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Trading and distribution in China

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Trading and distribution rights were major issues in the negotiation of China's entry to the World Trade Organisation, a process which took 14 years before concluding in late 2001. Trading rights, ie the right to import and export goods, had historically been mainly restricted to a small number of largely sector-specific state-owned monopoly trading enterprises. Trading rights were modestly liberalised in the years preceding China's entry, but generally remained tightly restricted.

Foreign-invested enterprises (FIEs), ie enterprises established by foreign investors in China (wholly foreign-owned enterprises (WFOEs) or joint ventures) were permitted to import raw materials and semi-manufactures for their own use and to export self-manufactured products directly. In this sense, FIEs were advantaged relative to most domestically-owned enterprises. However, FIEs generally were not permitted to trade in other products, including products manufactured by their parents and affiliates, causing inefficiencies by compelling the use of oligopolistic trading intermediaries. A small number of minority foreign-owned joint venture trading companies were established with special approval on an experimental basis,[1] but high capital and business volume preconditions coupled with ceilings on foreign ownership limited their attractiveness. Moreover, trading in a number of commodities was restricted to authorised state-owned enterprises because of strategic or commercial considerations. The principal exception involved China's free trade or bonded zones like Waigaoqiao in Shanghai, where wholly foreign-owned trading companies were permitted because they operated outside China's customs territory. Thus, they could legally import products into China's domestic markets through transactions mediated by commodities exchanges or other authorised trading agents.

A similar situation applied to distribution, ie the procurement and sale of products (wholesale and/or retail) on the domestic market. FIEs were permitted to procure components and raw materials on the China market for their own use and to sell their self-manufactured products in China, although they contractually agreed in some instances to allow their Chinese joint venturer to perform such functions. They were not, however, permitted to purchase or sell other products, including products manufactured by their parents or affiliates. This resulted in duplication of procurement and distribution systems as multinationals were compelled to establish separate systems for products manufactured in China and imported products, even if they were sold under the same brand. Alternatively, they could import products in semi-manufactured form for final processing in China, but this too was not necessarily efficient. Large multinationals which had established China-based investment or holding companies for their investments in China (hold cos) were eventually given the right to distribute products imported from their parents and affiliates, as well as by their investee FIEs, but the high registered capital threshold to establish a hold co excluded most foreign investors.

China's WTO commitments

China, as a condition to its WTO accession, committed to gradually grant trading rights to all enterprises in China within three years of accession, ie by 11 December 2004, except for certain goods which continued to be subject to state trading. All such goods were to be accorded national treatment with respect to their internal sale, offering for sale, purchase, transportation, distribution or use, including their direct access to end-users.[2]

China also committed to gradually open distribution to foreign service suppliers, including WFOEs, by 11 December 2004, except for the wholesaling of chemical fertilisers, processed oil and crude oil and the retailing of chemical fertilisers, for which full liberalisation was not required until 11 December 2006. China also committed to fully liberalise franchising and trade services away from a fixed location, ie direct selling, by 11 December 2004.[3]

Taken together, these commitments, subject to limited exceptions, promised to completely remove barriers to market entry with respect to trading and distribution. These reforms could be expected to enhance efficiency and consumer welfare in general, while also increasing the availability of imported goods.

China's implementation of its WTO commitments

Trading

In early 2003, China allowed foreign investors to establish joint ventures specialising in import and export for an approved range of products.[4] Unlike ordinary FIEs, approved joint ventures were permitted to conduct foreign trade business either as part of their ordinary business or on a commission basis, without restriction to self-manufactured products. This reform in several respects constituted only a partial implementation of China's commitment to liberalise trading. First, WFOEs were not yet authorised. Second, market entry was impeded by a very high registered capital threshold, set first at RMB100 million before being lowered to a still quite high RMB50 million, an amount much higher than that required for domestic companies. Third, joint venturers were required to have substantial trade experience. Both foreign and Chinese investors were required to have engaged in foreign trade with an average annual trade volume of at least US$300 million over the preceding three years, and the Chinese joint venturer was required to have its own foreign trade rights. This latter requirement meant that foreign investors were compelled to partner with competitors without assurance that the joint venture would endure. Not surprisingly, few such joint ventures were established. As noted above, WFOE trading companies were permitted only in China's free trade zones. Moreover, hold cos were permitted to imported products of their parent company in limited quantities to seed or test the market. Hold cos based in Beijing or Shanghai upgraded to regional headquarters pursuant to municipal regulations were also eligible for the right to import their parent company's products for domestic sale without quanti-

tative restriction as of 1999 and 2002, respectively. Approved foreign-invested research and development centres were also entitled to import equipment, technology and spare parts for their own use, and also to import products from their parent companies to be developed for the local market and to test or seed the market.

By mid-2004, China fulfilled its WTO commitment—in advance of the deadline. Under amendments to the Foreign Trade Law enacted on 6 April 2004 and the Measures on Registration of Foreign Trade Operators (Ministry of Commerce (MOFCOM) 25 June 2004), all domestic and foreign enterprises and natural persons were made eligible for full trading rights as of 1 July 2004.

Under the new procedures, the requirement to establish a specialised trading company was dispensed with and eligibility for trading rights was made available without the need to establish a specialised trading company. WFOEs were eligible for trading rights to the same extent as any other enterprise. Moreover, the former registered capital and experience requirements no longer applied. So long as the applicant satisfied minimum registered capital requirements for the establishment of a business entity—RMB100,000 under the Company Law, with higher minima in different localities based on the scope of business—an applicant would be eligible for trading rights regardless of its investors' prior experience.

Distribution rights

In contrast to trading rights for which China fulfilled its WTO commitments in advance, China has yet to completely fulfil its commitments with respect to distribution rights. As a result, the barriers to market entry have been only partially lifted, so competition remains more limited. Moreover, some restrictions have been imposed with respect to particular sectors.

Governing regulations

Prior to WTO accession, foreign investment in the wholesale and retail sectors was governed by the Foreign-Invested Commercial Enterprise Pilot Measures (MOFCOM 1999). Under the Pilot Measures, foreign investors could establish wholesale or retail enterprises only in the form of joint ventures; WFOEs were not permitted. Foreign investors were subject to substantial experience and capitalisation thresholds. Thus, while the Pilot Measures opened the door to foreign investment in the wholesale and retail sectors, WFOEs were prohibited and high market entry barriers were imposed.

In conjunction with the 6 April 2004 amendments to the Foreign Trade Law, China moved to fulfill its WTO commitments by replacing the Pilot Measures with the Administrative Measures on Foreign Investment in the Commercial Sector (the 'Administrative Measures', MOFCOM 16 April 2004 with effect from 1 July 2004). The Administrative Measures marked substantial progress by authorizing the establishment of WFOEs as well as joint ventures. The experience and size thresholds were deleted. The high and discriminatory registered capital minima were deleted, replaced by the minima applicable to domestic enterprises under the Company Law (RMB500,000 for wholesale, RMB300,000 for retail).

In addition to establishment of greenfield distribution companies, the Administrative Measures also permit existing FIEs to expand their scopes of business to include distribution rights. In practice, while MOFCOM has approved dozens of greenfield distribution FIEs since the promulgation of the Administrative Measures, existing FIEs (particularly manufacturing FIEs) have yet to be permitted to expand their scopes of business to include distribution rights because of delays in resolving such existing FIEs' tax status and compliance with the customs goods classification and coding system. Manufacturing FIEs generally enjoy a tax holiday (two-year exemption and three-year 50 per cent reduction in enterprise income tax) for which most services FIEs are not eligible. If manufacturing FIEs were permitted to engage in distribution, their eligibility for continued enjoyment of such tax holiday is unclear. Compliance with the customs goods classification and coding system presents a more technical issue with respect to non-self-manufactured products imported by FIEs for domestic distribution.

MOFCOM, the State Administration of Taxation (SAT) and the General Administration of Customs (GAC) have held multiple meetings to discuss the above issues and reached consensus only recently. In the future, any manufacturing FIE applying for distribution rights must elect, by completing a one-page declaration form, whether it wishes to remain a manufacturing FIE or become a distribution FIE. If it chooses to remain a manufacturing FIE its revenue generated from distributing non-self-manufactured products must not exceed 30 per cent of its total distribution revenue (including both self-manufactured and non-self-manufactured products). Once a manufacturing FIE elects to be a distribution FIE, it will no longer enjoy the tax holiday and will have to pay full income tax on all its future revenue, including revenue generated from selling self-manufactured products. There are other requirements imposed by MOFCOM for a manufacturing FIE to obtain distribution rights, eg, goods to be distributed must be in the same category as self-manufactured goods. With the promulgation of the above requirements, MOFCOM has committed to process applications for expansion of business scope for existing FIEs beginning in March 2005. However, the eligibility of trading FIEs in bonded zones to gain distribution rights remains unclear because such zones have different customs supervision and tax policies. On the whole, MOFCOM seems to encourage foreign investors to establish greenfield distribution FIEs as opposed to expanding the scope of business of existing FIEs to include distribution rights.

Franchising

MOFCOM promulgated the Administrative Measures on Commercial Franchise Business (the Franchise Measures) on 31 December 2004, effective 1 February 2005. The Franchise Measures replaced the Interim Measures for Administration of Commercial Franchise Operations (1997, the Interim Measures) which only applied to Chinese domestic franchisers. The Franchise Measures also superseded the draft Provisional Measures on Administration of FIEs Engaging in Commercial Franchising Business (the Provisional Measures), issued by MOFCOM for comment in November 2004, which were to have applied to foreign franchisers conducting franchise business through FIEs. The promulgation of the Franchise Measures represents China's implementation of its commitments under the WTO[5] with respect to elimination of legal restrictions on foreign investment in China's franchising businesses by 11 December 2004.

Franchising is defined in the Franchise Measures as a contractual relationship where a franchiser grants a franchisee the right to use its business resources, such as trademark, trade name and business model, and the franchisee operates under a uniform operating system and pays a franchise fee in accordance with the terms and conditions of the franchise agreement.

The Franchise Measures set out two franchise models: (i) the franchiser directly grants the franchise right to the franchisee and the latter invests to establish franchise stores and networks to engage in business without the right to sub-franchise; and (ii) the franchiser grants to the franchisee the exclusive franchise right for a designated territory, and the franchisee can sub-franchise to third parties and/or directly invest to establish a franchising network in the territory.

A franchiser must satisfy the following conditions: (i) be a lawfully established enterprise or other economic organisation, (ii) possess economic resources (trademark, trade name and business model) which it has the right to license for use by the franchisee, (iii) have

the capacity to provide long-term guidance and training to the franchisee, (iv) it or its subsidiary or parent have at least two directly operated stores in China with at least one year's operating experience, (v) if the franchise business requires the franchiser to supply goods, have a stable and quality-guaranteed goods supply system and be able to provide ancillary services, and (vi) have a sound business reputation and not have engaged in any fraudulent activities with respect to franchising. There are no specific requirements with respect to the qualifications of the franchisee, as long as it is a legally established entity and has the necessary funds, fixed locations and personnel to engage in a franchised business.

A franchiser under the Franchise Measures is entitled to receive franchise fees and a deposit. 'Franchise fees' include a membership fee (one-time fee paid by the franchisee to obtain franchise rights), royalties (regular fees paid during the term of the franchise calculated on the basis of a predetermined standard or a certain percentage of revenue), and other fees (fees paid for the goods or services supplied in connection with the franchise in accordance with the franchise agreement). 'Deposit' refers to a payment made by the franchisee to guarantee its performance of the franchise agreement, which is refundable after the expiration of the franchise agreement.

A franchiser is also required under the Franchise Measures to assume certain disclosure obligations. Such disclosure obligations includes the franchiser's name, address, capital, business model and scope of business, legal proceedings, registration status of the relevant trademarks, number of other franchisees, their locations and business circumstances, investment budget for franchise networks, general description of the franchiser's management, as well as other information requested by the franchisee. Note that "disclosing any information requested by the franchisee" is open-ended and potentially burdensome.

To many foreign companies' surprise, the Franchise Measures included a new provision compared to the Provisional Measures, requiring all companies intending to conduct franchise business in China to have established, directly or through their subsidiaries or parents, at least two directly-operated stores in China with at least one year's operating experience. This provision caused serious concern because it constitutes an additional market entry barrier and is seemingly inconsistent with a pure franchise model. We learned from MOFCOM that it added this provision to deter fraudulent activities. In MOFCOM's view, requiring franchisers to establish commercial presences in China makes it easier to regulate the franchise market and penalise violations. We also learned that the State Council and MOFCOM are now in the process of drafting another rule directed against fraudulent and other illegal activities relating to franchising.

With respect to how a foreign franchiser without a commercial presence can qualify to do business in China, MOFCOM's initial response was that such foreign franchiser must first apply for establishment of a foreign-invested commercial enterprise (FICE) in China, in accordance with the Administrative Measures. The FICE must have at least two 'direct operating stores' funded and managed directly by the FICE to qualify as a franchiser under the Franchise Measures. After one year of operation, the FICE may apply for the right to conduct a franchising business under the Franchise Regulations. In many foreign franchisers' view, the new provision, if implemented, will impede market entry compared to their Chinese counterparts.

The Franchise Measures provide a grace period for FIEs engaged in franchising business prior to the promulgation of the Franchise Measures. These FIEs must file for the record with MOFCOM and must comply with the Franchise Measures going forward, including the two stores requirement. If so, many existing franchising FIEs may be forced to delay expansion until they have satisfied the two stores, one-year operating experience requirement.

Direct selling

Direct selling in the form of multi-tier selling arrived in China in the early 1990s and expanded very quickly, but proved to be very controversial.[6] There were many abuses in the form of pyramid sales with naïve recruits paying substantial initiation fees and/or purchasing substantial quantities of goods with limited sales prospects. The State Administration for Industry and Commerce (SAIC) and ultimately the State Council became alarmed at the threat to social stability and promulgated regulations prohibiting such sales operations. Such operations also have a political dimension in China, as they bind together large numbers of citizens in organisations outside the control of the Communist Party and security organs.

Ten direct selling FIEs operating prior to the crackdown on direct selling were allowed to continue in business. They were required, however, to replace the system of sales by representatives away from fixed locations, a cardinal feature of direct selling, with sales from fixed locations predicated on a minimum number of locations in each provincial-level jurisdiction where they operate.

China's commitment under the WTO to allow sales without fixed locations is thus inconsistent with the abhorrence by security organs, as well as protectionist forces, for large autonomous organisations of sales representatives. This contradiction, including a lack of consensus on the distinction between prohibited pyramid sales (*chuanxiao*) and direct sales (*zhixiao*), and disagreements between MOFCOM—which has been relatively welcoming toward foreign investment and supportive of compliance with WTO obligations, and SAIC—which tends to be more protectionist towards domestic industry, has delayed the promulgation of regulations governing direct selling and authorising market entry by late entrants. Specific details regarding the requirement for fixed locations, recruitment requirements for sales representatives, registered capital thresholds, and the range of goods that enterprises may be approved to sell are critical unresolved issues. However, failure to honour its WTO commitments may render China vulnerable under the WTO's dispute resolution procedures.

The Administrative Measures include a restriction on foreign-invested retail enterprises with anti-competitive implications. First, all stores must conform to the municipal master plan and the municipality's requirements for commercial development. This creates a potential for discrimination against larger stores, in favour of smaller stores. Second, applicants must provide additional documents governing land use rights for larger stores, ie stores larger than 3,000 sq metres. Third, all applications to establish such enterprises require MOFCOM approval unless they are below specific size thresholds, in which case approval authority may be delegated to the provincial-level commerce authority which results in a simpler and faster approval process than ministerial approval. Applicants are eligible for provincial-level approval if (i) there will be no more than three stores in the province, the area of each store is less than 3,000 sq metres, and the maximum number of stores established in China by the foreign investor is 30; or (ii) there will be no more than 30 stores in the province, the area of each store is less than 300 sq metres, and the maximum number of the same type of store established in China by the foreign investor is 300. These provisions have the effect of restricting the establishment of larger stores and chain stores by FIEs, and are discriminatory because domestic enterprises are not subject to comparable restrictions.

Other competition regulations

Anti-monopoly

Historically, China had no need for anti-monopoly or antitrust regulations because the industrial and commercial sectors were largely state-owned, in part precisely to pursue the presumptive benefits of monopolies and monopsonies. As the economy was liberalised, the

perceived need for competition regulation grew. An anti-monopoly law is under active consideration but has yet to be enacted. However, transactions by foreign entities or involving FIEs may be subject to reporting obligations under the Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (MOFCOM and SAIC, 7 March 2003). The Interim Provisions under Article 3 are targeted against transactions that "cause excessive concentration, eliminate or restrict competition, disrupt the social and economic order or damage the interests of society and the public". Transactions involving FIEs must be reported for review if a party has operational revenues in the Chinese market of RMB1.5 billion or more, more than 10 domestic enterprises in the industry have been subject to a transaction in the year, or a party's existing market share is 20 per cent or more before the transaction or will increase to 25 per cent or more as a result of the transaction. Even overseas transactions are subject to such requirements if a party has assets in China of RMB3 billion or more, has operational revenues in the Chinese market of RMB1.5 billion or more, a party's existing market share is 20 per cent or more before the transaction or will increase to 25 per cent or more as a result of the transaction, or the transaction will result in a party having direct or indirect equity interests in more than 15 FIEs in the same domestic industry.

We are not aware of any transactions having been modified or rejected during such review, but the review is discriminatory as no comparable burden applies to transactions between domestic parties. The Interim Provisions can, however, impede expansion by foreign investors in the trading and distribution industries, particularly if markets are defined narrowly on the basis of particular products or geographies.

Competition behaviour

The Law Against Unfair Competition (1993), which is pending amendment, under Article 11 prohibits the sale of commodities below cost for the purpose of eliminating competition except under certain special circumstances: perishable commodities, clearance of overstocks or of inventory nearing expiration of the sales validity period, seasonal price reductions, and sales to reduce debt, occasioned by a change in business lines, or business closure. Tie-ins are also prohibited, as is the importation of unreasonable conditions on purchasers under Article 15. Similarly, the Law on the Protection of the Rights and Interests of Consumers (1993), under Article 9, provides consumers with the freedom of choice among business operators with respect to the provision of commodities or services, including whether or not to make a purchase. Article 10 also provides consumers with the right to reject transactions compelled by business operators.

Thus, businesses engaged in trading and distribution must not engage in tie-ins and must not engage in domestic dumping, particularly if the purpose can be construed as intended to drive out competitors. These regulations are presumably of greater concern to larger business operators with pricing power.

Notes

1 'Tentative Measures on Establishment of Sino-foreign Joint Venture Trading Enterprises on an Experimental Basis' (former Ministry of Foreign Trade and Economic Cooperation, 30 September 1996).
2 'Protocol on the Accession of the PRC' (WTO 10 November 2001), Part I, Section 5.
3 Annex 9, People's Republic of China. 'Schedule of Specific Commitments on Services', Section 4 Distribution Services.
4 'Interim Provisions on the Establishment of Chinese-Foreign Trading Joint Ventures' (Ministry of Commerce, 31 January 2003).
5 See note 3.
6 On direct selling, see generally Herbert H Ho, 'The Development of Direct Selling Regulation in China', 1994–2004. Washington, The US-China Business Council, 2004.

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