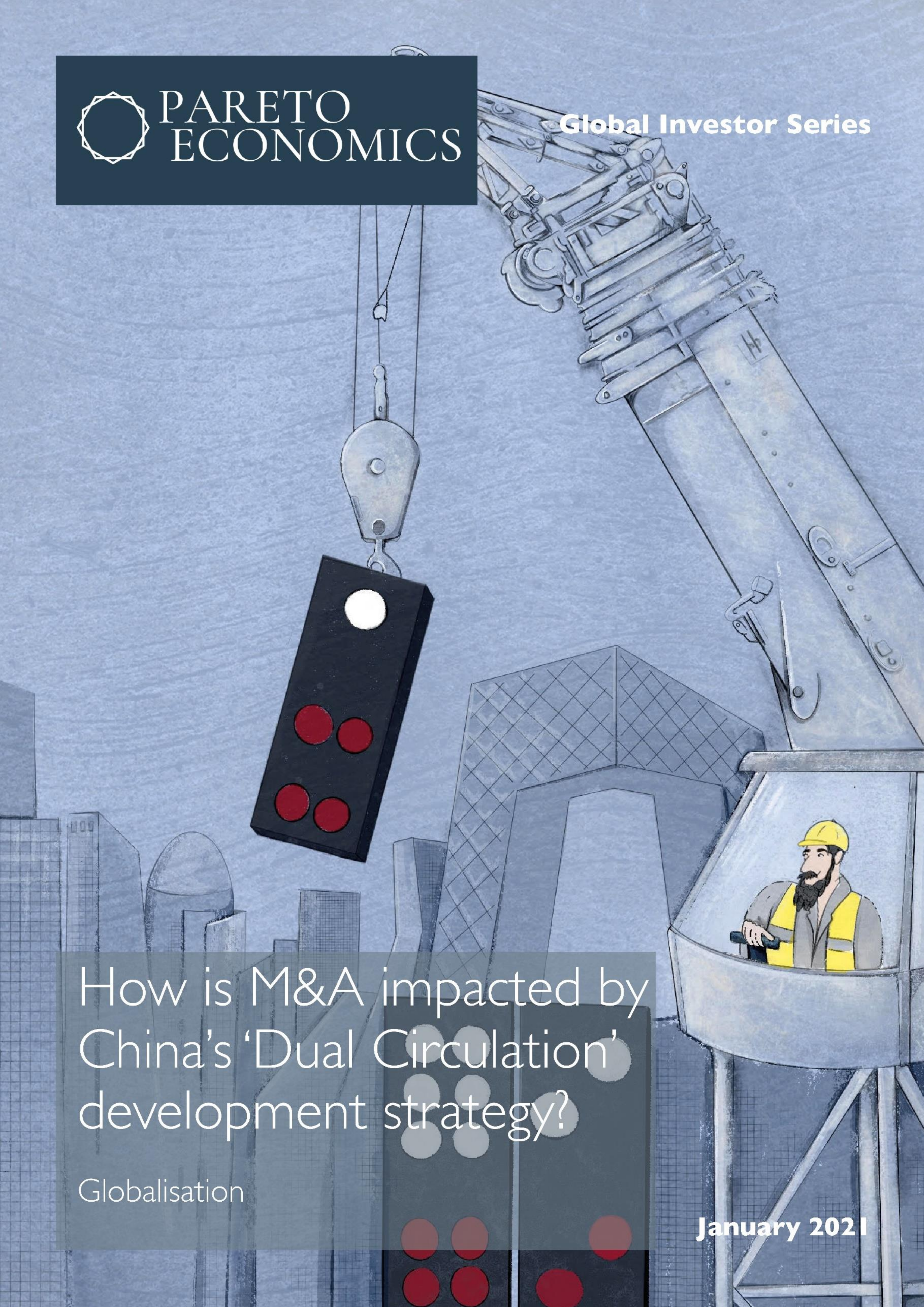

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# How is M&A impacted by China's 'Dual Circulation' development strategy?

Globalisation

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# Executive Summary

This whitepaper is an essential read for the institutional investor, cross border business operator and foreign investment policy maker who are looking to successfully navigate these seemingly unpredictable and growing hostile investing climate.

When reviewing the literature on cross-border M&A as it relates to China, one glaringly obvious trend emerges, that being – most whitepapers are written for a non-Chinese audience from the non-Chinese perspective. Little if any work covers this fascinating topic from the Chinese perspective for a non-Chinese audience. This is what this whitepaper attempts to do.

A better understanding of the Chinese perspective, plan and strategy will better equip the M&A community no matter where they are to make more informed, confident and profitable investing decisions.

This whitepaper covers the most important and at times least talked about flashpoints that have defined and continue to shape the Chinese M&A strategy and how the global West has responded.

We focus on three key bilateral relationships, including; US-China, EU-China and UK-China, this whitepaper details the unique aspects of these three bilateral relationships, how they have developed and what problems the M&A community will most likely face in the near future. It ends with the reader having a more comprehensive understanding of the state of these relationships, especially given the unique timing we are faced with today.

We then conclude with 10 further research questions which we feel are the natural next steps for any M&A practitioner to be asking. If you so wish to engage us with these or other questions, we would be more than happy to lend our thinking and experience to you.

# The Chinese Perspective

Much of the literature, forecasts, opinions and strategy regarding China and M&A comes from a western perspective for a western audience. Not much added value can be offered in that regard given the sheer volume of work that has facilitated that position thus far. What is less available and also much less understood or misunderstood, is the Chinese perspective on the changing investment and geopolitical landscape, their opinions on the West and how they plan to engage with western and other global players in this brave new world. This is the blind spot which this whitepaper will attempt to fill.

To begin with, it is important to realise that there seems to have developed an asymmetric understanding between the West and China that needs rebalancing. This investor parallax has afflicted the non-Chinese investor and business operator which has resulted in missteps, underestimations of China's ambitions and growth and an overestimation of the West's ability to absorb China into its way of doing things.

The policy of engagement with China began in 1972 with President Nixon & Henry Kissinger and has continued on through eight different presidential administrations. Most notably perhaps in 1979 when the then Chinese Vice Premier Deng Xiaoping visited Texas under the leadership of the Carter administration. This was a memorable public display of Sino-US friendship which hoped to usher in a new age of normalisation based on a common belief and acceptance of open markets, transparency, and cooperation.

*China's 1.433 billion market was and continues to be such an attractive pull for US industry that policymakers have given up earlier attempts to transform the nation politically...*

The macro strategy of the US was to reward relationship normalisation with opening US markets to Chinese investment and expecting the same, thus showing how much better off they would both be with this new free market status quo, this was then hoped to lead to a transition of the political order from Communism to Democracy on the part of China, which would naturally lead to a changing of the political guard as democracy would dictate, therefore ensuring a dramatically reduced military threat from what would have been a belligerent power. It didn't turn out that way.

The US strategy post WWII was to open up their manufacturing markets to the world, this allowed Japan to pursue an export-led growth model. Nations like South-Korea, Taiwan, and Singapore followed suit. This high export-led growth in South East Asia was to become known as the Asian Tigers. US businesses which produced low value goods like luggage for example were allowed to go out of business and were replaced by imports, thus allowing a focus on high value tech and financial services.

This was the same trajectory they expected the Chinese to take, but they did not. China's 1.433 billion market was and continues to be such an attractive pull for US industry that policymakers have given up earlier attempts to transform the nation politically, focusing mainly on accommodating the political situation whilst simultaneously taking advantage of its manufacturing base. Consecutive US presidents have undermined the personality, and historical make-up of the Chinese, they have learnt the long and hard way that China is not as malleable and prone to outsider influence especially when it comes to how it runs its political affairs. Having spent 4,000 tumultuous years consolidating its landmass, the only way China continues to be as powerful as it is, is by having a centralised political system that it can control. Socialism with Chinese characteristics as former Vice Premier Deng Xiaoping put it shows China's ability to be malleable and pragmatic…but on its own terms.

## KEY TAKE AWAYS

- An asymmetric understanding has developed between the West & China which has resulted in missteps, underestimation of China's ambitions and overestimation of the West's ability to bring China into its flow.
- The policy of engagement with China began in 1972 with President Nixon & Henry Kissinger and has spanned 8 presidential administrations who have all struggled with their China policy due to partly a shallow understanding of China's ambition and a blindingly optimistic hope of reform as well as the fact that China's development strategy is holy unique to its position, history and experience that cannot be compared to America.

# China's 14th Five-Year Plan

In response to increasing external economic shocks, China's $14^{th}$ Five-Year Plan, formulated at the $19^{th}$ Party Congress in October, attaches great importance to the pursuit of self-reliance and technological sovereignty. The new 'dual circulation' (经济双循环) development model, will be the overarching policy during the 14th five-year plan period. As uncertainty rises in the international environment, this model is set to prioritise the development of China's internal economy – to increase domestic consumption and upgrade the domestic industrial chain. This is not to suggest that China is abandoning its long-term policy of 'reform and opening up', as China has reaffirmed their commitment to international trade, cooperation and economic governance. However, it does indicate stronger nationalist sentiments among economic policymakers.

In an October 2020 speech, Xi Jinping announced that China must pursue independent innovation, make breakthroughs in key core technologies, strive to achieve independent control in key fields, ensure the security of the industrial chain and supply chain, and enhance China's science and technology ability to respond to international risks and challenges.

"我们必须坚定不移走自主创新道路，坚定信心、埋头苦干，突破关键核心技术，努力在关键领域实现自主可控，保障产业链供应链安全，增强我国科技应对国际风险挑战的能力"

China is likely to strengthen industrial policies aimed at financial, operational, and regulatory support for companies in key sectors. This is strongly aligned with its "Made in China 2025" (中国制造2025) initiative, first unveiled in 2015, which outlines China's plans for supply-side structural reform and a move away from low value-added manufacturing. China has vowed to develop a favourable policy environment for domestic firms in sectors of strategic importance, offering tax incentives, subsidies, and an accelerated administrative process.

As China enacts these plans, there is likely to be some significant changes in industry regulations which could impact foreign firms operating in Chinese markets. Equally, such preferential treatment is likely to heighten accusations of anti-competitive tactics.

## KEY TAKE AWAYS

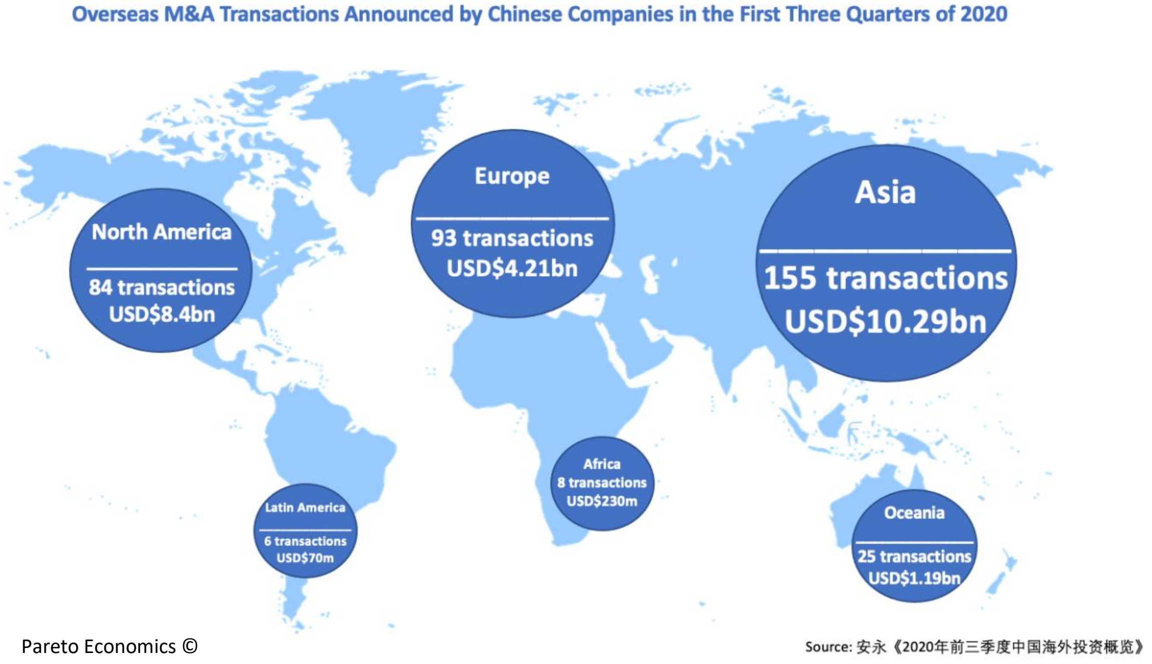
- In response to increasing external economic shocks, China's 14th Five-Year Plan, formulated at the 19th Party Congress in October, attaches great importance to the pursuit of self-reliance and technological sovereignty.
- China is likely to strengthen industrial policies aimed at financial, operational, and regulatory support for companies in key sectors. This is strongly aligned with its "Made in China 2025" (中国制造2025)

# China's Outbound Foreign Investment

In 2020, the volume of China's M&A transactions has declined for the fifth consecutive year. This has been due to several factors including heavier debt loads, tighter domestic liquidity conditions, Beijing's controls on outbound capital flow and an increase in trade and investment restrictions abroad. This downward trend is only set to continue as geopolitical tensions rise and supervision in destination markets is tightening.

However, in the context of China's latest economic "dual cycle" strategy, "external circulation" needs to serve domestic economic growth, and overseas investment and cross-border mergers and acquisitions will be no exception. The acquisition of international brands and advanced technology can bring additional investment, consumption and employment opportunities to the country, and is likely to receive strong support from the Chinese Communist Party (CCP).

**Fig 1: Overseas Chinese M&A transactions, 2020**




The State Administration of Foreign Exchange (SAFE) announced that controls on outbound capital flows would be relaxed further in major cities, granting domestic investors wider access to foreign opportunities, in efforts to encourage more domestic investment abroad as the yuan depreciates against the dollar.

Shanghai, Beijing and Shenzhen will respectively expand the pilot scale of the Qualified Domestic Limited Partnership (QDLP) and the Qualified Domestic Investment Enterprise (QDIE). At the same time, it will steadily expand the QDLP pilot area, with plans to add Hainan Free Trade Port and Chongqing Municipality to carry out QDLP pilot projects to better support the construction of Hainan Free Trade Port and the development of Chengdu-Chongqing Economic Circle.

In regards to outbound capital flows, Chinese money is facing increasing scrutiny in three major markets, including; the USA, UK and the EU. Geo-economic tensions have been the cause and result of increasingly suspicious and inhospitable environment for M&A.

## KEY TAKE AWAYS

- In 2020, the volume of China's M&A transactions has declined for the fifth consecutive year, this is due to several factors including heavier debt loads, tighter domestic liquidity conditions, Beijing's controls on outbound capital flow and an increase in trade and investment restrictions abroad due to geopolitical considerations.

## Sino-US Relations

Ever since President Nixon & Henry Kissinger landed in Beijing marking the beginning of the US's policy of engagement in 1972 US-China relations have changed considerably. However, one constant theme has characterised the US-China relationship ever since and that is the consistent hands-on approach by the US to actively form and shape the relationship, or rather shape what they wanted the Chinese to do in the relationship.

Given its position as the world's only superpower back then and still one now, this "proactive" approach was to be expected. The intention at the start was to form a bilateral relationship with the Chinese before the Russians did in order to disrupt what could have been a dangerous alignment of two strong powers.

*One constant theme has characterised the US-China relationship ever since and that is the consistent hands-on approach by the US to actively form and shape the relationship, or rather shape what they wanted the Chinese to do in the relationship.*

They were successful in this, but over the years and decades the US has become increasingly disillusioned with what they perceived as China's broken promises and increasingly antagonistic, secretive and belligerent behaviour in the fields of business, diplomacy, trade, research and technology.

However, from the Chinese perspective, it is clear to Beijing what benefits the US would enjoy if China were to behave in the way the US and the wider West wants, specifically in respect to trade, opening up its economy and allowing a transition to democratic elections. What is unclear to the Chinese is how the US sees these changes benefiting China, or more specifically the CCP.

### Foreign Investment Risk Review Modernisation Act (FIRRMA)

As it concerns M&A, when looking at the last four years under the Trump administration, many key decisions have been made which have impacted the inward follow of Chinese investment. The first of which includes the passing of the Foreign Investment Risk Review Modernisation Act (FIRRMA) in 2018. This bill was created as an extension of the legal protections regarding the national security of America in relation to trade and investment.

Coming from a long linage of legislative protections as it concerns national security, dating back to the Tariff Act of 1789, which was enacted as a response to Alexander Hamilton's thinking regarding "infant industries". This act was largely military and strategic in nature[1].

[1] Chernow, R. 2005. Alexander Hamilton. Penguin Group. New York

At the turn of the century, the Trading with the Enemy Act of 1917 was used to nationalise assets during World War I and to block all foreign investment during World War II[2].

FIRRMA was born out of the nexus of increased fear regarding China's growing strategic and economic clout and the potential loss of American technology supremacy, with urgency ignited by the attempted Broadcom-Qualcomm merger. The resulting legislation attracted significant industry attention, especially from venture capital[3].

With the enactment of FIRRMA the US is more clearly defining who its friends and foes are. FIRRMA grants the President the authority to block or suspend proposed or pending foreign "mergers, acquisitions, or takeovers" by or with any foreign person that could result in foreign control of any United States business, including such a merger, acquisition, or takeover carried out through a joint venture that threaten to impair national security[4]. The seven largest investing countries are all United States allies. They include; the United Kingdom, Japan, Germany, France, Canada, Switzerland, and the Netherlands – combined they account for 72.1 percent of U.S. affiliate value added. In response, FIRRMA limits reviews on investments from companies in allied countries, or "excepted foreign states" including Australia, Canada and the UK in regards to non-controlling transactions. Furthermore, it gives these nations two years to develop similar legislation in order to continue the daisy chain of nation security protectionism.

In regards to Chinese inbound investment, FIRRMA is especially invasive. The act underlines that every two years the Secretary of Commerce shall submit to congress and to CFIUS a report on ALL transactions made by entities of the People's Republic of China, including information on: The Ultimate Beneficial Owner, Dollar amount invested, Type of investment: Greenfield/Brownfield, Sector, and an analysis of patterns in the investment and how they align with the Made in China 2025 strategy. Naturally the Chinese are unhappy about this and highlight the fact that the United States is restricting the opportunity for China to share in the same benefits afforded to the Asian Tigers by the US after the cold war, under the auspices of national security. In response, the Chinese National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM) in December 2020 jointly released the new rules for reviewing foreign investment on security grounds. These are scheduled to come into force in January 2021. The 23-clause new rules rest upon the Foreign Investment Law and the National Security Law as a legal basis.

This has seen mixed reactions from the M&A community. Naturally, for Chinese firms this will slow down and limit business growth especially as it relates to acquisitions in industries related to national security. Given also the fact that there has been a creeping definition of what national security actually means, with industries like health and pharmaceuticals being watched even more closely. Given the spread of the coronavirus, national security no longer means warfare, but has developed a more sophisticated definition and practical application which covers health.

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[2] Zimmerman, Evan, The Foreign Investment Risk Review Modernisation Act: How CFIUS Became a Tech Office (April 9, 2019). Berkeley Technology Law Journal, Volume 34, Issue 4, Available at SSRN: https://ssrn.com/abstract=3368723

[3] Ibid.

[4] Jackson,J,K. (2020) The Committee on Foreign Investment in the United States (CFIUS). Congressional Research Service. https://crsreports.congress.gov/ [RL33388]

For the US or excepted foreign states companies this presents an opportunity to continue and even increase M&A activity knowing that competition for Chinese firms is restricted who might have had an edge given the amount of state subsidy support they would receive, especially for State Owned Enterprises (SOE). With commodities experiencing a deflated price, this allows for rapid consolidation in this industry as many smaller and medium players are experiencing tighter margins which cannot be sustained.

Securing reliable and cheap energy is key for China, they have an incentive to control the energy and commodity supply chain for growing internal consumption, however seeing as energy is a national security concern for the US, any attempt to take advantage of struggling US energy companies is curtailed with this act, giving a sizable opportunity for competitors to capitalise.

## KEY TAKE AWAYS

- With the enactment of FIRRMA the US is more clearly defining who its friends and foes are.
- FIRRMA limits reviews on investments from companies in allied countries, or "excepted foreign states" including Australia, Canada and the UK in regards to non-controlling transactions.
- The act underlines that ALL transactions made by entities of China be tracked and monitored, including information on: The Ultimate Beneficial Owner, Dollar amount invested, Type of investment: Greenfield/Brownfield, Sector, and an analysis of patterns in the investment and how they align with Made in China 2025 strategy.

### Reverse Mergers and Delisting Chinese Companies from US Exchanges

A reverse merger is a process in which a private company overtakes a public shell company and controls it. This method allows companies to avoid the costs and scrutiny inherent to an initial public offering, and allows them to more easily become listed in U.S. markets[5]. Although reverse mergers are not inherently nefarious investing processes, but the way they have been used by Chinese companies has led to action from the US Security and Exchange Commission in the form of instituting a stricter set of listing rules and even delisting Chinese companies from US Exchanges. Since 2009 an estimated 300 Chinese firms have reverse merged or reverse IPO'd with American companies. Many Chinese firms which have performed a reverse merger in the US and Canada have been found perusing fraudulent activity and keeping western investors in the dark.

[5] Altucher, J (2006). Mergers That Go Forward in Reverse. Financial Times. 1+. Access World News.

A few examples uncovered by research firm Muddy Waters[6] include; Sino-Forrest which is a forestry company located in Hong Kong. S-F listed on the Toronto Venture Exchange in Canada nearly over 20 years ago via reverse merger. It was eventually delisted by the Ontario Securities Commission when evidence surfaced of endemic fraud by the company including overstating assets to the tune of $900m, the creation of phoney third parties, and fraudulent purchase orders.

China Media Express holding (Fig.2) was also another example of a reverse merger gone wrong. CME is an advertising company that plays television ads in buses throughout the Republic of China. In 2009, they began trading on the Nasdaq via a reverse merger when they took over the shell company TM Entertainment & Media. CME were found to be involved in several illegal practices including; management pump and dump schemes, false claims of business penetration claiming to advertise on 27,200 buses when in fact only 12,565 carried them, inflation of revenue figures by over $78m, claiming falsely to be associated with Apple. After several other negative news stories its auditors Deloitte Touche Tohmantsu (Deloitte affiliate) resigned. On the same day (11th March), CME shares were halted after a 48% decline caused by the Muddy Waters report. In May of the same year, they were delisted from the Nasdaq.

Many more examples of these practices are still coming out which has prompted action by the Trump administration. On 4th June 2020, A memorandum on Protecting United States Investors from Significant Risks from Chinese Companies was issued by President Trump, tasking the President's Working Group on Financial Markets (PWG) with examining certain risk to investors in U.S. financial markets posed by the Chinese government's failure to allow audit firms that are registered with the Public Company Accounting Oversight Board (PCAOB) to comply with U.S. securities laws and investor protection requirements[7]. The PWG recommended several measures that would protect investors including; enhancing listing standards to require, as a condition to initial and continued exchange listing in the United States, PCAOB access to work papers of the principal audit firm for the audit of a listed company.

For companies that are unable to satisfy that standard as a result of governmental restrictions on access to audit work papers and practices in Non-Compliant Jurisdictions (NCJ), this standard may be satisfied by providing a co-audit from an audit firm with comparable resources and experience where the PCAOB determines if it has sufficient access to audit work papers and practices to conduct an appropriate inspection of the audit firm.

To reduce market disruption, the recommended new listing standards would provide for a transition period until 1st January, 2022 for currently listed companies from NCJs to come into compliance. The PWG also recommends enhanced issuer disclosures, enhanced fund disclosures, greater due diligence of indexes and index providers, and the issuance of guidance with respect to fiduciary obligations for investment advisors considering investment in NCJs[8].

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[6] Muddy Waters Research https://www.muddywatersresearch.com/

[7] President's Working Group on Financial Markets: Report on Protecting United States Investors from Significant Risks from Chinese Companies, July 24, 2020

[8] Ibid

**Figure 2. China MediaExpress Holdings**


Pareto Economics © Source: Yahoo Finance

## KEY TAKE AWAYS

- Reverse mergers are not inherently nefarious investing processes, however, the way they have been used by Chinese companies had led to action from the US SEC in the form instituting a stricter set of listing rules and even delisting Chinese companies from US Exchanges.
- Since 2009 an estimated 300 Chinese firms have reverse merged or reverse IPO with American companies.
- The Trump administration took action on this via the President's Working Group on Financial Markets (PWG), which recommended several measures that would protect investors including; enhancing listing standards to require as a condition to initial and continued exchange listing in the United States, PCAOB access to work papers of the principal audit firm for the audit of a listed company.

## Biden's China Policy

Before Biden officially took office, he committed to maintaining Trump's hard-line stance on China; although, it is widely expected that he will target China through multilateral action rather than using executive authority. However, recent signalling by the new Biden administration has showed he will be taking a more conciliatory tone with China, this move would please the Chinese administration but has worried the US defence and security establishment.

Biden has made it clear he will preserve protectionist measures on strategic, high-tech sectors such as aerospace, quantum communications, and AI. But it is unlikely Biden will follow Trump into arbitrary disputes over non-critical tech e.g., TikTok, WeChat.

As expected, President Biden has enacted a series of executive orders on his first day in office which clearly define his position on a range of issues, including; revoking permits for the keystone XL pipeline which struck a sour note with Canada, a reversal on travel bans targeting primarily Muslim countries and stopping construction of the border wall. However, his focus on other key policy issues such as; China, 5G security, illegal immigration, Iran, Nicaragua and Venezuela seem to have been demoted as compared with the Trump administration which held hawkish positions on those area.

Furthermore, his stance and strategy on a belligerent Russia and collaborative outreach for allies like the UK and EU on matters including post BREXIT trade, a unified response to terrorism and cyber defence have yet to be defined.

On 23ed November 2020, Biden announced several significant cabinet picks, most are veterans of the Obama administration who worked alongside Biden during his term as Vice President, they include;

Antony Blinken – *Secretary of State*

Member of Bill Clinton's White House staff in the 1990s and served under President Barack Obama. Blinken also advised Biden on national security when he was vice president.

Avril Haines – *Director of National Intelligence*

Previously the deputy director of the Central Intelligence Agency, she worked closely with Biden from 2007-08 in her role as deputy chief counsel for the Senate Democrats.

Jake Sullivan – *National Security Adviser*

The National Security Adviser to Biden when he was Vice-President and served as deputy chief of staff to Hillary Clinton when she was secretary of state.

Katherine Tai – *US-Trade representative*

Previously a senior member of the Office of the General Counsel for the U.S. trade representative during the Obama administration, responsible for China trade enforcement issues.

Lloyd Austin – *Secretary of Defence*

Retired U.S. Army four-star general who served in the military for 41 years. From 2013 until 2016, he was head of U.S. Central Command.

Eric Lander – *Director, Office of Science & Technology Policy*

Leads one of the world's top biomedical research institutes and was one of the principal leaders of the Human Genome Project. He also advised the Obama administration on science and technology issues.

William Burns – *CIA Director*

Current president of the Carnegie Endowment for International Peace, a think tank. He had a 33-year career in the foreign service, including serving as ambassador to Russia and earlier to Jordan.

Gary Gensler – *Chair, Security and Exchange Commission*

Former head of the Commodity Futures Trading Commission where he led derivatives markets reforms in the wake of the 2008 market crash. Previously, he worked at Goldman Sachs before working in former President Clinton's Treasury Department.

This team have had previous experience with President Biden in his role as former Vice President, or with the Democratic Party in general and they are likely to support Biden's efforts to reengage with allies and resume multilateral cooperation. What is notable that bar a small handful of appointees, none have deep experience engaging with China which may present a problem especially as Biden develops his macro-outlook and engagement strategy with China.

Despite this, the Chinese establishment have interpreted these selections as "a return to the establishment" and expect that diplomacy and national security policies will return to a more traditional and professional style, without the volatility of the prior Trump administration. Given China's unbroken political leadership it is unlikely that they will deviate much or not at all from their current dual circulation development model. This is because this model was developed in part due to the increasingly combative stance of the United States and formed with an underlining understanding that this would be the best road for China even if former President Trump won a second term. He didn't, so it may be the case that this model will be easier to implement especially if Biden adopts a more conciliatory tone with China.

Areas to watch with a Biden administration as it relates to China include; Trumps trade deal, forced technology transfers, COVID-19 origin investigation, regional security in South-East Asia, reverse mergers and compliant cross-border M&A activity.

## KEY TAKE AWAYS

- Biden's tough talk on China pre-inauguration has morphed into a more conciliatory tone which has worried the US defence establishment.
- His newly announced cabinet are overall very light on China engagement, which may present a problem especially as Biden develops his macro-outlook and China engagement strategy.
- The Chinese establishment have not commented on Biden's cabinet experience but rather have highlighted that his selection marks "a return to the establishment" and expect that diplomacy and national security policies will return to a more traditional and professional style, without the volatility of the prior Trump administration.

## Sino-EU M&A

Sino-EU relations presents a more complex picture because unlike the US the EU is a political and economic bloc made of 27 member nations all with their own perspectives, incentives, agendas and visions, so when it comes to pan EU alignment on new, and at times contentious issues like Chinese FDI it becomes difficult to speak with one voice. The majority of Chinese FDI is in the form of acquisitions. Some major acquisitions of European firms include; Volvo cars, and Kuka, a German maker of industrial robots.

In regards to its Dual Circulation Development Model, part of China's aim is to transcend the "middle income trap" and the best strategy to achieve this aim is via growth through acquisition. Given the maturity and experience of EU companies in industries like manufacturing, technology, logistics, robotics and others, China is taking advantage of their ability to provide state subsidies for M&A activity such as financing via government supported investment funds e.g., Sino-CEEF Fund, cheaper financing, loan guarantees, tax rebates etc.

Two problems arise when considering Sino-EU M&A, the first is in relation to EU rules laying out the limits and controls of state subsidies. These are very clear when it comes to intra-EU M&A, however the rules and regulations are more blurred and less comprehensive when it comes to non-EU inbound M&A. This allows an unfair advantage for non-EU countries to use disproportionate state subsidy support to bolster successful acquisition targets for State Owned Enterprises (SOE).

There is limited information on the actual number of foreign subsidies being granted. This is mainly due to a lack of transparency and low compliance[9] with the obligation to notify subsidies under the Agreement on Subsidies and Countervailing Measures (SCM Agreement[10]).

[9] A recent background note prepared by the WTO Secretariat (G/SCM/W/546/Rev.10) notes that between 1995 and 2017 the number of members that have failed to make a notification rose sharply. As on April 2019, 77 WTO members had not yet submitted subsidy notifications for 2017, 62 members have still not submitted subsidy notifications for 2015. See also: https://www.wto.org/english/news_e/news19_e/scm_30apr19_e.htm

[10] WTO Agreement on Subsidies and Countervailing Measures Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1869 U.N.T.S. 14. [Not reproduced in I.L.M.].

Some reports by the Organisation for Economic Co-operation and Development (OECD) indicate however that government interventions appear widespread in certain sectors[11].

Margrethe Vestager, European Commissioner for Competition is responding by creating regulation pertaining to the use of state subsidies for non-EU nations. This began with the commission adopting a White Paper on foreign subsidies in the Single Market dealing with the distortive effects caused by foreign subsidies in the Single Market.

Secondly, the Sino-EU relationship suffers from the same investment asymmetry that mirrors every other nation and economic bloc in the world. The EU economy is open to foreign investment[12], and it seems to the EU that China isn't. Furthermore, the EU has major concerns related to Chinese investment in Europe, including: an increase in China's ability to wield political influence in Europe, problems related to Chinese corporate governance & business practice, a lack of investment reciprocity, and what would Chinese control of key/strategic industries like energy, natural resources, military production, and critical infrastructure e.g. 5G look like.

## KEY TAKE AWAYS

- It is difficult to homogenise an EU foreign investment policy strategy especially with China as all 27 member states have their own perspectives, incentives and ambitions.
- Given the maturity and experience of EU companies in industries like manufacturing, technology, logistics, robotics and others, China is taking advantage of their ability to provide state subsidies for M&A activity such as financing via government supported investment funds e.g., Sino-CEEF Fund, cheaper financing, loan guarantees, tax rebates etc.

### China-EU Comprehensive Agreement on Investment (CAI)

On 30th December 2020, after 7 years and 35 rounds of negotiations, China and the European Union have finalised the Comprehensive Agreement on Investment (CAI). The China-EU CAI will replace the Bilateral Investment Treaty (BIT) concluded between China and 26 of the 27 EU member states (all countries except Ireland).

Li Yongjie 李詠箑, Director of the Department of Treaty and Law of the Ministry of Commerce, stated at a press conference on the evening of the 30th:

"the China-EU Investment Agreement is a comprehensive agreement that goes beyond a traditional bilateral investment agreement. The outcome of negotiations covers market access commitments, fair competition rules, sustainable development issues and dispute settlement

[11] The OECD estimated that in the aluminium sector total government support for firms studied reached between USD 20-70 billion over the 2013-17 period (depending on how financial support is estimated). See: https://www.oecdilibrary.org/docserver/c82911aben.pdf?expires=1587470829&id=id&accname=guest&checksum=CA92281E81EB5ECE7D5F87CED76198CF

[12] European Commission, 2020. WHITE PAPER on levelling the playing field as regards foreign subsidies. COM(2020) 253 final

commitments that apply to both sides. Both sides have made commitments to openness while retaining necessary regulatory powers."

"欧洲投资协定是一个全面的协定，超越了传统的双边投资协定的范畴，谈判的成果涵盖了市场准入承诺，公平竞争规则，可持续发展议题以及争端解决承诺适用于双方的，双方在作出开放承诺的同时，也都保留了必要的监管权。" - 商务部条法司司长李詠箑"

Xi Jinping emphasised that China is committed to building a new development pattern, which will provide Europe and the world with more market opportunities and create greater space for cooperation. It is hoped by the Chinese that the EU will adhere to free trade and multilateralism and provide Chinese investors with an open, fair and non-discriminatory business environment.

Chinese media claims the successful negotiations of CAI are undoubtedly a major victory for China. The China-EU investment agreement came at an interesting time. It in fact was agreed three weeks before the Biden Administration took office, safe in the knowledge that a Trump administration could not fire back at what is sees as a bad deal for the collective stance of democracy and human rights of the West. Furthermore, with the UK having "Brexited," the EU needs to plug the gapping budgetary whole that the UK left which stands at £11 billion (US$15 billion) in 2018. Knowing the problems, the EU faces in terms of non-EU state subsidies, this deal at least allows much greater access to Chinese markets.

Following the signing of the Regional Comprehensive Economic Partnership (RCEP), this investment agreement also signals deeper economic cooperation and integration between Europe and the Asia-Pacific region.

For Chinese investors, the EU market is already open and largely committed for services sectors under the General Agreement on Trade in Services (GATS). Sectors of strategic importance or sensitivity, such as energy, agriculture, fisheries, audio-visual, public services, etc. are all preserved in CAI.

Key Chinese Sectors opening to European Investment include;

Manufacturing: China has made comprehensive commitments to match EU openness in manufacturing sectors, with only very limited exclusions (in particular, in sectors with significant overcapacity). Roughly half of EU FDI is in the manufacturing sector (e.g., transport and telecommunication equipment, chemicals, health equipment etc.)

Automotive sector: China has agreed to remove and phase out joint venture requirements. China will commit market access for new energy vehicles.

Financial services: Joint venture requirements and foreign equity caps have been removed for banking, trading in securities and insurance (including reinsurance), as well as asset management.

Health (private hospitals): China will lift joint venture requirements for private hospitals in key Chinese cities, such as Beijing, Shanghai, Tianjin, Guangzhou and Shenzhen.

R&D (biological resources): The R&D sector has not historically been open to foreign investment. China has agreed not to introduce new restrictions and ensured any future lifting of restrictions in this area will be applied to the EU.

Telecommunication/Cloud services: China has agreed to lift the investment ban for cloud services, the sector will be open to EU investors subject to a 50% equity cap.

Computer services: China has agreed to bind market access for computer services. China will include a 'technology neutrality' clause, which would ensure that equity caps imposed for value-added telecom services will not be applied to other services (e.g., financial, logistics, medical services) if offered online.

International maritime transport: China will allow investment in the relevant land-based auxiliary activities, enabling EU companies to invest in cargo-handling, container depots and stations, maritime agencies, etc without restrictions.

Air transport-related services: China will open up in the key areas of computer reservation systems, ground handling and selling and marketing services. China has also removed its minimum capital requirement for rental and leasing of aircraft without crew, going beyond GATS.

Business services: China will eliminate joint venture requirements in real estate services, rental and leasing services, repair and maintenance for transport, advertising, market research, management consulting and translation services, etc.

Environmental services: China will remove joint venture requirements in environmental services such as sewage, noise abatement, solid waste disposal, cleaning of exhaust gases, nature and landscape protection, sanitations and other environmental services.

Construction services: China will eliminate the project limitations currently reserved in their GATS commitments.

Employees of EU investors: Managers and specialists of EU companies will be allowed to work up to three years in Chinese subsidiaries, without restrictions such as labour market tests or quotas. Representatives of EU investors will be allowed to visit freely prior to making an investment.

There are 5 key areas for EU-China cooperation in 2021:

1. 协调抗疫行动 To coordinate on anti-epidemic actions: Ensuring that vaccines are fairly distributed as a global public good, especially for the benefit of developing countries.

2. 共促经济复苏 To promote economic recovery: Strengthening policy communication and coordination, persisting in building an open world economy, and bringing the global industrial chain and supply chain back on track as soon as possible.

3. 对接发展战 To establish a development strategy: Increasing policy coordination, strengthen the joint construction of the "Belt and Road" initiative and the EU's Eurasian connectivity strategy, and explore cooperation in the digital field.

4. 加快绿色发展 The fourth is to accelerate green development. Make good use of the China-EU high-level dialogue mechanism on environment and climate to support each other's holding of international conferences on biodiversity, climate change and nature conservation.

5. 推动多边合作 The fifth is to promote multilateral cooperation. Strengthen coordination and cooperation within the frameworks of the United Nations, the G20, the World Trade Organization, and the World Health Organization, promote political settlement of international and regional hotspot issues, actively implement the G20 debt relief initiative, and support Africa's anti-epidemic and development efforts. Promote world development and prosperity.

## KEY TAKE AWAYS

- Xi Jinping emphasised that China is committed to building a new development pattern, which will provide Europe and the world with more market opportunities and create greater space for cooperation.
- Key Chinese Sectors opening to European Investment include; Manufacturing, Automotive Sector, Financial Services, Health, International Maritime Transport, Construction Services, Environmental services etc
- The past Trump Administration were against any and all moves by the EU to extend cooperation opportunities with perceived US foes like Russia (Nord Stream) and especially China, Biden is yet to comment on this agreement.

## Sino-UK M&A

The UK starts off 2021 having completed and agreed what was probably the most important political and economic agreement in a generation, that being BREXIT. It now sails into unchartered territory with a climate of economic uncertainty, an ever-consuming pandemic, shifting geopolitical sands and a leadership determined to prove that they are able to navigate the storms. Prime Minister Boris Johnson has a lot on his plate. He must now decide what role the UK plays in international affairs, this will be predicated on his vision, abilities and resources at his disposal.

As it relates to China, the UK has an ability to speak with a more defined and independent voice following BREXIT, with Prime Minister Johnson signalling to business his intentions which at times seem to be giving off mixed signals as it relates to China. The results of BREXIT have been similar for both sides for similar reasons. As we explored for the EU, they seek growth opportunities and new markets, the UK on the other hand is also looking towards China seeking a boost to UK exports, although officially no such ambition is expressed.

What can be observed for certain is the fractious nature of the cabinet in regards to the UK's stance on China. This was apparent during last year's major U-turn on Chinese 5G provider Huawei. Pressure was building the for government to U-turn on their proposals to use Huawei technologies for Briton's 5G infrastructure, its fate was sealed after Washington imposed sanctions claiming the firm poses a national security threat - something Huawei denies. Furthermore, the UK instructed UK mobile providers to remove all the Chinese firm's 5G kit from their networks by 2027.

January also saw an interesting developed in parliament when Lord Alton proposed a "genocide amendment" to a Trade Bill going through parliament. This would have allowed future trade deals with nations like China to be assessed on the basis that a corresponding nation does not violate human rights of its own people.

The amendment was proposed as an attempt to break the present gridlock which exists with international courts. Often these courts are unable to make rulings on genocide because nation states such as China do not recognise the relevant courts, or veto any reference to such matters.

This proposal would have allowed the UK high court be able to make legal judgements on genocide a preliminary determination, that the government would then have to consider. There was major cross-party support of this amendment including from former foreign secretary Jeremy Hunt and Conservative MP Ian Duncan Smith. On January Tuesday 19th this amendment was defeated by 319 to 308.

## KEY TAKE AWAYS

- The UK has an ability to speak with a more defined and independent voice following BREXIT, with Prime Minister Johnson signalling to business his intentions which at times seem to be giving off mixed signals regarding his China policy.
- Johnson's cabinet remains vehemently fractured regarding their position on China, which has meant the UK has moved very slowly with their China engagement policy, as was noted with the U-turn on Huawei and voting down the "genocide amendment" in a UK trade bill.

### National Security & Investment Bill

The UK has always been a good place for business which is why there has been such interest from foreign companies to stake their claim to the UK consumer, and furthermore to have a base in the UK from which to operate a regional office. The UK leads in tech innovation, healthcare, R&D and media and continues to attract the attention of the M&A activity. However, as the UK government recognises, we are also seeing long-term shifts in the balance of global economic and military power, increasing competition between states, and the emergence of more powerful non-state actors[13].

In response, the UK has moved to introduce new legislation which attempts to protect national security, whilst at the same time keeping the UK open and attractive for business investment to the rest of the world. This balancing act comes in the form of the new National Security & Investment Bill (NSIB). Resembling the US Foreign Investment Risk Review Modernisation Act and other similar measures taken by other allies including Canada and Australia, the NSIB will give government new powers to screen investments on the ground of national security. Some examples of "qualifying assets" which will aim to be protected include: trade secrets, databases, source code, algorithms, formulae, designs, plans, drawings and specifications, software[14].

Although not mentioning China explicitly the UK government does recognise that the UK, and UK businesses, face continued and broad-ranging hostile activity from those who seek to compromise their national security and that of their allies. Such behaviour left unchecked can leave the UK vulnerable to disruption, unfair leverage, and espionage. It is crucial that the government is able to fully combat these threats coming from ever more determined overseas actors[15].

With China's dual circulatory model focusing on increasing domestic consumption and upgrading its domestic industrial chain, these measures may, as a second order effect, impact China's ability to do this. This is especially true when external expertise and innovation in areas with dual use capabilities are required to reach these aims.

## KEY TAKE AWAYS

- The UK has moved to introduce new legislation which attempts to protect national security whilst at the same time keeping the UK open and attractive for business investment to the rest of the world.
- The NSIB will give government new powers to screen investments on the ground of national security. Some examples of "qualifying assets" which will aim to be protected include: trade secrets, databases, source code, algorithms, formulae, designs, plans, drawings and specifications, software.
- With China's dual circulatory model focusing on increasing domestic consumption and upgrading its domestic industrial chain, these measures may as a second order effect impact China's ability to do this.

[13] Overview of the National Security and Investment (NSI) Bill factsheet. 11 November 2020. https://www.gov.uk/government/publications/national-security-and-investment-bill-2020-factsheets/overview-of-the-national-security-and-investment-nsi-bill-factsheet

[14] National Security and Investment Bill, 2020

[15] Overview of the National Security and Investment (NSI) Bill factsheet. 11 November 2020. https://www.gov.uk/government/publications/national-security-and-investment-bill-2020-factsheets/overview-of-the-national-security-and-investment-nsi-bill-factsheet

# Further Research Questions

Below is a list of questions and themes we have investigated and think you would like the answers to.

1. How will a Biden administration tackle important national security concerns whilst keeping the appetite for cross border M&A high?
2. How will inbound M&A into China be impacted if/when national security becomes an issue for China?
3. How can the US, UK and EU present a united front when there exists a fractured approach to Chinese investment?
4. What industries are the winners and losers when considering the impact China's dual circulation development strategy?
5. Will the strain of BREXIT force the UK to establish a comprehensive trade deal with China?
6. How do foreign firms manage their growth strategy with China as public pressure increases to cut ties with the nation due to their human rights abuses?
7. How will EU policy on China look post Merkel?
8. If protectionist measures by the West continue, how does China transcend the middle-income trap?
9. Can the Chinese Communist Party sustain power given its lack of dollar reserves and growing M&A restrictions in key markets?
10. How should M&A operators be hedging geopolitical risk and this new hostile investing environment?

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