Foreign Wholesalers and Retailers Welcome, but Please Queue Up in an Orderly Fashion …

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On 1 June 2004 the “Administration of Foreign Investment in Commercial Sectors Procedures” (the Procedures) issued by China’s Ministry of Commerce (MOFCOM) came into effect, allowing foreign investors to establish one of four types of “commercial enterprises” in the form of majority foreign-owned joint ventures. As of 12 December 2004, it became possible to set up wholly foreign-owned commercial enterprises. Broadly speaking, the Procedures cover foreign investment in retailing, wholesaling, commission agency (sale of third party goods under contract) and franchising (collectively “Commercial Enterprises”).

I. Making good(s) on WTO

Under the Procedures, a Commercial Enterprise can now:

- source and export Chinese products and import products and distribute them through its own retail shops (Retail Commercial Enterprises);
- import and export any third party product, engage in commission agency services (other than auction services) and conduct wholesaling in China, without establishing a physical shop (Wholesale Commercial Enterprises); or
- set up a master franchisor entity in China.3

The Procedures were heralded by many market observers as a great step towards the fulfilment of one of the most important liberalisation commitments China made under its WTO obligations. Prior to the promulgation of the Procedures, foreign investment in retail and wholesale had a rather checkered history in China, with sporadic rectification campaigns (e.g. in 1997 and 2001) mainly launched against retail operations approved by local governments acting beyond their powers. Foreign investors were able to establish wholesale and retail operations under trial rules issued in 1999,4 but the high capitalisation thresholds and very tight geographical and operational restrictions limited applicants to a relatively small number of large foreign investors.

II. The devil is in the details

The Procedures allow for the establishment of a Commercial Enterprise with a minimum capitalisation of only RMB 500,000 (for a Wholesale Commercial Enterprise) and RMB 300,000 (for a Retail Commercial Enterprise).5 These numbers are the minima under the PRC Company Law for domestic Chinese enterprises and constitute a rare but welcome example of true parity. However, a closer look reveals that in the area of industry-specific rules (e.g. in the book selling industry) higher minimum capitalisations apply.

In addition, there are certain business scope restrictions reflecting China’s industry-specific policy concerns. For example, the products to be sold must be specified in the scope of business rather than having a “general trading company” concept. Certain products or industries are either temporarily off-limits (i.e. chemical fertilizers and certain oil products till 11 December 2006) or entirely off-limits (i.e. tobacco and salt which remain a State monopoly) to foreign investment under the Procedures, as per China’s WTO commitments. For Retail Commercial Enterprises, restrictions with regard to the number of shops in combination with the shop’s floor space exist on both a provincial level and on a national level. Furthermore, Retail Commercial Enterprises that mix different brands in their shops and aim to set up more than 30 shops in China may be subject to a maximum shareholding cap of 49%,7 which means that if certain products are to be sold, a minority stake in a joint venture with a Chinese party will be imposed. From all this, it is quite apparent that the intention is to channel retailing activities under the Procedures into the opening up of small to medium-sized single brand outlets, while big chain and general department store type operations are not encouraged by Beijing.

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3 Art. 3 para. 4 of the Procedures.
5 Art. 9 of the Procedures.
7 Art. 10 para. 3 of the Procedures.
It is not entirely clear whether certain logistical activities ancillary to retailing and wholesaling such as handling of bulk lots, delivery, storage and warehousing operations and certain sales and marketing activities are covered by the Procedures, since such activities are not expressly mentioned and only implicit in the ambiguous term "other related ancillary businesses". According to China's WTO commitments, foreign suppliers of retail and wholesale services will be permitted to "provide the full range of related subordinate services, including after sales services".

Franchising is also permissible for a Commercial Enterprise. However, recently issued franchising rules, which are effective as of 1 February 2005, impose some rather onerous requirements, including, for example, providing management guidance and training to franchisees, having at least two direct sales shops in China, annual reporting of franchising details, etc. Instead of requiring franchising in China to be carried out through a foreign invested enterprise master franchisor in China (an inference that could be drawn from the Procedures), it should be possible for foreign businesses to enter into direct cross-border franchising agreements with Chinese companies. This would be consistent with China's WTO commitments, which specifically provide for no restrictions on cross-border supply of franchising services or on commercial presence (the latter three years after WTO accession [i.e. 11 December 2004]).

We, however, have received rather confusing messages from MOFCOM regarding the permissibility of such cross-border franchising activities, which have existed for years in something of a "grey area" in the absence of any explicit ban on such activities. We will have to wait and see how this will pan out after 1 February.

III. What will change for foreign businesses?

Prior to the issuing of the Procedures, and due to China's long-standing policy of distinguishing import-export activities from domestic trading activities (i.e. wholesale and retail distribution), ordinary foreign invested enterprises (FIEs) could only sell their own self-produced products. This meant that without distribution rights, they could only conduct onward resale of products imported into the PRC if some value was added by the FIE in China so that the product appeared to be "made" by the FIE. This often involved redundant or semi-redundant repackaging or finishing operations. Similarly foreign companies that wanted to source products in China for onward sale to buyers outside of China had to "add value" prior to the onward sale, or would establish an FIE in a bonded zone to engage in trading, usually on the basis of "grey area" domestic trading activities, with the tacit acknowledgement of the bonded zone authorities. All this should (hopefully) become a thing of the past.

IV. The door is open, but the queue is long...

The question on everyone's lips is: how soon can Commercial Enterprises start operating? Currently a flood of applications is creating a backlog at central MOFCOM. MOFCOM at present only appears to be approving newly established joint-venture Commercial Enterprises. Several recent applications for wholly-owned Commercial Enterprises have not been approved. Furthermore, applications involving a combination of wholesale and retail operations in one Commercial Enterprise, or approval to expand the scope of business of an existing FIE (which would save the time and cost for setting up a new company), both of which are permitted under the Procedures, do not seem possible at the MOFCOM level for the time being. According to a Shanghai source familiar with MOFCOM, only three staff members are currently handling all the applications. It is unclear to what extent MOFCOM's current "go-slow" approval practice is driven by resources issues, or whether MOFCOM has a protectionist agenda and is trying to give Chinese companies a last few more months' head start in the retail game.

Overall our impression is that MOFCOM is facing a logistical issue. Our enquiries suggest that MOFCOM is currently giving priority to applications for Commercial Enterprises with higher registered capital (the current threshold seems to be registered capital of RMB 5 million). This "bigger is better" policy-based prioritisation is nothing new (why does a Qualified Foreign Institutional Investor who is a fund manager have to have at least US $10 billion of assets under management?), but is a rather rough form of justice for those smaller investors whose ambitions may be greater than their means, who, ironically, can only now access the market because of the lowered capitalisation thresholds.

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8 See e.g. Art. 3 and 9 of the Procedures.
9 Measures for the Administration of Commercial Franchises (商业特许经营管理办法) issued by the Ministry of Commerce on 30 December 2004 and effective as of 1 February 2005, for Chinese and English text see http://www.lawinfochina.com. The predecessor regulation Measures for the Administration of Commercial Franchises (for Trial Implementation) (商业特许经营管理办法试行) was issued by the (then) Ministry of Internal Trade on 14 November 1997 and was repealed on 1 February 2005.
10 After initial preliminary examination at the local level, all Commercial Enterprise applications have to be approved at the central MOFCOM level. This appears to be a little too heavy for the small investor seeking to invest a few hundred thousand RMB in a retail shop.