

# A CONFUSING YEAR FOR BUSINESS

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**T**IME IN THE business world in China used to be marked by progress: each year seemed to bring more reforms, more opening up, new ventures, new possibilities. This was the case throughout the 1990s and especially in the years surrounding China's accession to the World Trade Organisation in 2001.

Recent years, however, have seen a different kind of progression. The last twelve months have featured crackdowns, high-profile government-instigated cases against foreign businesses and a sense that doing business in China is getting harder, not easier.

Yet the year had begun with much promise. In November 2013,

the first year of the new Xi Jinping administration, the Communist Party of China held its Third Plenum. The Third Plenum of each five-year Party Congress traditionally focuses on business and economics. The Third Plenum of the Eleventh Party Congress in 1978 is generally regarded as the beginning of Deng Xiaoping's Reform and Open Door policies, which changed the course of modern Chinese history. Observers who saw Xi as a reformer expected that he would take the opportunity of the Third Plenum of the Eighteenth Party Congress last November to provide new impetus to economic reform in China following the stasis of the previous decade under Hu Jintao.



Shortly before the Third Plenum in November 2013, the State Council approved the establishment of the Shanghai Free-Trade Zone (FTZ). It is the first Hong Kong-like free trade area in mainland China  
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## The Shanghai FTZ and New Hope for Reform

Shortly before the Third Plenum, the State Council approved the establishment of the Shanghai Free Trade Zone 上海自由贸易区 (FTZ), raising the hopes of the business community for further market-led reform. While *The Economist* dismissed the FTZ as a ‘damp squib’ and its policies too timid to lead to meaningful reform, influential Chinese business journalist Hu Shuli 胡舒立, writing in *Caixin* 财新, stated that its significance ‘can not be overstated’. Many of the critics of the Shanghai FTZ, including commentators in *The Economist*, *Financial Times* and *The Wall Street Journal*, underestimated both its important symbolic role, and the potentially ground-breaking nature of the reforms it embodied.

The Shanghai FTZ sent a message to foreign investors that the Hu era was over and China was open to foreign investment again. It was also a message to Xi’s political rivals, including former allies of the ousted Bo Xilai, that Xi was in charge now and that the style of economic neo-Maoism espoused by Bo and his cronies was dead, as was the ‘state advances and private enterprise recedes’ 国进民退 approach of Hu Jintao: reforms were back on top of the agenda. This helped set the scene for the Third Plenum.

The reforms proposed for the FTZ are potentially very significant, in particular the introduction of the ‘negative list’ 负面清单 system, which prohibits foreign investors from engaging in any businesses or industries on the negative list, but leaves them otherwise free to operate any other type of business within the FTZ. Some criticise this as being little different to the current ‘Foreign Investment Industrial Guidance Catalogue’ 外商投资产业指导目录 in place nationwide, which divides business sectors into ‘encouraged’, ‘restricted’ and ‘prohibited’ categories, and provides that anything not in one of those three categories is permitted.

The items on the current negative list for the FTZ are indeed entire-

ly consistent with the ‘restricted’ and ‘prohibited’ categories under the old system, forbidding foreign business to enter sectors such as Internet and telecommunication services and restricting investment in the financial and certain other sectors. To this extent, it does not allow foreign investors to do anything new. However, to dismiss the negative list on this basis alone profoundly misunderstands its significance, which is that it sets the limits of government power in China for the first time.

In developed nations, and in particular under Anglo-American legal systems such as in the US, the UK and Australia, the law follows the principle of ‘whatever is not prohibited is allowed’. However, in China, law and regulations operate on exactly the opposite underlying assumption: ‘whatever is not allowed is prohibited’. If you cannot find a legal or regulatory source giving explicit permission to do something, you cannot do it. Under this model, government power is ‘infinite’, not circumscribed by the boundaries of the written laws. There is also significant scope for administrative discretion to grant ‘special’ approvals.

This is why the negative list is such a ground-breaking development. It tips

the legal paradigm of the People’s Republic upside down, limiting the scope of government power and therefore limiting the scope of administrative discretion. To the extent that the FTZ serves as a laboratory for future reforms to be rolled out across China, this may well be its true significance.

### **The Third Plenum**

The Third Plenum did not disappoint. Its policy statements, while vague and broadly worded, reiterated the nation’s commitment to the path of reform and opening up, and denied any possibility of a drift back to the new leftist economic policies espoused by some of Xi’s deposed rivals.

In particular, the Plenum’s emphasis on the state exercising its role in state-owned enterprises (SOEs) as a ‘shareholder’, a new policy of ‘mixed



**Hu Shuli is an influential Chinese business journalist and editor-in-chief of Caixin Media**

Photo: Weibo

ownership' 混合所有制 for SOEs encouraging private investment in public sector businesses and a focus on the 'decisive role' 决定性作用 of the market and market pricing mechanisms 由市场决定价格的机制 suggested an unprecedented move towards marketisation and corporatisation of the SOE sector. This renewed push for reform rendered subsequent events even more puzzling.

### The Crackdown: 'Selective and Subjective Enforcement'?

The past year has seen an intensifying crackdown on foreign business operations in China. The government has targeted foreign investors in cam-

paigns against corruption, monopolies, price-fixing and other unfair trade practices, often when there are arguably worse offenders among domestic companies who have gone unpunished.

To identify just a few of the more prominent examples:

- Food safety checks have focused on foreign fast-food operators.
- US technology giants Microsoft and Qualcomm have both been subject to government raids and anti-monopoly investigations.
- Price-fixing investigations have targeted foreign automotive manufacturers, resulting in reduced prices for vehicles and spare parts.
- The government has banned SOEs from employing American management consulting firms such as McKinsey and Boston Consulting on the grounds of protecting 'state secrets'.
- Bloomberg faces continued difficulties in its business activities in China, with state-owned financial institutions delaying or cancelling orders for Bloomberg data terminals



Peter Humphrey, a Shanghai-based British private investigator, was employed by GlaxoSmithKline to identify the whistle-blower who had reported its alleged corrupt practices to the authorities. Humphrey confessed on state broadcaster CCTV to having illegally bought and sold private information on Chinese citizens

Photo: CCTV

after the company's news arm published a series of investigative reports in 2012 on the financial interests of the families of Chinese leaders.

The American Chamber of Commerce in China surveyed its members and issued a report in September 2014 charging that China was less welcoming of foreign business than before, and that foreign companies were being singled out for 'selective and subjective enforcement'. Chinese government spokespeople responded that the accusations were 'groundless and baseless' and that the Chinese government actions were 'transparent, fair and done in accordance with the law'.

The ongoing anti-corruption campaign, a flagship and extremely popular policy of Xi's administration, has also had a significant impact on foreign businesses. Some of this was expected: luxury goods companies have seen a sharp drop-off in sales, for example (see Chapter 5 'Urban, Mobile and Global', p.204). Some came as a surprise: the government has banned government officials from accepting scholarships to attend MBA programs. And as the campaign has continued, Chinese and foreign businesses have had to learn to navigate a new way of building relationships in an environ-

ment in which hospitality and gift-giving is now effectively impossible.

### Sex and Drugs

All of these themes — the targeting of foreign businesses,

the anti-corruption crackdown, the lack of transparency and the unpredictable nature of the Chinese legal and regulatory system — converge in the case that has most dramatically gripped the attention of the foreign business community in China in the past year: that of UK pharmaceutical company GlaxoSmithKline (GSK).

The GSK story has all the hallmarks of an airport thriller: an internal whistle-blower raises allegations to senior management that the company is engaging in the systematic bribery of healthcare professionals in China. The whistle-blower alleges that the mastermind is the CEO of GSK's China operations, Briton Mark Reilly. The whistle-blower's claims are dismissed. Shortly afterwards, a sex video emerges of Reilly with his Chinese mistress.



**Former CEO of GSK's China operations Mark Reilly was arrested for bribery of healthcare professionals**  
Photo: news.com.au

GSK then retains ChinaWhys, a private investigation company run by Peter Humphrey and his wife Yu Yingzeng 虞英曾, both foreign citizens, to investigate this ‘security breach’. GSK also announces that their internal investigation of the bribery allegations has found no evidence of wrongdoing.

In the second act, Chinese authorities arrest several senior GSK China executives and accuse the company of extensive bribery and corruption. They prohibit Reilly from leaving China while he ‘assists authorities in their investigations’. They also arrest Humphrey and Yu, charging them with ‘illegally obtaining private information’ relating to the whistle-blower, who may or may not be a former government relations officer at GSK with strong local party connections.

The investigation into GSK China is ongoing, and it is expected the Chinese authorities will file formal charges. The allegation is that GSK executives worked with local intermediaries such as travel agencies to organise sham conferences and to over-bill for travel, training or other expenses, which enabled the GSK executives to obtain official invoices, called *fapiao* 发票. The GSK executives used the *fapiao* to obtain cash reimbursements

from GSK, which they allegedly then paid as bribes to hospital officials and doctors to use or prescribe GSK drugs. The Chinese authorities have said that as much as US\$490 million went into such bribery over a period of five years.

In the meantime, China Central Television showed Humphrey, in prison garb, confessing to having illegally bought and sold the private information of Chinese citizens (see Forum ‘Orange as the New Black’, p.316). Humphrey and Yu were convicted and sentenced to prison in August 2014 — two years for her, two and a half for him. The court was not impressed with their argument that they were unaware that what they were doing was illegal, and that both foreign and domestic private investigation firms commonly engage in such practices.

### Why GSK?

There are many ways to interpret the GSK case.

The foreign and Chinese media generally regard the case as part of the government’s attempt to clean up the country’s systemically corrupt health-care sector, using GSK to send a message to the industry as a whole to fall

into line. According to this ‘killing the rooster to frighten the monkeys’ 杀鸡惊猴 narrative, the audience is primarily domestic, and GSK is the soft foreign target that can be pursued to make a point without unduly disturbing domestic patronage networks. It is also politically expedient: it permits the government to demonstrate to the Chinese public that it is not handing any free passes to foreign companies that are misbehaving.

However, there is another narrative, for which the primary audience is global. One of the Party’s fundamental strategic objectives is to achieve status for China as a ‘great power’. Success would cement the Party’s legitimacy as China’s rightful rulers.

National power is commonly measured in terms of economic, military and cultural (or ‘soft’) power, and in all these areas China has been closing the gap with the US and other major powers. However, another aspect of power, frequently overlooked by commentators but not lost on China, is that of regulatory power.

Regulatory power is the power to regulate actors outside a state’s own borders. It is US regulatory power that has companies around the world concerned not to breach the US Foreign

Corrupt Practices Act and ensuring that their securities offerings do not breach the US Securities Act. The regulatory power of the US and the EU require companies everywhere who are contemplating mergers or acquisitions to obtain anti-trust clearances from the US Federal Trade Commission and the EU Competition Commission.

China sees the global respect paid to these regulators — and the regulatory power they exercise — and wishes to enjoy similar respect, power and influence. Seen in this context, investigations and enforcement actions against foreign businesses is not about ‘discrimination’ for the benefit of Chinese companies. Nor are such actions intended solely to score political points with the Chinese public. Rather, their purpose is to demonstrate China’s exercise of regulatory power to an international audience. There is every reason to expect continued and more muscular exercise of such power in future.

### **The New China Risk**

There is one final lesson for foreign businesses in the GSK/ChinaWhys case. Foreign business people have, rightly or wrongly, tended to regard

themselves as enjoying a kind of immunity in China. The ‘China rules’ by which they operated their businesses, with a nod and a wink from local authorities over a banquet or karaoke, led some to believe that they were enjoying a continuation of the extra-territorial system of the nineteenth- and early twentieth-century ‘foreign concessions’, whereby China’s national laws did not apply to foreigners.

This has meant that human rights in China, particularly with regard to

the operation of its justice system, was rarely personal for foreigners in China. The business community found it easy to gloss over abuses in its pursuit of profit.

Now, foreign executives are being detained, charged with breaches of laws of which they were not aware, tried in an unpredictable and non-transparent judicial system and imprisoned. Suddenly, human rights is frighteningly relevant to those doing business in the People’s Republic.

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