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Will the EU/China Comprehensive Agreement facilitate investments by EU companies in China?

Speed Read

The European Union (**EU**) and the People's Republic of China concluded the negotiations on their investment treaty, the EU/China Comprehensive Agreement on Investment (**CAI**), on 30 December 2020. Although the CAI has raised political objections and its text still needs to be finalised, it is already considered as a ground-breaking investment treaty between two of the biggest trading partners in the world and may represent a substantial opportunity for EU Companies to consider new investments in China. This bulletin seeks to identify what we know of the key agreed principles.

Why is the CAI a ground-breaking investment treaty?

The recent announcement of the conclusion of the negotiation of the CAI after seven years and 35 rounds of negotiations has raised political objections. There is a wide range of opinion as to whether more or less should have been included in the treaty, and there are many claims that the CAI already impacts or will impact relations between the U.S. and China and between the U.S. and the EU. It is also important to recognise that the text of the CAI has not yet been finalised and many events may slow down or even prevent its entry into force, which is not expected before 2022.

Still, the CAI is a ground-breaking investment treaty. It imposes obligations on both Parties, but in effect it is likely to benefit mainly EU companies investing in China, as the EU has already granted a broad access to its market to Chinese investors. It therefore represents a substantial opportunity for EU Companies to consider new investments in China.

The present alert focuses on the ways the CAI should facilitate EU investments in China.

1. The CAI will remove restrictions <u>at the time of</u> an investment by EU companies in China

   a. Pursuant to the CAI, China will reduce or remove legal restrictions at the time EU companies invest in China in some sectors, including some key service sectors. This concerns the lifting of some joint venture requirements or equity caps or other restrictions in various sectors (for more details please see the table at the end of this bulletin):

Lifting of some joint venture requirements or equity caps	Lifting of other restrictions
– manufacturing	– R&D (biological resources)
– automotive	– computer services
– financial services	– international maritime transport services
– private health services	– auxiliary air transport-related services
– telecommunication/cloud services	– construction services
– business services	
– environmental services	

b. It seems that China has also agreed a limited number of commitments in the sectors of agriculture, fisheries, mining and energy, but no details are available.

c. Although these commitments are substantial, it must be recognised that China is not removing its "negative list", even regarding these sectors (see below). It is also important to note that some of these commitments made by China in the CAI are already covered by existing domestic rules or initiatives, which benefit all foreign investors. For instance:

   i. In the automotive sector, China has agreed in the CAI to remove and phase out joint venture requirements and to improve market access for new energy vehicles production. This is, however, already in line with the auto industry policy that China will be enforcing in 2022 for liberalising foreign ownership cap and number of investments.

   ii. In the health sector, China has made a commitment in the CAI that it will lift joint venture requirements for private hospitals in key Chinese cities, including Beijing, Shanghai, Tianjin, Guangzhou and Shenzhen. This is already part of a pilot programme released in 2014 that is applicable in the seven major provinces or municipalities.

   iii. In relation to the telecommunication/cloud service sectors, China has agreed to lift the investment ban for cloud services, which will now be open to EU investors subject to a 50% equity cap. This commitment (including the 50% equity cap) is, however, an existing policy in China.

2. The CAI will remove restrictions <u>after</u> EU companies have invested in China

a. After EU companies have invested in China, the CAI aims to ensure a level playing field for these companies. These commitments are meant to address long standing criticisms raised by EU companies which have invested in China.

b. For instance, some specifically identified "performance requirements" (i.e. local content requirements or R&D targets) will be prohibited and EU companies should not be discriminated against domestic or foreign companies unless an express exemption is mentioned in the CAI.

c. Similarly, no transfer of technologies will be compelled. The Parties are not allowed to interfere in companies' freedom to license technologies, and the CAI also enhances the protection of IP-sensitive business information as well as trade secrets, including in the context of administrative processes.

d. EU companies will also have equal access to standard setting bodies in China.

e. The predictability of the authorisations to be granted by China to EU companies will also be enhanced. China has made a commitment that its regulatory and administrative measures will be more transparent, to enhance legal certainty and predictability, and to ensure procedural fairness and the right to judicial review, including in competition law cases.

f. The CAI also contains commitments not to impose nationality requirements as regards Senior Management and Board of Directors. Employees, managers and specialists of EU companies will be allowed to work up to three years in their subsidiaries in China. Notably, the same will be true in Europe for Chinese companies.

g. China has also agreed to increase the transparency regarding the rules applicable and subsidies granted to State owned enterprises (**SOEs**) that cover approx. 30% of Chinese GDP. This means that China may need to disclose information about subsidies that it would grant to its SOEs, including in the services sectors, which is beyond its current WTO commitments, and that could have negative effects on the investment interests of EU companies. This commitment must be read in conjunction with the EU's "Level playing field" White Paper of last June, in which the EU proposes to investigate and discipline foreign investors in the EU, who have received foreign subsidies *(European Commission targets foreign subsidies causing market distortions)*. These two developments strongly suggest that subsidies granted to SOEs will become increasingly scrutinised by interested parties both in China and in the EU.

h. Finally, Chinese SOEs will now be expected to take decisions solely based on commercial considerations and not to discriminate against EU companies.

3. The CAI will set up a "robust" State-to-State dispute resolution mechanism and a novel monitoring mechanism

a. The CAI will set up a transparent two-step mechanism for resolving disagreements between the EU and China, starting with a consultation phase (and the possibility of mediation) followed by the recourse to an independent "arbitration panel", composed of highly qualified, experienced and independent experts. The panel will deliver decisions that will be formal and binding. As is the case in the WTO, compliance and post-compliance stages of the proceedings (including retaliation) will also be agreed in the CAI. The EU is of the view that this mechanism meets the highest standards found in its existing trade agreements, and has described it as "robust".

b. The Parties have also agreed to set up an institutional framework for monitoring the day-to-day implementation of the CAI, with a view to addressing issues as they arise. The institutional oversight (Investment Committee) will be established at the level of Vice Premier for China and of Executive Vice President for the EU. The CAI will also ensure that civil society (i.e. the companies whose interests have been compromised) may be involved in the implementation process through regular dialogues, and adopt an *ad hoc* mechanism for prompt engagement at the political level in case of serious and urgent issues. These features are quite unique, and we understand that they are absent from China's existing bilateral treaties.

c. It is hoped that the "robust" State-to-State dispute resolution mechanism, coupled with the novel monitoring mechanism, will give teeth to the commitments in the CAI.

4. China has made both general and specific ESG commitments
   a. The Parties agreed that the standard of protection in the areas of labour and environment should not be lowered in order to attract investments.
   b. The Parties made a commitment to support the uptake of corporate social responsibility and responsible business practices by EU and Chinese companies, wherever they operate.
   c. China has also agreed to "effectively implement" the Paris Agreement on climate change as well as to ratify the outstanding International Labour Organisation Conventions (the **ILO Convention**). China has also agreed to specific commitments on the ratification of the two fundamental ILO Conventions on forced labour. The EU has indicated that it will support China's efforts relating to the fundamental ILO Conventions and that such efforts will be key to the successful adoption and ratification of the CAI.
   d. The CAI will set up a specific working group to follow the implementation of sustainable development related matters, including on labour and climate. More specifically, a mechanism, involving civil society, to address differences related to the implementation of the sustainable development commitments, will be put in place. This will include the recourse to an independent panel of experts, although it seems that the outcome of this review could only lead to the publication of a report.

What will the CAI not cover?

1. The CAI is not a comprehensive trade deal
   a. The CAI does not impact import or export rules, customs duties, rules of origin, etc.
   b. The CAI is not a free trade area or customs union agreement of any kind.
   c. Some sectors are specifically excluded from the scope of this section: audio-visual services, air transport services (other than specific auxiliary air services), and activities in the exercise of governmental authority.
   d. Government procurement is also not covered, i.e. EU and Chinese companies will not have a new and general access to bidding contests organised by local authorities on the basis of the CAI.
   e. Foreign investments (on both sides) will remain subject to national security scrutiny. On that note, please refer to our alert on the Chinese national security review regulations for foreign investments that will soon be published.
2. China will retain its "negative list"
   a. China has been regulating market access to foreign investment through a "negative list" regime, which applies to all foreign investors (including EU companies) and has successively been reduced over time in each of its periodic updates. Until the final text of the CAI is issued, it will be premature to assess the extent to which China will actually open up critical sectors, including the ones mentioned above, to EU investments, bearing in mind that the "relaxations" referred to in the EU's press release as "achievements by EU" are already to some extent covered in the existing policies or commitments of the Chinese government (see above).
   b. One of the possible outcomes would be for EU investors to receive preferential treatment or privilege regarding the implementation of the existing "negative list" regime. However, it remains to be seen if and how this will be applied.
3. The CAI does not implicate other countries
   a. The CAI is a bilateral agreement between the EU and China, and does not commit other countries. However, according to the EU, the commitments and openings in the services sectors will not only benefit EU companies, but also companies from other jurisdictions investing into China by virtue of the MFN principle embedded in the WTO agreement on services (**GATS**).
   b. The CAI is not expected to have any impact on the Regional Comprehensive Economic Partnership (**RCEP**) that was recently signed amongst Pacific countries, including China *(Ten things for lawyers to know about the RCEP)*.
   c. As a result of Brexit, UK-based companies will not benefit from the CAI.
   d. The U.S. was neither involved nor consulted in the negotiation of the CAI.
4. The CAI does not substantially improve Chinese access to the EU Market
   a. There are currently very limited restrictions against Chinese investors in Europe. The CAI offers them greater access, but only to the EU energy wholesale and retail markets (excluding trading platforms however) and renewable-energy markets (with a 5% cap at the level of EU countries and a reciprocity mechanism).
   b. However, no additional access will be granted to Chinese companies, in particular in the fields of energy, agriculture, fisheries, audio-visual, and public services.
5. The CAI does not cover all areas of cooperation between the EU and China
   a. The CAI does not engage on other more value-based engagements, including on democracies, open societies and market economies.
   b. The Parties pledged to continue to discuss cooperation regarding the COVID-19 pandemic, the Hong Kong situation and human rights.
   c. The Parties have not yet completed their negotiations on investment protection and investment dispute settlement. They plan to do so within two years of the signature of the CAI. The EU's objective is to adopt a modernised dispute settlement mechanism consistent with its stance on investor-State dispute settlement since 2015. In particular, it is expected that the EU will promote the establishment of a permanent body of tenured judges (or "Multilateral Investment Court") to decide investment disputes related to the CAI, instead of relying on arbitrators appointed by parties on an ad hoc basis. This is what it did for instance in the 2016 EU-Canada Comprehensive Economic Trade Agreement (**CETA**).
   d. The EU notes that its objective remains to replace and modernise the existing Bilateral Investment Treaties between the EU Member States and China, which often only cover the post-entry protection of investment and do not cover sustainability issues, rules on SOEs or transparency rules on subsidies.

Conclusion

The CAI is a groundbreaking agreement. It covers not only foreign investments by EU investors into China – that is, international trade arrangements that would only concern flows of goods between trading partners – but also service markets, which are traditionally not covered by bilateral trade agreements (unless these agreements are entered into between traditional partners or set up free trade areas). Finally, it is worth noting that the CAI also intends to commit China to increase transparency about its SOEs, and to set up a new "level playing field" principle.

It now remains to be seen how the final text will reflect these commitments, how it will interplay with existing Chinese market access rules granted to other WTO members, and how soon the CAI will be finalised and ratified. More broadly, it will be interesting to see how the CAI will impact U.S.-China relations particularly with the advent of a new U.S. administration. However, when finalised, the CAI is very likely to represent a substantial opportunity for EU Companies to consider new investments in China.

Specific Market Access Commitments

Commitments on joint venture requirements or equity cap		
Manufacturing sector (e.g., transport and telecommunication equipment, chemicals, health equipment etc.).	– No more Market Access requirements (e.g. removing joint venture requirements)	Limited exclusions (in particular, in sectors with significant overcapacity)
Automotive sector	– Removal of joint venture requirements – Full market access for new energy vehicles	
Financial services (banking, trading in securities and insurance, including reinsurance, and asset management)	– Removal of joint venture requirements – Removal of foreign equity caps	
Health (private hospitals)	– Removal of joint venture requirements	Concerns only private hospitals in key Chinese cities (including Beijing, Shanghai, Tianjian, Guangzhou and Shenzhen)
Telecommunication/Cloud services	– Limitation to a 50% equity cap – Removing of any other investment ban for cloud services	
Business services	– Removal of joint venture requirements	This only concerns: – real estate services – rental and leasing services – repair and maintenance for transport services – advertising services – market research services – management consulting services – translation services – other undisclosed business services
Environmental services	– Removal of joint venture requirements	This only concerns: – sewage services – noise abatement services – solid waste disposal services – cleaning of exhaust gases services – nature and landscape protection services – sanitation services – other undisclosed environmental services

Other types of commitments		
R&D (biological resources)	– Removal of all market access restrictions – Agreement not to introduce any new restriction	
Computer services	– Agreement to binding market access for computer services – Inclusion of a "technology neutrality" clause (i.e. equity caps imposed for value-added telecom services will not be applied to other services such as financial, logistics, medical etc. if offered online)	
International maritime transport services	– No restriction on investments in relevant "land-based auxiliary activities" of international maritime transport	This concerns cargo-handling, container depots and stations, maritime agencies, etc., including the domestic leg of international maritime transport
Auxiliary air transport-related services	– No restriction on investments in: computer reservation systems, ground handling, and selling and marketing services – Removal of minimum capital requirement for rental and leasing of aircraft without crew	Traffic rights are not covered; they are subject to separate aviation agreements
Construction services	– Elimination of project limitations currently reserved in their GATS commitments	

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