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Editor-in-Chief's Remarks

Dear Reader,

Welcome to the fourth issue of *Peking University Transnational Law Review* ("Law Review"). The Law Review is a journal focused on publishing legal scholarships and other articles on Chinese, U.S., international and transnational law, as well as articles regarding comparative law issues. The Law Review, founded in 2011, is published in English twice a year. It is operated independently by students of Peking University School of Transnational Law ("STL").

STL is a unique law school that prepares students to be transnational lawyers. It provides a four-year joint-degree program, which combines a Juris Master degree focused on Chinese law with a Juris Doctor degree focused on American law.

So far, we have published three issues. In this fourth issue, we are excited to share with you our own Bluebook Supplemental Rules. From the previous editing work we found that the Bluebook rules are inadequate in citing Chinese sources, therefore we initiated a set of internal rules to supplement the Bluebook rules. We hope these rules will be helpful for your future citation of Chinese sources.

The editorial board is dedicated to promote the Law Review to become a globally well-known law journal and an important tool for those who are researching and working on related topics. We welcome submissions worldwide, including but not limited to scholar's papers, book reviews, speech series, case notes and legal updates. No minimum or maximum requirements as to page or word numbers are required. We encourage footnotes, rather than endnotes, as well as conformity to the 19th edition of *The Bluebook: A Uniform System of Citation*.

We accept manuscripts year round. Please submit your manuscripts in electronic form to lawreview@stl.pku.edu.cn. Inquiries can be sent to the same email address as well. We will go through a rigid review process and provide timely feedback once we receive your submissions.

Yours Sincerely,

LI Yi

Editor-in-Chief

Peking University Transnational Law Review

**Multilateral Monitoring of Food Safety Law
in China:
The WTO Trade Policy Review Mechanism (TPRM),
2006–2014**

*Francis Snyder**

ABSTRACT

Established within the framework of the World Trade Organization (WTO), the Trade Policy Review Mechanism (TPRM) reviews periodically the trade policies of all WTO Members. The review includes many aspects of food safety regulation. China's trade policy is reviewed every two years. This paper analyses in detail the reviews of China's trade policy in 2006, 2008, 2010, 2012 and 2014. It focuses in particular on food safety law and types of standards, alignment of domestic standards with international standards, the role of different

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domestic institutions, transparency and notification of food safety measures under the WTO agreements on Sanitary and Phytosanitary Measures (SPS) and on Technical Barriers to Trade (TBT Agreement), import and export, and geographical indications (GIs). It concludes that the WTO TPRM can contribute, within its mandate, to reform of Chinese food safety law and improvement of food safety in China. It notes that China has already undertaken substantial reforms of its system for regulating food safety. It recommends that China should continue to participate actively in the TPRM, and follow its own path with regard to alignment and learn selectively from other WTO Members.

Key Words: *China, Chinese food safety law, food safety, food standards, Public health, Consumer welfare, World Trade Organization, WTO Law, Trade Policy Review Mechanism (TPRM), SPS Agreement, TBT Agreement.*

*This article is dedicated to the memory of Simon Roberts (1941–2014),
until recently Professor of Law at the London School of Economics,
whose publications on the anthropology of law never cease
to stimulate the imagination.*

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I. INTRODUCTION

No country is an island in regulating food safety. China is no exception. The 2008 melamine baby formula scandal marked the real integration of China into the world of global legal pluralism regarding food safety regulation.¹ Even before then, China's accession to the World Trade Organization (WTO) on 11 December 2001 signalled China's desire to join, benefit from and contribute to the world of global legal pluralism about trade. It laid the basis for subsequent developments such as the wide-ranging impact of WTO law on law, economy and society in China,² the 2009 Food Safety Law and subsequent reforms of legislation and standards, very active Chinese participation in international food standards bodies such as the Codex Alimentarius Commission, and increasing openness of Chinese governmental institutions to legal developments from other countries and international organisations.

We live in a world of global legal pluralism. By “global legal pluralism,” I mean “the totality of strategically determined, situationally specific and often episodic conjunctions of a multiplicity of sites of governance throughout the world.”³ Food safety regulation today is the handiwork of multiple sites of governance. A site of governance is “a locus of decision-making with the authority to settle disputes.”⁴ In origin, sites of governance may be public, private or hybrid, that is, mixed public-private. In scope, they may be international, transnational, regional, national or local. Each site of governance “has two dimensions: a structural dimension, comprising institutions, norms and dispute-settlement processes, and a relational dimension, which refers to relations between the site and other sites of governance.”⁵ These two dimensions are interconnected, because the institutions, norms and dispute-settlement processes of a site

¹ FRANCIS SNYDER, *THE THREE WORLDS OF MELAMINE: FOOD SAFETY CRISIS AND THE BIRTH OF TRANSNATIONAL FOOD SAFETY REGULATION IN CHINA* (forthcoming 2015).

² E.g. ZHANG XIN, *IMPLEMENTATION OF THE WTO AGREEMENTS IN CHINA* (2005); ESTHER LAM, *CHINA AND THE WTO: A LONG MARCH TOWARDS THE RULE OF LAW* (Kluwer Law Int'l 2009).

³ FRANCIS SNYDER, *THE EU, THE WTO AND CHINA: GLOBAL LEGAL PLURALISM AND INTERNATIONAL TRADE REGULATION* 49 (2010).

⁴ *Id.*

⁵ *Id.*

of governance will affect or condition its relations with other sites, and conversely a site's relations with other sites of governance will affect or condition its institutions, norms and dispute-settlement processes.⁶ Sites of governance may be but are not necessarily, and indeed not usually, co-terminus with nation state boundaries; instead, they are best conceived as belonging to distinct semi-autonomous social fields.⁷

China participates actively in the WTO Dispute Settlement Mechanism (DSM). As of 2 September 2014, China has been a complainant in 12 dispute cases, a respondent in 31 cases and a third-party participant in 112 cases.⁸ However, highly visible international trade disputes represent only a small part of China's participation in the WTO. Nor do they convey the full spectrum of the ways in which the WTO agreements are enforced and implemented, and by which international food safety standards and best practices are diffused. In theoretical terms, they are only one aspect of relations between these two sites of governance. In this article I consider another aspect of these relations: the WTO Trade Policy Review Mechanism (TPRM). I focus on the role of the TPRM in monitoring of food safety regulation in China. Specialists in fields other than law—and indeed many lawyers—may be very surprised indeed to learn to what extent WTO law, and the TPRM in particular, affects food safety regulation in China.

It is useful to situate the TPRM in a broader institutional perspective. We can distinguish between three different levels of

⁶ For numerous examples, *Id.*

⁷ *Supra* note 3 (recording my intellectual debts to KURT LEVIN, *FIELD THEORY IN SOCIAL SCIENCE: SELECTED THEORETICAL PAPERS* (D. Cartwright ed., Harper & Row 1951) and PIERRE BOURDIEU, *OUTLINE OF A THEORY OF PRACTICE* (R. Nice trans., Cambridge Univ. Press 1977) on social fields and to SALLY FALK MOORE, *LAW AS PROCESS: AN ANTHROPOLOGICAL APPROACH* (Routledge & Kegan Paul 1978), including her earlier article *Law and Social Change: The Semi-Autonomous Social Field as an Appropriate Subject of Study*, 7 *LAW & SOC'Y REV.* 719, 719–46 (1973), for the concept of semi-autonomous social field).

⁸ See *China and the WTO*, WORLD TRADE ORGANIZATION, http://www.wto.org/english/thewto_e/countries_e/china_e.htm (last visited Dec. 28, 2014) (In addition to its participation as a third party in panel stage of the WTO dispute settlement procedure, China has participated several times in the consultation phase). See Francis Snyder, *We Need a Global Food Safety Agency: Reflections on the Hidden Jurisprudence of the WTO*, 2 *PEKING UNIV. TRANSNATIONAL L. REV.* 162, 162–209 (2013).

implementation of WTO law in China.⁹ The first level consists of international law, in particular the implementing mechanism and instruments of the WTO. This level comprises monitoring, supervision and enforcement by WTO institutions, notably the TRPM, the General Council and various committees, and the dispute settlement mechanism, respectively. The second level concerns the constitutional law of the People's Republic of China. Among the central issues at this level are the constitutional relationship between international law and domestic law, the potential direct application of WTO law in domestic law and whether WTO law can be invoked directly by litigants in domestic courts. The third level refers to Chinese domestic regimes, whether legislative, administrative, judicial or other. It concerns in particular market access, nature and forms of domestic regulation and dispute resolution, whether judicial, administrative, or Party-based in nature. This article focuses on the first level and its effects on the third level, and more specifically the ways in which a WTO institution monitors and influences Chinese food safety regulation.

The article makes four arguments. First, food safety regulation in China today is part of global legal pluralism. It involves relations with other WTO Members, for example through the TRPM. Second, these relations are not only bilateral relations. The TRPM transforms what would otherwise be bilateral relations into multilateral relations. In other words, institutions matter. Third, the specific structural features of the TRPM (institutional, normative, dispute settlement processes) affect or condition relations between the TRPM and China, as well as between China and other WTO Members. To put it in theoretical terms, the structural dimension of a site of governance affects, conditions or determines the relations of the particular site with other sites of governance. Once again, institutions matter. Fourth, the relations within the TRPM between other WTO Members and China have effects on food safety regulation in China. In other words, the relations which a site of governance (such as China) has with other sites (such as the WTO TRPM) affect, condition or determine its (i.e. China's) related structural features (institutions, norms or dispute resolution processes). At first glance, the effects of an international organ such as the WTO TRPM might appear

⁹ ZHANG XIN, IMPLEMENTATION OF THE WTO AGREEMENTS IN CHINA (2005).

to be limited. However, this first glance gives only a very superficial view. Seen in the broader context of global legal pluralism, of which the TPRM is merely a part, the effects of the TPRM on Chinese food safety regulation are significant. For example, the obligation to meet, report, answer questions and discuss are aspects of the principles of transparency and accountability within the WTO. They contribute to shaping the contours of contemporary food safety regulation in China.

The remainder of the article is divided into three sections. The first section describes multilateral monitoring by the WTO. The following section describes the TPRM reviews of China's trade policy so far. The last main section analyses the main trends and implications of these trade policy reviews. A brief conclusion summarises the discussion and makes recommendations concerning China's participation in the TPRM and, more generally, about reforms of food safety regulation in China.

II. MULTILATERAL MONITORING WITHIN THE WTO

A. *China's WTO Rights and Obligations*

On joining the WTO, China benefitted from the rights of WTO membership and undertook numerous obligations. These obligations included those provided in the WTO Agreements, to which all WTO Members are subject. With regard to food safety, they included the Agreement on Sanitary and Phytosanitary Measures (SPS Agreement) regarding measures concerning human, animal and plant health and the Agreement on Technical Barriers to Trade (TBT Agreement) regarding legally binding measures (called technical regulations in WTO terminology) and non-legally binding standards (called standards in WTO terminology). In addition, China accepted other obligations, known as "WTO plus," which went beyond the WTO Agreements and also beyond any obligations ever imposed previously on any other acceding Member. The WTO plus obligations were specified, together with the basic WTO obligations, in the Report of the Working Party on the Accession of China¹⁰ and the Protocol on the Accession of the People's Republic of China.¹¹

¹⁰ WORLD TRADE ORGANIZATION, *PROTOCOL ON THE ACCESSION OF CHINA* (Cambridge Univ. Press 2003). Also available in WTO/OMC, *COMPILATION OF*

The Working Party Report contained a large number of legal obligations.¹² They included specific legal commitments concerning TBT measures¹³ and SPS measures.¹⁴ The Working Party Report recorded the detailed and sometimes intense exchange of views between the Working Party and the Chinese government with regard to these measures.¹⁵ With regard to TBT measures, the main points of discussion were the opportunity for public consultation and comment on proposed legislation and standards;¹⁶ the relationship between Chinese standards and international standards, guidelines or recommendations;¹⁷ differences between Chinese legal terminology and WTO terminology;¹⁸ local government and non-governmental bodies authorised to adopt legally binding measures (technical regulations in WTO terminology) or conformity assessment procedures;¹⁹ China's conformity assessment regime, including duplication of and discrimination in conformity assessment of imports, respect for confidentiality, acceptance of the results of conformity assessment bodies in other WTO Members and foreign or joint venture conformity assessment bodies;²⁰ and registration of imports of chemicals and problems with existing certification marks.²¹ With regard to SPS measures, the main points of discussion concerned the use of SPS measures as trade barriers;²² conformity of domestic Chinese measures with the SPS Agreement and international standards²³; and notification of domestic SPS measures to the WTO.²⁴

THE LEGAL INSTRUMENTS ON CHINA'S ACCESSION TO THE WORLD TRADE ORGANIZATION (Law Press China 2001).

¹¹ Also available in WTO/OMC, COMPILATION OF THE LEGAL INSTRUMENTS ON CHINA'S ACCESSION TO THE WORLD TRADE ORGANIZATION (Law Press China 2001).

¹² WORLD TRADE ORGANIZATION, PROTOCOL ON THE ACCESSION OF CHINA ¶ 342 (Cambridge Univ. Press 2003).

¹³ *Id.* ¶¶ 177–78, 180, 182, 184–85, 187, 190–97.

¹⁴ *Id.* ¶¶ 199–200.

¹⁵ *Id.* ¶¶ 177–97 (TBT measures), 198–202 (SPS measures).

¹⁶ *Id.* ¶¶ 177–78.

¹⁷ *Id.* ¶¶ 179–80, 183–84, 186–87.

¹⁸ *Id.* ¶¶ 181–82.

¹⁹ *Id.* ¶ 185.

²⁰ *Id.* ¶¶ 186–195.

²¹ *Id.* ¶¶ 196–97.

²² *Id.* ¶¶ 198–99.

²³ *Id.* ¶ 200.

²⁴ *Id.* ¶¶ 201–02.

The Protocol brought China's commitments as recorded in the Working Party Report into WTO law.²⁵ The Protocol itself also contained not only general legal obligations such as uniform administration of laws, regulations and other measures of central government and sub-national governments²⁶ and transparency (paragraph 2(C)). China was also required to publish all criteria for domestic TBT measures,²⁷ to bring all domestic TBT measures into conformity with the TBT Agreement (paragraph 13(2)), and to notify the WTO within 30 days after accession "all laws, regulations and other measures relating to its sanitary and phytosanitary measures, including product coverage and relevant international standards, guidelines and recommendations."²⁸

As part of these WTO obligations, China's trade policy has been subject to two types of multilateral monitoring within the WTO. The first type was a Transitional Review Mechanism (TRM), to which China was subject each year during its first ten years of WTO membership. It was part of WTO plus and expired at the end of 2011. The second type is the Trade Policy Review Mechanism (TPRM), to which all WTO Members are subject and in which China, as a WTO Member, is required to participate.²⁹ The following paragraphs consider first the TRM and then the TPRM. The article focuses mainly on the TPRM. It highlights systemic issues concerning relations between the WTO and the Chinese food safety regime, but it also identifies particular issues about market access for specific products. Questions regarding systemic issues, however, often mask pragmatic concerns about market access.

B. The Transitional Review Mechanism

During the first ten years of its membership of the WTO, China was subjected to a Transitional Review Mechanism as part of "WTO plus." The WTO Protocol on the Accession of China provided in its Section 18 for a Transitional Review Mechanism

²⁵ *Id.* ¶ 1(2).

²⁶ *Id.* ¶¶ 2(A)(1), (2).

²⁷ *Id.* ¶ 13(1).

²⁸ *Id.* ¶ 14.

²⁹ Trade Policy Review Body, *Trade Policy Review, China, Report by the Secretariat, revision*, WT/TPR/S/264/Rev.1 (July 20, 2012).

(TRM).³⁰ All subsidiary bodies of the WTO whose mandate covered China's WTO commitments were required to review China's implementation of its WTO obligations, whether under the WTO Agreements or under the Protocol, within the scope of its specific mandate.³¹ The review was to take place each year after accession for a period of eight years, with a final review in the tenth year after accession, or earlier if decided by the General Council.³²

The relevant subsidiary bodies included "Council for Trade in Goods, Council for Trade-Related Aspects of Intellectual Property Rights, Council for Trade, Committees on Balance-of-Payments Restrictions, Market Access (covering also ITA), Agriculture, Sanitary and Phytosanitary Measures [SPS Agreement, covering human, plant and animal health, including food safety], Technical Barriers to Trade [TBT Agreement, which also dealt with aspects of food safety], Subsidies and Countervailing Measures, Anti-Dumping Measures, Customs Valuation, Rules of Origin, Import Licensing, Trade-Related Investment Measures, Safeguards, [and] Trade in Financial Services."³³ China was required to provide specified information to each body.³⁴ Annex 1A of the Protocol listed this information in a non-exhaustive way; note that the Protocol, Article 18:1 provides for the provision of "relevant information, including information specified in Annex 1A."³⁵

With regard to information to be provided to the TBT Committee, Annex 1A(7) provided *inter alia* for:

- (a) notification of acceptance of the Code of Good Practice not later than four months after China's accession
- (b) periodic review of existing standards of government standardizing bodies and harmonization of the

³⁰ WORLD TRADE ORGANIZATION, *PROTOCOL ON THE ACCESSION OF CHINA* 10 (Cambridge Univ. Press 2003). Also available in WTO/OMC, *COMPILATION OF THE LEGAL INSTRUMENTS ON CHINA'S ACCESSION TO THE WORLD TRADE ORGANIZATION* (Law Press China 2001).

³¹ *Id.* § 18.1.

³² *Id.* §§ 18.1, 18.4.

³³ *Id.* § 18.1.

³⁴ *Id.*

³⁵ *Id.*

same with relevant international standards where appropriate

(c) revision of current voluntary national, local and sectoral standards so as to harmonize them with international standards

(d) use of the terms “technical regulations” and “standards” according to their meaning under the TBT Agreement in China’s notifications under the TBT Agreement, including under Article 15.2 thereof and publications referenced therein, and in modifications of existing measures

(e) progress report on increase of the use of international standards as the basis for technical regulations by ten per cent in five years

(f) progress report on increase of the use of international standards

(g) provision of procedures to implement Article 2.7 of the Agreement [on preparation, adoption and application of technical regulations by central government bodies]

(h) provision of a list of relevant local governmental and non-governmental bodies that are authorized to adopt technical regulations or conformity assessment procedures as part of China’s notification under Article 15.2 of the Agreement [concerning review of Member’s technical regulations or procedures]

...³⁶

Annex 1A did not mention information to be provided to the SPS Committee, even though such information was clearly required by Article 18:1 of the Protocol. Nevertheless, we may assume that, *mutatis mutandis*, similar requirements applied to China with regard to SPS measures.

China was entitled to raise any issues concerning reservations by other WTO Members or concerning other specific commitments made by other WTO Members.³⁷ Each body was re-

³⁶ *Id.* at 12.

³⁷ *Id.* § 18.1.

quired to report its review results promptly to the relevant Council, if applicable, and the relevant Council, if any, was required to report promptly to the General Council.³⁸

Article 18:2 of the Protocol provided that the WTO General Council was to review China's implementation of the WTO Agreements and the Accession Protocol each year after accession for eight years, with a final review in the tenth year or earlier if decided by the General Council.³⁹ Annex 1B of the Protocol provided the framework of the General Council's review. This included a review of the reports and issues covered by the subsidiary bodies, development of China's trade and "recent developments and cross-sectoral issues regarding China's trade regime."⁴⁰ In other words, the TPR imposed a considerable burden on the Chinese Government. The scope of this review was extremely broad, covering any issues regarding China's obligations under the WTO Agreements or the Accession Protocol, including food safety legislation and standards, and for the specified period the Review was carried out every year.

Despite the broad scope and annual periodicity of the TRM, an inspection of all TRM reports reveals that there seems to have been no discussion of China's 1995 Food Hygiene Law, which was in force at that time, or of China's food safety standards, or indeed of its Standardization Law or different types of standards, or indeed more broadly with China's compliance with the TBT Agreement or the SPS Agreement. This was so even though such questions had been mentioned not only in the Working Party Report and the Protocol but also in the bilateral agreements concluded by China with its main trading partners preceding WTO accession. For example, the US-China WTO Agreement, signed on 19 November 1999, recorded in its section on Agriculture that China agreed "to eliminate unscientific SPS barriers."⁴¹ The EU-China bilateral agreement, concluded on 19 May 2000, stated that China would comply with the WTO SPS Agreement, resolve various outstanding issues with EU Member States and conclude subsequent agreements with EU Member States as necessary

³⁸ *Id.*

³⁹ *Id.* §§ 18.2, 18.4.

⁴⁰ *Id.*

⁴¹ *US-China Agreement on China's WTO Accession*, THE CHINA BUSINESS REVIEW 2001, at II (on file with author). *The Bilateral Agreement and the United States*, THE CHINA BUSINESS REVIEW 2001 (on file with author).

before China's formal entry into the WTO.⁴² The concern with SPS issues was reiterated in the European Commission's Overview of the Terms of China's Accession to the WTO.⁴³ After the Working Party Report and the Protocol, however, it seems that, except for discussions in specific committees as will be seen later, these issues did not come to the fore in the WTO until China's first participation in the TPRM.

C. The Trade Policy Review Mechanism

The TPRM was originally established on 12 April 1989 under the 1947 General Agreement on Tariffs and Trade (GATT 1947),⁴⁴ hence before the WTO was established and therefore before China acceded to the WTO on 11 December 2001. In 1994 the Marrakesh Agreement Establishing the World Trade Organization (WTO Agreement) expanded the GATT 1947 TPRM to cover intellectual property rights and trade in services.⁴⁵ According to Article III: 4 of the WTO Agreement, TPRM is a basic function of the WTO. Article III: 4 WTO refers expressly to Annex 3 of the WTO Agreement, which provides objectives and

⁴² *The Sino-EU Agreement on China's Accession to the WTO: Results of the Bilateral Negotiations*, at 4 (June 20, 2001), available at http://trade.ec.europa.eu/doclib/docs/2003/april/tradoc_111851.pdf (last visited Dec. 28, 2014); also available in FRANCIS SNYDER, *THE EUROPEAN UNION AND CHINA, 1949-2008: BASIC DOCUMENTS AND COMMENTARY* 1061-64 (Hart Publishing, 2009), translated and published in Chinese as 欧洲联盟与中国(1949-2008):基本文件与评注 [平装], 2 volumes (Social Sciences Academic Press China, Beijing, April 2013).

⁴³ *European Commission Overview of the Terms of China's Accession to the WTO* (Oct. 1, 2001), available at http://trade.ec.europa.eu/doclib/docs/2003/october/tradoc_111955.pdf (last visited Dec. 28, 2014); also available in FRANCIS SNYDER, *THE EUROPEAN UNION AND CHINA, 1949-2008: BASIC DOCUMENTS AND COMMENTARY* 1069, 1073 (Hart Publishing, 2009), translated and published in Chinese as 欧洲联盟与中国(1949-2008):基本文件与评注 [平装], 2 volumes (Social Sciences Academic Press China, Beijing, April 2013).

⁴⁴ *Restructuring and further trade liberalization are keys to sustaining growth*, WORLD TRADE ORGANIZATION, available at http://www.wto.org/english/tratop_e/tp_r_e/tp330_e.htm (last visited Dec. 28, 2014). 1 THE GATT URUGUAY ROUND: A NEGOTIATING HISTORY 1027 n.59 (Terence B. Stewart eds., 1993). Petros C. Mavroidis, *Surveillance Schemes: The GATT's New Trade Policy Review Mechanism*, 13 MICH. J. INT'L L. 374, 374-414 (1992).

⁴⁵ WORLD TRADE ORGANIZATION, *THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS* 284, 321 (Cambridge Univ. Press 1999).

procedures.⁴⁶ The objectives of the TPRM are “to contribute to improved adherence by all Members to [WTO] rules, disciplines and commitments . . . and hence to the smoother functioning of the multilateral trading system, by achieving greater transparency in, and understanding of, the trade policies and practices of Members.” The TPRM makes possible a “regular collective appreciation and evaluation” of Members’ trade “policies and practices and their impact on the functioning of the multilateral trading system.”⁴⁷

Annex III, section C (i) WTO establishes the Trade Policy Review Body (TPRB) to carry out the TPRM. The WTO General Council, composed of representatives of all WTO Members,⁴⁸ discharges the responsibilities of the TPRB.⁴⁹ It reviews the trade policies and practices of each WTO Member periodically, with the frequency depending on the Member’s share of world trade. Annex III provides that the first four trading entities [now including China, the United States, the European Union as one Member and Japan] are to be reviewed every two years, the next ten entities every four years and other Members every six years, except that least-developed country Members may be reviewed less frequently.⁵⁰ Reviews are based on a full report by the Member being reviewed and a report by the WTO Secretariat; the latter is based on information provided by the reviewed Member, together with any other information available to it.⁵¹ The Secretariat’s report provides the centre of the discussion.⁵² One or two discussants are chosen, in collaboration with the Member under review, to introduce the TPRB discussions, in a personal capacity rather than in an official capacity. The reviews and the minutes of the relevant TPRB meeting are to be published “promptly after the review.”⁵³ However, the TPRM “is not . . . intended to serve as a basis for the enforcement of specific obligations under the

⁴⁶ *Id.* at 434–437.

⁴⁷ All quotations in this paragraph are drawn from *id.* at 380.

⁴⁸ *Id.* at 7–8, § VI: 2.

⁴⁹ *Id.* at 6, § IV: 4.

⁵⁰ *Id.* at 380, § C (ii).

⁵¹ *Id.* at 381, § C (v).

⁵² CRAIG VANGRASSTECK, *THE HISTORY AND FUTURE OF THE WORLD TRADE ORGANIZATION* 279, 284 (2013).

⁵³ WORLD TRADE ORGANIZATION, *THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL Trade Negotiations* 381, § C (vi) (Cambridge Univ. Press 1999).

Agreements or for dispute settlement procedures, or to impose new policy commitments on Members.”⁵⁴

III. WTO TPRM REVIEWS OF CHINA’S TRADE POLICY

A. *The TPRM and Food Safety Regulation in China*

So far, there have been five Reviews of China’s trade policies and practices. The first occurred on 19 and 21 April 2006,⁵⁵ the second on 21 and 23 May 2008,⁵⁶ the third on 31 May–2 June 2010⁵⁷ the fourth on 12 and 14 July 2012 and the fifth on 1 and 3 July 2014.⁵⁸ This section of the paper analyses these Trade Policy Reviews focusing on food safety. Here I interpret “food safety” broadly to include all matters concerning food from farm to table, including import procedures, food safety laws, standards and related matters that have a more or less direct effect on food safety. I concentrate mainly on the very informative, relatively full minutes of the meetings, which include questions and answers and follow-up questions and answers. In addition, I also consider other documents, such as the WTO Secretariat reports and Chinese Government reports. I identify the WTO Members which asked questions and the subject matter of the questions. The broad range of documents helps to convey the voices, interests, concerns and constraints of all participants, including China. Beginning with the 2006 TPRM, we can assess the road travelled by China in “joining the international track” with regard to food safety regulation as well as the increasing impact of the WTO TPRM on food safety regulation in China. The following section of paper discusses this data and its implications.

⁵⁴ *Id.* at 380, § A (i) (Cambridge Univ. Press 1999).

⁵⁵ See *Trade Policy Review: China*, WORLD TRADE ORGANIZATION, http://www.wto.org/english/tratop_e/tpr_e/tp262_e.htm (last visited Dec. 28, 2014).

⁵⁶ See *Trade Policy Review: China*, WORLD TRADE ORGANIZATION, http://www.wto.org/english/tratop_e/tpr_e/tp299_e.htm (last visited Dec. 28, 2014).

⁵⁷ See *Restructuring and further trade liberalization are keys to sustaining growth*, *supra* note 44.

⁵⁸ See *China and the WTO*, *supra* note 8.

B. The 2006 Trade Policy Review

The first China TPR was held almost five years after China's WTO accession. The Chinese Government Report⁵⁹ did not mention food safety directly, although it noted reform of other legislation to comply with WTO rules and improvements in government transparency.⁶⁰ The Ministry of Commerce was the notification authority for SPS measures. The SPS enquiry point was in the Administration for Quality Supervision and Quarantine (AQSIQ). The State Food and Drug Administration (SFDA), established in 2003, was responsible for overall supervision of food safety. In addition, the Ministry of Agriculture (MOA), the Ministry of Health (MOH), AQSIQ and the General Bureau of Industrial and Commercial Administration (i.e. The State Administration for Industry and Commerce (SAIC)) were responsible for supervision of specific food products and processed food products.⁶¹

The WTO Secretariat report noted a decline in non-tariff measures and a simplification of the import licensing regime and other border measures. However, China still had many SPS measures, and border examination and approval procedures were not clear.⁶² More critically, the Secretariat report remarked that:

Members have raised a number of questions concerning China's TBT and SPS measures in the relevant WTO Committees. In the TBT Committee, while commending China's efforts to bring its TBT measures into conformity with the Agreement, Members have raised concerns on a number of issues, including the CCC mark system, the adoption of international standards, and a number of sector-specific issues. China has stated that it recognizes the importance of adopting international standards, which were used as a basis for developing its technical regulations, standards and conformity assessment procedures, and that domestically produced and imported

⁵⁹ Trade Policy Review Body, *Trade Policy Review, Report by the People's Republic of China*, WT/TPR/G/161 (March 17, 2006).

⁶⁰ *Id.* at 12, ¶¶ 45–46.

⁶¹ Trade Policy Review Body, *Trade Policy Review, People's Republic of China, Report by the Secretariat*, at 93, ¶ 101, WT/TPR/S/161 (Feb. 28, 2006).

⁶² *Id.* at 60, ¶ 4.

products were treated in the same manner. In the SPS Committee, Members have raised concerns, *inter alia*, about China's apparent use of SPS measures to ban imports of affected products from countries rather than just the affected regions within countries; and an apparent failure to notify a number of its SPS regulations issued since 2002. With regard to the latter, China believes that Members had misunderstood the notifications China had made immediately upon accession to the WTO. In addition, China has indicated that its SPS standards were fully compliant with international standards and were based on risk assessment.⁶³

As of 2005, "32% of [Chinese] standards were based on international standards: as a result of a current review, 44% of current standards are to be revised to ensure their conformity with international standards, while 11.6% are to be abolished."⁶⁴ According to the Secretariat, the percentage of Chinese standards of all types which were equivalent to international standards had remained static at about 32% since 2000.⁶⁵

Another issue identified by the WTO Secretariat was institutional fragmentation. With regard to agriculture, for example, the Secretariat Report noted that

[A]t least 16 institutions, including ministries, banks, and commissions are involved in governing agriculture and its upstream and downstream subsectors: they are divided into four tiers according to legal responsibility [table omitted]. The coordination of policy-making and implementation among these agencies is difficult because their functions are often fragmented and overlap. For instance, eight agencies are responsible for quality and safety management of agricultural products, eight for agricultural investment, six for processing and allocation of farm products, and five for the provision of inputs. Coordination is also difficult because of the divergent priorities and

⁶³ *Id.* at 88, ¶ 101.

⁶⁴ *Id.* at xi, ¶ 12.

⁶⁵ *Id.* at 60, ¶ 4, at 90, ¶ 90.

interests of the different ministries. Coordination problems also arise because of the gradual decentralization in government power over the past 20 years. Sub-national governments have become more influential in the policy-making process and have often been free to decide how to implement national government policies, resulting in some variations in the ways national policies have been implemented.⁶⁶

Institutional fragmentation, together with alignment, would prove to be a major concern of China's trading partners in later reviews.

At the 2006 TPR the Chinese Government received over 1,100 questions, prepared advance replies to more than 400 of them and planned to answer the remaining questions within a month.⁶⁷ The written statement by the Chinese Government's representative suggests the scope of the endeavour:

In preparation for China's first Trade Policy Review, almost all of the Central Government bodies had been mobilized. Dozens of government officials had participated in the face to face discussions with the Secretariat in their three visits to Beijing, explaining the rationale for China's policies, which were aimed at meeting the challenges for its future sustainable development. Officials had also been working in China to respond to Members' questions.⁶⁸

The discussant, H.E. Burhan Gafoor from Singapore, noted that, among the record number of questions, "contingency measures, standards and intellectual property rights" attracted the most attention.⁶⁹ He remarked that the Chinese standards system was complex and asked how China planned to align its more national standards on international standards.⁷⁰

In discussion, all Members noted China's extraordinary economic growth, but numerous participants identified what they

⁶⁶ *Id.* at 165, ¶ 15.

⁶⁷ Trade Policy Review Body Report, *Trade Policy Review, People's Republic of China, Minutes of Meeting*, at 4, ¶ 5, WT/TPR/M/161 (June 6, 2006).

⁶⁸ *Id.* at 4, ¶ 5.

⁶⁹ *Id.* at 9, ¶ 30.

⁷⁰ *Id.* at 9, ¶ 31.

considered to be shortcomings of China's food safety regime. Here, for reasons of space, I give only selected examples about food safety. The United States noted that:

China had not fully embraced international SPS standards and science-based rulemaking. However, he [the US Representative] was pleased by China's commitment to make improvements. He also appreciated China's efforts to notify its food safety standards and requirements to the WTO, although he remained concerned that many Chinese regulatory agencies continued to implement and enforce new or revised SPS measures without prior notification or public comment periods.⁷¹

Switzerland expressed a similar concern about alignment.⁷²

New Zealand commented on the scale and complexity of Chinese quarantine and other SPS measures. According to its representative,

New Zealand had experienced an overly rigid and inefficient approach from some government agencies, which had accorded insufficient priority to the goal of, where possible, allowing less or least trade restrictive measures to meet SPS objectives. There remained room for improvement, including in risk assessment, equivalence, streamlining of information requirements, transparency, and removing duplicative testing measures, particularly as these were implemented locally.⁷³

Brazil and Kenya also commented on the complexity of China's SPS measures.⁷⁴ The European Communities [now European Union] noted that "[t]he legitimate expectations of market access at the time of China's entry to WTO had not been fully fulfilled," and commented that the CCC system and various SPS requirements amounted to non-tariff barriers.⁷⁵

⁷¹ *Id.* at 12, ¶ 41.

⁷² *Id.* at 13, ¶ 43.

⁷³ *Id.* at 15, ¶ 58.

⁷⁴ *Id.* at 20, ¶ 82, at 38, ¶ 123.

⁷⁵ *Id.* at 24, ¶ 97.

Several countries asked questions concerned directly with their specific products exported to China. India remarked that goods from some countries could be imported without any SPS protocols, hence the most-favoured-nation (MFN) principle was not being respected. It also noted that “it had taken China three years to finalize the protocol on mangoes” and that “China had been processing approval for only one fruit or vegetable at a time,” a very slow working method which it deemed to be a real barrier to trade.⁷⁶ Canada encouraged China to increase wheat imports and to promote “cultivation of higher-value agricultural products” to meet food security needs.⁷⁷ Mexico, “China’s second biggest trading partner according to Mexican statistics,” raised questions about import licensing and SPS measures.⁷⁸ Norway pointed out that the adoption of international standards would simplify and facilitate trade, noting that Norway and China had a dialogue on fish and marine products.⁷⁹ Uruguay, which exported citrus fruit, rice, soya, dairy products and meat to China, made the same point.⁸⁰

In answer to follow-up statements and questions, China’s representative pointed out the Chinese terminology for standards differed from that of the WTO. He also emphasised that “around 45% of national standards were equivalent to international standards. Chinese standards were harmonised not only with ISO and IEC standards, but also ITU, CAC and others, which were not included in the 32% adoption rate mentioned in the Secretariat Report.” For standards newly developed in 2005, the rate of alignment was stated to be almost 54%,⁸¹ though the EC questioned these percentages.⁸²

After the meeting, China replied to the questions submitted by other participants. For the 2006 Trade Policy Review, Table 1 shows the WTO Members asking questions about food safety and the subject matter of the questions.

⁷⁶ *Id.* at 16, ¶ 62.

⁷⁷ *Id.* at 17, ¶ 67.

⁷⁸ *Id.* at 19, ¶ 74.

⁷⁹ *Id.* at 20, ¶ 80.

⁸⁰ *Id.* at 27, ¶¶ 116–117.

⁸¹ *Id.* at 35, ¶ 155.

⁸² *Id.* at 36, ¶ 159.

TABLE 1: 2006 TRADE POLICY REVIEW: WTO MEMBERS ASKING QUESTIONS ABOUT FOOD SAFETY AND THE SUBJECT MATTER OF THE QUESTIONS (IN ORDER OF PAGE NUMBER IN THE TPRB REPORTS)

Country Asking the Question	TPRB Report	Page Number in TPRB Report	Subject Matter
Australia	Add.1	55	Domestic standards
Australia	Add.1	208	Domestic standards
Australia	Add.1	208	Domestic standards
Australia	Add.1	208	Domestic standards
Australia	Add.1	208	Domestic standards
Australia	Add.1	208	Relation between domestic standards and international standards alignment
Australia	Add.1	209	Domestic standards
India	Add.1	210	Domestic standards of fishery products and sesame seed
India	Add.1	211	Ban of Indian bovine meat because of foot and mouth disease
European Communities	Add.1	211	Domestic policy to ensure no discrimination
European Communities	Add.1	211	Domestic standards within China
European Communities	Add.1	212	Ban of EU products
European Communities	Add.1	212	Domestic and international standards alignment
European Communities	Add.1	213	Domestic standards
European Communities	Add.1	213	Domestic measures
Philippines	Add.1	152	Implementation of new SPS
Thailand	Add.1	155	Requirement of original country sanitary health certificates
South Africa	Add.1	158	Period of validity of import permit
South Africa	Add.1	158	Domestic standards
South Africa	Add.1	158	Domestic standards
South Africa	Add.1	158	Domestic standards
Chinese Taipei	Add.1	214	Domestic standards

European Communities	Add.2	48	Transparency
USA	Add.2	49	Labelling
Canada	Add.2	49	Labelling of GMOs
Malaysia	Add.2	51	CCC mark requirement
European Communities	Add.2	52	Labelling
USA	Add.2	92	GIs
USA	Add.2	92	GIs
USA	Add.2	93	GIs
USA	Add.2	93	GIs
USA	Add.2	93	GIs
USA	Add.2	93	GIs
USA	Add.2	94	GIs
USA	Add.2	94	GIs
Mexico	Add.2	94	GIs

Sources: Calculated by the author from WTO Trade Policy Review Body Report.⁸³

Food safety in the broad sense accounted for about 3% of total questions (35 of 1100).

Table 2 shows WTO Members asking questions about food safety, the number of questions asked by each Member and their main concerns.

TABLE 2: WTO MEMBERS ASKING QUESTIONS ABOUT FOOD SAFETY, NUMBER OF QUESTIONS AND MAIN CONCERNS IN 2006 CHINA TRADE POLICY REVIEW

WTO Member Asking Questions	Number of Questions	Main Concerns
Australia	7	Domestic standards
Canada	1	Labelling [of GMOs]
Chinese Taipei	1	Domestic standards
EC	8	Domestic standards, labelling

⁸³ World Trade Organization, Trade Policy Review Body, *Trade Policy Review, People's Republic of China, Minutes of Meeting, Addendum, WT/TPR/M/161/Add.1*, (June 15, 2006) and Trade Policy Review Body, *Trade Policy Review, People's Republic of China, Minutes of Meeting, Addendum 2, WT/TPR/M/161/Add.2* (Sept. 11, 2006).

India	2	Domestic standards, import ban
Malaysia	1	CCC mark
Mexico	1	GIs
Philippines	1	Implementation of SPS measures
South Africa	4	Domestic standards, import permits
Thailand	1	Health certificates
USA	8	GIs
TOTAL 11 countries	35	

Source: Calculated by the author from WTO Trade Policy Review Body Report.⁸⁴

Replies to questions submitted in advance of the meeting were published and circulated on 15 June 2006,⁸⁵ while replies to additional questions together with replies were published and circulated on 11 September 2006, in other words about five months after the meeting.⁸⁶

C. The 2008 Trade Policy Review

Two factors shaped the 2008 review. First, the 2006 Review had already provided other WTO Members with the general architecture and main features of China system for regulating food safety, taken in a broad sense, in so far as it affected international trade. Consequently the 2008 Review was in many respects essentially an updating exercise. Second, in 2008, with the beginning of the financial crisis, notably in western countries, the world economy was sliding into recession, resulting in increased protectionism in China's main trading partners.⁸⁷ Not surprisingly, given its effect on export markets, China's Report to the TPRB criticised this trend:

⁸⁴ *Id.*

⁸⁵ Trade Policy Review Body, *Trade Policy Review, People's Republic of China, Minutes of Meeting, Addendum*, WT/TPR/M/161/Add.1 (June 15, 2006).

⁸⁶ Trade Policy Review Body, *Trade Policy Review, People's Republic of China, Minutes of Meeting, Addendum 2*, WT/TPR/M/161/Add.2 (Sept. 11, 2006).

⁸⁷ Trade Policy Review Body Report, *Trade Policy Review, Report by China*, at 5, ¶ 1, WT/TPR/G/199 (May 7, 2008).

According to a survey by the Ministry of Commerce in 2007 on the influence of foreign standard measures on China's foreign trade, 15.22% of China's export enterprises were affected by TBT measures in 2006. Amongst all the 22 major categories of China's exports, 21 categories suffered direct losses from standard measures with a total value of US\$ 75.8 billion, accounting for 7.82% of the total export in 2006. The additional production costs to Chinese enterprises for compliance with the newly proposed technical standards reached US\$ 26.2 billion in 2006. Trade opportunities lost for China's export enterprises due to foreign technical barriers amounted to US\$143.7 billion, accounting for approximately 14.83% of the total export of China in 2006.⁸⁸

As this statement shows, WTO Trade Policy Review is not a one-way street: it also gives an opportunity for the country being reviewed to air its own concerns. It also indicated the fact that standards, including SPS measures and TBT technical regulations and standards, play an extremely significant role in international trade and global competition.

China reported that it had adopted a unified system for conformity assessment. It also confirmed its intention to reform its standards setting procedures and to encourage the development of enterprise standards. It planned to facilitate adoption of international standards and advanced foreign standards,⁸⁹ as provided in the State Council Regulations for Implementing the Standardization Law.⁹⁰

With regard specifically to food safety matters, the Chinese Government report made several further points. It had added 88 more commodities to the Inspection and Quarantine List.⁹¹ Moreover, it had adopted a unified system for conformity assessment. Finally, it confirmed its intention to reform its stand-

⁸⁸ *Id.* at 14, ¶ 61.

⁸⁹ *Id.* at 17, ¶ 77.

⁹⁰ 中华人民共和国标准化实施条例 [Regulations for the Implementation of the Standardisation Law of the People's Republic of China] (promulgated by Decree No. 53 of the St. Council, Apr. 6, 1990, effective as of the date of promulgation) art. 4.

⁹¹ *Supra* note 87, at 17, ¶ 76.

ards setting procedures, to encourage the development of enterprise standards and to facilitate adoption of advanced foreign standards and international standards;⁹² the last point was provided in the State Council Regulations for Implementing the Standardization Law.⁹³

Devoting considerable attention to food safety issues for the first time, the Secretariat Report identified specific concerns: administrative fragmentation, normative complexity, alignment, relation between food safety and environmental protection and labelling. It noted that, in China, “boundaries of regulatory responsibilities between the central and local governments are not clearly defined” and that central-local coordination remained weak.⁹⁴ It remarked that China had many laws governing SPS measures and its regime remained complex but recognised that China was improving alignment with international standards.⁹⁵ Alignment was increasing, with 46.4% of national standards aligned with international standards and an objective of 85% alignment having been fixed for 2010. China’s Standardization Administration (SAC) had signed cooperation agreements with Denmark, Germany, New Zealand and the United States to improve alignment.⁹⁶

Concerning types of standards, national standards were being reviewed: 44.2% were to be revised by 2008, 11.6% (2,513) would be abolished and national standards would increase in number to 21,410 by end 2006. However, only mechanical and electronic standards were mentioned, not food safety standards.⁹⁷ Compared with previous years, the number of national standards declined to 20,668 in 2005 and increased to 21,410 in 2006; as of 2006, 14.4% were mandatory and 85.6% were voluntary. Sectoral standards increased to 31,348 in 2005 and 33,552 in 2006, of which 15.2% were mandatory and 84.8% were voluntary in 2006. Local standards increased to 16,005 in 2005 and 18,128 in 2006; in 2006, 19.7% were mandatory and 80.3% were voluntary. Enterprise standards increased to 1,340,679 in 2005 but declined

⁹² *Id.* at 17, ¶ 77.

⁹³ *Supra* note 90.

⁹⁴ Trade Policy Review Body, *Trade Policy Review, China, Report by the Secretariat, revision*, at 31, ¶ 30, WT/TPR/S/199/Rev.1 (Aug. 12, 2008).

⁹⁵ *Id.* at ix, ¶ 15, at 43, ¶ 4.

⁹⁶ *Id.* at 63, ¶ 67.

⁹⁷ *Id.* at 63, ¶¶ 67–68.

to 1,243,238 in 2006.⁹⁸ It would seem that most of these standards concerned matters other than food safety. Nevertheless, there were more than 1,800 national food safety standards and more than 2,900 sectoral standards for the food industry.⁹⁹

Not surprisingly, the food safety regime remained very complex.¹⁰⁰ Administrative responsibility for food standards was fragmented between the China Standardisation Administration (SAC), Ministry of Agriculture, Ministry of Health, State Administration of Industry and Commerce (SAIC), AQSIQ and the State Food and Drug Administration (SFDA). Administrative responsibility for labelling was divided among SAC, AQSIQ and the Ministry of Agriculture, the latter being responsible for agricultural GMOs.¹⁰¹ Leaving aside quarantine and the entry/exit system,¹⁰² as well as the Law on Agriculture, China's main SPS measures included the Food Hygiene Law, the Law on Animal Disease Prevention, the Law on Import and Export Commodity Inspection, the Law on Frontier Health and Quarantine, the Law on the Entry and Exit of Animals and Plant Quarantine and numerous implementing measures and rules.¹⁰³ Special rules applied to GMOs.¹⁰⁴ Starting in 2001, food processing enterprises were required to apply for permits, involving consideration of national standards and inspection of production sites and post-production facilities, including random sampling in food markets.¹⁰⁵

The Secretariat noted the connection between food safety and environmental policy. It cautioned that “[a]s technical regulations [i.e. legally binding measures] are not followed, counterfeit products, linked with inferior quality, could have a significant effect on the health of humans, animals and plants, and the environment.”¹⁰⁶ In 2001, China began to implement the Hazard-free Food Action Plan, especially concerning pesticide residues in

⁹⁸ *Id.* at 64, Table III.4.

⁹⁹ *Id.* at 65, ¶ 71.

¹⁰⁰ *Id.* at ix, ¶ 15, at 43, ¶ 4.

¹⁰¹ *Id.* at 69–70, ¶¶ 94–96.

¹⁰² *Id.* at 67–68, ¶¶ 85–92.

¹⁰³ *Id.* at 67, ¶ 85.

¹⁰⁴ *Id.* at 69, ¶ 92.

¹⁰⁵ *Id.* at 65, ¶ 75.

¹⁰⁶ *Id.* at 65, ¶ 73.

vegetables and violations of residue standards.¹⁰⁷ According to the Chinese Government, special attention was being paid to environmental pollution, which otherwise could have very deleterious effects on food production.¹⁰⁸ The Secretariat also noted that as of 2007 China was formulating a food certification and accreditation system, including good agricultural practices (GAP), organic products, food quality and Hazard Analysis Critical Control Point (HACCP), and that China had established “a number of food inspection and testing institutions, to set up a nationwide food safety inspection and testing framework.”¹⁰⁹

Another main topic was labelling, which was regulated by the Standardization Law, the Food Hygiene Law and the Law on Product Quality.¹¹⁰ Labelling requirements were product-based, not sector-based, except for some sector-specific requirements, including for food and GMOs.¹¹¹ Food labels were required to include “ingredients in descending order by weight or volume, net weight and solid content, date of manufacture, and best before and expiry date.” Starting in May 2006, food importers no longer had to submit manufacturing country certificates to apply for Chinese-language labelling.¹¹² Administrative responsibility for labelling was divided however among SAC, AQSIQ and the Ministry of Agriculture, the latter being responsible for agricultural GMOs.¹¹³

In the following discussion, Brazil recognised reduction of NTBs and simplification of administration of border measures, including standards and SPS measures, but, together with Switzerland and Norway, expressed concern with the complexity of the SPS regime and inspection procedures.¹¹⁴ The United States pointed out that “China had not fully embraced international standards, science-based rulemaking and advance notification”

¹⁰⁷ *Id.* at 65, ¶ 75.

¹⁰⁸ *Id.* at 65, ¶ 76.

¹⁰⁹ *Id.* at 66–67, ¶ 76. The Secretariat Report does not list these institutions but instead refers merely to State Council Information Office, *The Quality and Safety of Food in China* (Aug. 2007, Beijing).

¹¹⁰ *Id.* at 69, ¶ 93.

¹¹¹ *Id.* at 69, ¶ 95.

¹¹² *Id.* at 69, ¶ 94.

¹¹³ *Id.* at 69–70, ¶¶ 94–96.

¹¹⁴ Trade Policy Review Body Report, *Trade Policy Review, China, Minutes of Meeting*, at 12, ¶ 55 [Brazil], at 12, ¶ 62 [Switzerland], at 23, ¶ 139 [Norway], WT/TPR/M/199 (July 24, 2008).

but had committed to make improvements.¹¹⁵ The EC urged China to adopt “a more transparent system of integrating international standards in the Chinese standardization system,” commenting that “[t]he emergence of “home-grown” mandatory national standards appeared to be geared towards building a Chinese-owned standard portfolio.”¹¹⁶ Honduras was concerned about registration of importers and exporters, certificates of origin and time required for customs clearance.¹¹⁷

Compared to 2006, the 2008 TPRM saw more specific questions about food safety. Table 3 shows WTO Members asking questions about food safety and the specific subject matter of the questions for the 2008 TPR.

TABLE 3: 2008 REVIEW OF CHINA’S TRADE POLICY: WTO MEMBERS ASKING QUESTIONS ABOUT FOOD SAFETY AND THE SUBJECT MATTER OF THE QUESTIONS (IN ORDER OF PAGE NUMBER IN THE TPRB REPORT)

Country Asking the Question	Question Number or Document	Page Number In TPRB Report	Subject Matter
Mexico	Add.2	180	Types of standards
Mexico	Add.2	180	Review of standards
Mexico	Add.2	181	Types of standards
Mexico	Add.2	181	Alignment
Philippines	3(a), 3(b)	181	Imports of food containing tartrazine
Philippines	4(a), 4(b), 4(c), 4(d)	181	Ban on imports for fresh coconuts
India	1	133, 182	MOU on application of SPS
India	2	133, 182	Import of fruit and vegetables
India	3	133, 182	Import of rice
India	4	133, 182	Import of meat and dairy products; Alignment
India	6	133, 183	MOU on application of SPS
India	7	133, 183	Quarantine procedure for imports
Chinese		184	Update 2002–2006 list of

¹¹⁵ *Id.* at 15, ¶ 80.

¹¹⁶ *Id.* at 18, ¶ 107.

¹¹⁷ *Id.* at 21, ¶ 127.

Taipei			standards
Chinese Taipei		184	Catalogue of Entry-Exit Commodities Subject to Inspection and Quarantine
Thailand	7	184	Alignment
Thailand	8	185	Alignment
Thailand	9	185	Existence of two different product certification systems
Thailand	10	185	Labelling requirements
USA	22(a), 22(b)	186	Types of standards
USA	22(c)	186	Scientific basis of food safety standards; Alignment
USA	23	187	Alignment
USA	24(a)	187	Certification of animal feed
USA	24(b), 24(c), 24(d)		Product registration
USA	25	188	Transparency
EC [now EU]	36	188	Transparency
EC [now EU]	28	190	Participation of foreign enterprises in China's standardisation activities; WTO Code of Good Practice
EC [now EU]	29	190	Alignment
EC [now EU]	30	190	Types of standards
EC [now EU]	31	191	Alignment
EC [now EU]	32	191	Alignment
EC [now EU]	33	191	Alignment
EC [now EU]	34–35	191	Alignment
EC [now EU]	37–38	192	Types of standards; Alignment
EC [now EU]		192	Standards and IPR enforcement
EC [now EU]	39–40	193	CCC [Compulsory Product Certification] system
EC [now EU]	54	193	Administrative organisation and SPS
EC [now EU]	55	193	Import permit
EC [now EU]		194	Transparency
Canada	27	194	Alignment

Canada	28	194	Revision of national standards
Canada	30	194	Alignment
Canada	34	195	Administrative organisation of standard setting
Canada	36	195	Types of standards
Canada	37	195	Types of standards; review period
Canada	44	196	Food certification and accreditation system
Australia	4(a), 4(b)	196	Alignment
Australia	7	197	Alignment
Australia	5(a), 5(b)	197	Administration organisation of SPS regime; NT
Australia	6(), 6(b),6(c), 6(d), 6(e), 6(f)	197	Transparency
USA	55	220	GIs and administrative organisation
Switzerland			GIs and administrative organisation
Mexico	67	285	Alignment
Mexico	71	286	Types of standards; transparency
Mexico	73	286	IPR; enforcement of standards
Mexico	74, 75, 76	287	Types of standards
Mexico	77–82	287	CCC system
Mexico	83	287	Enquiry point; transparency
Korea	13	290	Types of standards; Alignment
Argentina		294	Types of standards
USA	27(a), 27(b)	297	Food labelling
Philippines	1(a), 1(b), 1(c)	298	FSL
Japan	8	299	Types of standards
Japan	9	300	Types of standards
Japan	10	300	FSL
Japan	16	300	Export quotas on livestock

Canada	1	299	Alignment
Canada	31		Types of standards
Canada	32	303	Transparency
Canada	33	304	Transparency
Canada	35	304	Types of standards
EC [now EU]	49	312	CCC
EC [now EU]	52	312	CCC; foreign-owned certification bodies
EC [now EU]	53	313	CCC; foreign-based certification bodies
EC [now EU]	56	313	Quarantine system
EC [now EU]	59	314	Labelling
Argentina		336	GIs and administrative organisation
USA		336	GIs and administrative organisation
Japan		340	GIs
Japan		340	Protection of foreign GIs
Canada		342	GIs and administrative organisation
EC [now EU]		344	GIs and administrative organisation
EC[now EU]		345	GIs
Costa Rica		350	Safety of food imports
Costa Rica		350	CCC
EC [now EU]		13,	Types of standards
		WT/T/TPR/ M/199/Add.2	

Source: Calculated by the author from Trade Policy Review Body Report.¹¹⁸

¹¹⁸ Trade Policy Review Body, *China, Minutes of Meeting*, WT/TPR/M/19 (July 14, 2008); Trade Policy Review Body, *China, Minutes of the Meeting, Addendum*, WT/TPR/M/Add.1 (Aug. 28, 2008); *supra* note 86.

Table 4 shows the WTO Members asking questions about food safety, the number of questions and their main concerns.

TABLE 4: 2008: CHINA TRADE POLICY REVIEW: WTO MEMBERS ASKING QUESTIONS ABOUT FOOD SAFETY, THE NUMBER OF QUESTIONS AND THE MAIN CONCERNS

WTO Member Asking Questions	Number of Questions	Main Concerns
Argentina	2	Types of standards; GIs and administrative organisation
Australia	4	Alignment
Canada	13	Types of standard; alignment; transparency
Chinese Taipei	2	Update list of standards; Catalogue of Entry-Exit Commodities Subject to Inspection and Quarantine
Costa Rica	2	Safety of food imports; CCC
EC [now EU]	22	Alignment; CCC
India	6	Import of food
Japan	6	Types of standards
Korea	1	Types of standards; alignment
Mexico	10	Types of standards
Philippines	9	Imports of food
Switzerland	1	GIs and administrative organisation
Thailand	4	Alignment
USA	13	GIs and administrative organisation; alignment
TOTAL 14 countries	95	

Source: Calculated by the author from Trade Policy Review Body Report.¹¹⁹

Although no statistics were given on the total number of questions, the questions and the answers together totalled about 366 pages.¹²⁰

¹¹⁹ Trade Policy Review Body, *Trade Policy Review, China, Minutes of the Meeting, Addendum*, WT/TPR/M/Add.2 (April 13, 2010); Trade Policy Review Body, *Trade Policy Review, China, Minutes of the Meeting, Addendum*, WT/TPR/M/Add.1 (Aug. 28, 2008).

¹²⁰ Trade Policy Review Body, *Trade Policy Review, China, Minutes Of Meeting Addendum*, WT/TPR/M/199/Add.1, (Aug. 28, 2008); Trade Policy Review Body, *China, Minutes Of Meeting Addendum*, WT/TPR/M/199/Add.2 (April 13, 2010).

Specific examples illustrate the interaction between the Member asking a question and the Chinese Representative providing an answer. For instance, in response to the US question about science-based decision-making, the Chinese Representative replied that:

China has taken the following steps to ensure [sic] and demonstrate that food safety standards are based on science and are appropriate:

1. To actively adopt international standards, especially the CAC standards.
2. Development of standards has been based on risk assessment.
3. The process of standards development is open, transparent and participatory.
4. Where there is deviation between Chinese technical regulations and international standards, we would notify WTO as required.
5. To modify the standards in a timely manner according to the feedback during implantation [sic] and the new development of international standards.¹²¹

On alignment, the Chinese Representative noted that China planned to align 85% of its standards with international standards under the 11th Five-Year Development Plan (2006–2010).¹²² She also emphasised that China would discuss SPS issues with the US bilaterally but that, with regard to GIs, “China did not see the inconvenience of the regulations.”¹²³ In another instance, the EC asked about the definition of “foreign enterprise,” and in effect whether China’s rule that foreign enterprises could participate in SAC Technical Committees as an observer was contrary to the WTO principle of national treatment. Without answering the specific question about the definition, China confirmed that “[f]oreign enterprises are welcome to participate in China’s standardization activities.”¹²⁴ The Philippines requested further

¹²¹ Trade Policy Review Body, *Trade Policy Review, China, Minutes Of Meeting Addendum*, at 187, WT/TPR/M/199/Add.1 (Aug. 28, 2008).

¹²² *Supra* note 114, at 26, ¶ 164.

¹²³ *Id.* at 29, ¶ 185, at 31, ¶ 185.

¹²⁴ Trade Policy Review Body, *Trade Policy Review, China, Minutes of the Meeting, Addendum*, ¶ 190, WT/TPR/M/199/Add.2 (April 13, 2010).

information about the main features of China's forthcoming Food Safety Law, its compatibility with WTO principles, its accessibility to the public and its availability in an official WTO language (English, French, Spanish). China's Representative replied, again in general terms, that "this food safety law aims to improve food safety of both domestic and imported food and it complies with China's obligations under the WTO, both on procedure and on substance."¹²⁵ As to comments about the complexity of China's SPS regulatory regime, the Chinese Representative replied, correctly in my view, that it was consistent with the SPS Agreement. "As for administrative structure . . . , there has been no uniform international mode and modes by different Members are different from each other. Like many other Members, the administrative of SPS measures in China covers different government agencies, where [the] function of each agency is clear."¹²⁶

D. The 2010 Trade Policy Review

The 2010 China TPR provided the most extensive WTO review thus far. It reflected China's greater standing in the world economy and its increasing role as a leading trading partner. It also followed the melamine baby formula crisis, which was evoked indirectly in the Review. I consider first the reports by China and the Secretariat and then the discussion.

Largely as a result of the melamine crisis,¹²⁷ China in 2009 enacted its first Food Safety Law, which replaced the 1995 Food Hygiene Law and entered into force on 1 June 2009. In principle, under the Food Safety Law all food standards were mandatory, though reality was more complex: national, professional and local standards could be either mandatory or voluntary,¹²⁸ and enterprise standards applied only to the enterprise. The Secretariat Report noted that China's trading partners had expressed concerns that the new Law was not notified to the SPS Committee

¹²⁵ *Supra* note 121, at 299.

¹²⁶ *Id.* at 197.

¹²⁷ FRANCIS SNYDER, *THE THREE WORLDS OF MELAMINE: FOOD SAFETY CRISIS AND THE BIRTH OF TRANSNATIONAL FOOD SAFETY REGULATION IN CHINA* (forthcoming 2015).

¹²⁸ Trade Policy Review Body, *Trade Policy Review, China: Report by the Secretariat, Revision*, at 35–36, ¶ 43, at viii, ¶ 14, WT/TPR/S/230/Rev.1 (July 5, 2010).

before being implemented.¹²⁹ However, it also noted that China had strengthened its regime for testing of dairy products for domestic and foreign consumption.¹³⁰ China notified numerous measures related to dairy products to the SPS Committee.¹³¹ The notifications included China's acceptance of the TBT Code of Good Practice.¹³² Altogether, China submitted 7 SPS notifications in 2008 and 90 in 2009 together with 184 TBT notifications in 2008 and 199 in 2009;¹³³ all of the SPS notifications, but not all of the TBT notifications, concerned food safety.

The WTO Accession Protocol required China to liberalise the right to trade, so that within three years after accession, all enterprises in China, with some exceptions, had the right to export or import goods throughout China.¹³⁴ Specified food and other products remained subject to state trading requirements on import or export. For such products, trading rights remained restricted to listed state-owned enterprises.¹³⁵ Only state trading enterprises (STEs) were allowed to export, but non-state-trading enterprises as well as STEs were permitted to import.¹³⁶ Certain food exports, including rice and maize, continued to be subject to state trading; this requirement was temporarily abolished for tea; and since WTO accession China had not applied state trading arrangements to soybeans.¹³⁷ For certain products (maize, rice, wheat, tea), China imposed global quotas. It also imposed destination-specific quotas for live cattle, live swine and live fowl to Hong Kong and Macau.¹³⁸ AQSIQ had reformed its entry-exit inspection system, though food, animal and plants and their

¹²⁹ *Id.* at 37, ¶ 49. Committee on Sanitary and Phytosanitary Measures, *Summary of the Meeting of 28–29 October 2009*, ¶ 179, G/SPS/R/56 (Jan. 28, 2010).

¹³⁰ *Supra* note 128, at viii, ¶ 14.

¹³¹ *Id.* at 37, ¶ 50, at 15, ¶ 22, at 116–118, Table AII.2.

¹³² *Id.* at 118.

¹³³ *Id.* at 36, ¶ 44.

¹³⁴ World Trade Organization, *Report of the Working Party on the Accession of China*. World Trade Organization, at 14, ¶¶ 80, 82, 83(d), 84, 86, at 68, WT/ACC/CHN/49 (Oct. 1, 2010). See also COMPILATION OF THE LEGAL INSTRUMENTS ON CHINA'S ACCESSION TO THE WORLD TRADE ORGANIZATION (Law Press China, 2001).

¹³⁵ On imports, see World Trade Organization, *Protocol on the Accession of China*, Annex 2A1, WT/ACC/CHN/49/Add.1 (Dec. 11, 2001). On exports, see *id.* Annex 2A2.

¹³⁶ *Supra* note 128, at 46, ¶ 90.

¹³⁷ *Id.* at 46, ¶ 89.

¹³⁸ *Id.* at 73, ¶ 21.

products were not eligible for exemption from inspection and quarantine requirements.¹³⁹ Certain listed products could be inspected where they were produced, but goods not meeting SPS requirements could not be exported.¹⁴⁰

With regard to standards, the Secretariat report noted that:

China has four types of standards: national, professional, local, and enterprise standards. Within the national, professional, and local standards categories, there are voluntary and mandatory standards. In 2007 (the latest year for which data were available), around 14.5% of national standards, 15% of professional standards [data for 2006, the latest year for which data were provided to the Secretariat], and 19% of local standards were mandatory. Voluntary standards, however, can become mandatory if they are referenced in mandatory conformity assessment procedures. Concerns were raised in the TBT Committee in cases where no advance notice was given regarding such changes.¹⁴¹

Following a January 2009 revision of procedures by SAC, foreign-owned companies could participate as voting members in technical standards-setting committees as voting members, not merely as observers as was previously the case.¹⁴² It appears that this concerned only TBT standards, not SPS standards, but the exact scope of the 2009 revision, particularly with regard to food standards, which under the 2009 Food Safety Law are mandatory, is not clear from the report.¹⁴³

In July 2009, China also revised its compulsory product certification system.¹⁴⁴ Labelling requirements provided that

¹³⁹ *Id.* at 37–38, ¶¶ 52, 53.

¹⁴⁰ *Id.* at 42, ¶ 73.

¹⁴¹ *Id.* at 35–36, ¶ 43, at viii, ¶ 14.

¹⁴² *Id.* at 36, ¶ 46.

¹⁴³ *See id.* at 36, n.38 (The report refers to WTO Documents: Committee on Technical Barriers to Trade, *China's Transitional Review Mechanism*, G/TBT/W/326 (Oct. 29, 2009); Committee on Technical Barriers to Trade, *MINUTES OF THE MEETING OF 5–6 NOVEMBER 2009*, G/TBT/M/49 (Dec. 22, 2009)).

¹⁴⁴ *Id.* at 38, ¶ 55. *See also* 强制性产品认证管理规定 [Compulsory Product Certification Management Regulation] (issued by Circular No. 53 of AQSIQ,

labels must be in Chinese, except for products manufactured in China for export.¹⁴⁵ The Patent Law was revised in light of the Convention on Biological Diversity to require patent applicants to disclose the direct and original source of genetic resources if the invention to be patented depended on these resources.¹⁴⁶ However, at least as of 2010, the Patent Law did not require Access and Benefit Sharing (ABS) or Prior Informed Consent (PIC) for a patent application.¹⁴⁷ China planned to enact a new law on GIs in 2010. As of the date of the Review, however, GIs were regulated by the State Trademark Office, AQSIQ and the Ministry of Agriculture.¹⁴⁸

TABLE 5: REGISTRATION OF GEOGRAPHICAL INDICATIONS (GIS) IN CHINA 1994–2009

Time Period	State Trade- mark Office	AQ SIQ	Ministry of Agriculture
1994–2007	301	---	---
2008–first half of 2009	321	---	---
2005–end September 2009	---	932	---
February 2008–end October 2009	---	---	185

Source: Based on Trade Policy Review Body Report.¹⁴⁹

Table 5 shows the registration of GIs in China between 1994 and late 2009. Available data does not allow a strict comparison, but it indicates clearly an increase in the number of registered GIs.

China was a member of the Codex Alimentarius Commission, the leading international food standard-setting body, as well as the World Organisation for Animal Health (OIE) and the International Plant Protection Convention (IPPC), which performed similar functions with regard to animals and plants, respectively. In 2007 and 2008, China signed more than 60 bilateral

May 26, 2009 and effective on Sept. 1, 2009), available at http://www.gov.cn/flfg/2009-07/21/content_1369826.htm.

¹⁴⁵ *Supra* note 128, at 39, ¶ 60.

¹⁴⁶ *Id.* at 65, ¶ 160.

¹⁴⁷ Trade Policy Review Body, *Trade Policy Review, China, Record of the Meeting, Addendum*, at 28, 29, WT/TPR/M/230/Add.1 (Feb. 22, 2011). On this problem, see also Francis Snyder, *The EU, The WTO and China: Global Legal Pluralism and International Trade Regulation*, 410–413 (2010).

¹⁴⁸ *Supra* note 128, at 67, ¶¶ 169–172.

¹⁴⁹ *Id.*

or regional agreements on standards and SPS measures with WTO Members, including EU, Japan, and the United States.¹⁵⁰

Setting an initially congratulatory tone to the meeting, the discussant, H.E. Mrs Marie-Claire Swärd Capra from Sweden, affirmed that China now has “a central, leading role to play in the WTO.”¹⁵¹ She noted, however, that the standards regime was very complex, especially regarding voluntary standards, and asked whether the Chinese Government intended to align its standards further with international standards.¹⁵² The point was echoed by Mexico, which also welcomed AQSISQ’s new policy of allowing inspections at destination.¹⁵³ Norway emphasised the same point and urged greater alignment, stating that “[c]ountry-only standards and related mandatory certification schemes seriously hamper business development for trading partners.”¹⁵⁴ The EU complained that China had submitted replies to some 2008 EU questions with two years delay and urged China to respect the principle of transparency,¹⁵⁵ for example by adopting a more risk-based approach to conformity assessment and by aligning its standards with international standards where they existed instead of adopting “diverging Chinese-specific national standards.”¹⁵⁶

Before the 2010 meeting, the Chinese Government received 1508 questions from 27 Members, as well as numerous subsequent questions. Table 6 lists the WTO Members asking questions about food safety and the subject matter of the questions in the 2010 China Trade Policy Review.

TABLE 6: 2010 REVIEW OF CHINA’S TRADE POLICY: WTO MEMBERS ASKING QUESTIONS ABOUT FOOD SAFETY AND SUBJECT MATTER OF THE QUESTIONS (IN ORDER OF PAGE NUMBER IN THE TPRB REPORT)

Country	Question	Page	Subject Matter
Asking the	Number	Number in	
Question	Among	Minutes of	

¹⁵⁰ *Id.* at 38, ¶ 54.

¹⁵¹ Trade Policy Review Body, *Trade Policy Review, China, Record of the Meeting*, at 8, ¶ 46, WT/TPR/M/230 (June 29, 2010).

¹⁵² *Id.* at 10, ¶ 56.

¹⁵³ *Id.* at 35, ¶¶ 249–250.

¹⁵⁴ *Id.* at 15, ¶ 91.

¹⁵⁵ *Id.* at 19, ¶ 125.

¹⁵⁶ *Id.* at 20, ¶ 126.

	Asker's Questions	the Meet- ing Add.1	
Brazil	11	9–10	Preferential rules of origin
Brazil	12	10	Preferential rules of origin
Brazil	13	10	Treatment of propolis as healthcare food
Brazil	20	14	Parallel import policy
Brazil	21	14	GIs
Brazil	22	14–15	Direct release system and stand- ards
Brazil	23	15	Translation of national standards into English
Brazil	24	15	Measures on testing of dairy products
Korea	1	23	ban on imports of modified milk powder from Korea
Korea	2	28	Chinese Patent Law implementing CBD on obligation to disclose origin of genetic resources
Korea	Follow up to 1	28–29	Chinese Patent Law on ABS and PIC
Korea	Follow up to 2	29	GIs and administrative organisa- tion
Pakistan	4	31–32	GIs and administrative organisa- tion
Australia	17	46–47	Import licensing of certain dairy products
Switzerland	51	59	Catalogue of Entry-Exit Com- modities Subject to Inspection and Quarantine
EU	10	69	Transparency and publication
EU	11	69–70	Coordination of governmental bodies
EU	59	86	Alignment
EU	60	86	Alignment
EU	61	87	Time for comment on proposed Chinese SPS measures
EU	62	87	Fulfilment of SPS transparency requirements
EU	63	88	Imports of beef from EU Member States

EU	64	88	Alignment
EU	65	89	Alignment
EU	66	89	Alignment
EU	67	89–90	SPS protocols and inspection procedures
EU	148	120	Patent Law and genetic resources
EU	160	124–125	TRIPS and data protection for agrochemicals
EU	Follow up to 59, 60	153	Meaning of “advanced overseas standards”
EU	Follow up to 61	155–156	Comment on and transparency of SPS measures
Egypt		163	Institutional framework for implementing SPS measures
Egypt		164	Meaning of “specialised supervision” under 2009 FSL
Egypt		164	Administrative organisation for implementing food safety measures
Egypt		165	Role of private sector in ensuring food safety standards
Turkey		176	GIs and administrative organisation
Malaysia		186	Administrative bodies for development of different types of standards
Malaysia		187	Administrative authorities for mandatory certification
USA		209–210	Ban on meat imports
USA		210–211	State trading
USA		214	Types of standards
USA		215	2009 FSL and administrative organisation
USA		215–216	Notification of and measures under 2009 FSL
USA		231	CBD and origin of genetic resources
USA		232	GIs
USA		232	GIs
India		270	2009 FSL, including relation to

			international standards
India		275	Import of fruit and vegetables from India
India		276	Import of buffalo meat from India
India		276	Import of rice from India
Japan		296	Quotas and licensing for agricultural exports
Japan	21	302	GIs and administrative organisation
Canada	39	344	Alignment
Canada	40	344	Meaning of “mandatory standard”
Canada	41	344	Meaning of “mandatory standard”
Canada	42	344	Meaning of “mandatory standard”
Canada	43	345	Types of standards
Canada	45	345	Alignment
Canada	46	345	Alignment
Canada	48	346	Import of beef
Canada	49	346	Import of beef and OIE recommendations
Canada	50	347	Import of swine and international recommendations
Canada	51	347	Import of plants and IPPC standards
Canada	52	347	Import of pork and international standards
Canada	53	348	CCC
Canada	54	348	CCC
Canada	59	349	Accreditation of foreign CABs
Canada	60	349	Accreditation of foreign CABs
Canada	61	350	MRAs and accreditation of foreign CABs
Canada		365	Patent Law and disclosure requirements on genetic resources
Canada	126	366	Agricultural issues and administrative organisation
Joint US/Canada/Mexico		386	Catalogue of Exit-Entry Commodities Subject to Inspection and Quarantine
New Zealand		388	GIs and administrative organisation
Peru		390	Types of standards

Peru		391	Alignment
Peru		391	Types of standards
Peru		396	Rules of origin
Peru		397	Rules of origin
Peru		397	Rules of origin
Mexico		409	AQSIQ reform of exit-entry system
Mexico		410	Export restrictions
Mexico		411	Export restrictions
Mexico		419	GIs
Mexico		419	GIs
Mexico		433	Compliance with exit sanitary requirements
Mexico		433	Compliance with exit sanitary requirements
Mexico		433	Compliance with exit sanitary requirements
Mexico		433	Compliance with exit sanitary requirements
Mexico		433	Import of meat products
Mexico		434	Import and export licences
Mexico		434	Import and export licences
Mexico		434	Export licences
Mexico	10	434	State trading of agricultural products
Mexico	11	435	Export of poultry and administrative organisation
Mexico	12	435	Verification of safety of agricultural products
Mexico	13	435	Availability of food safety standards
Mexico	14	435	Health requirements for exporting poultry
Mexico	15	436	Catalogue of Entry-Exit Commodities Subject to Inspection and Quarantine
Mexico	16	436	Catalogue of Entry-Exit Commodities Subject to Inspection and Quarantine
Mexico	17	436	Catalogue of Entry-Exit Commodities Subject to Inspection and

Quarantine			
Mexico	18	437	Quarantine measures for plants
Mexico	19	437	AQSIQ requirements for direct release system
Mexico	20	437	Catalogue of Entry-Exit Commodities Subject to Inspection and Quarantine
Mexico	21	437	Alignment
Mexico	22	437	Equivalence
Mexico	23	437	Approval of Chinese laboratories; Catalogue of Entry-Exit Commodities Subject to Inspection and Quarantine
Mexico	24	438	Proof of pest-or disease-free status
Mexico	25	438	Notification of SPS measures
Mexico	26	438	Pest prevention and control
Mexico	27	439	Publication of new regulations
Mexico	28	439	Administrative organisation of phytosanitary system
Mexico	29	439	Phytosanitary risks on exports
Mexico	30	439	Bilateral cooperation protocols
Mexico		440	Import permits
Mexico	31	440	Database of phytosanitary requirements for imports
Mexico	32	440	Communication between central and local authorities
Mexico	33	440	Quarantine treatment enterprises
Mexico	34	440	Administrative organisation for quarantine certificates for imports and exports
Ecuador	16	447	Transparency: Notification of 2009 FSL; publication of draft technical regulations and CAPs
Argentina		488	Types of standards
Argentina		490	2009 FSL and administrative organisation
Argentina		491	CCC
Costa Rica		508	Certification and accreditation

Source: Calculated by the author based on Trade Policy Review Body Report.¹⁵⁷

Table 7 shows the WTO Members asking questions about food safety, the number of questions and the main concerns in the 2010 China Trade Policy Review.

TABLE 7: WTO MEMBERS ASKING QUESTIONS AND NUMBER OF QUESTIONS IN 2010 CHINA TRADE POLICY REVIEW

WTO Member Asking Questions (in alphabetical order)	Number of Questions Asked	Main Concerns
Argentina	3	Types of standards, administrative organisation, certification
Australia	1	Import licensing (dairy)
Brazil	8	Preferential rules of origin
Canada	19	Meaning of “mandatory standard”; alignment; import of food
Costa Rica	1	Certification and accreditation
Ecuador	1	Transparency: Notification of 2009 FSL; publication of draft technical regulations and CAPs
Egypt	4	Implementing food safety measures
European Union	15	Alignment
India	4	Import of food
Japan	2	Quotas and licensing for agricultural exports;
		GIs and administrative organisation
Korea	4	Chinese patent law
Malaysia	2	Administrative bodies
Mexico	40	Compliance with exit sanitary requirements;
New Zealand	1	GIs and administrative organisation
Pakistan	1	GIs and administrative organisation
Peru	6	Rules of origin
Switzerland	1	Catalogue of Entry-Exit Commodities Subject to Inspection and Quarantine
Turkey	1	GIs and administrative organisation
USA	8	GIs

¹⁵⁷ *Supra* note 151.

USA, Canada,	1	Catalogue of Exit-Entry Commodities
Mexico jointly		Subject to Inspection and Quarantine
TOTAL 20	123 questions	
countries		

Source: Calculated by the author based on Trade Policy Review Body Report.¹⁵⁸

A total of 20 countries asked a total of 123 questions about food safety matters.

Complementing this quantitative data, specific examples allow us to appreciate the TPR discussions from a qualitative standpoint. The United States emphasised that China's transition periods as a WTO Member had expired. It urged the Chinese Government to accept the responsibility that went with its influence in international trade, and it commented that China's earlier market liberalisation seemed to have slowed down.¹⁵⁹ The US also remarked that China had "still not fully embraced international standards, science-based rulemaking and advance notification, particularly with regard to sanitary and phytosanitary measures."¹⁶⁰ It noted that the US and China would seek to make progress through bilateral relations, notably the US-China Joint Commission on Commerce and Trade and the US-China Strategic and Economic Dialogue.¹⁶¹ Canada also encouraged China to adopt a more science-based approach to regulation in the agriculture sector and with regard to product safety¹⁶² and to follow the TBT Code of Good Practice.¹⁶³

However, Brazil considered that China had made progress in simplifying its SPS regime and inspection procedures.¹⁶⁴ Hong Kong also struck a positive note, remarking that 46.5% of Chinese national standards were equivalent to international standards by 2007.¹⁶⁵ Indeed, the Chinese Government Representative replied to earlier questions:

¹⁵⁸ Trade Policy Review Body, *Trade Policy Review, China, Record of the Meeting, Addendum*, WT/TPR/M/230/Add.1 (Feb. 22, 2011).

¹⁵⁹ *Id.* at 26–27, ¶¶ 173, 175, 176, 177.

¹⁶⁰ *Id.* at 28, ¶ 186.

¹⁶¹ *Id.* at 28, ¶ 188.

¹⁶² *Id.* at 33, ¶¶ 230, 231.

¹⁶³ *Id.* at 33, ¶¶ 227.

¹⁶⁴ *Id.* at 12, ¶ 67.

¹⁶⁵ *Id.* at 22, ¶ 138.

. . . as a general practice, China formulates and revised standards on the basis of relevant international standards, including the international standards at the final stage of formulation. Exceptions would only apply when those international standards are ineffective or inappropriate for China . . . [citing the justifications in the TBT Agreement, Article 2.4]. When adopting international standards, China gives priority to those fundamental standards and test method standards. By the end of 2009, the rate of adopting international standards and advanced foreign standards in China reached 68%.¹⁶⁶

Adoption of international standards remained important in the long term.¹⁶⁷ From the Chinese perspective, however, which echoed the terminology of the Chinese Standardization Law Implementing Regulation,¹⁶⁸ “international standards” meant both standards adopted by international standard-setting bodies such as the Codex Alimentarius Commission and advanced foreign standards, that is those set by wealthier, more industrialised and usually western countries.

A number of specific questions focused on the Chinese Government’s reaction to the melamine crisis and on the new 2009 Food Safety Law. First, the EU asked why the Chinese Government did not notify the new Food Safety Law to the WTO before implementing it.¹⁶⁹ The Chinese Government Representative replied that:

The *Food Safety Law* is based on the previous *Food Hygiene Law* and there is no technical requirement that will have a major impact on international trade, therefore, China had not submitted a notification before the Law was passed. However, after the *Food Safety Law* entered into force, China timely submitted notifications on the 178 relevant food safety rules and standards based on the Law and provided time for comments by the members.¹⁷⁰

¹⁶⁶ *Id.* at 56, ¶ 406.

¹⁶⁷ *Id.* at 57, ¶ 407.

¹⁶⁸ *Supra* note 158 (follow up to Question 59 and Question 60).

¹⁶⁹ *Id.* at 87 (Questions 61–62).

¹⁷⁰ *Id.*

The EU was not very satisfied with this reply,¹⁷¹ which was based on a very narrow and indeed questionable interpretation of WTO legal obligations. The US asked the same question and received the same reply.¹⁷²

Second, Brazil asked which specific measures the Government had taken to strengthen testing of dairy products after the crisis.¹⁷³ In fact, the State Council promulgated a Regulation on Supervision and Administration of Dairy Product Safety,¹⁷⁴ issued a Notice on Strengthening Production Licensing of Dairy Products¹⁷⁵ and enacted Rules on Supervision of Dairy Products Producing Enterprises on Their Implementation of Quality Safety Responsibilities.¹⁷⁶ The Ministry of Health on 27 April 2010 “issued 66 new national standards on the safety of dairy products, which included 15 new standards for dairy products, 2 production rules and 49 standards for inspection methods.” AQSIQ strengthened inspection procedures, and other measures were taken.¹⁷⁷

Third, Egypt asked about the meaning of “specific supervision” of food safety and whether it was dealt with in the Food Safety Law.¹⁷⁸ The Chinese Representative briefly described “specialised supervision” with regard to food safety regulation.¹⁷⁹ The 2004 Decision of the State Council about Strengthening Food Safety had consolidated this system of institutional fragmentation (*zhèngchū duōmén*, 政出多门), and the 2009 Food Safety Law retained its essential features. The US asked whether it was correct that food safety regulation under the new Law

¹⁷¹ *Id.* (follow up to Question 61).

¹⁷² *Id.* at 215–216 (Question 22(a); Answer (a–c)).

¹⁷³ *Id.* at 15 (Question 24).

¹⁷⁴ 乳制品安全监督管理条例 [Regulation on the Supervision and Administration of the Quality and Safety of Dairy Products] (promulgated by State Council Order No. 536, Oct. 9, 2008) CLI.2.109190 CHINALAWINFO.

¹⁷⁵ 国家质量监督检验检疫总局关于加强乳制品生产许可工作的通知 [Notice on Strengthening Production Licensing of Dairy Products] (issued by AQSIQ No. 757, Oct. 12, 2008), CLI.4.112933 CHINALAWINFO.

¹⁷⁶ 乳制品生产企业落实质量安全主体责任监督检查规定 [Rules on Supervision of Dairy Products Producing Enterprises on Their Implementation of Quality Safety Responsibilities] (promulgated by AQSIQ, Sep. 27, 2009), CLI.4.125957, CHINALAWINFO.

¹⁷⁷ *Supra* note 158, at 15–16.

¹⁷⁸ *Id.* at 163–164.

¹⁷⁹ *Id.* at 164–165.

involved 12 different ministries,¹⁸⁰ to which the Chinese Government Representative replied by describing briefly the “food safety regulatory system of divided responsibilities in specific links of the entire food safety chain plus overall comprehensive coordination.”¹⁸¹

Fourth, Argentina drew attention to the fact that the new Chinese Food Safety Law had caused difficulties for entry of Argentina soy oil into the Chinese market.¹⁸² India identified problems with access to India fruit and vegetables to the Chinese market.¹⁸³ These questions and answers show how deeply the WTO TRPM penetrates into the social and legal fields involving WTO Members, and they also demonstrate the limits of the TRPM based mainly on discussion, transparency and peer pressure.

In follow-up questions, the US urged China to establish a mechanism to monitor the performance of individual ministries and agencies in their use of the notice-and-comment procedure, which, from the US perspective, China had made mandatory for new laws, regulations and other measures.¹⁸⁴ While recognising that China had to deal with a large number of questions, the EU stated that 42 of its questions had not yet been answered, a problem which the EU considered to be of systemic importance for the WTO.¹⁸⁵ In reply, China’s Representative rightly pointed out:

We got a lot of other questions and we will try to answer all of those questions. But I just want to raise one concern about this job, that is, even though my team is working very hard, we can hardly finish all the answers. It seems that the WTO has language discrimination. We do not speak English [or Spanish or French], so normally we have to translate all the questions into Chinese and pass them to various agencies in the Government. They will try to prepare the answers to you and we have to translate them back into English. So it creates a big burden and we

¹⁸⁰ *Id.* at 215 (Question 21).

¹⁸¹ *Id.* (Answer (a–b)).

¹⁸² *Supra* note 151, at 38, ¶ 273.

¹⁸³ *Id.* at 30, ¶ 197.

¹⁸⁴ *Id.* at 59, ¶ 428.

¹⁸⁵ *Id.* at 61, ¶ 441.

hope that you can have your understanding if there is a little bit delay. But we will try to make it.¹⁸⁶

In conclusion, the Chairperson noted that the procedure by which Chinese voluntary standards could be made mandatory was not clear to many Members and that the alignment of national standards to international standards was “less than half.”¹⁸⁷ However, in reply to a question by the EU, the Chinese Government stated clearly that:

Overseas advanced standards refer to the national standards promulgated by countries with high economic development level, advanced technical level, high living standard and GDP per capita, and high standardization level and that have made great contribution to international standardization work, or the industrial standards promulgated by national industrial associations of these countries. They also include standards of regional organizations which have relatively great influence on international standards or which have been adopted frequently by Chinese national standards.¹⁸⁸

The Implementing Regulation of the Chinese Standardization Law allows the use of either international standards or advanced foreign standards.¹⁸⁹

E. The 2012 Trade Policy Review

The fifth China TPR, which took place on 12 and 14 June 2012, opened in an extremely unfavourable global economic climate, with China’s previous prodigious growth rate gradually slowing down.¹⁹⁰ The Chinese Government report concentrated on the economic and trade environment, macroeconomic policy direction and trade and investment. It did not mention food safety directly. Indirectly, however, it highlighted several structural and institutional conditions for successful food safety regulation. First,

¹⁸⁶ *Id.* at 64, ¶ 461.

¹⁸⁷ *Id.* at 65, ¶ 472.

¹⁸⁸ *Supra* note 158, at 153 (Follow up to Question 59 and Question 60).

¹⁸⁹ *Supra* note 90.

¹⁹⁰ Trade Policy Review Body, *Trade Policy Review, Report by China*, at 5, ¶ 4, at 6, ¶ 9, WT/TPR/G/264 (May 8, 2012).

it affirmed that “[t]he multilateral trading system is the cornerstone of China’s foreign economic and trade relations.”¹⁹¹ Second, it stated that “[r]ule of law is a fundamental principle for China to effectively govern the country”, meaning that “China needs to bring into being a comprehensive system of laws with Chinese characteristics so as to ensure that there are laws to abide by for the carrying on of state affairs and social life.”¹⁹² It noted that the State Council issued in October 2010 the Opinions on Strengthening the Construction of a Law Based Government, which concerned regular reform of rules and administrative measures, solicitation of public opinion and legitimacy review of legislation and administrative measures, strengthening of administrative review procedures and increased efforts to disclose government information.¹⁹³ Third, the scale of China’s reforms is historically unprecedented, because China accounts for 1/5 of the world’s population.¹⁹⁴ Directly or indirectly, the multilateral trading system, the development of a rule of law and China’s large population help to shape the basic features of food safety regulation in China, though further analysis lies outside the scope of this paper.

Against this background, the Secretariat Report took a more direct, more critical assessment of China’s food safety regime. While recognising that China had taken “some small steps” to improve transparency, it remarked that “many aspects of China’s trade and investment policy regime remain complex and opaque, leaving scope for administrative discretion and corruption.”¹⁹⁵ With regard to public participation in policy making, it referred to the OECD view¹⁹⁶ that “public participation in policy formulation in China is still at a relatively early stage, characterized by informing the public rather than collecting opinions for improving policy making.”¹⁹⁷ It pointed out, again following the OECD,¹⁹⁸ that China has “a shared governance structure that requires continuous negotiation among different levels of gov-

¹⁹¹ *Id.* at 5, ¶ 3.

¹⁹² *Id.* at 13, ¶ 41.

¹⁹³ *Id.* at 14, ¶ 44.

¹⁹⁴ *Id.* at 29, ¶ 127.

¹⁹⁵ *Supra* note 29 at 11, ¶¶ 4, 5.

¹⁹⁶ OECD, OECD ECONOMIC SURVEYS: CHINA 220 (2010).

¹⁹⁷ *Supra* note 29 at 13, ¶ 14.

¹⁹⁸ OECD, OECD TERRITORIAL REVIEWS: GUANGDONG CHINA 222 (2010).

ernment,”¹⁹⁹ but “coordination between the agency at the central level and its counterparts at the local level remains weak, raising issues of policy coherence.”²⁰⁰

The Report provided a clear presentation of the normative and institutional arrangements for food safety regulation, for example regarding measures directly affecting imports,²⁰¹ exports,²⁰² standards and other technical requirements,²⁰³ SPS measures,²⁰⁴ labelling²⁰⁵ and GIs.²⁰⁶ It noted the evolution of Chinese standards, including but not limited to food safety standards, as shown in Table 8.

TABLE 8: EVOLUTION OF CHINESE STANDARDS, 2006–2010

Type of Standard	2006	2007	2008	2009	2010
National	1,889	1,385	5,911	3,121	2,796
of which: mandatory	276	157	594	283	493
of which: voluntary	1,613	1,228	5,317	2,838	2,303
Professional standards	2,178	3,029	3,087	1,428	3,015
of which: mandatory	335	245	216	255	183
of which: voluntary	1,843	2,784	2,871	1,173	2,832
Local standards	2,377	2,805	2,809	3,110	n/a
of which: mandatory	220	277	300	252	n/a
of which: voluntary	2,157	2,528	2,509	2,858	n/a

Source: Trade Policy Review Body Report,²⁰⁷ which is based on data provided by the Chinese authorities.

Under the 2009 Food Safety Law, all national food safety standards must, as a matter of law, be mandatory.²⁰⁸

¹⁹⁹ *Supra* note 29 at 14, ¶ 17.

²⁰⁰ *Id.* at 14, ¶ 19.

²⁰¹ *Id.* at 24–42, ¶¶ 1, 44, 45.

²⁰² *Id.* at 57–63, ¶¶ 134, 148, 149, 152, 153.

²⁰³ *Id.* at 45–53, ¶¶ 80–98.

²⁰⁴ *Id.* at 49–52, ¶¶ 99–108.

²⁰⁵ *Id.* at 52–53, ¶¶ 109–110.

²⁰⁶ *Id.* at 93, ¶¶ 308–311.

²⁰⁷ *Supra* note 29, at 49, ¶ 91.

²⁰⁸ 食品安全法 [Food Safety Law of the People’s Republic of China] (promulgated by the St. Council, Feb. 28, 2009 and effective on June 1, 2008) art. 9, CLI.1.113981, CHINALAWINFO (Article 9 provides that “[t]he food safety standards are standards for mandatory execution. Except for food safety standards, no other mandatory food standards shall be set down.” And at least in English translation, this provision is not without ambiguity.).

The Secretariat Report also recorded the continued fragmentation of administrative responsibility for SPS measures between (as of 2010) the State Food and Drug Administration (SFDA), the Ministry of Health, the Ministry of Agriculture, MOFCOM, AQSIQ and other agencies,²⁰⁹ as well as the many different laws dealing with SPS matters.²¹⁰ China was an active participant in the SPS Committee, making 376 notifications between 1 January 2009 and 31 October 2011. However, Members expressed concerns about notifications in particular following adoption of the 2009 Food Safety Law, when mainly as a result of the melamine scandal China notified almost 100 measures during a 15-day period.²¹¹

Based on the reports by China and the Secretariat, the Report of the Chairperson of the TPRB meeting identified standards, SPS measures and other technical requirements as among the specific topics of most interest to Members.²¹² However, in his opening remarks the Discussant commented that the Secretariat sometimes was not able to gather sufficient information; some rules were very complex, implementation of law was not always clear and local administration was sometimes cumbersome.²¹³

More than 1700 questions were put to the Chinese Government.²¹⁴ Table 9 shows the WTO Members asking questions about food safety and the subject matter of the questions in the 2012 China Trade Policy Review.

TABLE 9: 2012 CHINA TRADE POLICY REVIEW: WTO MEMBERS ASKING QUESTIONS AND SUBJECT MATTER OF QUESTIONS (IN ORDER OF PAGE NUMBER IN THE RECORD OF THE MEETING)

Country	Question	Page	Subject Matter	
Asking the	Number	Number		
Question	Among	in		
	Asker's	TPRB		
	Questions	Report		
Argentina	Add.1	23	11	Import/Certification

²⁰⁹ *Supra* note 29, at 49–50, ¶ 99.

²¹⁰ *Id.* at 50–51, ¶ 100.

²¹¹ *Id.* at 51, ¶ 102.

²¹² Trade Policy Review Body, *Trade Policy Review, China, Record of the Meeting*, at 3, ¶ 7, WT/TPR/M/264 (July 17, 2012).

²¹³ *Id.* at 10, ¶ 56.

²¹⁴ *Id.* at 60, ¶ 428.

Australia	Add.1	8	21	Imports/Licensing
Australia	Add.1	12	22	Administrative organisation
Australia	Add.1	13	22	Alignment
Australia	Add.1	14	23	Alignment
Australia	Add.1	15	23	Imports
Australia	Add.1	17	23	Imports
Australia	Add.1	24	25	GIs
Australia	Add.1	25	26	GIs
Brazil	Add.1		39	Types of standards
Brazil	Add.1		39	Alignment
Brazil	Add.1		39	Transparency
Brazil	Add.1	1&2	48	Alignment
Brazil	Add.1		49	Certification
Canada	Add.1	32	69	Imports
Canada	Add.1	33	69	Imports
Chile	Add.1	4	106	GIs
Colombia	Add.1	16	119	Imports
Costa Rica	Add.1	19	127	Imports
Dominican Republic	Add.1	1&2	135	Imports
EC [now EU]	Add.1	35	157	Certification (CCC [Compulsory Product Certification] system)
EC [now EU]	Add.1	36	157	Certification (CCC system)
EC [now EU]	Add.1	38	158	Certification (CCC system)
EC [now EU]	Add.1	39	159	Certification (CCC system)
EC [now EU]	Add.1	61	164	Imports
EC [now EU]	Add.1	62	165	Imports
EC [now EU]	Add.1	63	165	Alignment
EC [now EU]	Add.1	64	165	Alignment
EC [now EU]	Add.1	65	165	Imports
EC [now EU]	Add.1	66&67	167	Labelling
Indonesia	Add.1	8	215	Alignment
Indonesia	Add.1	9	219	Imports
Indonesia	Add.1	10	219	Imports
Indonesia	Add.1	11	219	Imports

Indonesia	Add.1	13	219	Imports
Indonesia	Add.1	14	219	Transparency
Mexico	Add.1	21–25	285	Imports
Mexico	Add.1	49	290	Types of standards
New Zealand	Add.1	4	296	Imports
New Zealand	Add.1	9	301	Imports
New Zealand	Add.1	10	302	Imports
Peru	Add.1		308	Alignment
Peru	Add.1		308	Imports
Peru	Add.1		309	Certification
Singapore	Add.1		312	Imports
South Africa	Add.1	8	317	Imports (SOEs)
South Africa	Add.1	9	318	Imports
South Africa	Add.1	10	318	Imports
Switzerland	Add.1		333	SOEs
Switzerland	Add.1		335	Exports
Thailand	Add.1	7	340	Subsidies
Turkey	Add.1		351	Imports
United States	Add.1	29	379	Administrative organisation
United States	Add.1	30	379	Additives
United States	Add.1	31	380	Transparency
United States	Add.1	32	381	Imports
United States	Add.1	33	381	Imports

Source: Calculated by the author based on Trade Policy Review Body Report.²¹⁵

TABLE 10: 2012 CHINA TRADE POLICY REVIEW: WTO MEMBERS ASKING QUESTIONS, NUMBER OF QUESTIONS AND MAIN CONCERNS

WTO Member	Number of	Main Concerns
Asking Questions	Questions	
Argentina	1	Import/Certification
Australia	8	Alignment; import; GIs
Brazil	5	Alignment
Canada	2	Imports
Chile	1	GIs
Colombia	1	Imports

²¹⁵ *Id.* Trade Policy Review Body, *Trade Policy Review, China, Record of the Meeting, Addendum*, WT/TPR/M/264/Add.1 (Aug. 22, 2012).

Costa Rica	1	Imports
Dominican Republic	1	Imports
EU	11	CCC
Indonesia	6	Imports
Mexico	2	Imports; Types of standards
New Zealand	3	Imports
Peru	3	Alignment; Imports; Certification
Singapore	1	Imports
South Africa	3	Imports
Switzerland	2	SOEs; Exports
Thailand	1	Subsidies
Turkey	1	Imports
USA	5	Imports
TOTAL 19 Members		57 questions

Source: Calculated by the author based on Trade Policy Review Body Report.²¹⁶

At the 2012 China Trade Policy Review, a total of 19 Members asked a total of 57 questions, a decline from the 2010 Review.

We can grasp the scope and details of the discussion by considering examples of specific questions and answers concerning the 2009 Food Safety Law and other consequences of the melamine scandal, alignment with international standards, certification, and GIs. With regard to the 2009 Food Safety Law, questions concerned consequent measures rather than the text of Law itself, which by then must have been well-known to all interested Members. Brazil asked why the Ministry of Health 4 December 2009 Circular No. 108 on the Conduct of Food Packaging Material Clean-up Operations was not notified to the WTO so foreign companies could comment on additives.²¹⁷ The Chinese Representative considered that the Circular

²¹⁶ Trade Policy Review Body, *Trade Policy Review, China, Record of the Meeting*, at 3, ¶ 7, WT/TPR/M/264 (July 17, 2012). Trade Policy Review Body, *Trade Policy Review, China, Record of the Meeting, Addendum*, WT/TPR/M/264/Add.1 (Aug. 22, 2012).

²¹⁷ Trade Policy Review Body, *Trade Policy Review, China, Record of the Meeting, Addendum*, at 40, WT/TPR/M/264/Add.1 (Aug. 22, 2012). See also supra note 29, at 51, ¶ 102 (According to the TPR procedure, the Secretariat prepares a report [original report] which is circulated for comments to the Member being reviewed, and after comments are received, the Secretariat prepares a revised report. Most references in the text are to the revised report.).

Is mainly a campaign aimed at cracking down on illegal behaviours of producing food packaging and containers using poisonous and harmful materials, particularly waste materials. It is not legislation. If we intend to modify the safety standards of food containers, packaging material or additives, we will notify the WTO in accordance with relevant procedures.²¹⁸

Hence the Circular did not fall within the scope of the Government's notification obligation, as narrowly interpreted.

Mexico asked a question concerning participation of consumer organisations in the development of standards under the Food Safety Law.²¹⁹ In reply, the Chinese Representative pointed out that the China Consumers Association had been invited to participate in drafting and to comment on the 12th Five Year Plan for National Standards on Food Safety.²²⁰ Turkey enquired about quarantine measures and assessment procedures for dairy products and poultry,²²¹ both are sensitive products in international trade, especially dairy products after the melamine scandal. The Chinese Representative provided a very detailed answer regarding relevant institutions, applicable administrative measures and procedures.²²²

Concerning standards, Australia asked what proportion of Chinese standards were more restrictive than Codex standards and, if there is no domestic standard, whether China "could . . . consider" adopting a Codex standard until a domestic standard was developed.²²³ The Chinese Representative, without really answering the question, replied that Chinese standards were "basically consistent" with Codex standards, they were "not totally the same as CAC [Codex Alimentarius Commission] but we have the scientific basis" and "the Ministry of Health stipulates the Chinese national food safety standards based on the results of food safety risk evaluations, the residents' different food consumption and diet structure and the actual production

²¹⁸ Trade Policy Review Body, *Trade Policy Review, China, Record of the Meeting. Addendum*, at 40, WT/TPR/M/264/Add.1 (Aug. 22, 2012).

²¹⁹ *Id.* at 290 (Question 49).

²²⁰ *Id.* at 290.

²²¹ *Id.* at 351.

²²² *Id.* at 351, 352.

²²³ *Id.* at 22 (Question 13). *See also supra* note 29, at 51, ¶101.

and operation conditions and with reference to the international standards.”²²⁴ Similarly, Brazil asked why China had not accepted proposed maximum residue limits (MRLs) for ractopamine, which had been evaluated three times and recommended for approval by the Codex Alimentarius Commission.²²⁵ The Chinese Representative replied that the MRL was still under multilateral discussion and that, in any event, Members should carry out their own risk assessment and if, having done so, their standard diverged from Codex standard, this did not mean the standard was in violation of WTO law or Codex principles. China had carried out a risk assessment, which showed that the residue level of ractopamine was “high on pigs organs, especially lungs, which are Chinese regular food resources.”²²⁶

With regard to certification, a crucial issue for market access, Brazil asked about the requirements to be met by foreign certification bodies in order to be accredited by the China National Accreditation Service (CNAS).²²⁷ The Chinese Representative replied that China was “actively promoting and allowing mutual recognition in international product testing and factory inspection within the framework of multilateral or bilateral MRAs [mutual recognition agreements]. It had already concluded agreements with 19 certifying bodies in Europe, the US, Japan and elsewhere, whose inspection results would be accepted for CCC purposes by the China National Certification and Accreditation Administration (CNCA).”²²⁸ In a related question about market access, Canada sought to obtain a procedural document regarding registration by foreign food manufacturers and producers who wished to export products to China.²²⁹ The Chinese Representative pointed out that the procedures could be found in The Catalogue of Administrative Measures for Registration of Foreign Manufacturers of Imported Food, issued by AQSIQ as

²²⁴ *Supra* note 218, at 22, 23.

²²⁵ *Id.* at 48 (Question 1). *See also supra* note 29, at 46, ¶ 84.

²²⁶ *Supra* note 218, at 48 (Answer to Question 1 & 2).

²²⁷ *Id.* ¶ vii.

²²⁸ *Id.* *See also* Panel Report, *United States—Certain Measures Affecting Imports of Poultry from China*, WT/DS/392R (Sep. 29, 2010) (adopted Oct. 25, 2010).

²²⁹ *Supra* note 218, ¶ vii.

Announcement No. 73 in 2012.²³⁰ Under China's Administrative Measures for Registration of Overseas Manufacturers of Imported Food,²³¹ the CNCA was responsible for implementation and supervision of registration.²³² However, in reply to a long question by the EU about product certification, include the CCC scheme,²³³ the Chinese Representative replied that "[a]t present, China cannot designate overseas labs as 3C-designated labs by Chinese laws and regulations, taking into account the difficulties in tracing responsibilities and following practices in the EU. EU labs have been widely participating in 3C certification via multi-lateral/bilateral channels."²³⁴

Finally, Australia asked about the coherence of the GI regulatory regime.²³⁵ The Chinese Representative described the system at length:

Currently, SAIC, AQSIQ and MOA are jointly studying how to establish the joint Geographical Indications certification system.

The three agencies have different focuses in GI protection. The SAIC protects geographical indications by applying collective trademark and certification trademark registration pursuant to the Trademark Law. Corresponding remedies for geographical indication infringement include administrative, civil and criminal ones. The Ministry of Agriculture has registration administration for geographical indications of agricultural products based on administrative rules formulated in accordance with the Law on Quality Secu-

²³⁰ 国家质量监督检验检疫总局关于公布《进口食品境外生产企业注册实施目录》的公告 [Notice concerning Publish the "Implementation Catalogue for Registration of Overseas Manufacturers of Imported Food"] (promulgated by the AQSIQ, May 7, 2012), available at http://www.aqsiq.gov.cn/xxgk_13386/jlgg_12538/zjgg/2012/201207/t20120713_238975.htm.

²³¹ 进口食品境外生产企业注册管理规定 [Administrative Measures for Registration of Overseas Manufacturers of Imported Food] (promulgated by the State Administration of Quality Supervision, Inspection and Quarantine, June 21, 2011, effective May 1, 2012), available at http://www.aqsiq.gov.cn/xxgk_13386/zvfg/flfg/201307/t20130705_365373.htm.

²³² *Supra* note 218, ¶ vii.

²³³ *Id.* ¶¶ 35–60.

²³⁴ *Id.* ¶ 39.

²³⁵ *Id.* ¶ vii. See also Trade Policy Review Body, *Report by the Secretariat*, ¶¶ 308–11, WT/TPR/S/300 (May 27, 2014).

rity of Agricultural Products. The focus of the protection is on geographical indication resources of agricultural products, product quality and traditional farming culture. AQSIQ's protection of geographical indication focuses on processing, which is based on administrative rules formulated in accordance with the Product Quality Law.²³⁶

With regard to the trademark register, the Chinese Representative noted:

Trademark Office shall compile the Trademark Gazette, and release to the public, on a regular basis, all the relevant information about trademark registration, transfer, change and others, including geographical indications. The . . . [AQSIQ] shall publish on its official website www.aqsiq.gov.cn the Protection Provisions for Geographical Indication Products and other laws and regulations, and shall regularly publish the admissibility announcement and ratification announcement of geographical indication product protection, and the announcement of approving enterprises to use the geographical indication product names and special marks. The above information is available for reference by foreign individuals or companies.²³⁷

As the China Representative explained, the legal basis for protecting GIs was complex, including the "Trademark Law, Implementing Regulations of Trademark Law, Registration and Management Measures of Collective Marks and Certification Marks, Administrative Measures of Geographical Indications of Agricultural Products, Protection Regulations for Geographical Indication Products and other laws and regulations." He considered that all were totally consistent with the WTO TRIPS Agreement.²³⁸ These answers indicated once again, however, the administrative and normative fragmentation of China's food safety regime as it stood in 2012.

²³⁶ *Supra* note 218, ¶ 24.

²³⁷ *Id.* ¶ 26.

²³⁸ *Id.*

Many Members reiterated specific previous concerns. The United States noted that China still had not completely adopted science-based decision making²³⁹ or international standards and needed to improve its notification of proposed SPS measures.²⁴⁰ Brazil noted that some progress had been made regarding SPS inspection and approval procedures.²⁴¹ Canada remarked that China's regulatory process was overly complex and that CCC system should be reformed consistently with international practice to accredit foreign conformity assessment bodies.²⁴² Costa Rica raised questions about the CCC certificates and inspection and quarantine protocols.²⁴³ The EU was concerned about lack of transparency of legislation, divergence from international standards and overly complex conformity assessment and approval procedures.²⁴⁴ Australia urged China to adopt Codex standards for food safety and to provide sufficient resources for auditing overseas export establishments where required.²⁴⁵ Argentina announced that it had reached agreement with China regarding agriculture, livestock, SPS measures, agricultural biotechnology and bio-security.²⁴⁶

A number of other Members also raised specific market access concerns of their own, most or all invoking regulatory measures concerning foodstuffs. Japan commented that certain technical standards were more trade-restrictive than necessary and requested that China relax import restrictions on Japanese food and agricultural products introduced after the Fukushima disaster.²⁴⁷ Norway complained about testing and quarantine measures on fresh chilled salmon.²⁴⁸ Mexico sought greater market access for tequila and pork,²⁴⁹ as did Uruguay for soybeans, bovine animals, premium beef cuts, dairy products and wines.²⁵⁰

²³⁹ *Supra* note 212, ¶ 69.

²⁴⁰ *Id.* ¶ 70.

²⁴¹ *Id.* ¶ 108.

²⁴² *Id.* ¶ 181.

²⁴³ *Id.* ¶ 193.

²⁴⁴ *Id.* ¶¶ 293–42.

²⁴⁵ *Id.* ¶ 337.

²⁴⁶ *Id.* ¶ 380.

²⁴⁷ *Id.* ¶ 132.

²⁴⁸ *Id.* ¶ 149.

²⁴⁹ *Id.* ¶¶ 275, 276, 470.

²⁵⁰ *Id.* ¶ 304.

China's Representative affirmed that China was continuing to align its standards, so that 68% of national standards had adopted international or advanced foreign standards by end 2011, "far above our WTO commitment which is 50%."²⁵¹ He also remarked that "we believe it is unfair to say that China is developing its own standards and violates the TBT Agreement just because it does not follow the standards of some other Members in a few areas."²⁵² He emphasised China's openness to further discussions and its support for more WTO dialogues on international standards.²⁵³ With regard to notifications, he commented that China made the most SPS and TBT notifications in the WTO. Concerning criticisms of late notification, he remarked that

I looked into this and found that the main reason is our staff had different opinions on whether the technical regulations should be notified under the TBT Agreement. For instance, some general laws and regulations are considered to have no direct impact on trade, while some have adopted recommended standards or international standards. I think these are technical issues.²⁵⁴

Nonetheless, the EU voiced its surprise that China seemed to have no recent statistics on alignment.²⁵⁵

F. The 2014 Trade Policy Review

The 5th WTO review of China's trade policy was held on 1 and 3 July 2014. The Chinese Government Report emphasised China's continuing opening up and deepening of domestic reform, "making progress while maintaining stability."²⁵⁶ It stated that "[t]he core of economic system reform is to handle well the relationship between government and market and to let the market play the decisive role in the allocation of resources and bring the role of the Government into better play."²⁵⁷ The Report reiterated

²⁵¹ *Id.* ¶ 402.

²⁵² *Id.* ¶ 403.

²⁵³ *Id.* ¶ 405.

²⁵⁴ *Id.* ¶ 407.

²⁵⁵ *Id.* ¶ 435.

²⁵⁶ Trade Policy Review Body, *Report by the Secretariat*, ¶¶ 1.1, 1.2, WT/TPR/S/300 (May 27, 2014).

²⁵⁷ *Id.* ¶ 2.35.

China's strong support for the multilateral trading system, while it supported "development and cooperation through bilateral, regional, sub-regional and multilateral channels."²⁵⁸ It mentioned the March institutional reform of the State Council, including with regard to food and drugs.²⁵⁹ However, it did not deal with food safety regulation directly, which was probably due in part to the fact that a major reform of the 2009 Food Safety Law was then underway.²⁶⁰ A draft of the proposed new Law was circulated for public comment from 1–31 July 2014.²⁶¹ Consideration of the draft is still underway at the time of writing.

The Secretariat Report noted that China had become the world's largest trader (except for trade within the EU).²⁶² There were no changes from previous years in many procedures or institutions, for example regarding establishment of SPS requirements²⁶³ or inspection procedures for imports and exports subject to SPS measures.²⁶⁴ However, the Report identified various SPS measures imposed on imports between 2011 and 2013 before the measures had been notified to the WTO. They included "quarantine and testing procedures for salmon; testing methods for food additives; import conditions related to phthalates, import restrictions on beef due to BSE; and registration requirements for foreign companies importing food into China."²⁶⁵

The Secretariat summarised China's food safety regime (see Table 11):

TABLE 11: LAWS AND REGULATIONS RELATED TO CHINA'S SPS REGIME

Laws	Promulgated / Amended
Law on the Entry and Exit Animal and Plant Quarantine	30.10.1991/27.08.2009

²⁵⁸ *Id.* ¶ 1.3.

²⁵⁹ *Id.* ¶ 2.36.

²⁶⁰ See U.S. Foreign Agric. Service, *People's Republic of China, Food Safety Law Draft for Comment (Compared with the 2009 Food Safety Law)*, Global Agric. Info. Network Report No. 13064 (2013), http://gain.fas.usda.gov/Recent%20GAIN%20Publications/Food%20Safety%20Law%20Draft%20for%20Comment%20_Beijing_China%20-%20Peoples%20Republic%20of_11-8-2013.pdf (last visited Dec.28, 2014).

²⁶¹ *Id.*

²⁶² *Supra* note 256, ¶ 6.

²⁶³ *Id.* ¶ 3.79.

²⁶⁴ *Id.*

²⁶⁵ *Id.* ¶ 3.

Regulations on Implementation of the Law on the Entry and Exit Animal and Plant Quarantine	02.12.1996
Law on Quality and Safety of Agricultural Products	29.04.2006
Animal Disease Prevention Law	03.07.1997/30.08.2007
Regulations on Plant Quarantine	03.01.1983/13.05.1992
Regulations on Control of Pesticides	08.05.1997/29.11.2001
Regulations on Control of Veterinary Drugs	21.05.1987/29.11.2001 and 09.04.2004
Regulations on the Administration of Feed and Feed Additives	29.05.1999/29.11.2001 and 03.11.2011
Law on Frontier Health and Quarantine.	[no information]
Law on Import and Export Commodity Inspection	[no information]
Food Safety Law	28.02.2009
Rules and Administrative Measures	Source
Measures for the Supervision and Administration of Inspection and Quarantine of Import and Export Aquatic Products	AQSIQ Decree No.135 of 2011
Measures for the Supervision and Administration of Inspection and Quarantine of Import and Export Meat Products	AQSIQ Decree No. 136 of 2011
Measures for the Prevention and Treatment of AIDS at Frontier	AQSIQ Decree No. 139 of 2011
Measures for the Supervision and Administration of Inspection and Quarantine of Import and Export Cosmetic Products	AQSIQ Decree No. 143 of 2011
Administrative Measures on the Safety of Import and Export Food	AQSIQ Decree No. 144 of 2011
Administrative Measures for Registration of Overseas Manufacturers of Imported Food	AQSIQ Decree No. 145 of 2012
Measures for the Supervision and Administration of Inspection and Quarantine of Import and Export Dairy Products	AQSIQ Decree No. 152 of 2013

Source: Based on information provided by the Chinese authorities.²⁶⁶

The Secretariat commented, however, that “some of these laws are outdated and repetitive.”²⁶⁷

The Report noted that Central Government trade-related laws and regulations were published on the website of the China Legislative Information System [Legislative Affairs Office of the State Council] (www.chinalaw.gov.cn), which since 2008 has also published all draft administrative regulations for public comment.²⁶⁸ In the ensuing discussion, however, several Members reiterated the WTO Secretariat’s remark about the difficulty of obtaining adequate information for the review.²⁶⁹ Many questions focused on transparency in standard-setting and implementation.²⁷⁰ For example, the EU noted that there was “much room for improvement” with regard to transparency (lack of availability or lack of translations), notifications and consistent implementation of legislation.²⁷¹ Canada commented on “challenges” posed by China’s regulatory process.²⁷² Peru noted the need to improve frequency of notifications to the WTO.²⁷³ Russia also requested clarification regarding SPS measures.²⁷⁴ The US stated that “it has been our experience that many aspects of China’s trade and investment policies and practices seem to remain hidden away in unpublished measures, internal instructions, oral directives and confidential documents—or for some other reasons are simply unavailable.”²⁷⁵ It identified specific problems as being China’s implementation of its WTO commitments regarding translation, public comments on draft measures and publication in China’s official journal.²⁷⁶

The Secretariat also summarised China’s institutions for dealing with SPS matters (see Table 12).

²⁶⁶ *Id.* at 76, ¶ 3.77.

²⁶⁷ *Id.*

²⁶⁸ *Id.* ¶ 2.12.

²⁶⁹ Trade Policy Review Body, *Trade Policy Review, China, Minutes of the Meeting*, at 23, ¶ 4.101, at 24, ¶ 110, at 33, ¶ 4.179, WT/TPR/M/300 (Aug. 26, 2014).

²⁷⁰ *Id.* ¶ 3.12.

²⁷¹ *Id.* ¶¶ 4.101, 5.56–7.

²⁷² *Id.* ¶ 4.177.

²⁷³ *Id.* ¶ 4.185.

²⁷⁴ *Id.* ¶ 5.49.

²⁷⁵ *Id.* ¶ 4.110.

²⁷⁶ *Id.* ¶ 5.78.

TABLE 12: INSTITUTIONS IN CHARGE OF THE SPS SYSTEM IN CHINA

Institutions	Responsibilities
Ministry of Health (MOH)	Responsible for food safety risk assessment and the formulation of food safety standards
Ministry of Agriculture (MOA)	In charge of implementing entry and exist animal and plant quarantine
General Administration of Quality Supervision Inspection and Quarantine (AQSIQ)	In charge of national quality, entry-exit commodity inspection, entry-exit animal and plant quarantine, import-export food safety, certification and accreditation
State Administration for Industry and Commerce (SAIC)	In charge of regulating product quality and safety in the market
State Food and Drug Administration (SFDA)	In charge of drafting laws, regulations and rules to supervise food safety (including food additives), drugs (including traditional Chinese medicines), medical devices and cosmetics

Source: Based on information provided by the Chinese authorities.²⁷⁷

In its view, the fragmentation of administrative responsibility might lead to lack of clear responsibility and lack of accountability.²⁷⁸ Only much later in the Report did the Secretariat note the major recent reform of China's SPS regulatory institutions, namely the creation of the China Food and Drug Administration (CFDA),²⁷⁹ which is part of a gradual process of institutional consolidation and clarification of rules with regard to food safety.

In discussion, several Members evoked China's fragmented regulatory system. Colombia referred to "[d]ifferent layers of regulation, making it difficult to unravel which sectoral policies are being applied" and to "conflicting guidelines for policy implementation, reflecting different institutional agendas."²⁸⁰ Israel asked "whether SAC holds the sole responsibility for standards in China, or whether other units of the Government have a mandate to develop standards at various levels."²⁸¹ It also commented that the "fragmentation of the SPS regulatory system presents a challenge for our exporters to understand and comply with. Some

²⁷⁷ *Supra* note 255, at 77, ¶ 3.78, Table 3.8.

²⁷⁸ *Id.*

²⁷⁹ *Id.* ¶ 4.6, Table 4.2.

²⁸⁰ *Supra* note 269, ¶ 4.162.

²⁸¹ *Id.* at 52, ¶ 4.381.

Members have pointed out that this fragmentation also poses a challenge in terms of accountability—with food safety implications in some cases.”²⁸² The US again remarked that China was not fully using international standards and science-based rule-making for SPS measures,²⁸³ but it noted that it was working bilaterally with China to try to resolve problems.²⁸⁴

Other comments concerned specific sectors of interest to particular WTO Members. Hong Kong urged China to adopt a more liberal and simplified trading regime.²⁸⁵ Korea proposed a negative rather than positive approach for customs inspection.²⁸⁶ Norway again stressed its request to China for a bilateral expert meeting on testing and quarantine measures on fresh salmon.²⁸⁷ India commented on market access obstacles for its beef, fruit and vegetables;²⁸⁸ Brazil regarding its soybeans, sugar and other products.²⁸⁹

The Representative of China pointed out in his reply that the Government was proceeding with translation of laws, regulations and other measures: The NPC Legislative Affairs Commission published an English edition of the laws. The State Council Legislative Affairs Office promulgates “periodically” laws and regulations on “foreign-related matters” in Chinese and English. The State Council General Office, on 24 February 2003, “issued the Notice on Enhancing the Verification of Official English Translation of Administrative Regulations, requiring government agencies at all levels to enhance efforts in the verification of official English translation of administrative regulations based on the requirement in the notice.”²⁹⁰ Regarding lack of uniformity of customs procedures, he noted that legislation and enforcement was unified but that:

[I]n practice, a few local customs may have different understandings of the regulations due to different levels of economic development and geographical con-

²⁸² *Id.* at 52, ¶ 4.382.

²⁸³ *Id.* at 25, ¶ 4.117.

²⁸⁴ *Id.* at 26, ¶ 4.118.

²⁸⁵ *Id.* at 14, ¶ 4.28.

²⁸⁶ *Id.* at 28, ¶ 4.138.

²⁸⁷ *Id.* at 29, ¶ 4.154.

²⁸⁸ *Id.* at 34, ¶ 4.194.

²⁸⁹ *Id.* at 37, ¶ 4.224.

²⁹⁰ *Id.* at 57–58, ¶ 5.15.

ditions Enforcement in pilot regions and non-pilot regions for the matter of customs clearance reform may also have temporary differences.²⁹¹

He undertook to improve the official Gazette and translation of measures according to China's Accession Protocol.²⁹²

The Accession Protocol provides in Article 2(2) that "China shall establish or designate an official journal dedicated to the publication of all laws, regulations and other measures pertaining to or affecting trade in goods, services, TRIPS or the control of foreign exchange China shall publish this journal on a regular basis and make copies of all issues of this journal readily available to individuals and enterprises."²⁹³ China also committed itself to "make available to WTO Members translations into one or more of the official languages of the WTO all laws, regulations and other measures pertaining to or affecting trade in goods, services, TRIPS or the control of forex, and to the maximum extent possible would make these laws, regulations and other measures available before they were implemented or enforced, but in no case later than 90 days after they were implemented or enforced."²⁹⁴ However, these obligations, which are part of "WTO plus", are virtually unworkable and unenforceable, except perhaps in the long term.²⁹⁵

Following the meeting, the Chinese Government provided replies to the written questions submitted before the meeting and to additional questions by WTO Members; containing more than 1700 questions, the document was 456 single-spaced pages in length.²⁹⁶ Compared to the 2012 Trade Policy Review, more WTO Members asked more questions about food safety. Table 13 shows the WTO Members asking questions about food safety and the subject matter of the questions.

²⁹¹ *Id.* at 58, ¶ 5.22.

²⁹² *Id.* at 58, ¶ 5.16.

²⁹³ WTO, PROTOCOL ON THE ACCESSION OF CHINA (Cambridge Univ. Press 2003). See also WTO/OMC, COMPILATION OF THE LEGAL INSTRUMENTS ON CHINA'S ACCESSION TO THE WORLD TRADE ORGANIZATION (Beijing, Law Press China 2001).

²⁹⁴ WTO/OMC, COMPILATION OF THE LEGAL INSTRUMENTS ON CHINA'S ACCESSION TO THE WORLD TRADE ORGANIZATION ¶ 334 (Law Press China 2001). See also *id.* ¶ 342. See also WTO, PROTOCOL ON THE ACCESSION OF CHINA art. 1(2) (Cambridge Univ. Press 2003).

²⁹⁵ ZHANG XIN, IMPLEMENTATION OF THE WTO AGREEMENTS IN CHINA, 59-61 (Wildy, Simmons & Hill Publishing 2005).

²⁹⁶ *Supra* note 269.

TABLE 13: 2014 REVIEW OF CHINA'S TRADE POLICY: WTO MEMBERS ASKING QUESTIONS ABOUT FOOD SAFETY AND SUBJECT MATTER OF THE QUESTIONS (IN ORDER OF PAGE NUMBER IN THE TPRB REPORT)

Country Asking the Question	Question Number Among Ask-er's Questions	Page Number in Minutes of the Meet-ing Add.1	Subject Matter
Pakistan		3	Import licensing and restrictions
Singapore	9	10	Domestic standards
Singapore	10	10	CCC
Argentina	12	23	TBT notification
Argentina	13	23	CCC
Argentina	14	24	SPS regulation agencies
New Zealand	7	34	National standards
New Zealand	8	34	Fragmentation/overlapping of regulators
Iceland		38	Fish liver oil products
Colombia	26	56	TBT measures
Colombia	27	56	TBT measures
Colombia	32	58, 59	Prices of corn, rice, bean and wheat
Colombia	37	60	Test of plant variety
Colombia	42	62	GIs and trademarks
Colombia	49	65	Test method of food additives
Korea		79	Overseas inspection report & China Food Safety Act
Chile	1	82	Approval system for inspection and quarantine of China
Chinese Taipei	23	89	Voluntary standards & mandatory standards
Chinese Taipei	24	89	Alignment
Chinese Taipei	25	89, 90	Mandatory sectoral stand-ards & mandatory local standards
Chinese Taipei	26	90	Format for technical regulation

Chinese Taipei	27	90	Certification
Japan	16	107	Domestic standards
Japan	17	107	Fragmentation/overlapping of regulators
Japan	18	108	Marketing Authorisation Holder (MAH) system & technical requirements
Japan	19	109	TBT agreement
Japan	22	110	TBT notifications
Japan	25	111	Notification of mandatory standards
Mexico		135	Voluntary and mandatory standards
Turkey		144	SPS requirements
Turkey		145	SPS requirements (product safety & commercial quality)
Turkey		145	Commercial quality requirements
Turkey		145	Alignment
Turkey		145	Commercial quality control
Turkey		145	Commercial quality control
Turkey		145	Commercial quality control
Turkey		145	Commercial quality control
Norway	4	153	SPS agreement (salmon)
Norway	4 (additional)	154	Import licensing
EU	13	159	Standardisation system
EU	15	160	Foreign testing agencies & CCC
EU	16	160	TBT
EU	17	161	Temporary prohibitions
EU	18	161	SPS agreement
EU	20	162	Fragmentation of regulatory authorities
EU	21	162	Fragmentation of regulatory authorities

EU	22	162	Process of removing from black list
EU	23	163	Prohibition on imports of animals and plants
EU	24	163, 164	Notification of SPS measures
EU	40	169	GI protection systems
United States	14(a)	195	Notification of SPS
United States	14(b)	195	Notification of SPS
United States	31	204, 205	Voluntary standards & mandatory standards
United States	32	205	Fragmentation of regulatory authorities
United States	61(a)	218	GIs
United States	61(b)	218	GIs
United States	70	222	Biotechnology products
United States	71(a)	222, 223	Food recall system
United States	71(b)	223	Food recall system
United States	71(c)	223	Food recall system
United States	71(d)	223	Food recall system
United States	Part II 4(b)	234	Publicising cases
United States	Part II 4(c)	234	Publicising cases
Canada		251	Technical committee (standards)
Canada		251	Technical committee
Canada		252	Information on new standards
Canada		252, 253	National standard
Canada		253	National standard
Canada		253	National standard
Canada		253	Compulsory standards
Canada		253	Compulsory standards
Canada		253	Compulsory standards
Canada		253, 254	Local and industry standards
Canada		254	Period of notification
Canada		254	Mandatory certification bodies
Canada		254	CCC
Canada		255	Foreign conformity assessment bodies

Canada		257	Regulatory agencies
Canada		257	Food additives testing
Costa Rica	12	285	GIs
Costa Rica	13	285	GIs
Indonesia	17	294	Institutions in the development of standards
Indonesia	18	294	Standardisation institution and certification institution
Indonesia	19	294	CQC certification
Indonesia	20	294	CCC certification
Indonesia	21	295	Licensing & CCC
Indonesia	23	295	Testing results from foreign labs
Indonesia	39	300	Requirement to register
Indonesia	40	300	Process of registration
Indonesia	41	300	Process of registration
Indonesia	13	305, 306	Quality certification
Indonesia	14(additional)	306	Quality certification
Indonesia	19(additional)	308	Testing results from foreign labs
Indonesia	27(additional)	309	Percentage of cadmium permitted on mangosteen
Indonesia	29	310	Import of bird nest
Peru	6	313, 314	Technical regulations & mechanism for publication of answers
Peru	7	314	CCC
Peru	8	314	Voluntary product certification
Peru	9	314, 315	CCC
India	6	320, 321	Private standards
India	7	321	Private standards & TBT/SPS
India	8	321	Private standards
India	9	321	Private standards
India	10	321	Private standards & TBT/SPS
India	11	321, 322	Private standards & TBT/SPS
India	13	322	Industry/sectoral, local and enterprise standards

India	14	322, 323	Enterprise standards
India	15	323	Enterprise standards
India	16	323	Harmonisation of standards
India	17	323	Standards & SPS/TBT
India	18	323	Mandatory & voluntary standards
India	19	323	Standards on food
India	20	324	Fragmentation of regulatory authorities
India	21	325	TBT notifications
Australia		338	Harmonisation of customs procedures
Australia		341	Alignment of standards
Australia		341	National standards
Australia		341, 342	National, sectoral and local standards
Australia		342	Development of standards
Australia		342	Development of standards
Australia		342	Local/provincial standards
Australia		342, 343	CCC
Australia		343	Conformity assessment
Australia		343	Conformity assessment
Australia		343	Conformity assessment
Australia		343, 344	SPS measures
Australia		344	Reporting of SPS measures
Australia		348	GIs
Malaysia	71	376	Imports of beef
Malaysia	96	382	GIs
Malaysia	97	382	GIs
Ecuador	1	399	Import/export
Ecuador	6	400	Food safety standards
Myanmar	2	406	Fragmentation of regulatory authorities
Myanmar	3	407	SPS requirements & notification
Trinidad and Tobago		409	Quality assurance standards
EU	9 (Follow-up 15)	415	Foreign testing labs

EU	10 (Follow-up 17)	416	Temporary prohibitions
EU	11 (Follow-up 18)	417, 418	SPS agreement
EU	12 (Follow-up 13)	419	Standardisation system
EU	14 (Follow-up 22)	420	Process of removing from black list
EU	15 (Follow-up 23)	421	Imports of spirits
EU	16	421	Imports of wines
EU	27 (Follow-up 40)	427	GI protection systems
Canada		449	CCC
Canada		450	Foreign conformity as- sessment bodies

Source: Calculated by the author from World Trade Organization, Trade Policy Review Body Report.²⁹⁷

A total of 25 WTO Members asked a total of 146 questions about food safety, accounting for about 8.5% of all questions (146/1700).

Table 14 shows the WTO Members asking questions about food safety, the number of questions asked by each of these Members and their main concerns.

TABLE 14: WTO MEMBERS ASKING QUESTIONS ABOUT FOOD SAFETY, NUMBER OF QUESTIONS AND MAIN CONCERNS IN 2014 CHINA TRADE POLICY REVIEW²⁹⁸

WTO Member Asking Questions	Number of Questions	Main Concerns
Argentina	3	SPS/TBT
Australia	14	Standards and Conformity assessment
Canada	18	National standard
Chile	1	Approval system for inspection and quarantine of China
Chinese Taipei	5	Standards

²⁹⁷ Trade Policy Review Body, *Minutes of the Meeting, Addendum*, WT/TPR/M/300/Add.1 (Sept. 9, 2014).

²⁹⁸ *Id.*

Costa Rica	2	GIs
Ecuador	2	Import restrictions and Food safety standards
EU	19	Fragmentation of regulatory authorities
Gobierno de Colombia	6	TBT measures
Iceland	1	Fish liver oil products
India	15	Private standards
Indonesia	14	Standards and certifications
Japan	6	Notifications
Korea	1	Overseas inspection report & China Food Safety Act
Malaysia	3	GIs
Mexico	1	Voluntary and mandatory standards
Myanmar	2	SPS and Fragmentation of regulatory authorities
New Zealand	2	National standards, Fragment/overlapping of regulators
Norway	2	SPS agreement, Import licensing
Pakistan	1	Import licensing and restrictions
Peru	4	CCC
Singapore	2	Domestic standards, CCC
Trinidad and Tobago	1	Quality assurance standards
Turkey	8	Commercial quality control
United States	13	Notification of SPS, Food recall system
TOTAL 25 members	TOTAL 146 questions	

Source: Calculated by the author from World Trade Organization, Trade Policy Review Body Report.²⁹⁹

The most questions were asked by the EU (19), Canada (18), India (15), Australia (14), Indonesia (14) and the United States (13), the larger WTO Members, who are among China's

²⁹⁹ *Id.*

most important trading partners. One should note that this group included two developing countries, India and Indonesia, as well as WTO Members with a much higher per capita income. Fragmentation of regulatory authorities, standards and notifications continued to be major concerns; a new theme was China's food recall system, with reform now in progress; and several countries used the TPR to ask specific questions bearing on their exports.³⁰⁰

Administrative fragmentation of the food safety regime remained a constant theme, despite major Chinese institutional reforms undertaken so far. The Chinese Government has energetically and knowledgeably defended its system. For example, in response to a question by New Zealand, it pointed out correctly that

WTO did not stipulate how many departments a member country should have to be responsible for measures on phytosanitation, many member countries, including the U.S., have multiple departments to be responsible for SPS measures, and measures of each department involve international trade So there is no problem of fragment / overlapping of regulators³⁰¹

Exactly the same reply was given to questions by Japan,³⁰² the EU³⁰³ and the United States.³⁰⁴

Alignment also was a recurrent theme. China noted that 73.52% of its national standards were equivalent to international standards as of the end of 2013.³⁰⁵

Numerous questions concerned the Chinese system of standards. In a particularly interesting but confusing exchange, Turkey asked whether China's SPS measures included both product safety and product quality.³⁰⁶ The Chinese Government indicated that China's SPS measures are "generally . . . compel-

³⁰⁰ *Id.* at 38 (Iceland: fish liver oil products), 153–154 (Norway: salmon), 309 (Indonesia: mangosteen), 310 (Indonesia: bird nest), 376 (Brazil: beef), 417 (EU: beef), 418 (EU: pork), 421 (EU: wine).

³⁰¹ *Id.* at 34 (Q&A 8).

³⁰² *Id.* at 107 (Q&A 17).

³⁰³ *Id.* at 162 (Q&A 21).

³⁰⁴ *Id.* at 205 (Q&A 32).

³⁰⁵ *Id.* at 89 (Q&A 24), 341 (Q&A 3.68).

³⁰⁶ *Id.* at 144 (Q&A 3.1.9).

ling [legally binding] technical regulations and standard[s]. [. . . A]ccording to the Food Safety Act, Article 20, food safety standard[s] should also cover the quality requirements related to food safety.”³⁰⁷ The 2009 Act “stipulate[s] that quality requirements related to food safety [are] included in the food safety standard and are mandatory standards[, while] quality requirements with less connection to the food safety such as the product specification, uniformity, taste have appeared in the form of recommended standards.”³⁰⁸ Apparently taking both mandatory and recommended measures together, the Chinese Government replied that “[m]ost of them are based on international standards, some of them are national, and some of them are local.”³⁰⁹ This exchange reveals a certain lack of communication, due partly to the rigid written question format of the TPR, and partly to the lack of a shared terminology, despite the apparent umbrella of agreed terminology in the WTO Agreements.

India, noting the growing influence of the private sector, asked about the existence of private standards, how they were disciplined, and in which sectors they were used.³¹⁰ The Chinese Government reply identified the four types of standards and simply requested India to “give the definition of private standard.”³¹¹ The increasing role of private standards in China, the relation to enterprise standards (for example made by State-Owned Enterprises (SOEs)) and the application of WTO obligations to enterprise standards and private standards clearly deserves further enquiry.

Another issue regarding China’s standards system concerns diversity among local standards. Australia asked about possible inconsistency and suggested that it would be “[p]erhaps worthwhile to establish a whole-of-government approach to transparency and stakeholder input that would be applicable to all Ministries involved in standards/regulatory development.”³¹² The Chinese Government noted that

³⁰⁷ *Id.* at 145.

³⁰⁸ *Id.*

³⁰⁹ *Id.*

³¹⁰ *Id.* at 320–321 (Q&As 6, 8, 9).

³¹¹ *Id.* at 321 (Q&As 6, 9).

³¹² *Id.* at 342 (Q&A 3.68).

China has a vast territory and great differences exist among different provinces in geographic environment, culture and custom, but the mandatory local standards developed by different provinces comply with WTO rules In practice the mandatory local standards may vary in certain criteria but local standards shall not be in conflict with related laws, administrative regulations, and standards of a higher level [where they exist: FS] and should not adversely affect trade. Meanwhile, the Administrative Regulation on Local Standards stipulates that in case a filed local standard breaches relevant laws and regulations, the standardization authority of the State Council together with related administrative authorities will require the local government to take corrective actions with a limited time or stop implementation of the standard.³¹³

This candid and revealing reply highlights clearly the effect of geography, culture and demography on standards within China, indicates the complexity of the Chinese standards system, and invites further research to understand better the elaboration, implementation and effects of different types of standards in China.

With regard to notification, in reply to a question by Japan, the Chinese Government pointed out that a draft national standard, regardless of its effect on trade, did not need to be notified to the WTO if it was equivalent to an international standard.³¹⁴ The discussion concerned “mandatory national standards”, which in WTO terminology are technical regulations. However, the TBT Agreement provides that, if international standards exist, WTO Members “shall use them . . . as a basis” for their technical regulations, with specified exceptions, if the domestic law or regulation has “a significant effect on trade.”³¹⁵ Whether “equivalent” is the same as “based on” is a nice question of legal interpretation.³¹⁶ The United States also raised questions about notification

³¹³ *Id.*

³¹⁴ *Id.* at 111 (Q&A 25).

³¹⁵ Agreement on Technical Barriers to Trade arts. 2.4, 2.5, 2.9, Apr. 12, 1979, 1186 U.N.T.S. 276, GATT, B.I.S.D., 26th Supp. 8 (1980).

³¹⁶ See generally Appellate Body Report, *European Communities—Measures concerning Meat and Meat Products (Hormones)*, ¶¶ 160–166, WT/DS26/AB/R, WT/DS48/AB/R (Jan. 16, 1998) (adopted Feb. 13, 1998).

of food standards, pesticide maximum residue tolerances and other measures.³¹⁷ In reply, the Chinese Government provided a detailed list of measures, while offering its interpretation of the WTO notification requirements by stating that

China has notified relevant measures in strict accordance with TBT/SPS agreements. As of June 2014, China already notified to the WTO 1,200 TBT measures and 832 SPS measures. Some of [sic] measures that were not timely notified by China are in line with international standards, some slightly influence trade and others are attributed to translations of different versions or name changes to laws and regulations.³¹⁸

A related question, also by the United States, concerned China's apparently frequent practice of "citing voluntary standards in technical regulations, thereby in effect turning these voluntary standards into mandatory standards", but generally not notifying these voluntary standards to the WTO for review and comment.³¹⁹ The Chinese Government replied that China had "been actively performing its obligation of transparent notification and will further do a good job in TBT/SPS notification."³²⁰ This exchange raises specific legal issues with broader economic implications, both of which have undoubtedly been addressed already in the domestic law of China's trading partners, and which merit further attention.

IV. DISCUSSION

The TPRM deals with the institutional and normative parameters of food safety which are related directly or indirectly to trade. Following the WTO mandate, it does not deal directly with unintentional (e.g. microbial) or intentional threats to food safety, unless they are evoked in conjunction with domestic legislation, international standards or risk assessment in the context of international trade. Nevertheless, its mandate is extremely wide and concerns many aspects of domestic food safety regimes, as indi-

³¹⁷ *Supra* note 297.

³¹⁸ *Id.* at 195 (Q&A 14).

³¹⁹ *Id.* at 204 (Q&A 31).

³²⁰ *Id.* at 205 (Q&A 31).

cated by the titles of the WTO press releases for the China reviews.³²¹

The TPRM is not a negotiating forum. Nor is the TPRB a mediator, an arbitrator or a court. The TPRM combines power and interests in a heady mixture of diplomacy, power politics and more diplomacy, in which carefully phrased questions and equally carefully phrased answers convey much information and part of reality, often using legal code words or subtle legal interpretations. Nevertheless, the scope, depth, continuity and sometimes intensity of the questions indicate the importance given to the TPRM by all participating WTO Members. It furnishes a way of periodically seeking information, airing grievances, advancing criticisms, putting pressure on the country being reviewed and revisiting familiar themes, which usually, if not always, are of considerable economic interest to the Member asking the question.

Questioners and questions in reviews of China's trade policy, including food safety, evolved over time. However, they also demonstrated considerable continuity (see Table 2), which is not surprising if we consider that a small number of countries, including China, dominate world trade. Numbers for questions asked are based on the TPRB listing of questions; a single question may occasionally contain several more specific questions, so the numbers are best understood as indicators of magnitude.

TABLE 15: EVOLUTION OF QUESTIONS ABOUT FOOD SAFETY IN REVIEWS OF CHINA'S TRADE POLICY, 2006–2014

Year of TPRM	Total Questions	Number of Members Asking Questions about Food Safety	Number of Questions about Food Safety	Members Asking the Most Questions	Main Concerns
2006	>1,100	11	35	US 8, EU 8, Australia 7, South Africa 4	Domestic standards, labelling

³²¹ *Economic reform has produced impressive results but important challenges remain, supra note 55. See also Restructuring and further trade liberalization are keys to sustaining growth, supra note 44.*

2008	>900	14	95	EU 22, US 13, Canada 13, Mexico 10	Domestic standards, alignment, imports
2010	1,508	20	123	Mexico 40, Canada 19, EU 15, US 8, Brazil 8	Alignment, administrative organization, imports, GIs
2012	>1,700	19	57	EU 11, Australia 8, Indonesia 6, US 5, Brazil 5	Imports, alignment
2014	1,700	25	146	EU 19, Canada 18, India 15, Australia 14, Indonesia 14, US 13	Standards, administrative organization, notification

Source: Calculated by the author from WTO Reports.³²²

The total number of questions, including but not limited to food safety, began with approximately 1,100 questions in 2006 and rose to about 1,700 questions in 2014. Questions concerning food safety fluctuated, with a high point in 2010 following the melamine scandal and the enactment of China's first Food Safety Law in 2009. In 2006, 11 countries asked a total of 35 questions (see Table 2). Food safety in the broad sense accounted for about 3% of total questions (35 of 1100). China's major trading partners among developed countries asked almost 60% of the ques-

³²² *Supra* notes 29, 61, 86, 94, 114, 128, 129, 169, 212, 218, 256 and Trade Policy Review Body, *Trade Policy Review, People's Republic of China, Minutes of Meeting*, WT/TPR/M/161 (April 19 and 21, 2006), Trade Policy Body, *Trade Policy Review, Report by China*, WT/TPR/G/230 (April 26, 2010), except the figure of >900 for Total Questions in 2008 is from Rongzhen Yang, *Research of China's Participation in the WTO Trade Policy Review Process* (Ind. Univ. RCCPB, Working Paper No. 8, 2011).

tions: USA 8, EU 8, Australia 7, followed by South Africa 4. The main concerns were China's domestic standards and GIs. In principle, WTO law provided a foundation for the questions. For example, the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) provides for the protection of GIs, which it defines as "indications which identify a good as originating in the territory of a Member, or a region or locality in that territory, where a given quality, reputation or other characteristic of the good is essentially attributable to its geographical origin."³²³ WTO Members, including China, are required to provide legal means to allow interested parties to prevent misleading use of or unfair competition involving GIs.³²⁴ Registration of a trademark could be refused on these grounds.³²⁵

In 2008, questioners increased slightly and questions about food safety matters almost tripled as 14 countries asked a total of 95 questions. With one important exception, most questions were asked by China's major trading partners among developed countries: EC [now EU] 22, USA 13 and Canada 13 asked more than 50% of questions. However, Mexico, for whom China is the most important market outside NAFTA, asked more than 10% of questions (10); this was the first time that a developing country joined the ranks of major questioners. Note that the EC in 2008 comprised 27 countries, each of which is separately a WTO Member. In voting, EC votes are equal to the number of EC Member States. However the EC usually replaces the EC Member States in WTO meetings; in the table the EC is counted as one unit.

In 2010, compared to 2006, the number of questions about food safety tripled from 35 to 123. Those who asked questions were again among China's main trading partners, with the addition of Mexico. Mexico asked the most questions (40) and indeed almost one-third of the questions (40 of 123), mainly about market access. It also joined with the other NAFTA countries, the US and Canada, in asking a joint question. Among major developed countries, Canada led with 19, followed closely by the EU with 15, whereas the USA tied with Brazil with 8 questions. Their

³²³ WTO, *THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS* 329 (Cambridge Univ. Press 1999).

³²⁴ *Id.*

³²⁵ *Id.*

main preoccupations were the types of technical regulations and standards used in China, alignment, transparency of China's SPS measures, the multiplicity or fragmentation of administrative authorities dealing with food safety regulation, the 2009 Food Safety Law, geographical indications, and import measures and export measures.

In 2012, compared to 2010, there was a decline in the use of the Review to gather information from the Chinese Government. Approximately the same number of WTO Members asked questions as in 2010 (2010: 20, 2012: 19), though there was a slight change in the identity of the specific Members asking questions. However, it is striking that there was a considerable decrease in the number of questions (2010: 123, 2012: 57). The decline in the number of questions is mainly due to the fact that two members of NAFTA, Canada and particularly Mexico, asked far fewer questions in 2012 than in 2010 (Canada 2 in 2012 as compared to 19 in 2010, Mexico 2 in 2012 as compared to 40 in 2010). Three years after the enactment of the 2009 Food Safety Law, the Chinese regulatory system and the Chinese Government's position were well-known to most, if not all, WTO Members, notably regarding import and export, administrative organization, types of standards, alignment and GIs. Larger Members continued to persuade China to make reforms. Some Members, such as the EU, continued to seek more details about Chinese policies. Others, such as the US, were more involved in seeking solutions to outstanding issues by means of its bilateral relations with China. Members such as Mexico and others were mainly concerned with import procedures, but they already knew the basic policies, institutions and rules concerning access to China's large market. It is possible that some issues were also aired within the context of NAFTA.

In 2014, the first WTO Review of China's trade policy since the election of the new leadership in China, all WTO Members recognised the tremendous achievements of the Chinese Government, its continuing domestic reforms, the importance of China in the world trade, and its significance for the WTO multilateral system.³²⁶ Forty-five delegations intervened in the discussion on 1 July 2014, most taking the 7 minutes maxi-

³²⁶ *Supra* note 269, at 59–60, ¶¶ 5.32–5.36.

num time for each Member.³²⁷ Thirty-one Members submitted a total of 1,700 written questions.³²⁸ As the Discussant pointed out, “[i]f not a new record for the TPRB, it surely must be among the most extensive exchanges that have occurred in this important body.”³²⁹

Table 16 indicates the evolution of main subjects of questions in the reviews from 2006 to 2012.

TABLE16: MAIN SUBJECTS OF QUESTIONS IN REVIEWS OF CHINA’S TRADE POLICY, 2006–2014

Subject Matter	2006	2008	2010	2012	2014	Total
Types of standards	0	16	6	2	50	74
Alignment	2	19	10	8	3	42
Administrative organisation	0	9	14	2	8	33
Transparency	1	8	4	3	10	26
CCC	1	6	3	4	17	31
Imports	2	8	21	28	13	72
GIs	9	9	10	3	10	41

Source: Calculated by the author from WTO Reports.³³⁰

Questions came principally from China’s main trading partners, whether developed country trading partners (US, EU, Canada, Australia) or the leading BRICS (South Africa, Mexico, Brazil). In the early years, WTO Members sought basic facts about how the Chinese food safety system functioned, though some, for example the US or the EU, asked precise questions based their companies’ specific experiences of access to the Chinese market. Later, the questions frequently became more wide-ranging. From 2006 to 2012, the most frequent topics of questions have been alignment (39 questions), types of standards (24), administrative organisation (25), transparency (16), CCC (14), imports (59), GIs (31) and dairy products (5). In 2014 the types, diversity and application of standards assumed great importance, and questions regarding alignment declined, probably because the Chinese Government had clearly defined its policy and legal position. Transparency and certification remained im-

³²⁷ *Id.* at 59, ¶ 5.30.

³²⁸ *Id.* at 56, ¶ 5.2, at 2, ¶ 1.3.

³²⁹ *Id.* at 59, ¶ 5.30.

³³⁰ *Supra* note 322.

portant, while the recall system, now in reform, attracted special interest for the first time. The main factors leading to these changes would appear to be an increase in knowledge due to changes in questioners, for example, increased participation by developing countries led to more questions about import, increased knowledge due to previous reviews, and food crisis and law reform, for example, the melamine crisis and enactment of the 2009 Food Law.

Throughout the period, each Member asked questions from its own perspective and interests. Reflecting the rapid development of China's role in world trade, the Secretariat Reports, Chinese Government Reports and discussions and questions tended to become increasingly detailed, indeed legalistic. For example, it would appear that WTO Members increasingly put their concerns in the form of leading questions, which, together with more or less detailed comments, tended to suggest relevant answers. The decline in questions about types of standards is likely to be due to the fact that now the Chinese standards system is better known to China's trading partners. Alignment of domestic standards with international standards, however, has remained a major concern, and the diversity of local standards and the role of private standards emerged as new concerns. Increasing questions about transparency, administrative organisation and imports are doubtless a reflection of the increasing openness of the Chinese domestic market, together with concerns with remaining barriers to market access, while concerns about local diversity and private standards reflect the greater decentralisation of Chinese government and the increasing role of the private sector, including foreign companies, in the economy.

These questions are often put in terms of concerns for the WTO system. In addition to being phrased in systemic terms, they are systemic concerns also in the sense that playing for principles is often the best strategy for dominant players in the market.³³¹ Changes in types of question are also correlated more or less directly with changes in the identity of the Member asking the questions; an example is the role of Mexico. The increase in questions about dairy products reflected the melamine crisis. Questions about administrative organisation, which all focus on

³³¹ Marc Galanter, *Why the "Haves" Come out Ahead: Speculations on the Limits of Legal Change*, 9 *LAW & SOC'Y REV.*, 95, 123 (1974).

the fragmentation of administrative authority and responsibility in the field of food safety regulation as a whole, have also increased dramatically. The TPR appears to have contributed, however, to increased inter-departmental cooperation among Chinese administrative authorities.³³² During the period from 2006 to 2014, the replies of the Chinese Government grew increasingly sophisticated, testifying not only to the rapid development of a very complete and complex institutional and normative system for food safety matters in China but also to an increasing knowledge on the part of Chinese Government officials in dealing with the WTO institutions, the interpretation of WTO law and the TPRM in particular.

V. CONCLUSION AND RECOMMENDATIONS

China has made tremendous strides since the 1995 Food Hygiene Law in improving its system of food safety regulation, including the current draft Food Law now before the National People's Congress. Institutional reforms are still continuing. Food safety regulation today is part of global legal pluralism, in which China participates actively. Consequently, the regulation of food safety in China, as with any other WTO Member, involves relations with other WTO Members and almost inevitably is shaped or even conditioned by these relations.

For WTO Members, including China, the TPRM represents an invaluable process of mutual learning. It enables WTO Members to garner much more information about other Members' trade policy and practices than it might obtain in other ways, even though the Member whose trade policy is being reviewed may couch its replies in terms of standardised responses, give very short answers, simply refer to already published legislation, other documents or websites, or otherwise avoid answering a question directly. The TPRM can spread best practices, contribute to alignment on the basis of international norms, put pressure on Members to address specific problems in national systems of food safety regulation and create the preconditions for regulating food safety in a more coherent, more effective way. It does not create legal rights or obligations. A reply to a question in the TPR

³³² Rongzhen Yang, *Research of China's Participation in the WTO Trade Policy Review Process* 15 (Ind. Univ. RCCPB, Working Paper No. 8, 2011).

cannot in itself be the subject of WTO dispute settlement procedures, even though the TPRB, exercising a “creative function,” may make “implicit judgments, however weak, that the country has or has not complied with [WTO] rules,”³³³ and even though an empirical study of the trade policy reviews of Canada, the US and Mexico found that “the TPRM is a good predictor of member sentiment, in the sense that issues that dominate TPRs tend also to be challenged at the DSM [WTO Dispute Settlement Mechanism].”³³⁴

Within the WTO framework, the TPRM is therefore a relatively risk-free forum, despite the assumed interest of Members in controlling the type and amount of information which they provide. It can, should and does serve as a vehicle of social change toward improved regulation of food safety and public health in the interest of all citizens. In this sense, social change encompasses legislative reform, implementation of law, public and professional education and compliance with law. In the field of food safety regulation, as in other fields, we need to envisage social change as “a continuous process, not as a fixed stage of affairs and as ‘involv[ing] conflict, negotiation, compromise and mutual adjustment.’”³³⁵ In this respect, the WTO TPRM can contribute to improvement of food safety regulation in China.

We can draw several conclusions from this brief review. First, the TPRM reviews of China’s trade policy exemplify relations between different sites of governance. Second, the structural features of the TPRM shape its relations with China, and structural features of China shape China’s relations with the TPRM, for example with regard to transparency and access to information. Third, the TPRM provides a means of encouraging and stimulating the reviewed Member to provide information, engage in peer discussion of common issues and attempt to channel

³³³ Petros C Mavroidis, *Surveillance Schemes: The GATT’s New Trade Policy Review Mechanism*, 13 Mich. J. Int’l L. 374, 392 (1992).

³³⁴ Marc D. Froese, *Trade Policy Review and Dispute Settlement at the WTO*, in HANDBOOK OF THE INTERNATIONAL POLITICAL ECONOMY OF TRADE 369 (David A. Deese ed., 2014). See also Julien Chaisse & Debashis Chakraborty, *Implementing WTO Rules Through Negotiations and Sanctions: The Role of Trade Policy Review Mechanism and Dispute Settlement System*, 28 U. Pa. J. Int’l Econ. L. 153 (2007).

³³⁵ Francis Snyder, *The Effectiveness of European Community Law: Institutions, Processes, Tools and Techniques*, 56 MODERN L. REV., 19, 26 (1993).

desired reforms in a contextually acceptable direction. Fourth, the TPR may appear to be heated at times, but its effectiveness relies on discussion and peer pressure, not on legal challenges or on third-party dispute settlement institutions. Fifth, relations between the TPRM and China are reciprocal in their effects. This kind of “structural reform”³³⁶ is a common feature of legal pluralism. Within the TPRM, China’s major trading partners, acting within and therefore limited by this specific multilateral forum, often seek to promote reform of Chinese policies, institutions and laws. As this paper has suggested, nowadays China consents and cooperates, within limits, in its own changes.³³⁷ This is broadly consistent with the conclusions of Daly’s research on more than 90 TPRs of Asia-Pacific countries during a 20-year period,³³⁸ and Valdés’ study of TPRs in the western hemisphere between 1989 and 2009.³³⁹ China and its trading partners within the WTO are changing China together, again with limits, perhaps because of China’s increasing openness, perhaps because the utility of international, transnational or even foreign law, standards and best practice in the context of food safety regulation in China, and perhaps most of all because China is committed to the WTO and the multilateral forum of the TPRM.

Based on this discussion and earlier research, it is possible to identify four main challenges in the reform of Chinese food safety law: to provide consistent, coherent and effective laws, regulations and standards; to establish optimum institutional arrangements; to bring small enterprises under the food safety umbrella; and to improve enforcement and public education. To help to meet these challenges, I wish to make several general and specific recommendations.

³³⁶ *Id.* at 36.

³³⁷ Compare with JONATHAN SPENCE, *TO CHANGE CHINA: WESTERN ADVISOR IN CHINA* (Penguin Books 1980) (giving numerous examples in which Chinese did not consent to, did not cooperate in or resisted changes suggested, encouraged or enforced by outsiders).

³³⁸ Michael Daly, *Evolution of Asia’s Outward-Looking Economic Policies: Some Lessons from Trade Policy Reviews* 50 (WTO, Econ. Research and Statistics Division, Working Paper ERSC-2011-12, 2011), http://www.wto.org/english/res_e/reser_e/ersd201112_e.pdf.

³³⁹ Raymond Valdés, *Lessons from the First Two Decades of Trade Policy Reviews in the Americas* (WTO, Econ. Research and Statistics Division, Working Paper ERSC-2010-15, 2010), http://www.wto.org/english/res_e/reser_e/ersd201015_e.pdf.

The general recommendations are as follows:

- The Chinese Government should continue to participate actively in the WTO TPRM, not only as a Member being reviewed, but also including all other occasions.
- China should practice and insist on scrupulous respect for WTO notification requirements. Such practice will help to enhance China's international credibility and soft power.
- China should practice and insist on WTO canons of interpretation, based clearly on the Vienna Convention of the Law of Treaties as elaborated by the case law of WTO panels and the Appellate Body.
- China should find its own path to guarantee food safety on the basis of its own priorities, for example in selective adoption of international standards and best practices which are appropriate for the Chinese context.
- Competition regarding standards is inevitable in the global economy today, but it is important to recall that ensuring food safety and a successful food safety regime are much broader than standards alone.
- China may learn much from other WTO Members, not only those with very advanced systems of food safety regulation, which might supply useful models or helpful suggestions, but also from those at the same level of per capita income, which can provide necessary comparators for domestic reforms. The latter group is often neglected in thinking about reforms of China's food safety regime, but it may provide many useful lessons for law and practice regarding food safety in China.

The specific recommendations are as follows:

- China's food safety regime should be based on clearly articulated principles: (a) national strategy, goals and substantive principles, (b) focus on prevention, (c) traceability, (d) enterprise responsibility, (e) local enforcement, (f) strategic alignment with international standards and (g) diversity, experimentation and adaptation.

- Risk management should be based on a precautionary principle.
- Special efforts should be made to improve consistency and economy of legislation.
- Relations between different types of standards need to be clarified.
- An integrated institutional framework is essential in order to preserve safety in the entire food supply chain.
- Public-private partnerships should be encouraged in developing and applying standards.
- All enterprises operating in the market should be required to have an appropriate licence.
- Small workshops should be given high priority, with attention to social justice.
- Transparency, information sharing and reporting should be encouraged and supported.
- Much more importance should be given to public education and preservation of integrity.
- China should adopt a specific national food safety strategy, which would set down goals, means, benchmarks and procedures for the short term (1–4 years), medium term (5–9 years) and long term (10 years or more).

Recent legislative reforms, including the current draft, have adopted some of these suggestions. In considering these recommendations, however, it is useful to recall that law reform cannot be reduced to legislative reform. Law reform takes account of reform of legislation, implementation of legislation and compliance with legislation. In other words, it involves much broader social processes, it reflects the fact that law and legal culture are deeply embedded in specific societies and thus it invites us to try to understand the real meaning of law in society.

Competition Law Meets Corporate Governance: Ownership Structure, Voting Leverage, and Investor Protection of Large Family Corporate Groups in Korea

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ABSTRACT

In Korea, the Monopoly Regulation and Fair Trade Act (MRFTA), competition law, applies to corporate law issues of chaebols, large family corporate groups. In this context, this Article analyzes a chaebol controller's incentive mechanism, private benefit extraction, and the controlling minority structure (CMS). In relation to voting leverage, this Article recommends that the Korean legal system not adopt the dual-class equity structure. Based on law and economics analysis, this Article also examines why a holding company system generally possesses comparative advantages over circular shareholding in terms of the possibility of restructuring, ownership structure transparency, and minority shareholder protection. In particular, this Article explains that due to combined two network effects in a chaebol ("Type I and II network effects"), tunneling could be worse under circular shareholding than under a holding company system. In addition, this Article discusses that due to the complicated cross-ownership among chaebol affiliates ("Type I network effect"), the CMS can be more sustainable under a holding company system than under circular shareholding.

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Generally, we use English versions of statutes translated by the Korea Legislation Research Institute. We rely on the Commercial Act and the Monopoly Regulation and Fair Trade Act (MRFTA) effective as of September 2014, and the Telecommunication Business Act effective as of April 2003.

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I. INTRODUCTION

It is virtually impossible to explain the economic miracle of South Korea (hereinafter Korea)¹ without understanding the role and development of *chaebols*, large corporate groups dominated by controlling family shareholders.² Currently, *chaebols* such as Samsung Group, Hyundai Motors Group, and LG Group successfully compete in the global market, representing the prosperity of Korean economy. On the other hand, *chaebols* have generated a variety of socio-economic and even political problems that have overshadowed Korean society for a long time.

The core problem with *chaebols* lies in the fact that economic power in the domestic market is disproportionately concentrated in them. Most of all, affiliated companies of *chaebols* are quasi-monopolistic players in almost all the product and service markets in Korea. In addition, since a *chaebol* is usually composed of more than 50 affiliates,³ a small number of *chaebols* can dominate the entire Korean economy.⁴ Due to the concerns raised by such a concentration of economic power, *chaebols* have been regulated by the Monopoly Regulation and Fair Trade Act (MRFTA), competition law.

The MRFTA plays another key role. Corporate law in Korea—a chapter of the Commercial Act—is basically designed to regulate stand-alone “companies.” Legally speaking, an affiliated

¹ See Dani Rodrik, *Getting Interventions Right: How South Korea and Taiwan Grew Rich*, 10 *ECON. POL'Y* 55, 55 (1995) (“In 1960, South Korea was poorer than many sub-Saharan African countries.”). For example, the per capita Gross Domestic Product (GDP) of Korea in 1960 was similar to that of Ghana. Their per capita GDP was \$883 measured in 1985 U.S. dollars. *Id.* at 56 (citing Penn World Trade Table 5.5.). As of 2013, the current per capita GDP of Korea is \$25,977. See *GDP Per Capita (Current US\$)*, THE WORLD BANK, <http://data.worldbank.org/indicator/NY.GDP.PCAP.CD> (last visited Dec. 28, 2014).

² See generally Ronald J. Gilson & Curtis J. Milhaupt, *Economically Benevolent Dictators: Lessons for Developing Democracies*, 59 *AM. J. COMP. L.* 227, 243–49 (2011) (explaining economic development of Korea based on the *chaebol* system).

³ See *infra* Table 1 (showing the numbers of affiliated companies in *chaebols*).

⁴ Suppose that there are 200 corporations in a country with a *chaebol* system. If each *chaebol* has 50 affiliates, there are only four *chaebols*.

company of a *chaebol* is an independent legal person. In the hierarchical management structure and control ownership within a “corporate group,” however, the *chaebol* acts like one unified economic organization, so that in practice the affiliate is treated as a component, rather than a distinct legal entity, of the *chaebol*. In this respect, corporate law does not reflect the reality of the Korean economy where a decision-making entity is not a “corporation” (affiliate) but a “corporate group.” In order to fill this regulatory gap, it is necessary that the MRFTA—which is designed to regulate “corporate groups”—applies to corporate governance issues in *chaebols*. Similarly, the Korea Fair Trade Commission (KFTC)—the Korean equivalent of the U.S. Federal Trade Commission (FTC)—polices corporate law problems in large corporate groups as well, just as the Securities and Exchange Commission (SEC) polices certain corporate governance problems in public companies in the United States.

A primary corporate governance issue emphasized by the MRFTA is voting leverage in a corporate group. Through cross-ownership or stock pyramiding, a controlling shareholder (and the family) can inflate voting power while holding a mere fraction of an economic stake in a *chaebol*.⁵ In this sense, the ownership structure of a typical *chaebol* is referred to as the “controlling minority structure” (CMS) since the “controlling” shareholder is actually a “minority” shareholder in terms of ownership.⁶ Indeed, this phenomenon of separation of control from ownership is a principal cause of corporate governance problems in *chaebols*.⁷ The CMS can distort the incentive mechanism of a controlling minority shareholder, resulting in benefiting him to the detriment of non-controlling minority shareholders.

Traditionally, circular shareholding has been used as an effective voting leverage device for a typical *chaebol* controller. It

⁵ See generally Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP (Randall K. Morck ed., 2000), available at <http://www.nber.org/chapters/c9013.pdf>.

⁶ For a further explanation of the CMS, see generally *id.* See also *infra* Part II.B.

⁷ See, e.g., Ok-Rial Song, *The Legacy of Controlling Minority Structure: A Kaleidoscope of Corporate Governance Reform in Korean Chaebol*, 34 LAW & POLY INT'L BUS. 183, 244–45 (2002).

becomes more effective as the number of affiliates in a *chaebol* grows, since the controlling shareholder can utilize more ownership connections.⁸ Since the Asian financial crisis at the end of the 1990s, a holding company system—which had until then been prohibited—was introduced in the MRFTA. In addition, the KFTC has recommended that *chaebols* transform their ownership structure to a holding company system to improve transparency in ownership structures and restructure the corporate sector.⁹ Nonetheless, few, if any, studies so far examine from a rigorous law and economics perspective the impacts of circular shareholding and a holding company system on corporate governance.

Against this backdrop, with respect to investor protection, this Article explores potential concerns as well as comparative advantages of a firmly established holding company system.¹⁰ In particular, the Article demonstrates that the complicated network effects make it more difficult for outsiders (e.g., public investors) to recognize and respond to agency problems created by the *chaebol* controller and his managers.¹¹ Such network effects would be mitigated to a great extent under a holding company system due to a simple and transparent linear structure.

In addition, this Article examines why recently *chaebol* controlling families are more interested in a holding company system by explaining the nature of circular shareholding's inherent instability, regulatory environment, and a controlling shareholder's family issues (e.g., inheritance and family feuds).¹² Also, this Article proposes that under the current situation where circular shareholding and stock pyramiding are available, the dual-class equity structure—which business circles in Korea have attempted to place in the legal system—should not be introduced. This is because a *chaebol* controller's disproportionately large voting rights, compared to his cash flow rights, will be even larger under the cumulative effect of more than two voting leverage devices.

⁸ See *infra* Part II.B.3.

⁹ For a further analysis of merits of a holding company system, see *infra* Part III.B.

¹⁰ See *infra* Part III.B–D.

¹¹ See *infra* Part III.B (explaining Type I and Type II network effects with respect to a controlling shareholder's extraction of private benefits).

¹² See *infra* Part III.C.

The remainder of this Article is structured as follows. Part II sketches a *chaebol*-based economy in Korea. It explains typical characteristics of *chaebols* and the CMS. In addition, direct cross-shareholding and circular shareholding are compared. Subsequently, a *chaebol* controller's self-dealing problem is examined in the context of the CMS. Part III discusses a holding company system in more depth. Merits of a holding company system in terms of corporate governance are analyzed. In addition, this Part explains that a holding company system is a more secure ownership structure for a *chaebol* controller and his family than circular shareholding. Subsequently, further considerations regarding a holding company system and its corporate governance features are discussed. Part IV summarizes and concludes.

II. CHAEBOL: OWNERSHIP STRUCTURE AND GOVERNANCE ISSUES

Despite the success of the *chaebol* system in Korea, *chaebols* have been heavily criticized for their monopolistic nature and corporate governance problems.¹³ This Part first introduces the central features of *chaebols* and subsequently analyzes a typical *chaebol's* ownership structure and corporate governance issues regarding the controlling shareholder's private benefits.

A. Chaebol: Overview and Ownership Concentration

There are a large number of corporate governance studies on Korean *chaebols*. Interestingly, however, a *chaebol* is not defined precisely as an academic or a legal term. For example, even the MRFTA—the administrative law designed to mainly regulate *chaebols*—does not use the term *chaebol* but rather “enterprise group” (i.e., corporate group), a broader concept than *chaebol*. Indeed, *chaebol* is merely a colloquial expression for a large private business entity in Korea. Nonetheless, there are generally accepted features of a *chaebol*.

¹³ See generally Jeong Seo, *Who Will Control Frankenstein?: The Korean Chaebol's Corporate Governance*, 14 CARDOZO J. INT'L & COMP. L. 21 (2006) (explaining corporate governance problems and ownership structure issues of *chaebols*).

Most of all, a *chaebol* is a “large corporate group” consisting of independent affiliated companies.¹⁴ Thus, a large conglomerate with multiple departments (rather than a corporate group with multiple legal entities) is not a *chaebol*. Another important condition is the presence of a “controlling shareholder.” For example, Korea Electric Power Corporation (KEPCO), a corporate group larger than Hyundai Motors Group, the second largest *chaebol*, is not a *chaebol* since its shareholding is dispersed and control does not belong to a single person. In addition, a controlling shareholder should be a natural person. As a result, a large corporate group with a legal person in control is not considered a *chaebol*. Also, given that a *chaebol* is a family-based corporate entity, it is expected that its control is inherited to the next generation (or siblings and other family members in rare cases).

Moreover, the ownership structure of a typical *chaebol* is characterized by the CMS. Based on the CMS, a controlling shareholder can control a large number of affiliated companies (e.g., 50 affiliated companies) with his limited capital. Accordingly, the *chaebol* achieves a diversified business portfolio with vertical and horizontal integration, producing from “(potato) chips to (semi-conductor) chips” or from “chips to ships.”¹⁵ As a result, the product markets and the financial markets are dominated by a handful of controlling shareholders. Put differently, “ownership concentration” (OC)¹⁶—a phenomenon where the vast majority of the decision-making power of a large economic entity belongs solely to one controlling family shareholder—

¹⁴ Although a clear numerical standard does not exist, a corporate group with an asset size of 5 trillion won is generally deemed to be a *chaebol*. According to the current exchange ratio, one dollar is equivalent to 1,047.7 won as of October 29th 2014. See Korea Exchange Bank, <http://fx.keb.co.kr/FER1101C.web?schID=fex&mID=FER1101C> (last visited Dec. 28, 2014).

¹⁵ See, e.g., Don Kirk, *Pressure on Chaebol: Change Now or Break Up*, N.Y. Times (Dec. 4, 1997), <http://www.nytimes.com/1997/12/04/news/04iht-chaebol.t.html>. A *chaebol*'s ownership of a bank is highly regulated. However, non-banking financial institutions are permitted as affiliates with fewer restrictions and regulations.

¹⁶ See, e.g., Doo-Jin Kim, *Regulation of Over-concentration of Economic Power in the Monopoly Regulation and Fair Trade Act*, 2006 KOREA LEGIS. RES. INST. 19 (explaining OC).

deepens in the *chaebol*-oriented economy. Table 1 provides an overview of the largest *chaebols* in Korea.¹⁷

TABLE 1: LARGEST *CHAEBOLS* IN KOREA (AS OF APRIL 2014)¹⁸

Rank	<i>Chaebol</i>	Controlling Shareholder	Number of Affiliated Companies	Asset Size ¹⁹
1	Samsung	Kun-Hee Lee	74	331,444
2	Hyundai Motors	Mong Koo Chung	57	180,945
3	SK	Tae-Won Choi	80	145,171
4	LG	Bon-Moo Ku	61	102,060
5	Lotte	Kyuk-ho Shin	74	91,666
6	Hyundai Heavy Industries	Mong-Joon Chung	26	58,395
7	GS	Chang-Soo Huh	80	58,087
8	Hanjin	Yang Ho Cho	48	39,522
9	Hanwha	Seung Youn Kim	51	37,063
10	Doosan	Yong-Gon Park	22	30,021

¹⁷ In addition to the Authors' explanation, the following description of a *chaebol* is also useful and informative. See Gilson & Milhaupt, *supra* note 2, at 246.

[*Chaebol* structures] feature a de facto holding company under the direct control of the founding entrepreneur or his heirs, and an elaborate web of subsidiaries—some with minority public investors, many without—bound together through cross- and pyramidal shareholding structures and interlocking directorates. These shareholding patterns magnify the voting rights of the founding family, allowing it to retain control over the group despite massive growth and diversification of the underlying businesses. Cross-subsidization of intra-group firms is common, and balance sheets show high leverage, reflecting the traditional reliance on debt finance for expansion.

¹⁸ Modified from the KFTC's raw data (deleting data of non-*chaebol* corporate groups), <http://www.ftc.go.kr/info/dataopen/openOpniList1.jsp> (last visited Dec. 9, 2014).

¹⁹ Asset size is measured in Korean won (1 billion won).

B. *Chaebols' Ownership Structure: Controlling Minority Structure*

When shareholders own stock, they generally have two rights in return for their investment: (1) they receive dividends from a corporation (cash flow rights); and (2) they cast votes in relation to important corporate events such as director election, mergers and acquisitions, and charter amendment (voting rights). In principle, shareholders' voting rights are proportional to their cash flow rights under the one-share-one-vote rule. For instance, a shareholder's voting rights amount to 5% when he holds 5% of the common stock. Under the CMS, however, this principle does not hold, so it is possible that a shareholder with a 5% economic interest can cast 51% of votes. Due to its inherent nature of a wide discrepancy between ownership and control, the CMS distorts a controlling shareholder's economic incentive.

1. Controlling Shareholder as a Minority Stock Owner

To control a large number of affiliated companies, a dominant shareholder in a *chaebol* with a limited financial capability typically has to rely on the CMS. As the term explains itself, a CMS controller has two opposing characteristics.²⁰ On the one hand, he is characterized as a "minority" shareholder due to his status with a fractional ownership of stock in a *chaebol*. Since 2000, for example, the ownership that controlling shareholders of the ten largest *chaebols* hold has been around 1% (in particular, it is 0.9% in 2014²¹).

On the other hand, the dominant shareholder in the CMS is a "controlling" shareholder since he is able to wield a majority of voting rights in a corporate group through voting leverage mechanisms.²² In theory, there are three voting leverage mecha-

²⁰ See Song, *supra* note 7, at 201 ("The controlling families [in Korea] have been able to control the affiliated firms by directly owning only around 10% of total cash flow rights. Therefore, the direct contrast between the owner-controlling system (CO structure) and the professional non-owning manager controlling system (DO structure) is misleading in the sense that controlling families in Korea do not really own 'majority' shares.").

²¹ KOREA FAIR TRADE COMM'N, STOCK OWNERSHIP OF LARGE CORPORATE GROUPS IN 2014, at 4 (2014), available at http://www.ftc.go.kr/news/ftc/reportRelationView.jsp?report_data_no=5722 (last visited Dec. 28, 2014).

²² See generally Bebbchuk et al., *supra* note 5.

nisms:²³ (1) the dual-class equity structure, which is used in the United States, is not allowed in Korea since the one-share-one-vote rule prohibits such a mechanism;²⁴ (2) stock pyramiding is available in Korea since a holding company system is in principle allowed with some restrictions under the MRFTA; and (3) “cross-ownership”—an ownership structure where more than two corporations have an economic stake and ownership relations with each other—has been popularly used in Korean corporate groups.²⁵

Three points are worth noting. First, in Korea the CMS and its voting leverage devices—which are topics of corporate governance—are mainly regulated by the MRFTA, competition law. Second, stock pyramiding and cross-ownership are concepts based on the notion of a corporate group with more than two corporations. To the contrary, the dual-class equity structure is available although there is only one corporation. Third, in this Article, cross-ownership is classified into two sub-concepts: “direct cross-shareholding” and “circular shareholding.”²⁶ Direct cross-shareholding is defined as the ownership structure between two corporations. For example, Company A holds stock in Company B that holds stock in Company A.²⁷ Circular shareholding refers to an ownership structure among at least three corporations. The simplest form is when Company A holds stock in Company B, which holds stock in Company C, which holds stock in Company A.²⁸ Of course, a more complicated form of circular shareholding is possible as the number of affiliates grows.

When cross-ownership is available, fictitious capital can be made.²⁹ Accordingly, the capital adequacy principle in corporate

²³ *Id.* (explaining voting leverage mechanisms such as the dual-class equity structure, stock pyramids, and cross-ownership).

²⁴ Commercial Act art. 369(1) (“A shareholder shall have one vote for each share.”).

²⁵ For a further explanation of a controlling shareholder ownership (including the CMS), see Sang Yop Kang, *Re-envisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Often Embrace*, 16 U. PA. J. BUS. L. 843, 851–54 (2014).

²⁶ Generally, literature on this topic in English often uses the terms “cross-ownership,” “cross-shareholding,” “intra-shareholding,” “circular ownership” and “circular shareholding” interchangeably and in a manner that is not unified. In this Article, however, our analysis is based on the clear distinctions among “cross-ownership,” “direct cross-shareholding,” and “circular shareholding.”

²⁷ See OH SEUNG KWON, *ECONOMIC LAW* 249–50 (11th ed. 2014).

²⁸ *Id.* at 250.

²⁹ HYUN YOON SHIN, *ECONOMIC LAW* 214 (6th ed. 2014).

law could be weakened,³⁰ potentially jeopardizing creditors' protection. In addition, the control relationship between affiliated companies is murky. For instance, in the above direct cross-shareholding example,³¹ it is unclear whether Company A owns (or controls) Company B or vice versa. A similar question arises between Company A and Company C in the simplest model of circular shareholding: which company owns (or controls) which?³² Although Company A does not directly hold shares in Company C, Company A indirectly (through Company B) has an economic interest in Company C. Also, a controlling shareholder—if any—would have voting rights or influence in both corporations via fictitious capital.³³ In particular, when a large number of affiliated companies generate a more complex matrix form of circular-shareholding, a dominant shareholder—based on indirect voting through control chains connected among affiliated companies—can easily inflate voting rights beyond his real capital investment. In other words, by dominating the boards of directors of affiliated companies that are “shareholders” of other affiliates, a dominant shareholder with a small economic interest in a corporate group controls the entire *chaebol*.

Also, the concept of “internal ownership” in a corporate group is noteworthy. The internal ownership is the sum of ownership stakes of a controlling shareholder, his family, executives of affiliates, and affiliated companies.³⁴ In practice, a controlling shareholder and his family can exercise control over executives of affiliates via employment relationship and affiliated companies via ownership connections. Thus, as the internal ownership of a *chaebol* is higher, the controlling shareholder's control over affiliated companies is more powerful and entrenched. Table 2 provides the internal ownership of the largest 10 *chaebols* during the past 5 years (expressed in terms of percentage). This Table reflects how *chaebols* heavily rely on the ownership stake of affiliated companies and overcome the problem of a controlling

³⁰ *Id.*

³¹ See *supra* note 27 and accompanying text.

³² See *supra* note 28 and accompanying text.

³³ See SHIN, *supra* note 29, at 214.

³⁴ *Fair Trade Commission News: Stock Ownership of Large Corporate Groups in 2014*, KOREA FAIR TRADE COMM'N (July 10, 2014, 13:48), http://www.ftc.go.kr/news/policy/competeView.jsp?news_div_cd=1&news_no=2246 (explaining the concept of the internal ownership).

shareholder's (or his family's) small economic interest. For example, in the four largest *chaebols*, a controlling shareholder and the family hold 0.9% and 1.2% ownership respectively in 2014. In this same year, the weights of the internal ownership of the four largest *chaebols* and the next six largest ones are 48.3% and 59.2% respectively.

TABLE 2: INTERNAL OWNERSHIP IN THE LARGEST *CHAEBOLS* DURING THE RECENT 5 YEARS (UNIT: PERCENTAGE)³⁵

	<i>Chaebols</i> (Top 1~4 in terms of size)					<i>Chaebols</i> (Top 5~10 in terms of size)				
	Controlling Shareholder	Controlling Family	Affiliated Companies	Etc.	Total	Controlling Shareholder	Controlling Family	Affiliated Companies	Etc.	Total
2010	1.1	1.3	41.8	2.9	47.1	0.9	3.4	41.1	2.5	47.9
2011	1.0	1.3	44.8	2.6	49.8	1.1	2.9	53.9	2.0	59.8
2012	0.9	1.2	48.1	2.3	52.5	1.0	2.8	55.1	2.4	61.3
2013	1.0	1.3	44.4	1.4	48.1	1.0	3.3	54.1	2.4	60.8
2014	0.9	1.2	44.7	1.5	48.3	0.9	3.0	53.3	2.1	59.2

Another important legal issue in relation to a *chaebol* is whether the dual-class equity structure should be allowed in the Korean legal system.³⁶ The dual-class equity structure is used by some U.S. business entities such as Warren Buffett's Berkshire Hathaway,³⁷ Facebook,³⁸ and Google. For example, in Berkshire Hathaway, "[t]he Class B stock is worth 1/30th of the Class A stock. But the Class B shares have 1/200th of the voting rights of the Class A version, according to a 2003 memo from Buffett."³⁹ In the United States "[m]any families and individuals who start companies grant themselves these special voting shares as a way to preserve control of the company while selling shares to the public."⁴⁰ In addition, the dual-class equity structure is implemented in a corporation as a built-in defense device insulating corporate insiders from the hostile takeover market. Indeed, there

³⁵ See KOREA FAIR TRADE COMM'N, *supra* note 21, at 4.

³⁶ See generally Yang Kyoong Park, *Economic Analysis of Dual Class Stock*, 18 J. REG. STUD. 143 (2009) (advocating dual-class equity structure).

³⁷ Alistair Barr, *Buffett Defends Newspapers' Dual-class Shares*, MARKETWATCH (May 5, 2007, 5:15 PM), <http://www.marketwatch.com/story/buffett-defends-dual-class-shares-for-newspapers>.

³⁸ Brad Stone, *Facebook Will Form 2 Classes of Stock*, N.Y. TIMES (Nov. 24, 2009), http://www.nytimes.com/2009/11/25/technology/internet/25facebook.html?_r=0.

³⁹ See Barr, *supra* note 37.

⁴⁰ See Stone, *supra* note 38.

is wide criticism of the dual-class equity structure in the United States, since it disenfranchises public shareholders.⁴¹

In this respect, it would be more inappropriate to adopt the dual-class equity structure in Korea, in particular for *chaebols*. This is because Korea is exposed to more serious corporate governance problems caused by self-dealing in a corporate group than the United States, which redresses a controlling shareholder's agency problem relatively well. Also a controlling family shareholder in a *chaebol* already benefits from a great deal of discrepancy between the voting rights and equity investment under the current system. In other words, given the seriously biased CMS in favor of a *chaebol* controller who relies on circular shareholding or a holding company system, additional availability of the dual-class equity structure would generate excessively disproportionate voting rights compared to a controller's economic interest in a *chaebol*.

2. Direct Cross-Shareholding

In Korea, direct cross-shareholding is heavily regulated in a cumulative way (through the Commercial Act and the MRFTA).⁴² According to Article 342-2(1) of the Commercial Act, in principle a subsidiary may not acquire shares of a parent company.⁴³ In cases where a parent-subsidiary relationship is not present, two corporations with direct cross-shareholding are subject to the restriction regarding voting power in accordance with the Commercial Act Article 369(3).⁴⁴ Besides the Commercial Act, the MRFTA imposes additional regulations on direct cross-shareholding. According to Article 9(1) of the MRFTA, in principle “[a]ny company belonging to an enterprise group whose

⁴¹ *Id.*

⁴² See KWON, *supra* note 27, at 249–50 (explaining the Commercial Act art. 342-2(1) and art. 369(3)).

⁴³ Commercial Act art. 342-2(1) (“In case[s] where a company (hereafter referred to as the ‘parent company’) holds more than 50/100 of the total issued and outstanding shares in another company (hereafter referred to as the ‘subsidiary company’), the subsidiary company may not acquire shares in the parent company . . .”).

⁴⁴ Commercial Act art. 369(3) (“In case[s] where] a company, its parent company and its subsidiary company together, or its subsidiary company alone holds more than 1/10 of the total issued and outstanding shares in another company, the shares of the company or of the parent company held by such another company shall not be entitled to vote.”).

total assets [are more than 5 trillion won] . . . shall not acquire or own stocks of an affiliated company which acquires or owns its stocks”⁴⁵

3. Circular Shareholding

In terms of the power of voting leverage, circular shareholding is more efficient to a controlling shareholder than direct cross-shareholding for the following reason. For instance, when there are 3 affiliated companies (Company A, B, and C), theoretically there are 3 possible ownership connections, provided that direct cross-shareholding is not allowed (ownership connections between Company A and B, Company B and C, and Company C and A).⁴⁶ Likewise, to generalize, when there are “N” affiliated companies in a corporate group, there are potentially “ $N \times (N - 1) / 2$ ” ownership connections among affiliated companies.⁴⁷ In other words, as “N” grows, basically the total number of ownership connections increases exponentially (simply put, “N-squared” or “ N^2 ”). We call this exponential increase of ownership connections the “Type I network effect in a *chaebol*.”

According to Table 1, the number of affiliated companies of the ten largest *chaebols* is 573, meaning that on average a large *chaebol* has 57.3 affiliated companies. Thus, *theoretically* there could be 1,596 ownership connections if an average *chaebol* relies on circular shareholding without further regulation (when $N = 57$).⁴⁸ The *chaebol* that holds the largest number of affiliates is SK Group with 80 affiliated companies.⁴⁹ In this case, suppose

⁴⁵ The Monopoly Regulation and Fair Trade Act (MRFTA) art. 9(1). As for the standard of total assets (5 trillion won) and exceptions, see the Enforcement Decree of the Monopoly Regulation and Fair Trade Act art. 17 (explaining the criteria of an enterprise group subject to the limitations on direct cross-shareholding).

⁴⁶ When direct cross-shareholding is available, the total number of ownership connections among three affiliates doubles to six.

⁴⁷ Each company has possibly ownership connections with “ $(N - 1)$ ” affiliated companies. Since there are “N” affiliated companies, the possible total number of ownership connections in a corporate group is “ $N \times (N - 1)$.” However, since the ownership connections “from Company A to Company B” and “from Company B to Company A” are duplicative and amount to prohibitive direct cross-shareholding, the possible total number of ownership connections should be divided by two. See Kang, *supra* note 25, at 853 n.52.

⁴⁸ $(57 \times 56) / 2 = 1,596$.

⁴⁹ GS Group has 80 affiliated companies as well. See *supra* Table 1.

that SK Group solely uses circular shareholding without relying on a holding company system (which does not reflect the current situation since SK Group was mainly transformed into a holding company system). Then, the number of potential ownership connections in each corporate group would be 3,160.⁵⁰ In sum, based on Type I network effect, a controlling shareholder has more leeway to create a complicated ownership structure in his favor, resulting in enhanced voting power.

In this respect, if cross ownership is regulated due to the distortion of ownership structures and a controlling shareholder's incentive mechanism, circular shareholding should be regulated more strictly than direct cross-shareholding. Interestingly, however, in principle heavy regulations on direct cross-shareholding—as discussed above⁵¹—did not apply to circular shareholding for a long time. Indeed, circular shareholding—a legal loophole that *chaebol* controllers found—had been generally permitted until recently.⁵² Accordingly, the problem of regulatory arbitrage between different voting leverage devices emerged. For example, when a controlling shareholder was subject to regulations imposed on direct cross-shareholding between two companies, he could avoid such regulations by connecting ownership structures of two companies with that of the third company and utilizing circular shareholding.

From a controlling shareholder's *personal* point of view (rather than from the standpoint of a corporate group), relying on circular shareholding—by creating as many affiliated companies in a *chaebol* as possible—is beneficial. Based on a powerful voting leverage device of circular shareholding, the controlling shareholder controls a large business fleet and has the opportunity to take private benefits from minority shareholders.⁵³ Although the controlling shareholder is the most favored beneficiary of circular shareholding, circular shareholding does not cost him personally very much. Formally speaking, circular shareholding is affiliates' collective choice (through the controlling shareholder's inflated voting power) rather than the controller's choice. As

⁵⁰ $(80 \times 79) / 2 = 3,160$.

⁵¹ See *supra* Part II.B.2.

⁵² See *infra* note 58.

⁵³ For a further explanation of a controlling shareholder's private benefits of control, see *infra* Part II.C.

such, affiliated companies bear the cost. As a shareholder of affiliated companies, the controlling shareholder ultimately assumes the cost on a pro-rata basis. However, the controller's ownership stake is minimal under the current CMS in Korea.⁵⁴

Cognizant of circular shareholding's advantages in favor of a *chaebol* controller and of the regulatory arbitrage problem between circular shareholding and direct cross-shareholding, the MRFTA has attempted to fill the regulatory gap through several means. For example, in the past a "total equity investment ceiling" (TEIC) was used as a policy tool in order to limit equity investment among affiliated companies.⁵⁵ Accordingly, the TEIC regulated circular shareholding and weakened a controlling shareholder's disproportionate voting power to some extent.⁵⁶ Of course, *chaebols* (more precisely, *chaebol* controllers) were strongly opposed to the TEIC. Nonetheless, many scholars and practitioners argue that even the TEIC was not a sufficiently effective regulation to curb a controlling shareholder's CMS strategy.

During the reign of former President Myung-Bak Lee, the Korean government implemented several business-friendly policies and repealed the TEIC with the support of the National Assembly.⁵⁷ As a result, the effectiveness of circular shareholding as a *chaebol* controller's primary tool to increase voting power was enhanced. However, since current President Keun-Hye Park came to office, the government readjusted its policy regarding circular shareholding in order to lessen the concentration of *chaebols'* economic power. A variety of policy suggestions were proposed and discussed, including the dissolution of all circular shareholding in *chaebols*. *Chaebols* lobbied against such drastic proposals. Finally, through the revision of the MRFTA in January 2014, a compromised solution emerged: *chaebols* are no longer allowed to form new circular shareholding.⁵⁸ Also, it is recommended that existing circular shareholding be resolved.

⁵⁴ See *supra* Table 2.

⁵⁵ See Woochan Kim et al., *Group Control Motive as a Determinant of Ownership Structure in Business Conglomerates: Evidence from Korea's Chaebols*, 15 PACIFIC-BASIN FIN. J. 213, 231 (2007).

⁵⁶ *Id.*

⁵⁷ See KOREA FAIR TRADE COMM'N, FAIR TRADE WHITE PAPER 2010, at 276–77 (2010) (explaining chronology of the TEIC).

⁵⁸ MRFTA art. 9-2(2).

C. The Controlling Minority Structure and the Private Benefits of Control

In a *chaebol*, managerial shirking can be monitored and regulated relatively well by the presence of a strong controlling shareholder. In this sense, minority shareholders get a free-ride for enhanced management efficiency. On the other hand, minority shareholders are exposed to the risk of a controlling shareholder's "tunneling," a term to "describe the transfer of assets and profits out of firms for the benefit of those who control them."⁵⁹ Due to the centralized feature of a *chaebol*, a fundamental problem is that a controlling shareholder is able to direct management and even the board of directors of an affiliate to extract corporate value for the controller. Simply put, in practice executives and directors of affiliates are used as "tools" or "retainers" for private benefits of the controller.

It is generally known that unfair self-dealing among affiliated companies is the most salient corporate governance problem in Korea.⁶⁰ In the United States, jurisprudence and case law regarding a controlling shareholder's self-dealing have been developed along with corporate law and courts mainly in Delaware. In Korea, basically the Commercial Act, which includes a chapter on corporate law, regulates self-dealing. However, the Commercial Act is not an effective law that governs self-dealing within a *chaebol*. It is partly because the Commercial Act is designed to apply to a stand-alone corporation rather than a corporate group. In addition, the private litigation mechanism provided by the Commercial Act is still underdeveloped. To fill this regulatory gap, the MRFTA—competition law aimed to regulate powerful enterprise groups—provides stringent regulations against self-dealing in a corporate group context.⁶¹

For example, according to Article 23-2 of the MRFTA, a controlling shareholder and his family shall be prohibited from obtaining unjustified benefits within a corporate group.⁶² Unfair

⁵⁹ Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22, 22 (2000) (expounding on the term "tunneling").

⁶⁰ See generally Haksoo Ko, *Dealing with Corporate Self-Dealing in Korea: A New Institutional Law and Economic Approach*, 17 ASIA PAC. L. REV. 201 (2009) (explaining issues in relation to self-dealing in Korea).

⁶¹ See *id.* at 202.

⁶² MRFTA art. 23-2.

self-dealing often takes place in the form of an internal transaction among affiliated companies. In the transaction, a company where a controlling shareholder (or his family) holds a large economic stake has more favorable terms and conditions than the other company where he (or his family) holds a small economic stake. For instance, it is possible that a controlling shareholder sets up a company which is 100% owned by his son. Through repeated transactions beneficial for the son's company, the son—the sole shareholder of the company—reaps extraordinary profits from an affiliated company with a large number of public shareholders.

In the case of a large discrepancy between cash flow rights and voting rights (i.e., the deep CMS, which is common in Korea), the economic incentive mechanism of a controlling shareholder is distorted. This is because the controller's interest is not aligned with the interest of the corporation that he controls. Thus, in the worst case scenario, the controlling shareholder benefits even if his decision intentionally hurts affiliated companies and the public minority shareholders of such companies. Nonetheless, it is fair to say that the discrepancy between two rights is merely an indicator to show the "potential" harm to minority shareholders from tunneling. Radical separation of control and ownership turns out to be problematic only when the controller is actually involved in an unfair internal transaction. In this respect, when it comes to self-dealing, legal issues and economic analysis regarding fairness are also important topics.⁶³

In addition, it is noteworthy that the extent of a controlling shareholder agency's problem varies across jurisdictions. For example, there are two types of controlling shareholders in bad-law jurisdictions with insufficient investor protection: (1) a "stationary controller" who exploits minority shareholders periodically in the long run to a "generous" extent;⁶⁴ and (2) a "roving controller" who plunders a significant level of corporate value at

⁶³ Delaware's fairness test is useful when analyzing the self-dealing issue in Korean *chaebols*. However, the self-dealing issue in Korean *chaebols* should be explored within the context of a CMS controller and a corporate group, and its significant influence in Korea's macro-economy.

⁶⁴ See generally Sang Yop Kang, "Generous Thieves": The Puzzle of Controlling Shareholder Arrangements in Bad-Law Jurisdictions, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2305645.

once.⁶⁵ It is alleged that controlling shareholders in *chaebols* (in particular before the end of the 1990s) often took advantage of tunneling and siphoned corporate value. Due to the nature of repeat-players (i.e., stationary controllers), however, *chaebol* controllers did not take all, or a substantial level, of the corporate value.⁶⁶ In this sense, *chaebol* controllers in the past, even when the quality of corporate governance was lower than now, are distinguished from Russian oligarchs who siphoned a substantial proportion of corporate assets during the privatization era in the 1990s.⁶⁷

It is probable that non-controlling public investors already discount the share price of a *chaebol* affiliated company to a proper extent, since they are concerned about the prevailing self-dealing. In this case, it is difficult to generally declare that public investors are victims in terms of a pecuniary standard.⁶⁸ Suppose that a corporation's share price is \$80 in a capital market whereas the intrinsic value of the share price—reflecting the ideal value of a share without a controller's tunneling—is \$100. In other words, public investors in the market perceive \$20 as the adequate discount, compensating the private benefits of control. As long as the extent of tunneling is the *same* over two points in time when public investors purchase and sell, they are not harmed: public investors basically purchased a share at \$80 and can sell it at \$80.⁶⁹

Thus, the central issue regarding protecting non-controlling minority shareholders is not whether a controlling shareholder relies on tunneling. Rather, it is whether the degree of tunneling is exacerbated over time and the discount rate becomes higher than when public investors purchased their shares. Although the practice of tunneling is maintained, public investors are able to make profits as the quality of corporate governance is enhanced. For instance, if non-controlling minority shareholders can sell their shares at \$90 with improved corporate governance (and the market perceives the improvement), they reap a \$10 profit per share without the enhancement of a company's performance.

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ See, e.g., Kang, *supra* note 25, at 890–91.

⁶⁹ See *id.*

III. THE HOLDING COMPANY SYSTEM: A NEW PARADIGM FOR *CHAEBOLS*?

Based on the explanation of the CMS, voting leverage mechanisms, and tunneling in Part II, Part III examines comparative advantages and disadvantages of a holding company system—vis-à-vis circular shareholding—and potential corporate governance effects that the holding company system may bring.

A. *The Holding Company System: Overview*

According to the MRFTA, a “holding company” is generally defined as “a company which makes controlling any domestic company’s business through the ownership of stocks.”⁷⁰ Depending on the nature of business activity, there are two types of holding companies:⁷¹ (1) a pure holding company is a company whose only purpose is to hold ownership of subsidiaries; and (2) an operating holding company has its own innate business. Also, holding companies can be categorized into general (non-financial) holding companies and financial holding companies.⁷² A holding company system was prohibited in principle since 1986 in the first revision of the MRFTA. The main reason for such a restriction is the disconcerting potential of *chaebols*’ relentless expansion. Given the OC problem, a controlling shareholder can ultimately control *all* the affiliated companies under a holding company.

For example, suppose that a controller has 50% shares of the holding company, which owns 50% shares of its son-subsubsidiary, which owns 50% shares of a grandson-subsubsidiary.⁷³ Under the corporate pyramiding with three generations, the controlling shareholder wields corporate decision-making power in the grandson-subsubsidiary to the fullest extent with an “economic

⁷⁰ MRFTA art. 2.

⁷¹ See SHIN, *supra* note 29, at 190.

⁷² *Id.*

⁷³ In order to exercise control over a corporation, more precisely, one usually needs “50% plus one share.” For the sake of simplicity, in this example Authors assume that 50% is enough for control. Also, it is worth noting that Authors only consider cases where a majority of votes is required for shareholders’ decisions. Other factors—such as a super majority requirement, quorum issues, and turn-out ratio—are not taken into account in this Article.

interest” of merely 12.5%.⁷⁴ It is significant to note that in order to control the grandson-subsiary, the controlling shareholder does not necessarily have to directly own even one share. This is because the grandson-subsiary’s control belongs to the *chaebol* controller via the continuous ownership chain from the top (i.e., controller) to the bottom (i.e., grandson-subsiary). As the number of layers increases, the extent of the CMS could be deepened in stock pyramids.

In theory, however, it is probable that the concern of a holding company system with respect to voting leverage is overstated, given the availability and popular usage (and misuse) of circular shareholding. Most of all, circular shareholding already provides an effective voting leverage mechanism in a similar manner that a holding company provides. Thus, in principle there is no compelling reason that a holding company system should be prohibited while circular shareholding is permitted. Of course, if stock pyramiding is available *in addition to* circular shareholding, the extent that a controlling shareholder can inflate voting rights is enormous and would be quite worrisome from a societal standpoint. This possibility can be ruled out, however, if the legal system regulates the combined use of circular shareholding and a holding company system.

Eventually, a holding company system was allowed in 1999 with the revision of the MRFTA.⁷⁵ In order to reduce potential corporate governance problems regarding OC, however, additional restrictions on a holding company system are currently instated in the MRFTA. First, in principle a holding company may not “[hold] liabilities exceeding twice the total capital amount (referring to the amount obtained by deducting liabilities from the total amount of assets on the balance sheet . . .).”⁷⁶ If a high debt-equity ratio is allowed (or if there is no restriction on debt-equity ratio at all), a holding company may use financial leverage in favor of a controlling shareholder. In this case, more debts—basically other people’s money—can be used predomi-

⁷⁴ $50\% \times 50\% \times 50\% = 12.5\%$. It is assumed that the equity of an upper-level company is reinvested as the equity of a lower-level company.

⁷⁵ It is generally known that after the Asian financial crisis, international organizations and foreign investors recommended that the Korean government adopt a holding company system.

⁷⁶ MRFTA art. 8-2(2) 1.

nantly for a controlling shareholder to maximize his private control power.

Second, in principle a holding company may not “[hold] less than 40/100 of the total number of stocks issued by the subsidiary.”⁷⁷ Under certain circumstances, this requirement is relaxed. For example, when the subsidiary is a listed corporation in a securities exchange, the percentage shall be more than 20/100.⁷⁸ The equity investment requirement serves the same purpose as the debt-equity ratio regulation: to prevent a controlling shareholder from abusing a holding company by means of non-controlling minority shareholders’ capital.⁷⁹ In this sense, one may criticize the current standard of 40% and 20% as inadequately low.⁸⁰ Indeed, holding companies in foreign countries often hold 100% ownership of a subsidiary. Nonetheless, this issue is debatable since under strict rules, *chaebols* would lose an incentive to change its ownership structure into a holding company system.

Initially, a holding company system was not popular in business circles, as it had more stringent regulations than the current regulations. As time went by, however, many *chaebols* became interested in a holding company system partly because of deregulation and the government’s encouragement through carrot-and-stick policies. *Chaebol* controllers also realized that their control over corporate groups could be more stabilized under a holding company system than under circular shareholding.⁸¹ In 2000, LG Group—currently, the fourth largest *chaebol*—announced that it would adopt a holding company system. It completed its restructuring in 2003.⁸² In 2007, SK Corporation transformed into a holding company and SK Group actively adopted a holding company system. As of September 2014, there are 132 holding companies under the MRFTA.⁸³ Among them,

⁷⁷ *Id.* art. 8-2(2) 2.

⁷⁸ *Id.*

⁷⁹ See, e.g., KWON, *supra* note 27, at 236–37.

⁸⁰ A similar criticism arises regarding a holding company’s level of debt-equity ratio.

⁸¹ See *infra* Part III.C.

⁸² See Ju-Young Kim et al., *Transformation into a Holding Company System and Corporate Governance*, 2 BUS. FIN. & L. 43, 45 (2003).

⁸³ KOREA FAIR TRADE COMM’N, ANALYSIS OF HOLDING COMPANIES IN 2014 UNDER THE MRFTA 1 (Oct. 30, 2014), available at

31 are holding companies in large corporate groups, including but not limited to *chaebols*.⁸⁴

In the largest *chaebols* such as Samsung Group and Hyundai Motors Group, a holding company system is not a main ownership tool yet. However, participants in the capital market in Korea speculate that Samsung Group has seriously considered restructuring its ownership to a holding company system.⁸⁵ Also, it is noteworthy that Samsung's potential ownership change is highly associated with the next generation's inheritance of corporate control. In fact, Kun-Hee Lee, the current controlling shareholder of Samsung Group, has been hospitalized since May 2014 (after a heart attack).⁸⁶ Perhaps, Samsung has closely examined issues in relation to a succession plan such as the impact of inheritance tax on the maintenance of control and possible division of the group for Mr. Lee's only son and two daughters.⁸⁷ Recently, Cheil Industries—Samsung Group's de facto holding company—and Samsung SDS have decided to go public.⁸⁸ This fact is interpreted in the market as a signal that Samsung Group will adopt a holding company system extensively.

B. Merits of a Holding Company System

For several policy reasons, a holding company system is considered a better ownership structure for *chaebols* than circular shareholding. This Subpart provides a further analysis.

1. Corporate Restructuring

http://www.ftc.go.kr/news/ftc/reportView.jsp?report_data_no=5919 (last visited Dec. 28, 2014).

⁸⁴ *Id.*

⁸⁵ Ja-young Yoon, *Samsung May Launch Holding Firm*, KOREA TIMES (May 15, 2014, 13:58), http://www.koreatimes.co.kr/www/news/biz/2014/05/488_157235.html.

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *See, e.g.*, Jungah Lee & Rose Kim, *Samsung Group Files IPOs as Lee Family Restructures*, BLOOMBERGBUSINESSWEEK (Oct. 31, 2014), <http://www.businessweek.com/news/2014-10-31/cheil-files-to-raise-as-much-as-1-dot-4-billion-in-ipo>.

To begin with, a holding company system is well equipped to adapt to corporate restructuring.⁸⁹ Under circular shareholding, a sale or restructuring of one affiliated company could affect the ownership structure of an entire corporate group due to the complicated web of ownership among affiliated companies. When a part of a complicated ownership web is cut, it is possible that a controlling shareholder's ownership structure could unravel. Then, he would lose control over the entire corporate group. Accordingly, the *chaebol* controller is reluctant to consider restructuring or a sale of the affiliated company even if the company encounters substantial financial and business problems. Even worse, he may have a strong incentive to subsidize the affiliated company in difficulty, resulting in damaging minority shareholders and constituencies in a subsidizing company.

On the other hand, under a holding company system, only corporations located downstream of a particular affiliated company are affected by the restructuring or a sale of the affiliated company. Thus, the impact of a sale or restructuring of an affiliated company on the entire corporate group is limited. For instance, an affiliated company in the last generation does not create any further ripple effects on the corporate group's ownership structure. Similar to a lizard which amputates its own tail without risking its life, a controlling shareholder is willing to restructure the business portfolio of a *chaebol* in a more flexible way. This would enable the *chaebol* to focus on core and profitable business lines. Excessive business diversification can be solved.

2. Transparency

In addition, the system based on a holding company—which has only linear descendants—is more transparent than circular shareholding with its complicated ownership web via vertical and horizontal connections.⁹⁰ In this respect, from the standpoint of monitors and “gatekeepers”⁹¹—such as the gov-

⁸⁹ See KOREA FAIR TRADE COMM'N, FAIR TRADE WHITE PAPER 2013, at 311 (2013).

⁹⁰ *Id.*

⁹¹ See John C. Coffee Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1296 (2003) (“The term ‘gatekeeper’ has frequently been used to describe the independent professionals who serve

ernment, creditors (e.g., banks), institutional investors, minority shareholders, lawyers, accountants, rating agencies, securities exchanges, and other self-regulatory organizations (SRO)⁹²—it is more convenient to keep an eye on a *chaebol* and its controlling shareholder under a holding company system than under circular shareholding.⁹³

Tunneling through internal transactions among affiliated companies can also explain that a holding company system has a comparative advantage over circular shareholding. Suppose that there are “N” affiliates in a *chaebol*. Similar to an analysis of the number of ownership connections, there are potentially “N x (N – 1)” paths of internal transactions.⁹⁴ As the number of affiliated companies increases, the number of internal transaction options that a controlling shareholder potentially takes advantage of rises significantly. We refer to this phenomenon as the “Type II network effect in a *chaebol*.” Accordingly, outsiders find it difficult to particularize one specific unfair transaction among “N x (N – 1)” transaction paths. In principle, both a holding company system and circular shareholding have Type II network effect.

To recognize the unfairness in tunneling, outsiders also need to know the controller’s economic interests in the two affiliates involved in the transaction. This is because the controller can transfer wealth from one company where his economic interest is small to the other where his interest is large. Under circular shareholding, however, a large number of ownership connections (via Type I network effect) affect the controller’s economic interests in a complicated way. As a result, the precise information of the *chaebol* controller’s personal payoff from the internal transaction would be unavailable to outsiders. Put differently, particularly public shareholders would be obfuscated by circular shareholding where the two network effects are combined.

investors by preparing, verifying, or assessing the disclosures that they receive.”)

⁹² See *id.* (explaining examples of gatekeepers).

⁹³ See KOREA FAIR TRADE COMM’N, *supra* note 89, at 311.

⁹⁴ When calculating the number of potential ownership connections, “N x (N – 1)” should be divided by 2 when direct cross-shareholding is not available. See *supra* note 47 and accompanying text. When calculating the number of potential paths of internal transactions among affiliates, however, “N x (N – 1)” does not have to be divided by 2. This is because a transaction from Company A (a seller) to Company B (a buyer) is different from a transaction from Company B (a seller) to Company A (a buyer).

When there are numerous unlisted corporations in a corporate group—which is the typical case for *chaebols*⁹⁵—it is even worse. This is because unlisted corporations are generally subject to fewer disclosure requirements in corporate law and securities regulation. Recognizing this problem, the MRFTA has mandated disclosure requirements for a large amount of internal transactions and unlisted companies.⁹⁶ Nonetheless, under circular shareholding with a complicated ownership web, it seems that outsiders including minority shareholders still receive limited, disjointed information regarding internal transactions which can entail unfair self-dealing.

In contrast, under a holding company system which has a simple and linear ownership structure, outsiders can understand more easily whether the controlling shareholder benefits from internal transactions, and (when he benefits) how much corporate value is transferred from minority shareholders to the controlling shareholder. In other words, when outsiders analyze unfairness of an internal transaction under a holding company system, Type I network effect is not a concern to them.

In general, affiliated companies in Korean *chaebols* are subject to a so-called “Korea discount,” the phenomenon that “many Korean companies’ market values are less than comparable firms’ in other capital markets due to the poor corporate governance system in Korea.”⁹⁷ In this context, transforming an ownership structure from circular shareholding to a holding company system might give a positive signal to foreign investors who are concerned about the general quality of corporate governance in Korea. As of October 2014, the weight of foreign portfolio investors in the Korea Composite Stock Price Index (KOSPI) market—measured in terms of market capitalization—is 35.22%.⁹⁸ Thus, the influence of foreign portfolio investors is

⁹⁵ KOREA FAIR TRADE COMM’N, *supra* note 21, at 14 (explaining that as of April 2014, only 15.4% of affiliated companies of large corporate groups with controlling shareholders are listed).

⁹⁶ MRFTA art. 11-2 and art. 11-3.

⁹⁷ Byungmo Kim & Inmoo Lee, *Agency Problems and Performance of Korean Companies During the Asian Financial Crisis: Chaebol vs. Non-Chaebol Firms*, 11 PACIFIC-BASIN FIN. J. 327, 327 (2003).

⁹⁸ *The Weight of Foreign Investors in the Korean Stock Market*, KOREAN EXCHANGE, http://www.krx.co.kr/m2/m2_5/m2_5_7/JHPKOR02005_07.jsp (last visited Nov. 13, 2014).

huge in the Korean capital market.⁹⁹ Relying on the signal from ownership to convert its corporate structure to a holding company could entice more domestic investors as well and possibly solve the “lemon market” problem (i.e., information asymmetry) that every *chaebol* faces in relation to the Korea discount.¹⁰⁰

3. A Control Person’s Liability

Under circular shareholding, the effect of a complicated ownership structure merits further analysis with respect to a controlling shareholder’s liability. Recall the simplest circular shareholding case where Company A owns stock in Company B which owns stock in Company C which owns stock in Company A.¹⁰¹ As discussed, it is unclear whether Company C controls Company A or Company A controls Company C.¹⁰² As the number of affiliates grows (e.g., 50 companies), the nature of the control relationship and internal transactions becomes more confusing due to Type I and II network effects. As a result, it is extremely difficult for outsiders to trace back through a long and complicated ownership chain and find a control person (a natural person) who directs self-dealing.¹⁰³ In this sense, the Commercial Act Article 401-2—“liability of [a] person who instructs another person to conduct business”¹⁰⁴—would be powerless, so that the control person is unlikely to be liable for business misconduct.¹⁰⁵ Based on common sense, the control person is (almost always) a *chaebol* controlling shareholder. Nonetheless, it is another task to argue legally.

In contrast, under a holding company system, it would likely be “relatively easy” to find the person liable for his misconduct

⁹⁹ See, e.g., *Main Stock Index KOSPI Falls Below 2,000*, DONG-A ILBO (Feb. 12, 2011, 11:38) (“The bearish sentiment in Korea was due to massive foreign selling of Korean stocks.”), <http://english.donga.com/srv/service.php3?biid=2011021238088>.

¹⁰⁰ Nonetheless, it is premature to systematically conclude that this signal would improve the quality of corporate governance and overcome the asymmetric information problem in *chaebols*.

¹⁰¹ See *supra* note 28 and accompanying text.

¹⁰² See *supra* note 32 and accompanying text.

¹⁰³ As for the numbers of affiliates in *chaebols*, see *supra* Table 1 (showing that large *chaebols* have more than 50 affiliates on average).

¹⁰⁴ Commercial Act art. 401-2.

¹⁰⁵ Kyung Hoon Chun, *Overview of Legal Problems in Corporate Groups*, 59 BUS. FIN. & L. 6, 15–16 (2013).

and tunneling¹⁰⁶ due to the relatively transparent and straightforward ownership structure. Of course, “relatively easy” does not necessarily mean that it is “easy” in terms of absolute level of difficulty. However, it is noteworthy that recently the KFTC and prosecutors in Korea have tended to be less lenient with *chaebol* controlling shareholders. In particular, criminal punishment can provide a significant chilling effect in association with a holding company system. With the perception that tunneling can be detected in a relatively easy way under a holding company system, a *chaebol* controller would refrain from such business misconduct. The current stringent position of courts as to a controlling shareholder’s potential criminal penalty reinforces deterrence. For example, recently controlling shareholders of large *chaebols* such as SK Group, Hanwha Group, and CJ Group¹⁰⁷ served time (and some of them are still) in jail for corporate scandals.¹⁰⁸

Nonetheless, it does not necessarily mean that the current level of criminal punishment is desirable. There is a debate as to whether the Korean judiciary system is biased towards the “excessive criminalization of business activities.” In particular, Korean business circles have criticized that the scope and requirement of breach of trust are so wide and equivocal that *chaebol* controlling shareholders are criminally punished in an unfair manner.¹⁰⁹ This is an important topic that should be explored in more depth in another independent study.

C. A Holding Company System as an Ownership-Stabilizing Mechanism

Under a holding company system, the controlling shareholder’s control over an entire corporate group is more stable than under circular shareholding. Under circular shareholding,

¹⁰⁶ *Id.*

¹⁰⁷ For an explanation of the relation between Samsung Group and CJ Group, see *infra* notes 121–125 and accompanying text.

¹⁰⁸ See, e.g., Kyung-min Lee, *CJ Chairman Given 3-Year Term*, KOREA TIMES (Sept. 12, 2014, 19:33), http://www.koreatimes.co.kr/www/news/nation/2014/09/116_164481.html.

¹⁰⁹ See, e.g., Junesun Choi, *How to Solve Problems of Special Breach of Trust in the Commercial Act*, KOREA ECON. RES. INST. (Aug. 26, 2013), available at

http://www.keri.org/web/www/research_0201?p_p_id=EXT_BBS&p_p_lifecycle=0&p_p_state=normal&p_p_mode=view&_EXT_BBS_struts_action=%2Fext%2Fbbs%2Fview_message&_EXT_BBS_messageId=344135.

even if only a part of ownership chain among many affiliated companies is broken, it would be possible that the entire corporate group's ownership structure could collapse. As discussed in Type I network effect, in theory there are " $N \times (N - 1) / 2$ " ownership connections for " N " affiliates.¹¹⁰ Thus, a controlling shareholder with a large number of affiliated companies (e.g., 80 affiliates) should vigilantly monitor any weakness in the chain of control in his corporate group. For example, an external threat to take over an affiliated company could result in the disastrous unraveling of a *chaebol's* ownership structure.¹¹¹

In this respect, the case of SK Group's peril in 2003 is suggestive.¹¹² SK Corporation (SK)—the largest oil refiner in Korea—was a core company in SK Group in terms of ownership structure.¹¹³ “[Tae-Won Choi] owned only 0.6 percent of the shares of SK (about 1 percent if shares held by family members are included), yet he was able to effectively control the entire SK Group via circular and pyramidal share ownership structures.”¹¹⁴ In addition, “control of SK constitutes de facto control over the entire group, because SK holds major stakes in the group's other publicly traded firms such as SK Telecom, SK Networks, and SKC. These firms, in turn, control many other affiliates, and—completing the ownership loop—hold significant stakes in SK or SK C&C.”¹¹⁵

In April 2003, Sovereign Asset (a foreign institutional investor) acquired 14.9% of SK's common stock.¹¹⁶ Under the complicated regulation regarding voting, an acquisition of 15% of SK's common stock by Sovereign Asset would lead to changing the status of SK into a foreign entity.¹¹⁷ Then, SK—the de facto

¹¹⁰ See *supra* note 47 and accompanying text.

¹¹¹ See Sang Yop Kang, *Transplanting a Poison Pill to Controlling Shareholder Regimes: Why It Is So Difficult*, 33 *Nw. J. INT'L L. & BUS.* 619, 659 (2013).

¹¹² See generally CURTIS J. MILHAUPT & KATHARINA PISTOR, *Law, Growth, and Reform in Korea: The SK Episode*, in *LAW & CAPITALISM* 109, 109–24 (2008).

¹¹³ *Id.* at 115 Figure 6.1 (based on data disclosed in SK Corporation, Quarterly Report (Nov. 18, 2005)).

¹¹⁴ *Id.* at 114.

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 109.

¹¹⁷ See Telecommunications Business Act art. 6; Enforcement Decree of the Telecommunications Business Act art. 3.

holding company of SK Group—would have lost a significant amount of voting rights over SK Telecom, the main cash cow of SK Group.¹¹⁸ In other words, Sovereign Asset could use the threat to acquire additional shares of SK as leverage in negotiations with SK Group. Also, if Sovereign Asset's hostile takeover of SK were successful, key affiliates that were hubs of a complicated ownership web could have been separate from the ownership structure of SK Group.¹¹⁹ In sum, this episode vividly shows the potential instability of circular shareholding from a controlling shareholder's perspective.

Likewise, when a new regulation—affecting the contour of an ownership structure within a *chaebol* or voting power of an affiliated company—is introduced, a *chaebol's* ownership structure could destabilize, resulting in serious consequences that a regulatory agency did not intend. For example, it seems that one of the original aims of the above voting regulation against a foreign entity in the SK incident was to protect domestic market participants in the telecommunications industry. Such paternalistic protectionism would have almost led to the collapse of the third largest *chaebol* at the time.¹²⁰

Under circular shareholding, even siblings' family feuds regarding inheritance issues can dismantle the *chaebol's* control structure. The Lee family's dispute regarding the Samsung Group (and CJ Group¹²¹) is exemplary. Byung-Cheol Lee—the founding father of Samsung Group—passed away in 1987. His third son, Kun-Hee Lee, succeeded his father's control over the largest *chaebol* in Korea.¹²² The pattern of succession was unusual, given the Confucian tradition of primogeniture. In 2012, Maeng-Hee Lee, Byung-Cheol Lee's first son (and the father of Jae-Hyun Lee, the controlling shareholder of CJ Group), filed a

¹¹⁸ See Telecommunications Business Act art. 7(1).

¹¹⁹ For a further explanation of a regulation on voting, see Kang, *supra* note 111, at 634–44. It is alleged that the purpose of Sovereign Asset was to reap abnormal profits via a greenmail by threatening the dissolution of a corporate group.

¹²⁰ See MILHAUPT & PISTOR, *supra* note 112, at 109 (explaining that SK Group used to be the third largest *chaebol* in 2003).

¹²¹ Jae-Hyun Lee, the controlling shareholder of CJ Group, is a nephew of Kun-Hee Lee, the controlling shareholder of Samsung Group.

¹²² See Young-jin Oh, *Lee Kun-hee v. Steve Jobs*, KOREA TIMES (Apr. 13, 2010, 18:03), http://www.koreatimes.co.kr/www/news/opinion/2014/08/164_64114.html.

civil suit in relation to inheritance against Kun-Hee Lee.¹²³ This lawsuit could have resulted in unraveling the ownership structure of Samsung Group,¹²⁴ or it could have made it difficult for the children of Kun-Hee Lee to succeed the position of the controlling shareholder of Samsung Group. Eventually, the Seoul High Court ruled in favor of Kun-Hee Lee.¹²⁵ Nonetheless, this lawsuit reminded Samsung Group of the possibility—even if remote—of the involuntary dissolution of the entire corporate group due to circular shareholding.

In contrast, when a *chaebol* adopts an ownership structure based on holding companies, a *chaebol* controller's status would be protected in a more efficient and secure manner. He does not have to be concerned about the ownership-chain and its connections in detail. The controlling shareholder might lose control over a subsidiary at the lower-level when an ownership-chain connection between an upper-level affiliate and the lower-level affiliate is broken. Nonetheless, unless the *chaebol* controller loses his majority voting power in a holding company—which is almost impractical—he would not lose control over the entire corporate group. Even in the worst scenario, if a corporate group has multiple holding companies, the controller would only lose a part of his control and ownership of the *chaebol*.

D. Further Considerations of a Holding Company System

As previously discussed, in some aspects a holding company system is better than circular shareholding in terms of corporate governance.¹²⁶ However, it is difficult to preemptively generalize the superiority of a holding company system over circular shareholding. For example, if a pyramiding structure is allowed without any limit (e.g., if 10 generations from a holding company is allowed), a holding company system would create larger dis-

¹²³ See, e.g., Jun Yang, *Samsung's Family Feud*, BLOOMBERGBUSINESSWEEK (June 7, 2012), <http://www.businessweek.com/articles/2012-06-06/samsungs-family-feud>.

¹²⁴ See Youkyung Lee, *Samsung Chairman Keeps Fortune in Inheritance Case*, ASSOC. PRESS (Feb. 1, 2013, 3:57 AM), <http://bigstory.ap.org/article/skorea-a-court-rule-samsung-inheritance-battle>.

¹²⁵ Young-won Kim, *Samsung Chairman Wins Inheritance Lawsuit*, KOREA HERALD (Feb. 6, 2014, 20:14), <http://www.koreaherald.com/view.php?ud=20140206001214>.

¹²⁶ See *supra* Part III.B.

crepancy between cash flow rights and voting rights than circular shareholding. According to the MRFTA, in principle a holding company is not allowed to have a domestic great-grandson company.¹²⁷ A notable exception is found when a grandson company holds 100% shares of the great-grandson company (“excluding a company operating financial business or insurance business”).¹²⁸ It is another policy question whether to relax or strengthen the regulation on the number of layers of corporate pyramids.

Since a holding company system is a secure ownership structure,¹²⁹ a controlling shareholder is likely to be insulated from the market for corporate control (at a corporate group level) and entrenched. For instance, after LG Group transformed into a holding company system, it has been argued that the control ownership of the controlling shareholder was strengthened further.¹³⁰ Absent pressure from the takeover of the entire corporate group, generally a controlling shareholder of a *chaebol*—not necessarily the controlling shareholder of LG Group in particular—would not have a strong incentive to improve business performance or the quality of corporate governance in order to collect support from public shareholders.

In addition, the risk of value diversion still exists under a holding company system. In LG Group’s case, during the transformation of the ownership structure, it is alleged that the value of minority shareholders’ shares was diluted to the benefit of the controlling shareholder.¹³¹ Also, self-dealing in a product market is possible between an upper-generation company where a controlling shareholder has more economic stake and a lower-generation company where he has less economic stake. Accordingly, corporate value is transferred from the lower-generation company to the upper-generation company.

Moreover, a holding company makes profits from dividends, brand loyalty and service expense that subsidiaries pay.¹³² In this sense, a concern is that a holding company can influence

¹²⁷ MRFTA art. 8-2(4).

¹²⁸ See *id.* art. 8-2(4) 4.

¹²⁹ See *supra* Part III.C.

¹³⁰ See Ju-Young Kim et al., *supra* note 82, at 49–50.

¹³¹ *Id.* at 51.

¹³² See Kon Sik Kim & Hyeok-Joon Rho, *Management of Holding Companies and Corporate Law: Overview*, in *THE HOLDING COMPANY AND THE LAW* 291, 311 (Kon Sik Kim & Hyeok-Joon Rho eds., 2005).

the dividend payment policy of a subsidiary in favor of the holding company and its controlling shareholder. Another problem could arise when a holding company sets pricing for brand loyalty and service provided for a subsidiary.¹³³ Such transactions are possibly tainted by the unfairness in the process and pricing due to the holding company's dominance in a corporate group.

IV. CONCLUDING REMARKS

In Korea, corporate governance issues of a *chaebol* such as a controlling shareholder's private benefit extraction, ownership structures, and voting leverage devices are major topics of the MRFTA. The CMS aggravates the problem of economic concentration in a handful of controlling families. In addition, the *chaebol* controller's incentive mechanism is distorted, and self-dealing is facilitated exclusively in favor of the controller to the detriment of public investors. Since the CMS is supported by voting leverage, analysis of the pros and cons of the dual-equity structure, circular shareholding, and a holding company system is important. The dual-equity structure should not be adopted in Korea because it would worsen economic concentration and the extraction of private benefits due to the cumulative effects of this structure and current voting leverage devices.

In general, a holding company system possesses comparative advantages over circular shareholding in terms of the possibility of restructuring, ownership structure transparency, and minority shareholder protection. In particular, when two network effects are combined, circular shareholding provides more favorable (harmful) conditions of tunneling to a *chaebol* controller (public investors). Nonetheless, since a holding company system stabilizes the ownership structure of a corporate group, the CMS is more likely to be maintained. Accordingly, a controlling shareholder can find it relatively easy to perpetuate his family's control position even in future generations. If the KFTC pursues a holding company system as a prevailing ownership structure in *chaebols*, the next corporate governance agenda should include questions such as: (1) how to cope with the mean-reverting prob-

¹³³ *Id.* at 312.

lem in the next generations;¹³⁴ and (2) whether the relative generosity of stationary banditry can be maintained during/after the transfer of control from the founding father to his children.

To redress a *chaebol* controller's agency problem, one may suggest a drastic policy: replacing the CMS.¹³⁵ Such a fundamental change will result in the destruction of the *chaebol*-based economic system since a *chaebol* controller with limited personal wealth has no choice other than to rely on the CMS to maintain control over a corporate group. Indeed, whether dismantling *chaebols* will enhance the level of general social welfare is a complicated equation which requires further rigorous analysis in another independent project. Currently (albeit with limited information), we speculate that such a radical policy would backfire because a variety of unintended and chaotic consequences would emerge as the revolutionary regime change takes place. We look forward to corporate governance scholars' pioneering research in this area in the near future.

¹³⁴ Mean-reverting is generally referred to as the phenomenon that the second generation is usually inferior to the founding father in terms of managerial capability.

¹³⁵ See, e.g., Song, *supra* note 7, at 245 (“[T]he destruction of the [CMS] has two main benefits to society. The first is the elimination of combined incentive problems; the second is, given a certain level of investor protection, the alignment of private incentives with the social optimum. Therefore, the corporate governance research and reform agenda going forward should focus on the question of how we can replace the [CMS].”).

Why the Joint Agencies Shouldn't Apply the Volcker Rule to Private Equity Real Estate Funds*

*Seth Chertok***

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I. INTRODUCTION

Following the financial crisis of 2008, stamped by poor mortgage lending practices that ultimately imposed systemic risks on the society, the regulators across the country reached a heightened state of alert, which motivated Congress to enact the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).¹ The Dodd-Frank Act was a sweeping financial legislation intended to prevent against systemic risks, as analogous to the preventative medicines prescribed by an alarmed doctor for conditions beyond the patient’s specific illness. That is why the Dodd-Frank Act imposed massive rules that regulated the financial system vastly beyond mortgage lending practices.

Among many other financial activities, private equity real estate (“PERE”) was hit hard by the Dodd-Frank Act and became subject to much tightened regulations, even though PERE didn’t contribute to the 2008 financial crisis. One portion of the Dodd-Frank Act particularly relevant to PERE is the Volcker Rule, which prohibits “banking entities” from sponsoring or owning private equity funds exempt under Sections 3(c)(1) and (3)(c)(7) of the Investment Company Act, subject to a de minimis carve-out.² The term “banking entities” is defined to include not only commercial banks, but also includes bank holding companies (“BHCs”) and their affiliates.³

Although the application of the Volcker Rule to c1/c7 exempt funds is mandated by the statute, the Volcker Rule granted the joint agencies charged with a final rule the discretion to apply the Volcker Rule against PERE funds utilizing non-c1/c7 exemptions, which are less frequently used exemptions that are primarily aimed at funds investing in non-securities or real estate.

The author made an early call for the joint agencies to limit their discretion, and not to apply the Volcker Rule against PERE funds utilizing non-c1/c7 exemptions. The author of this paper made an argument that applying the Volcker Rule against PERE

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S. Code).

² *Id.* § 619(d)(4)(B)(ii), 1627.

³ *Id.* § 619(h)(1), 1629.

funds utilizing non-c1/c7 exemptions will present over-regulation dangers, just as how taking medicines before multi-organ failure might ultimately damage a patient's health. In December, 2013, the joint agencies finalized a rule implementing the Volcker Rule, and as the author had urged, the joint agencies elected to limit their discretion and not to apply the Volcker Rule against PERE funds utilizing non-c1/c7 exemptions.

The final implementation of the Volcker Rule provides: "Except as otherwise provided in this subpart, a banking entity may not, as principal, directly or indirectly, acquire or retain any ownership interest in or sponsor a covered fund."⁴ The final rule defines "covered fund," as it relates to funds exempt under the Investment Company Act, as "[an] issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*), but for section 3(c)(1) or 3(c)(7) of the Act (15 U.S.C. 80a-3(c)(1) or (7))"⁵ To clarify any ambiguities, the final rule provides as follows:

Notwithstanding paragraph (b) of this section, unless the appropriate Federal banking agencies, the SEC, and the CFTC jointly determine otherwise, a covered fund does not include: . . . (12) [a]n issuer: . . . (ii) [t]hat may rely on an exclusion or exemption from the definition of "investment company" under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*) other than the exclusions contained in section 3(c)(1) and 3(c)(7) of that Act⁶

In the release for the final Volcker Rule, the regulators confirmed this interpretation.

Thus, for example, an entity that invests in securities and relies on any exclusion or exemption from the definition of "investment company" under the Investment Company Act other than the exclusion contained in section 3(c)(1) or 3(c)(7) of that Act would not be considered a covered fund so long as it satis-

⁴ Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536-01 (Jan.31, 2014), § ____ .10(a)(1), available at <http://www.sec.gov/rules/final/2013/bhca-1.pdf>.

⁵ *Id.* § ____ .10(b)(1)(i)

⁶ *Id.* § ____ .10(c).

fies the conditions of another Investment Company Act exclusion or exemption. Such an entity would not be an investment company but for section 3(c)(1) or 3(c)(7), and the Agencies have modified the final rule to explicitly exclude such an entity.⁷

This article begins by presenting the policy behind the Volcker Rule, and then proceeds to analyze how the policy behind the Volcker Rule supports the view that the Volcker Rule shouldn't be applied against PERE funds utilizing non-c1/c7 exemptions. This view is now actual law in the United States following the joint agencies' final implementation of the Volcker Rule.

II. POLICY ANALYSIS

The legislative history for the Volcker Rule begins by noting that the Volcker Rule prohibits banking activities “that are high-risk or which create significant conflicts of interest between these institutions and their customers,”⁸ such as “the possibility that firms will favor inside funds when placing funds for clients.”⁹ “When losses from high-risk activities are significant, they can threaten the safety and soundness of individual firms and contribute to overall financial instability. Moreover, when the losses accrue to insured depositories or their holding companies, they can cause taxpayer losses.”¹⁰ An additional point in the legislative history of the Volcker Rule is that “[t]he prohibitions also will reduce the scale, complexity, and interconnectedness of those banks that . . . have hedge fund or private equity exposure.”¹¹ Clearly, the primary focus of the Volcker Rule is to prevent systemic risks to the economy as a whole.

This paper will ultimately show that none of these concerns of the Volcker Rule applies to banking investments in PERE funds utilizing non-c1/c7 exemptions. However, in order to bear out this view, we must first understand the exact meaning of “systemic risks.”

⁷ *Id.* at 512.

⁸ S. REP. NO. 111-176, at 8 (2010).

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

A. Systemic Risks Defined

“There is . . . a great deal of confusion about what types of risk are truly ‘systemic’—the term meaning ‘[o]f or pertaining to a system’”¹² “If a problem cannot be defined, it cannot be solved—or, at least, it cannot be efficiently solved—because confusion over the nature of the problem can obscure attempts to provide solutions.”¹³

Prof. Schwarcz sought to trek through the different threads of “systemic risk” definitions in order to create a synthesized definition that would function for regulatory purposes. His 2008 article “Systemic Risk” began by noting that “[a] common factor in the various definitions of systemic risk is that a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences—sometimes referred to as a domino effect. These consequences could include (a chain of) financial institution and/or market failures.”¹⁴ This definition is helpful, but isn’t enough to solve the problem of whether PERE generates systemic risks.

One simple analogy to the financial systemic effect is a physical network of nodes, composed of metal balls and linked by metal chains, where the vibration of one node is violent enough to break the whole network of chains and balls. The physical property of the network is such that three characteristics of its components would determine the breakability of the whole network: (1) The weight of a given ball, relative to the total mass of the network, and the heavier it is, the more likely its vibration will lead to the breakage of the network; (2) The strengths of a given ball’s connections to the rest of the nodes along the chains, and the stronger its connections to the other nodes, the higher the chance is for it to exert a systemic impact on the whole network; (3) The resonant tendency between a given ball and other balls across the chains, and the more closely the ball’s oscillations match the system’s natural frequency of vibration (meaning that the balls vibrate at about the same rate), the more likely that its own violent motions may lead to a catastrophic collapse of the

¹² Steve L. Schwarcz, *Systemic Risk*, 97 GEO L.J. 193, 196 (2008).

¹³ *Id.* at 197.

¹⁴ *Id.* at 198.

whole system, a phenomenon known in physics as “resonance disaster.”

So, what significance does a physical chain of nodes carry for the financial systemic effect of our interest? Interestingly, many financial phenomena appear to operate under similar natural laws as physical phenomena in life. The translation of the above three characteristics into economical terms would be: (1) The industry size of an investment scheme or financial institution, relative to the markets in which they operates, and possibly other markets that might subsequently be affected by them; (2) The financial as well as the operational connections between one investment scheme and other markets as well as the causal relationship between them; (3) The synchronization between one investment scheme’s gain/loss and other types of schemes’ gain/loss across the markets, with or without possible time delays.

A classic example of financial institution systemic failure, which is often referred to by economic scholars, is a “‘bank run,’ in which the ability of a bank to satisfy withdrawal-demands causes its failure, in turn causing other banks or their creditors to fail.”¹⁵ If a bank cannot pay all withdrawal-demands, it will default and ultimately fail. “The chain of subsequent failures can occur because banks are closely intertwined financially. They lend to and borrow from each other, hold deposit balances with each other, and make payments through the interbank clearing system”¹⁶ This example suits the aforementioned second characteristic of a financial network component, which is prone to generate a systemic effect on the whole network.

B. Why PERE Itself Poses No Direct Systemic Risks

Unlike banks, PERE itself doesn’t seem to suit any one of the three characteristics mentioned above. First, it constitutes a very small industry size in comparison to many other types of investment schemes, such as hedge funds and banks. PERE likely has less than one-tenth of the assets of the private equity industry as a whole and a tiny fraction of the trillions of dollars in assets that banks possess.¹⁷

¹⁵ *Id.* at 199.

¹⁶ *Id.*

¹⁷ See *infra* Part C (See “The Size of Industry” under Part C).

Second, the financial connections between PERE and markets are significantly weaker than, say, hedge funds and banks. Hedge funds have exposure to a wide variety of markets via derivatives transactions and their broad investment strategies, but PERE strategies are much narrower and they don't do much with derivatives. Banks have inherent exposure to many markets via derivatives transactions and interbank lending, among other things.

In terms of synchronization, PERE has often desynchronized investment returns with other investment schemes. Geltner observed stocks, real estate long-term bonds and t-bills, and concluded that "the four major asset classes . . . do not all 'move together' in their investment performance."¹⁸

Therefore, it is unlikely that PERE will pose direct systemic risks through its sheer industry size, its financial connections or its synchronizations.

C. Comparisons Between Hedge Funds and PERE Funds

Some view the enactment of the Dodd-Frank Act as providing necessary preventative measures against any systemic risks posed by hedge funds, especially since a parallel could be drawn between bank systemic risk and the kinds of risks posed by hedge funds. For example, in either instance,

[M]arket shocks triggered institutional failures which in turn led, or could have led, to a chain of institutional and market failures.¹⁹ Both also were transmitted through linkages in a chain of relationships: in bank systemic risk, the linkages are interbank borrowings and the interbank clearing system for payments; in LTCM, the linkages arose from its derivatives-based hedging strategy with other institutions, which, in turn, had linkages with yet other institutions and markets.²⁰

¹⁸ DAVID M. GELTNER, NORMAN G. MILLER, JIM CLAYTON & PIET EICHHOLTZ, *COMMERCIAL REAL ESTATE ANALYSIS AND INVESTMENTS* 138 (Sara Glassmeyer et al. eds., 3d ed. 2014).

¹⁹ Schwarcz, *supra* note 12, at 201.

²⁰ *Id.*

Such a view is further strengthened by additional explanations for why hedge funds might give rise to systemic risk: (1) derivatives trades, (2) the size of industry, (3) runs on prime brokers, (4) short selling, (5) usage of leverage, (6) illiquidity, (7) mortgage-backed securities exposure and (8) lack of adequate information.²¹ But of course, not everyone agrees that hedge funds do give rise to systemic risks.

Notwithstanding the merits of these opposing views, for the interest of this article we must ask if the same systemic risks concerns are applicable to PERE funds. It is important to compare hedge funds and PERE funds, which are in many respects regulated very similarly, and thus tend to be seen by inexperienced parties as possibly imposing the same levels of systemic risks.

A table is constructed below to summarize the key differences between the two types of funds. The systemic risk concerns of hedge funds don't necessarily indicate that they really do pose systemic risks, but only reflect concerns raised by some commentators about such potential risks.

TABLE 1. KEY DIFFERENCES BETWEEN THE TWO TYPES OF FUNDS

	Hedge Funds (HF)	PERE Funds (PEREF)	Systemic Risk Con- cerns	
			HF	PEREF
Size of Industry	Relatively Large (~2.2 trillion) ²²	Relatively Small (~\$154 billion) ²³	Yes	No
% of trading activity in	25–60% ²⁴	Very small ²⁵	Yes	No

²¹ Lloyd Dixon, Noreen Clancy & Krishna B. Kumar, *Hedge Funds and Systemic Risk*, available at http://www.rand.org/content/dam/rand/pubs/conf_proceedings/CF300/CF308/RAND_CF308.pdf (last visited Dec. 24, 2014).

²² Svea Herbst-Bayliss, *Hedge Funds Reach Record Size Thanks to Recent Strong Returns*, REUTERS (Oct. 18, 2012), <http://in.reuters.com/article/2012/10/18/hedgofunds-flows-idINL1E8LI5SQ20121018>.

²³ John Mather, *Private Equity Real Estate Funds—Q3 2012 Fundraising Update*, PREQIN (Oct. 23, 2012), <https://www.preqin.com/blog/101/5823/re-q3-fundraising-update>.

²⁴ Dixon *et al.*, *supra* note 21.

²⁵ Even for REITs, which are a type of public real estate investment trusts that potentially carries a much bigger industry market capitalization (approximately \$603.4153 billion in 2012) than private equity real estate, according to

markets				
Derivatives Market	Relatively Large Exposure	Tiny Exposure	Yes	No
Use of Prime Brokers	Yes	No	Yes	No
Short Selling	Yes	No	Yes	No
Use of Leverage	Moderate to High (Average is ~340%) ²⁶	Low to Moderate (Average is ~60–70%) ²⁷	Yes	No
Illiquidity	Yes	Yes	Yes	Unlikely (<i>due to small size, lack of connections and no synchronization</i>)
Mortgage-Backed Securities Investment	Yes	Very Limited	Yes	No
Lack of Information	Yes (<i>before Dodd-Frank</i>)	No	Yes	No

Geltner, “REITs control only a fraction of all commercial property investment. In real estate, it is not uncommon for individual or institutional investors to effectively own the underlying productive assets directly, with no corporate-level entity involved in the investment decision-making process.” GELTNER ET AL., *supra* note 18, at 287. Geltner et al. estimate that “[t]he [“pure-play”] real estate asset class total value [is] approximately \$17 trillion . . . [including] residential as well as commercial property. . . .” GELTNER ET AL., *supra* note 18, at 136.

²⁶ Katya Wachtel, *Hedge Funds Love Affair with Leverage Still on Hiatus, for Now*, REUTERS BLOG (Oct. 5, 2012), <http://blogs.reuters.com/unstructuredfinance/2012/10/05/hedge-funds-love-affair-with-leverage-still-on-hiatus-for-now/>.

²⁷ *Trends Facing Real Estate Private Equity: Changes to Fund Structuring Terms*, ERNST & YOUNG, <http://www.ey.com/GL/en/Industries/Real-Estate/Trends-facing-real-estate-private-equity---Changes-to-fund-structuring-terms> (last visited July 26, 2014).

*D. Indirect Systemic Risk Concerns of Banking Investments
in PERE*

We have just shown that PERE itself poses no direct systemic risk concerns. Let's now do the following thought experiment. Suppose that the markets are a body of water, which consists of streams, rivers, lakes, seas and oceans, and suppose that the banks are rivers feeding into the seas and oceans and PERE is a stream. We already know that the stream itself has minimal effects on the whole water body, and therefore must not be directly connected with the big oceans in any major way. But it is still worth noting that, even though the stream doesn't join the oceans by itself, the stream is still connected to the rivers, which feed into the seas and oceans. Thus, although PERE itself poses no systemic risk concerns, could banking investments in PERE induce failures of banks, which would in turn give rise to a different form of systemic risk?

Let's consider a flow chart that demonstrates our problem at hand:

Economy \leftrightarrow Market \leftrightarrow Banks \leftrightarrow PERE \leftrightarrow Real estate investments

As we mentioned earlier, because of the strong connections between banks and various other financial entities in the markets, banks carry inherent systemic risks. If we were to determine the possibility of a risk "ripple effect" across the flow chart illustrated above, namely, the back propagation of banks' inherent risks through the market via potential contributing factors of PERE, what would be the factors of our interest?

Obviously, the inherent risks of PERE investments could potentially feed backward to the banks and propagate along the whole chain of the financial markets. Most comfortably, thus far our analysis of systemic risks has ruled out any direct systemic risk concerns of PERE itself. But what about the investment risks of such funds, which conduct real estate investments?

Secondly, should we be concerned about the incentive compensation structures of PERE funds? Oftentimes, the incentive compensation structures of a particular type of funds could either aggravate or mitigate the risks of the funds. How do the

incentive compensation structures used by PERE impact its risk profile?

Last, but not least, recall one of the points in the legislative history of the Volcker Rule, which concerns the prohibitive effect of the Volcker rule to “reduce the scale, complexity, and interconnectedness of those banks that ... have hedge fund or private equity exposure.”²⁸ What are the nature and strength of PERE’s connection with the banks?

In the ensuing subsections, we will examine these factors, one by one.

1. The Typically Moderate Investment Risks of PERE

The portfolio of each PERE fund varies from case to case, but in general, most PERE funds largely invest in operational real estate (including improvement properties), and then moderately in land. However, many types of PERE funds don’t invest in land at all. The local investment risks of these real estate investments are examined below.

2. Risk Assessment of Real Estate Investments

One point that greatly favors unleveraged stabilized real estate as an investment target is that it is historically an investment with a low to moderate risk profile, in comparison with many other types of investments. A book entitled *Commercial Real Estate Analysis and Investments* provided a table on the stereotypical characterization of major investment asset classes.

TABLE 2. THE STEREOTYPICAL CHARACTERIZATION OF MAJOR INVESTMENT ASSET CLASS

Investment Concern	Stocks	Real Estate*	Long-Term Bonds**	Cash (T-Bills)
Risk	High	Moderate to Low***	Moderate to Low***	Lowest
Total Return	High	Moderate	Moderate	Lowest
Current Yield	Low	High	Highest	Moderate
Growth	High	Low	None	None****
Inflation Protection	L.R. Good	Good	Bad	Best (if reinvested)

²⁸ S. REP. NO. 111-176, at 8 (2010).

* Unlevered institutional quality commercial property (fully operational, “stabilized”).

** Investment grade corporate or government bonds.

*** Low risk for investors with long-term horizons and deep pockets, so they can hold the assets to maturity or until prices are favorable. Moderate risk for investors fully exposed to asset market price volatility.

**** Unless the investment is rolled over (reinvested), in which case there is no current yield.²⁹

The authors of this book noted:

[I]n the risk and return dimensions, unlevered investment in real estate tends to fall between stocks at one extreme and cash (or short-term bonds such as T-bills) at the other extreme. In this regard, real estate is much like long-term bonds. Unlike bonds, however, real estate provides some capital growth and relatively good inflation protection.³⁰

Another observation apparent from this table is that for an asset class with low to moderate risks, fully operational unlevered institutional quality commercial property real estate offers an excellent combination of total return and current yield.

The same authors also studied both the average annual total return from 1970–2010 and the annual volatility from 1970–2010.³¹ Real estate had approximately an 11% annual volatility level, while stocks had approximately an 18% annual volatility level.³² The authors note that volatility “is a basic way to measure the risk in an investment, because it indicates the range of variability in the investment performance outcomes across time.”³³ On the side of the average annual total return, real estate had approximately a 10% return level, while stocks had an approximately 12% return level.³⁴ While stocks exhibited volatility that was approximately 63.64% greater than real estate, they only ap-

²⁹ GELTNER ET AL., *supra* note 18, at 137.

³⁰ *Id.*

³¹ *Id.* at 142.

³² *See id.*

³³ *Id.*

³⁴ *See id.*

peared to generate returns that were 20% greater. That suggests that real estate might deliver strong risk-adjusted returns.

Of course, the chart mentioned above in the textbook evaluates the characteristics of real estate on an unlevered basis. But even in the leveraged case, the fact that PERE typically uses moderate leverage keeps the risks of leverage relatively moderate. The observation that PERE funds averaged leverage in the 60–70% range in 2011,³⁵ combined with the generally low volatility of the real estate markets, suggests only a moderate risk of leveraged assets for PERE investors. The architects of the Volcker Rule were likely concerned about the amount of leverage used by hedge funds.³⁶ One article noted that LTCM “had borrowed . . . a leverage factor of roughly thirty to one.”³⁷ Of course, today hedge funds don't typically borrow at that level. One recent article noted that “hedge fund managers reported leverage of 3.4, on average.”³⁸ It is therefore apparent that even the most leveraged variety of PERE funds are typically much less leveraged than hedge funds.

Furthermore, when the volatility of PERE investments is computed with the consideration of leverage, leverage appears to increase the volatilities of PERE funds by a moderate amount. For example, when a side-by-side comparison was made between the cumulative total returns (income plus capital appreciation) from 2000 through early 2012 as tracked by the NCREIF Property Index (NPI)³⁹ and by two institutional investor fund-level indices published by NCREIF in cooperation with the Townsend Group (an institutional investment consultancy),⁴⁰ the NPI had quarterly

³⁵ ERNST & YOUNG, *supra* note 27.

³⁶ FINANCIAL STABILITY OVERSIGHT COUNCIL, STUDY AND RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING AND CERTAIN RELATIONSHIPS WITH HEDGE FUNDS AND PRIVATE EQUITY FUNDS 56 (2011).

³⁷ Alison K. Gary, *Creating a Future Economic Crisis: Political Failure and the Loopholes of the Volcker Rule*, 90 OR. L. REV. 1339, 1380 (2012).

³⁸ Wachtel, *supra* note 26.

³⁹ The NCREIF Property Index (NPI) is a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties (unlevered) acquired in the private market for investment purposes only. NCREIF Property Index Returns, NAT'L COUNCIL OF REAL ESTATE INV. FIDUCIARIES, <http://www.ncreif.org/property-index-returns.aspx>.

⁴⁰ Unlike the NPI index, the NCREIF / Townsend indices are private equity real estate fund-level indices, which exemplify an “attempt to track the performance actually realized by investors in funds that invest in properties, rather

volatility of 2.9%, the core funds⁴¹ index had quarterly volatility of 4.0% and the value-added funds⁴² index had quarterly volatility of 5.6%.⁴³ This suggests that even compared to the unlevered commercial property investments, even value-added PERE funds, one of the higher risk types of PERE funds, carry only moderately higher risks. Given all this, one may view PERE as a relatively safe investment tool, even with the consideration of leverage.⁴⁴

The chart also only evaluates the investment characteristics of institutional quality commercial property, rather than other types of real estate investments. Many PERE funds invest in institutional quality commercial property, but some may invest in land or properties to be improved, either of which is riskier, but carries the potential for greater returns that is commensurate with the additional risks. As noted above, value-added funds, which invest in some property improvements, still appear to exhibit moderate volatility.

Land as an investment class is considerably riskier than other types of naked real estate investments. Under the call option model of land value, “land is viewed as obtaining its value through the option it gives its owner to develop a structure on the land. The land owner can obtain a valuable rent-paying asset upon the payment of the construction cost necessary to build the structure.”⁴⁵ It’s worth noting that land effectively adds leverage to the funds’ investments. When investing in land, the

[P]ortfolio of investments includes a long position in the underlying real estate asset (the forward commitment) and a short position in the construction costs (the leverage). The combination of short and long cash flows is inherently levered because the cash out-

than the performance achieved directly by the underlying properties.” GELTNER ET AL., *supra* note 18, at 679.

⁴¹ *Id.* at 680 (“Traditionally core investment funds employed little or no leverage, but by the 2000s they were often using modest amounts of debt, up to 20 percent to 30 percent loan-to-value ratios (LTVs).”).

⁴² *Id.* (“Perhaps most significantly, the value-added style traditionally allows considerably more financial leverage than the core style, with typical LTVs in the neighborhood of 50 percent or slightly more. This is still conservative by the standards of many real estate investors . . .”).

⁴³ *Id.*

⁴⁴ Occasionally, a private equity real estate fund could use higher leverage that raises the investment risks, but the industry doesn’t trend in that direction.

⁴⁵ *Id.* at 707.

flows do not occur at the same time and because the construction costs are not perfectly and positively correlated with the value of the underlying asset.⁴⁶

Although land effectively adds leverage, “the option enables the landowner to avoid much of the negative consequences of the downside outcome of future market volatility, while still retaining the ability to profit from the upside.”⁴⁷ Nonetheless, land has a risky side to it, since the decision to hold off on developing the land involves risks about what the future might bring. The value of the land option depends very sensitively on the difference between the construction costs and the value of what can be built. “As investments, call options are much more risky than their underlying assets (in this case, the usage value of the built property), and hence require a much higher expected return.”⁴⁸

Despite the fact that land investments might significantly increase the risks of PERE, a footnote in the above chart noted that real estate is lower risk “for investors with long-term horizons and deep pockets, so they can hold the assets to maturity or until prices are favorable.”⁴⁹ This is auspicious news for PERE, since PERE usually does have long-term investment horizons.⁵⁰ The long-term horizon of PERE will clearly help offset short-term real estate market fluctuations, and therefore help ease the risks of land investments, even though land investments are still relatively risky. Keep in mind, however, that many types of PERE funds have nothing to do with land investments.

Another point worth noting is that Dodd-Frank requires [B]anks to develop in-depth internal ratings methodologies to assess investment risk. As a result, regulators and boards will likely have higher expectations for the investment due diligence processes banks and their external service providers have in place. Banks

⁴⁶ Matthew S. Flowers, *Show Me the Money: A Study of Real Estate Development Returns* 8 (Sept. 2008) (unpublished M.S. dissertation, Massachusetts Institute of Technology) (on file with DSpace, Massachusetts Institute of Technology).

⁴⁷ GELTNER ET AL., *supra* note 18, at 709.

⁴⁸ *Id.* at 96.

⁴⁹ *Id.* at 137.

⁵⁰ *Id.* at 678.

without the resources to develop these internal processes may be forced to significantly limit their investment opportunity set, possibly limiting earnings and diversification potential in the securities portfolio.⁵¹

As a result, there is every reason to expect that banks will be reasonable about limiting their investments in PERE with higher investment risk profiles.

Another point to note is that, during the financial crisis of 2008, it is highly likely that mortgage-backed securities were even more toxic as an asset class than real estate itself. During the crisis, banks had many trillions of dollars in exposure to toxic mortgage assets. On the contrary, the PERE industry really focuses primarily on operating and developing real properties, and not on investing in mortgage-backed securities. Furthermore, banks already have so much exposure to mortgage-backed securities that it is highly improbable for any secondary exposure from rare types of PERE funds to “tip the scales” and raise systemic risk concerns.

There is more favorable news for PERE. One of the investments that arguably made hedge funds high risk was derivatives. For PERE, the real estate derivatives market is currently very slim in the United States. “While there are no formal data, experts suggest that trades total in the hundreds of millions of dollars rather than billions.”⁵² This is obviously an extremely tiny fraction of the notional value of U.S. total derivatives, which Wikipedia estimated as \$182.2 trillion in 2008.⁵³

Another source of risk for hedge funds that makes hedge funds very risky was short selling. “In real estate, short sales are impossible in reality”⁵⁴ That fact is also comforting.

⁵¹ Sabrina C. Callin & Justin J. Ayre, *Rethinking Best Practices for Bank Investment Portfolios*, PIMCO (May 2012), <http://pimco.com/EN/insights/pages/rethinking-best-practices-for-bank-investment-portfolios.aspx>.

⁵² Molly Dover, *Real-Estate Finance: How Derivatives Give Shelter—Financial-Market Uncertainty May be Catalyst for Big Boost in Instruments in U.S., U.K.*, WALL ST. J. (Sept. 26, 2007), at B7, available at <http://online.wsj.com/news/articles/SB119075791771139163>.

⁵³ *Derivatives Market*, WIKIPEDIA, http://en.wikipedia.org/wiki/Derivatives_market (last visited Dec. 24, 2014).

⁵⁴ GELTNER ET AL., *supra* note 18, at 711.

Some naysayers might argue that the financial crisis of 2008 was caused by the fact that banks were exposed to real estate investments. While real estate suffered a particularly sharp decline after the financial crisis of 2008, that was an anomalous drop. No other real estate crises since 1969 resulted in a drop of an even remotely comparable magnitude. Figure 1 below shows the history of U.S. commercial real estate from December 1969 until December 2009.⁵⁵

FIGURE 1. THE U.S. INSTITUTIONAL COMMERCIAL PROPERTY PRICES OVER RECENT DECADES



Sources: Moody's/REAL, TBI, and estimates of Geltner, et al.

More importantly, the sharp decline in the real estate markets after the 2008 financial crisis was caused primarily by poor mortgage lending practices, which had both induced the real estate bubble and then burst it. But the inauguration of the Dodd-Frank Act was intended to solve the root of these problems. If the Dodd-Frank succeeds in its goals, in light of the history of real estate as an asset class and its characteristically low volatility, there is no reason to anticipate real estate to perform inconsistently with its historical characteristics. However, if by any chance, the sweeping financial legislation suffers from an incomplete success and the nation encounters another large-scale market crash, it would be extremely difficult to envision real estate investment as the leading culprit of the potential crisis, given the fact that it wasn't real estate investment itself but poor mortgage lending practices that triggered the 2008 financial crisis and that real estate has typically been one of the lowest risk investment

⁵⁵ *Id.* at 143.

types in the nation's financial history. Keep in mind that if there were ever a future real estate crisis, banks would suffer great exposure to real estate risks via their mortgage practices, and any secondary exposure to real estate from PERE would be minimal. Thus, the regulators should focus on the root of the problem, toxic mortgages, and avoid over-regulating PERE.

3. Incentive Compensation Structures of PERE Funds

When incentive compensation structures are used, incentives are based on profits, but there's no contribution if there are losses. On the face of it, it seems to give PERE advisers an incentive to take more risks, since more risks are correlated with greater returns. However, if we look beyond the surface, we will see that the incentive compensations structures of PERE funds actually have a mitigating effect on risk taking.

TABLE 3. MITIGATION EFFECT OF PERE FUNDS ON RISK TAKING

Structural Features	Effect	Investment Risks
Booking period	Short period, combined with high volatility, tends to incentivize undiversified investments to profit from upward and downward volatility. However, PERE, with a long period and less volatility, isn't subject to this problem.	Reduced
Back-end incentive scheme	The fund sponsor won't be able to take profits until all capital is returned to investors, plus a preferred return. Thus, the fund sponsor won't have an incentive to invest in risky investments, and then sell off the high paying ones first to take incentive compensation, followed by selling off the poor performers later.	Reduced
Deal-by-deal incentive scheme with GP clawback	Since the vast majority of deal-by-deal schemes have a GP clawback, the fund sponsor is required to pay back to the fund subsequent losses in the event a deal-by-deal incentive scheme is used. Thus, the fund sponsor doesn't have an incentive to sell off the high performing risky investments first, followed by selling off the poor performers later.	Reduced (risks are restrained by GP clawback)
High	A high water mark would make the fund	Reduced

Water Marks	sponsor do extra work to get back into incentive compensation territory when the value of the fund falls below its high water mark, which incentivizes risks when the fund's value falls below it. PERE funds almost never have high water marks.	
Fund sponsor commitment	The fund sponsor generally commits to the fund his own capital, which is now expected to be meaningful. ⁵⁶ If fund sponsor commitments are meaningful, that reduces risk taking incentives.	Reduced

4. The Interconnectedness of Banks with PERE Funds and Other Investment Schemes

Given the scope and magnitude of banks' connections with other financial institutions as well as investment schemes, the connection between banks and PERE, depending on its strength, could potentially exaggerate the risks of PERE through bank's multi-channeled connections with the whole financial market. But would such a connection be so overwhelmingly strong that systemic risks could stem from such a typically moderate-risk investment scheme as PERE, or even from a higher risk investment scheme if a PERE fund were to invest in land?

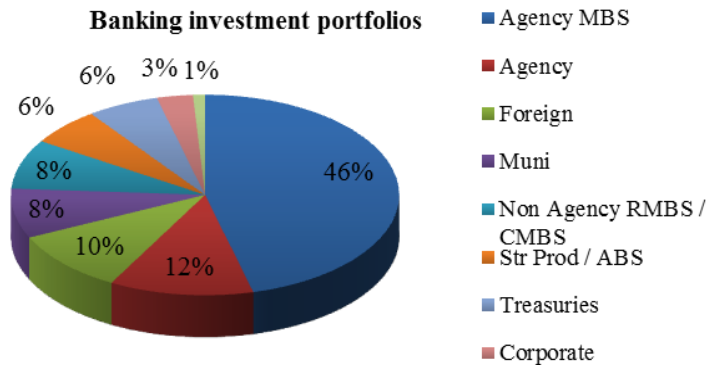
In order to answer this question, we will first inspect the percentage of banks' investments in PERE relative to their whole investment portfolios, and then examine the fund contributions of banks to PERE.

Overall, much evidence supports that BHCs aren't too heavily invested in PERE. First of all, below is a pie chart (Fig. 2) that illustrates the distribution of various investment targets in BHC investment portfolios. BHC investment portfolios, as of the end of 2011, accounted for \$2.85 trillion, which amounted to 21% of BHC total assets.⁵⁷

⁵⁶ ERNST & YOUNG, *supra* note 27.

⁵⁷ Sabrina C. Callin & Justin J. Ayre, *supra* note 51.

FIGURE 2. THE DISTRIBUTION OF INVESTMENT TARGETS IN BANKS' INVESTMENT PORTFOLIOS⁵⁸



As the reader can see, 8% of banks' investment portfolios are exposed to non-agency mortgage-backed securities, which aren't guaranteed. That gives banks exposure to real estate, regardless of their exposure to PERE. Outside of their investments, banks are also very often exposed to real estate through their mortgage lending practices. In addition, banks invest 3% of their portfolios in corporations and 10% of their portfolios in foreign securities. Among all types of investment activities of banks, PERE is by no means the "frontrunner" of all others.

Secondly, out of the "1% Other" banking investments shown above, only a small fraction of it has been invested in PERE. Prequin has noted that "[b]anks accounted for 11% (\$115bn) of the total capital invested in private equity funds in 2008, whereas this figure fell to 8% (\$110bn) in 2011."⁵⁹ This figure accounts for banking investments in all types of private equity funds. The PERE industry is significantly smaller than the private equity industry. Bain Capital recently noted that in 2012, the global private equity industry had "[a]lmost \$2 trillion worth of assets on general partners' books . . ." ⁶⁰ One article notes that, as of Q3 2013, there were "468 private equity real estate funds

⁵⁸ *Id.*

⁵⁹ *Prequin Special Report: Banks as Investors in Private Equity*, PREQIN (2012), https://www.prequin.com/docs/reports/Prequin_Special_Report_Banks_as_Investors_in_Private_Equity.pdf.

⁶⁰ Bain & Company, *Global Private Equity Report 2012*, available at http://www.bain.com/bainweb/pdfs/Bain_and_Company_Global_Private_Equity_Report_2012.pdf.

(targeting assets rather than other funds) seeking an aggregate of \$154 [billion] in capital commitments.”⁶¹ Thus, it appears that the aggregate size of PERE is less than 10% of the aggregate size of private equity as a whole. In turn, that suggests that if banks have \$110 billion invested in private equity, they may only have as little as \$10 billion invested in PERE. Given that the investment assets of BHCs are likely around \$2.85 trillion, that means that PERE may likely constitute as little as one-third of one percent of the investment assets of banks. As a result, the connections between banks and PERE are very weak, and thus the potential for systemic risk is very low.

Compare this figure to the level of banks' exposure to mortgage loans and mortgage-backed securities before the financial crisis.

By the in the autumn of 2008, when the securitization market “seized up” and investors would “no longer lend at any price,” securitized lending made up about \$10 trillion of the roughly \$25 trillion American credit market, (i.e. what “American homeowners, consumers, and corporations owed”). In February 2009, Ben Bernanke stated that securitization markets remained effectively shut, with the exception of conforming mortgages, which could be sold to Fannie Mae and Freddie Mac.⁶²

Obviously, banks were invested in the securitization markets as well as in mortgage loans directly. Thus, banks were exposed to various mortgage dangers in an amount which exceeded banks' exposure to PERE by a great many orders of magnitude.

Currently banking investments in PERE is very low, but will this trend change over time, if regulations remain lenient? The answer is that it is unlikely. First off, as discussed above, prior to the Volcker Rule, banks in 2008 only invested \$115 billion in private equity funds as a whole. There is every reason to think that, in spite of the Volcker Rule, banks will continue to allocate their private equity investments to a certain amount of

⁶¹ John Mather, *supra* note 23.

⁶² *Subprime Mortgage Crisis*, WIKIPEDIA, http://en.wikipedia.org/wiki/Subprime_mortgage_crisis (last visited Dec. 24, 2014).

non-real estate private equity, since the Volcker Rule contains a quite generous *de minimis* carve-out on banking investments in non-real estate private equity. Because of that carve-out, the connections between banks (the river) and traditional private equity funds (other streams) aren't dammed, so there's no reason to expect that the upstream waters from all the banking funds previously allocated to private equity funds would flood into PERE. Thus, even in the unlikely event that PERE went up from one-third of one percent to, say, hypothetically, one percent of banking investments, that still wouldn't be a large enough exposure to create systemic risk concerns.

Moreover, it's important to remember that if banks were prohibited from investing in PERE, they would delegate their extra funds to other investment revenues, which most likely carry equal levels of investment risks as PERE, if not greater. As we know from the experiences of water navigations, when damming one watercourse downstream, the upstream stretch of water would reroute and flow into different brooks or rivers, which could carry flood risks themselves. Therefore it's important to study the whole map of tributaries and understand the risks of all alternative waterways before plugging the connection between the estuary and a particular stream, if such a measure is absolutely necessary. However, in the case of PERE, as we discussed earlier, it poses no systemic risks and typically only moderate investment risks. Accordingly, from a regulatory perspective, there is no reason to believe that other choices of banking investment targets, which take up much bigger proportions of banking funds, carry less investment risks than PERE and should be placed as more optimal investment options than PERE.

To conclude, banks investing in PERE might create some interconnectedness between banks and PERE, but this interconnectedness, in light of the small percentage of PERE investment relative to the banks' whole investment portfolios and the insubstantial capital contribution of banks to PERE, shouldn't give rise to systemic risk concerns. Furthermore, it's unlikely for these connections to become strengthened in the future.

E. Conflicts of Interest

Besides preventing systemic risk problems, the Volcker Rule sought to avoid conflicts of interest between banks and their clients. Even if banks aren't permitted to sponsor their own PERE funds, they might still have conflicts of interest when placing client funds with outside PERE. For example, a bank could have any number of relationships with outside PERE funds, which might cause a bank to suffer from a conflict of interest when placing client funds. Furthermore, conflicts of interest in the securities context are a prevalent phenomenon in the market. Although the solutions for this problem vary from case to case, the general principle from a regulatory viewpoint is not to eliminate the financial activity that entails conflicts of interest, but to disclose the conflicts to the parties involved, so that both the financial freedom of the institutions and the customers' rights could be protected.

Given the fact that the Volcker Rule presents over-regulation dangers for PERE, the better solution would be to require banks to disclose their conflicts of interest, especially considering the minimal systemic risk concerns of banking investments in PERE.

F. Potential Repercussions of Over-Regulating PERE

Applying the Volcker Rule against PERE would cut off a significant source of capital to PERE funds, even though banks aren't a gigantic percentage of PERE's investors. This is problematic, since PERE has had a significant role in paving the way to the recovery of the real estate markets after various financial crises.⁶³ Further, PERE funds that invest in land should help lead the way to recovery of development activities for the country's GDP, which is also particularly important. Cutting off that source of capital might also put PERE in the United States at a competitive disadvantage with global PERE funds.

⁶³ GELTNER ET AL., *supra* note 18, at 148 ("As in the 1990s, the recovery [after the financial crisis of 2008] in the commercial property market was once again led by private equity funds and REITs seeking to buy distressed assets at bargain prices or to place capital into safe, income-generating and potentially inflation-hedging assets.").

The regulators appear to agree with the view that PERE doesn't generate systemic risks. The recently finalized Form PF doesn't require PERE advisers to file Form PF. Furthermore, as noted, in their implementation of the final Volcker Rule, the joint agencies didn't apply the Volcker Rule against PERE funds utilizing non-c1/c7 exemptions.⁶⁴

III. CONCLUSION

Given the above policy analysis, the author wholeheartedly approves of the fact that the joint agencies charged with issuing a final rule on the Volcker Rule elected to limit their discretion and not to apply the Volcker Rule against PERE funds utilizing non-c1/c7 Investment Company Act exemptions. The author argues that (1) PERE itself carries no characteristics that tend to generate systemic risks, (2) the possibility of a risk "ripple effect" propagating from PERE through banks to the markets is low, given that, (a) PERE investments typically pose moderate investments risks, except for investments in land, which not all PERE funds invest in, (b) PERE incentive compensation structures tend to rein in risk taking behavior, and (c) the interconnection between banks and PERE is quite weak due to the relatively tiny size of the banks' investments in PERE and the minuscule percentage that PERE occupies in the banks' investment portfolios, and isn't likely to become strengthened in the future. Although some naysayers might believe that leverage and land investments could potentially create ripple effects, such effects would clearly be mitigated by the absence of other systemic risk concerns, in particular given the fact that the interconnectedness between PERE and banks isn't sufficiently strong to give rise to systemic effects.

⁶⁴ Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, Exchange Act Release No. 34, 65545, 101 SEC Docket 603, (Oct. 12, 2011), n.222 ("Under the proposed rule, if an issuer (including an issuer of asset-backed securities) may rely on another exclusion or exemption from the definition of 'investment company' under the Investment Company Act other than the exclusions contained in section 3(c)(1) or 3(c)(7) of the Act, it would not be considered a covered fund, as long as it can satisfy all of the conditions of an alternative exclusion or exemption for which it is eligible."), *available at* <http://www.sec.gov/rules/proposed/2011/34-65545.pdf>.

At this fragile time in our nation's economy, the regulators should strive to find the optimal balance between business freedom and regulation, and avoid over-regulation dangers for PERE, which should help with the recovery of the real estate markets and the GDP.

The Current Situation and Reform of Legal Institution of Corporation Divestiture in China

*Zhu Daming**

ABSTRACT

Corporate divestiture is a major method of corporate reorganization. It is an important way for companies to achieve specialization and efficiency in operation. With the continuous development of legal institution in the world, especially under the circumstance of economic globalization, corporate divestiture has been increasingly attracting extensive attention in the corporate laws of various countries in the world. However, the legal institution of corporate divestiture in China, first established by the company law passed in 1993, has not received significant development and improvement. Therefore, the current legal institution of corporate divestiture reveals more and more shortcomings in legal practice.

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I. PREFACE

Corporate divestiture is a major means of corporate reorganization. It is an important way for companies to reduce business scale and achieve specialization and efficiency in operation.

Legislations on corporate divestiture in various countries differ from one another. There is no institution of corporate divestiture in the United States (the “U.S.”) corporate law,¹ while the countries and regions of civil law, such as Germany, Japan, and Taiwan region, established it as an organization behavior in company laws by legislation. China adopted the same approach as Germany and Japan, and stipulated the institution of corporate divestiture in the Company Law of the People’s Republic of China (the “PRC”). However, although there are provisions on corporate divestiture in the Company Law of the PRC, the application of them brings many puzzles since the institution of corporate divestiture, consisting of Article 176 and Article 177 of the Company Law of the PRC, is too general. The purpose of this essay is to describe the origin of the institution of corporate divestiture by reviewing the history and development of corporate divestiture in China, and to do research on the current situation and existing problems with the method of comparative law, so as to find out the direction of the reform of China’s institution of corporate divestiture.

II. THE LEGISLATIVE HISTORY OF CORPORATE DIVESTITURE IN CHINA

Corporate divestiture is the outcome of legislations of the civil law system countries. Compared with mergers, the emergence and development of corporate divestiture is lagging. Not until 1994, Germany started to make detailed provisions on corporate divestiture in the Law of Reproduction of Business Asso-

¹ 莱纳克拉克曼 (REINIER KRAAKMAN), 保罗戴维斯 (PAUL DAVIS), 亨利汉斯曼 (HENRY HANSMANN), 杰拉德赫蒂格 (GERARD HERTIG), 克劳斯霍普特 (KLAUS HOPT), 神田秀树 (HIDEKI KANDA), 爱德华洛克 (EDWARD ROCK), 公司法解剖: 比较与功能的视角 [THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH], at 164 (2007).

ciation, while Japan introduced corporate divestiture in its revision of the Business Law in 2000. After the establishment of the PRC, corporate divestiture was explicitly stipulated in Article 185 of China's first company law in 1993. In 2005, the Company Law of the PRC was massively amended. Compared with the old company law, the revised Company Law of the PRC kept the original basic structure of corporate divestiture, and meanwhile adjusted the protection of creditors in division of a company. The adjustments are mainly in three aspects. First, the frequency of announcements is changed from three times to once (paragraph 2, Article 176); second, the provision of guarantee is cancelled; third, the new companies after the division shall assume joint and several liability for the debts prior to the division (Article 177). Additionally, the provisions on the appraisal right of shareholders indirectly improve the corporate divestiture.

THE COMPANY LAW OF THE PRC (1993)	THE COMPANY LAW OF THE PRC (REVISED IN 2005)
Article 185	Article 176
Where a company proceeds into a division, its assets shall be divided correspondingly.	Where a company proceeds into a division, its assets shall be divided appropriately.
Where a company decides to divide itself, it shall formulate a balance sheet and a detailed inventory of assets and shall inform its creditors of the intended division within 10 days following the date on which the division resolution is adopted, and make at least three announcements in newspaper within 30 days. The creditors shall have the right to claim full repayment of their debts or provide a corresponding guarantee from the company within 30 days from the date of receipt of the notice or, within 90 days from the date of the first public announcement for those who have not received the notice. The company that fails to pay its debts in full or to provide a corresponding guarantee shall not be divided.	When a company intends to divide itself, it shall draw up a balance sheet and a detailed inventory of assets. The company shall, within 10 days from the date the resolution on such division is adopted, notify its creditors of the intended division, and make an announcement about it in the newspaper within 30 days therefrom.
	Article 177
The debts prior to the division of a company shall be assumed by the companies following the division in accordance with the	The companies after the division shall assume joint and several liability for the debts prior to the division, except where the company before the division and its creditors have otherwise reached a written

agreement reached between them.

agreement on repayment of the debts.

III. THE CURRENT SITUATION AND PROBLEMS OF CORPORATE DIVESTITURE IN CHINA

The institution of corporate divestiture is established at the core of Article 176 and Article 177 of the Company Law of the PRC and it does not expressly stipulate the definition of division of a company, the specific methods of division, the scope of properties divided or the consideration of the division. Therefore, there are great limitations on the understanding and interpretation of corporate divestiture in China. However, the systems of corporate divestiture in civil law countries and regions like Germany and Japan are more integrated, and they have very important reference value for China in developing the institution of corporate divestiture in future. Therefore, these foreign legal systems will be introduced as well as the current situation and problems of corporate divestiture in China in the sections below.

A. Definition of corporate divestiture

The Company Law of the PRC does not define corporate divestiture and the expression of Article 176 “[W]here a company proceeds into a division, its assets shall be divided appropriately” is derived from Article 185 of the old company law (1993). According to Article 176, the act of division of a company can be explained as a legal act that divides a company’s own properties, but this interpretation does not illustrate the legal features of corporate divestiture as a legal act. Hence, academic interpretations make more efforts on that. Professor Jiang Ping said that “Corporate divestiture means a company divides into two or more companies in accordance with the laws and regulations.”² Professor Wang Baoshu further pointed out that “Corporate divestiture is that a company divides its property without the liquidation procedures and splits into two or more companies.”³ This inter-

² 江平 (JIANG PING), 新编公司法教程 [NEW INTERPRETATION OF CORPORATION], at 151 (1994).

³ 王保树 (WANG BAOSHU), 中国商法 [COMMERCIAL LAW OF CHINA], at 272 (2010).

pretation emphasizing the legal feature of no liquidation procedure has become a widely accepted statement of the definition of corporate divestiture and plays an important role in legal practice.

A definition is a high-level overview of the content. The definition of corporate divestiture in China is confusing because the content in the Company Law of the PRC is incomplete. For reference, the definitions of corporate divestiture in Germany and Japan are as followed.

1. Taiwan Region

Item 6, paragraph 1, Article 4 of the Law of Merger and Acquisition of Enterprises of Taiwan region, clearly states that corporate divestiture is a company transfer of part of its independent business or the entire business to an existing company or a new company in exchange for shares issued by the existing company or the new company according to this law or other laws and regulations.

2. Japan

There is no explicit definition of corporate divestiture in the Company Law of Japan. According to Japan's academic interpretation, corporate divestiture is the legal act that a corporation transfers part or all rights and obligations related to its business to an existing company or a new company.⁴

B. The object of corporate divestiture

Article 176 of the Company Law of the PRC clearly states that corporate divestiture is the division of the properties of a company. Based on the interpretation mentioned in the above section, the object of corporate divestiture is a company's "property." However, it is hard to define a company's "properties." China's Accounting Standards for Business Enterprise uses "assets," "liabilities" and other expressions,⁵ so whether the scope

⁴ KENJIRO EGASHIRA, CORPORATION LAW 824 (4th ed. 2011).

⁵ 企业会计准则 [The Accounting Standards for Business Enterprise (2006 Revision)] (promulgated by the Ministry of Finance, Feb. 15, 2006, effective July 1, 2007) chap. 3-4, CLI.2.6044 CHINALAWINFO.

of “properties” includes the liabilities and unique business model are difficult to be valued and other problems need further explanation. As to the object of corporate divestiture, Japan adopts the formulation of “the rights and obligations related to its business”⁶ and Taiwan region uses “business.”⁷ These might provide references to amendments of the Company Law of the PRC.

In addition, Article 176 of the Company Law of the PRC does not answer whether the scope of the object of corporate divestiture includes all the properties or part of the properties. In the light of major theory in the academia, which is described later, division by dissolution means that, after the old company divides all the properties, it shall be dissolved. Therefore, the object of corporate divestiture shall include all or part of the properties.

C. Methods of corporate divestiture

The method of corporate divestiture is an important element in relation to achieving the division of a company, but the Company Law of the PRC does not mention it. In accordance with the major theory in the academia, there are two methods of division: division by continued existence and division by dissolution. Division by continued existence, in other words, split-off, means that a company sets up one or more companies with part of its assets and the old company survives. Division by dissolution, in other words, split-up, occurs when a company divides its properties into two or more portions and sets up new companies with each portion, and the old company is dissolved.⁸ This point of view is the extension of Article 91 of the Opinions on Regulating Companies Limited by Shares published in 1992.⁹ Furthermore, item 2, paragraph 1, Article 2 of the Opinions of the State Administration for Industry & Commerce on Properly Handling the Registration of Mergers and Divisions of Companies and Sup-

⁶ 日本会社法 [KAISHAHŌ] [CORP. C.] 2005 art. 2, para. 1 (Japan).

⁷ 台湾企业并购法 [Law on Merger & Acquisition Law] art. 4 (2002) (Taiwan).

⁸ 江平 (JIANG PING), *supra* note 2, at 151; 王保树 (WANG BAOSHU), *supra* note 3, at 272; 刘俊海 (LIU JUNHAI), 现代公司法 [THE MODERN CORPORATE LAW], at 594(2011).

⁹ 股份有限公司规范意见 [The Opinions on Regulating Companies Limited by Shares] (promulgated by the State Commission for Restructuring Economy, May 15, 1992, effective May 15, 1995) art. 91, CLI.4.5738 CHINALAWINFO .

porting the Mergers and Restructuring of Enterprises (2011) stipulates that division of a company includes two ways, division by continued existence and division by dissolution,¹⁰ and confirms the above academic classification in legal practice.

According to the methods of the academic classification, there are three characters of China's corporate divestiture. First, the entity of division is a single company; second, the new companies must be built to receive the properties of old company; third, the methods are division by continued existence and division by dissolution. However, compared with foreign legal institution of corporate divestiture, the scope of the methods of division in China is too narrow. The following are the methods of corporate divestiture in Germany, Japan and Taiwan region as well as the common measures to achieve the purpose of division of a company in America.

1. Japan

There are two major means in the Company Law of Japan, "division by new establishment" and "division by assimilation."¹¹

(a). Division by New Establishment

Division by new establishment means one or more companies set up a new company or companies during division and the new company or companies receive the rights and obligations related to the business of the old company or companies. Since the new company or companies may accept all the assets of the old company or companies, division by new establishment can have the function of creating a parent-subsidiary corporation structure.

Based on whether the old company or companies is one company or more companies, division by new establishment can

¹⁰ 关于做好公司合并分立登记支持企业兼并重组的意见 [The Opinions of the State Administration for Industry & Commerce on Properly Handling the Registration of Mergers and Divisions of Companies and Supporting the Mergers and Restructuring of Enterprises] (promulgated by the State Administration for Industry, Nov. 28, 2011, effective Nov. 28, 2011) art. 2, CLI.4.162829 CHINALAWINFO.

¹¹ KAISHAHŌ, *supra* note 6.

be classified as a single division by new establishment and joint division by new establishment.

(b). Division by Assimilation

A division by assimilation is a company transfer of part or the whole rights and obligations related to its business to an existing company.

Division by assimilation is similar to consolidation by merger. The greatest difference between them is that the old company no longer exists in a consolidation by merger, while the old company survives in a division by assimilation. Division by assimilation also has similarities with business transfer in appearance. The biggest distinction is that the general transfer in division by assimilation includes the labor relation of old employees, while in business transfer, the receiving company usually does not inherit relevant labor contracts of the old employees.

(c). Simple Division and Elliptical Division

Corporate divestiture is an important act of a company and it needs the resolution of shareholders general assembly. However, under special circumstances, the resolution of shareholders general assembly of the party(ies) involved can be exempted.

Simple division means a company can divide its assets without the resolution of shareholders general assembly, if the assets divided are not more than one fifth of the total assets (paragraph 3, Article 784 and Article 805 of the Company Law of Japan).

Elliptical division occurs in a division by assimilation with a parent-subsidiary company relationship where the subsidiary company is the receiving company. If the parent company has more than ninety percent of the voting right, the resolution of the shareholders general assembly of the subsidiary company is just a formality and the law permits this kind of resolution of shareholders general assembly to be omitted.

2. Germany

In 1994, Germany passed the Law of Reproduction of Business Organization and regulates reorganization acts through

separate legislation. In the Law of Reproduction of Business Association, corporate divestiture can be categorized as division by dissolution, division by portion and division by subsidiary.¹² Division by dissolution occurs when one company transfers its properties to two or more new companies and the old company is dissolved.¹³ Division by portion is that a company assigns part of its assets or business to a new company or other existing company, and the assignee(s) pays consideration to the shareholders of the original company and the original continues to operate.¹⁴ Division by subsidiary is that a company transfers part of its assets or business to a new company, and the new company pays consideration to the old company.¹⁵ Division by dissolution in Germany is like division by dissolution in China. Division by portion emphasizes separation of person, while division by subsidiary focuses on separation of properties.

3. Taiwan Region

The institution of corporate divestiture was introduced in the Taiwan region in 2000.¹⁶ In general, corporate divestiture in Taiwan region is similar to corporate divestiture in Japan, but there are some differences in specific designs. There are two types of division in Taiwan: division by new establishment and division by assimilation. Taiwan also has special ways of corporate divestiture: simple division and elliptical division. Taiwan's division by new establishment is further classified as division by new establishment and continued existence, and division by new establishment and extermination. Division by new establishment and continued existence means that the old company still exists after transferring part of its properties to the new company(ies), while division by new establishment and extermination means that a company transfers all its properties to two or more than two new companies, and the old company is dissolved. In practice, Taiwan's division by new establishment and continued existence is like division by continued existence in mainland China, and

¹² 王志诚 (WANG ZHICHENG), 企业组织再造法制 [THE LEGAL SYSTEM OF REPRODUCTION OF BUSINESS ORGANIZATION], at 104 (2005).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.* at 95.

Taiwan's division by new establishment and extermination is almost the same as division by dissolution in mainland China.

4. The United States

There is no legal institution of corporate divestiture in America and the purpose of division is usually achieved through decomposition of the acts of division. Therefore, the biggest characteristic of the American laws is that there is no statute of corporate divestiture. The U.S. laws give each separate behavior decomposed from division tax preferences to encourage companies to implement these behaviors.¹⁷

In legal practice, a company usually adopts three ways to make a division: spin-off, split-off and split-up. The most important differences among these three methods are who receives the payment of consideration of the division and how to divide the properties. In the spin-off and the split-off, a parent corporation organizes a subsidiary corporation to which it transfers part of its assets in exchange for all of the subsidiary's equity interests, which is subsequently transferred to the shareholders of the parent corporation in exchange for a portion of their equity interests. A split-off differs from a spin-off in that the shareholders in a split-off must relinquish their shares in the parent corporation in order to receive shares of the subsidiary corporation whereas the shareholders in a spin-off need not do so.

In the split up, a company sets up new companies with all the business (first building new companies, and then transferring its business to the new companies) to make a parent-subsiary structure. Further, the parent company enters into the process of liquidation and assigns all its properties including the equity interests of the new companies to its shareholders. Then the parent company shall be cancelled.¹⁸

D. Consideration of corporate divestiture

Consideration of corporate divestiture is the core question

¹⁷ ROBERT W. HAMILTON, *THE LAW OF CORPORATIONS* 614 (5th ed. 2000).

¹⁸ CHERYL D. BLOCK, *CORPORATE TAXATION: EXAMPLES & EXPLANATIONS* 419 (2nd ed. 2001).

in the legal institution. In a division of a company, the original company shall receive consideration when transferring its properties or business to the receiving companies (new company(ies) or existing company(ies)). There are two major issues in payment of consideration: first, the kinds of payment of consideration—whether currency, stocks or others can be used as payment of consideration; second, the receiver of payment of consideration—who will be given the payment of consideration.

1. Kinds of Payment of Consideration

In the Company Law of the PRC, there are no provisions governing whether stocks, cash or other marketable securities can become payment of consideration. The Notice of the Ministry of Finance and State Administration of Taxation on Certain Issues Concerning the Handling of Enterprise Income Tax in Enterprise Restructuring, published in 2009, expressly states that the payment of consideration by a transferee enterprise may be in the form of payment of equity interests, non-equity interests or combination of both.¹⁹ Moreover, this Notice defines “payment of equity interests” and “payment of non-equity interests.” The term “payment of equity interests” mentioned in this Notice means that an enterprise takes its or any of its holding enterprises’ equity interests or shares as form of payment of consideration for purchasing or obtaining in return assets in enterprise restructuring; and the term “payment of non-equity interests” in this Notice means that an enterprise takes as form of payment its cash, bank deposit or receivables or its or any of its holding enterprises’ negotiable securities other than equity interests or shares, securities, stocks, fixed assets, other assets, undertaking of debts, etc.²⁰ As describe in this Notice, the payment of consideration in China almost has no limitations and includes shares of the new company or the original company, cash, and other negotiable securities. However, in building the legal system of corporate divestiture,

¹⁹ 国家税务总局关于企业重组业务企业所得税处理若干问题的通知 [Notice of the Ministry of Finance and the State Administration of Taxation on Several Issues Concerning the Enterprise Income Tax Treatment on Enterprise Reorganization] (promulgated by the Ministry of Finance and the State Administration of Taxation, Apr. 30, 2011, effective Jan. 1, 2008) art. 1, CLI.4.116672 CHINALAWINFO.

²⁰ *Id.* art. 2.

the nature of the payment of consideration and diversification of payment of consideration need theoretical support. In division by new establishment, because the ground of payment of consideration is the assets or business received from the original company, if the payment of consideration is the payment of equity interests of the new company, the value of the equity interests of the new company will also be from the properties received from the original company. From the perspective of incorporation of new companies, the act that a company incorporates new companies in accordance with the division agreement is no different from formation of new companies with physical contribution in appearance. In that case, from the point of view of contribution, the payment of consideration can only be the payment of equity interests of the new companies. This becomes a challenge of diversification of payment of consideration. It seems that the theory of diversification of payment of consideration can only find support from the interpretation of organic laws.

In addition, if the value of the assets or business transferred is negative, then there is no need to give the payment of consideration. In Germany, the governing law requires that the assets or business transferred must not be negative,²¹ while in Japan, this issue shall be decided by the shareholders general assembly.²²

With the premise of permitting diversification of payment, there are another two means of corporate divestiture: cash division and triangle division. Cash division means that the payment of consideration for assets and business transferred is cash. In a triangle division, the payment of consideration is the equity interests of the parent company of the inheriting company (the possibility of directly receiving equity interests from parent company of the inheriting company also exists).

2. The Receiver of Payment of Consideration

Depending on who will be given the payment of consideration, corporate divestiture can be distinguished as division of persons and division of matters. If the receiver of payment of

²¹ 托马斯莱赛尔 (THOMAS RAISER), 吕迪格法伊尔 (RUDIGER VEIL), 德国资合公司法 [CORPORATION LAW OF GERMAN], at 762 (2005).

²² Shigeru Morimoto, *Corporation Law Review*, 17 SHOJIHOMU 244 (2010).

consideration is the original company, it is a division of matters. If the receiver of payment of consideration are the shareholders of the original company, it is a division of persons. When the original company obtains the payment of consideration, it can distribute the payment of consideration to its shareholders through profit distribution or share repurchase. According to whether the payment of consideration is equally distributed to the shareholders, corporate divestiture can be classified as equal distribution division and non-equal distribution division. In the U.S., split-off is a typical non-equal distribution division. In Germany, equal distribution division is also admitted with the precondition of consensus of all the shareholders of the original company.²³ Japan only allows division of matters. The inheriting company cannot directly give the payment of consideration to the original company's shareholders, but the original company may distribute the payment of consideration to the shareholders, which has the same effect as division of persons. That's also why the Japan's company law does not stipulate division of persons.²⁴ Besides that, in Japan's academia's opinion, non-equal distribution division should be permitted.²⁵

The Company Law of the PRC does not regulate the receiver of the payment of consideration. The Circular of Issues Relating to Income Tax on Merger or Division Business of Enterprises, published in 2000, states that either the original company or its shareholders can receive the payment of consideration from the perspective of tax collection and may bring some enlightenments. The Company Law of PRC does not discuss the issue of distribution of payment of consideration to the shareholders (whether the inheriting companies directly pay the shareholders or the original company distributes the payment of consideration to its shareholders after receiving it from the inheriting companies). However, directly giving the payment of consideration is determined in the division agreement, and the division agreement is the result of resolution of the shareholders general assembly. Also, distributing the profits to the shareholders is the

²³ 王志诚 (WANG ZHICHENG), *supra* note 12, at 126.

²⁴ Morimoto, *supra* note 22, at 242.

²⁵ Kenjiro Egashira, *Development of Legal Institution of Corporation Divestiture*, Commercial Law Review, 1525 SHOJIHOMU (1999).

power of shareholders general assembly. Therefore, it seems that whether the original company or its shareholder receiving the payment of consideration can be decided by shareholders general assembly.

E. Protection of stakeholders of the company

1. Shareholders

Division of a company is an important act of a company and brings significant changes to its operation. There might be risks of impairing the interests of the shareholders, especially the minority shareholders. Because important company actions are usually the items of resolution of the shareholders general assembly and the principle for shareholders general assembly to make a decision is that the decision can be passed only with majority's approval, and the minority shareholders are given appraisal right as protection and amendment of the principle of majority vote. In Germany and Japan, the laws provide the protection of minority shareholders through the rights of request repurchase.²⁶ Article 75 and Article 143 of the Company Law of the PRC also entitle the shareholders to the right to request the company to purchase their equity interests.

However, in the Company Law of the PRC, the precondition of the right of request repurchase is that the shareholders must vote against (in a limited liability company) or hold objection to (in a company limited by shares) the resolution of division. The shareholders must prove that they hold objection to the division resolution. Following this logic, the shareholders holding objection to the resolution shall include the shareholders absent from the shareholders general assembly as well as the ones voting against the resolution. If so, on one hand, the interests of minority shareholders are given better protection; on the other hand, it also facilitates the resolution of division and improves the implantation of the division.

²⁶ 王志诚(WANG ZHICHENG), *supra* note 12, at 14; KAISHAHŌ, *supra* note 6, art. 785.

2. Creditors

Corporate divestiture will change a company's assets and liability structure, so it is necessary to protect the interests of the creditors.

There are detailed provisions on protection of the creditors in the Company Law of the PRC. Paragraph 2, Article 176 states that the company shall notify its creditors of the intended division within 10 days from the date the resolution on such division is adopted, and make an announcement about it in the newspaper within 30 days therefrom, and Article 177 stipulates that the companies after the division shall assume joint and several liability for the debts prior to the division, except where the company before the division and its creditors have otherwise reached a written agreement on repayment of the debts.

There are three concerning issues in the protection of creditors in corporate divestiture. First, what is the definition of the term "creditors" in the provision "the company shall, within 10 days from the date the resolution on such division is adopted, notify its creditors of the intended division"? Does the term "creditors" refer to all the creditors or the ones whose interests might be harmed in the division? Second, is the provision of "the companies after the division shall assume joint and several liability for the debts prior to the division" is too harsh? Third, what are the legal consequences of violating the above provisions? As to the first question, since the company shall make an announcement about the division in the newspaper, it is more appropriate just to notify the creditors whose interests might be harmed in the division. For the second question, if there is no limitation on the joint and several liability, it will be too strict for the inheriting companies. Restricting the scope of joint and several liability to the properties received from the original company is appropriate. To answer the third question, if the above provisions on protection creditors are violated, administrative penalties shall be imposed on the inheriting company.²⁷ Also the shareholders can file a lawsuit to request the people's court to declare the resolution

²⁷公司法 [Company Law of the People's Republic of China (2013 revision)] (promulgated by the Nat'l People's Cong., Dec. 28, 2013, effective Jan. 1, 2006) art. 205, CLI.1.218774 CHINALAWINFO.

invalid or rescind it.²⁸ However, the shareholders cannot object to the act of division itself in China, while the Company Law of Japan has special provisions on the litigation related to company's organization and behaviors.²⁹

3. Employees

While receiving the assets or business from the original company, as a principle, the inheriting companies will also take the related labor contracts. Therefore, corporate divestiture has a close relationship with the interests of the employees. There is no relevant provision in the Company Law of the PRC, and the employees can only be protected by the Labor Law of the PRC and the Labor Contract Law of the PRC. Building a negotiation channel between the company and the employees might be beneficial for both the success of the division and protection of interests of the company and employees.

As to the protection of employees, the Company Law of Japan regulates that the company of division has the negotiation obligation.³⁰ Specifically the company of division shall explain the division plan to the employees, listen to their opinions and reach an agreement with the employees on job content, places of employment, forms of job and other matters two weeks prior to the shareholders general assembly. If the company violates such negotiation obligations, the division might be null and void.³¹

IV. THE DIRECTION OF PERFECTING CORPORATE DIVESTITURE IN CHINA

In conclusion, there are still many problems in the China's legal institution of corporate divestiture and bringing forward these problems might be helpful for legislation in future. Therefore, the problems are summarized as follows.

²⁸ *Id.* art. 22.

²⁹ KAISHAHŌ, *supra* note 6, arts. 2–9.

³⁰ KAISHAHŌ, *supra* note 6, art. 5, para. 1.

³¹ EGASHIRA, *supra* note 4, at 835.

A. Definition of corporate divestiture

Since China is a civil law country, lack of definition of division creates enormous difficulties in fully understanding and applying legal institution of corporate divestiture, and this cannot be ignored. Certainly, it is hard to define a legal act. Thus, from the perspective of legislative techniques, accurately regulating the specific methods of division seems to be an alternative option.

B. Object of corporate divestiture

According the current Company Law of the PRC, the object of corporate divestiture is property of a company, but what is the “property”? This question could be solved through legislative interpretation and academic interpretation. In relevant provisions of State Administration of Taxation, there are also “business,”³² “assets”³³ and other expressions which refer to the object of division of a company. For the unity and harmony, it is better to define it through legislation.

C. Means of corporate divestiture

The Company Law of the PRC does not stipulate the specific methods of corporate divestiture. The methods of division are an important issue concerning whether the legal institution of division can be effectively used. Therefore, it is necessary to determine the methods of division selectively, and division by new establishment and division by assimilation are appropriate choices.

³² 国家税务总局关于企业合并分立业务有关所得税问题的通知 [The Circular of Issues Relating to Income Tax on Merger or Division Business of Enterprises] (promulgated by the State Administration of Taxation, Jun. 21, 2000, effective Jun. 21, 2000) art. 2, CLI.4.29413 CHINALAWINFO.

³³ 财政部、国家税务总局关于企业重组业务企业所得税处理若干问题的通知 [Notice of the Ministry of Finance and the State Administration of Taxation on Several Issues Concerning the Enterprise Income Tax Treatment on Enterprise Reorganization] (promulgated by the Ministry of Finance and the State Administration of Taxation, Apr. 30, 2011, effective Jan. 1, 2008) art. 1, CLI.4.116672 CHINALAWINFO.

D. Payment of consideration of corporate divestiture

The types of payment of consideration should be stipulated in the Company Law of the PRC. Compared with foreign legal systems, in order to promote the corporate divestiture, the inheriting companies' equity interests, cash, the equity interests of the parent company of the inheriting companies should be allowed to be the payment of consideration in a division.

E. The receiver of payment of consideration

Both the original company and its shareholders should be permitted to be the receiver of the payment of consideration, and the choice should be decided in the resolution of division—in other words, determined by the shareholders.

F. The precondition of shareholders exercising their appraisal rights

Article 143 of the Company Law of the PRC allows a shareholder of a company limited by shares to request the company to purchase his shares, if he holds objections to the resolution on the division of the company adopted by the shareholders general assembly. To improve the implantation of division resolution and protect the interests of minority shareholders, the shareholders that objected to the resolution shall include the shareholders voting against the resolution and the ones absent from the shareholders general assembly.

G. The scope of creditors notified

The Company Law of the PRC regulates that the company shall notify its creditors of the intended division within 10 days from the date the resolution on such division is adopted. The “creditors” mentioned here should be the ones whose interests might be impaired in corporate divestiture.

H. The joint and several liability of the inheriting companies to the creditors

It is better to restrict the scope of joint and several liability of the inheriting companies to the properties received from the

original company.

I. Protection of the employees

Creating an opportunity of negotiation between the employees and the company during the process of division can protect the interest of both the employees and the company.

J. The institution of invalidation litigation in corporate divestiture

Establishing the institution of action for invalidation in a division of a company protects not only the legality of the division, but also the interests of the shareholders and creditors.

V. CONCLUSION

Corporate divestiture not only has significant meanings to adjust business structure and improvement of the efficiency of private enterprise, but also plays an important role in deepening the reform of state owned enterprise. Therefore, the reformation of the current institution of corporate divestiture and the building of an impeccable institution of division in conformity with China's national conditions are of great benefits to promote sustainable economic development and industrial restructuring.

A Uniform Precautionary Principle Under EU Law

Patrick Jiang^{*}

ABSTRACT

The precautionary principle is a legal and political theory that strengthens a government's hand in protecting health and the environment. It is especially powerful in the context of European Union law because it is incorporated into the Treaty on the Functioning of the European Union (TFEU). Thus, the significant jurisprudence of the precautionary principle under EU law has become a leading example to legal regimes worldwide. Because the interpretation of the principle is so important, it has made fertile ground for debate and speculation. The purpose of this article is to dispel a few critical misunderstandings about the principle, basing its analysis on well-established legal fundamentals. It is particularly important that the law moves forward with a clear and uniform interpretation. The reputation and viability of the precautionary principle around the world will depend on how effectively it develops in the European Union.

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I. INTRODUCTION

The precautionary principle is a foundational concept in international environmental law. It is a partly legal and partly political theory that lets governments regulate risks, even when the scientific justifications are not completely clear. In the field of environmental protection, where scientific evidence is often compelling but rarely complete, the precautionary principle is a crucial tool for effecting regulations that would otherwise get bogged down for lack of scientific certainty.

The precautionary principle provides a mandate for organizations ranging from the UN to the WTO.¹ It was incorporated by the 1992 Maastricht Treaty of the European Union and thereby elevated to constitutional status under EU law.² Hence, it has gained a large body of jurisprudence from European Court of Justice. The legal theories established by Europe will undoubtedly lead the development of the principle worldwide. But unfortunately, the principle remains muddled in practice; it has suffered speculation and misunderstanding as people have dutifully tried to parse its every detail through the court judgements. Much of the criticism, I think, is misplaced.

As with all legal concepts, the precautionary principle needs to be logically coherent, internally consistent, and intellectually appealing.³ Some authors may not think this is the reality, but I believe differently. Precaution in the EU is built on a few fundamental doctrines, from which all of its technical rules are derived. The doctrines are, essentially, to provide a high level of protection in a well-reasoned, proportionate, and non-discriminatory way. These are the same basic requirements that underpin all good governance and all of EU law. Understanding these doctrines, as they apply to precaution, can dispel certain

¹ The principle has its roots in several UN instruments. See Jose Luis da Cruz Vilaca, *The Precautionary Principle in EC Law*, 10 EUR. PUB. L. 369, 370 (2004).

² *Id.* at 371.

³ The development of such a coherent precautionary principle in EU law has been urged by Lardeur. Karl-Heinz Lardeur, *The Introduction of the Precautionary Principle into EU Law: A Pyrrhic Victory for Environmental and Public Health Law? Decision-making under Conditions of Complexity in Multi-Level Political Systems*, 40 COMMON MARKET L. REV. 1455, 1479 (2003).

misconceptions that have long persisted in the academic scholarship.

In this article, I offer a basic introduction to the precautionary principle. I interpret it through European court judgements and other EU publications and show that it is consistent with the principles of EU law. I then deduce answers to some of the most debated questions in the literature, including: (1) what level of precaution exists in EU law; (2) what level of scientific uncertainty triggers precaution; and (3) what is the role of scientific evidence in the principle? In response to the second question, I propose a new “trivial uncertainty” test as an improvement to the current “hypothetical risk” test, which is a threshold test for implementing precaution. The trivial uncertainty test uses the same logic as the hypothetical risk test but addresses more diverse situations.

Finally, I give a brief account of the most serious challenge to the precautionary principle: the lack of perceived legitimacy. Legitimacy is related to the broader EU problem of democratic deficit. The precautionary principle will not gain full acceptance unless it earns the public trust. In the short to medium term, that might require more involvement of the European Parliament, because the democratic influence of the Parliament will make precautionary actions more palatable to the public.

II. WHAT IS THE PRECAUTIONARY PRINCIPLE?

A. Introductory Background on the Precautionary Principle

Normally, before a government takes an administrative action, it is expected to put forward a justification. For example, if the government wants to ban a certain product for being hazardous to health, it will usually establish, by credible evidence, that there is a genuine and serious danger. If the evidence has not been vetted by experts, or proves to be unconvincing, the ban can be annulled by a court of law. Indeed, to put forward evidence with a level of scientific certainty might be understood as a trait of good lawmaking. However, scientific certainty is not always possible. When it comes to environmental issues in particular, where sometimes scientific studies can only look at lagging indicators, consensus is not available when decisions need to be made. Therefore, we recognise in those situations that it might be desirable to

impose a more relaxed standard of justification. The precautionary principle states that protective measures can be taken in dangerous situations, even when evidence is less than concrete.

A poignant example in recent years comes from the global warming debate in the United States. The US federal government has famously failed to ratify the Kyoto Protocol, the foremost international effort to reduce greenhouse gas emissions. To rationalise such inaction, some US lawmakers have claimed that there is uncertainty as to whether global warming is caused by humans at all. This is despite the fact that the science of the last decade has long since put such claims into disrepute. The precautionary principle is meant to counter this kind of inaction.⁴

The principle was first defined by the 1992 UN Conference on Environment and Development in Rio de Janeiro. The Rio Declaration states:

In order to protect the environment, the precautionary approach shall be widely applied by States according to their capabilities. Where there are threats of serious or irreversible damage, lack of full scientific certainty shall not be used as a reason for postponing cost-effective measures to prevent environmental degradation.⁵

In other words, when faced with serious dangers from global warming, be it rising sea levels or severe weather patterns, a relatively minor uncertainty, arising from mostly discredited science, should not impede action. The Rio Declaration was intended to give world governing organizations a broad mandate to protect the environment without having to justify their actions to a scientific certainty. The Rio Declaration suggests, as a matter of policy, that governments should favour preventative, cost-effective measures before environmental damage becomes permanent.

⁴ David Michaels points out that the so-called climate change denial is a disingenuous strategy on the part of entrenched interest groups to discredit good science. If this were true, then the precautionary principle would be a valuable tool to defeat deliberate obstruction. See DAVID MICHAELS, *DOUBT IS THEIR PRODUCT: HOW INDUSTRY'S ASSAULT ON SCIENCE THREATENS YOUR HEALTH* 198 (2008).

⁵ United Nations Conference on Environment and Development, Rio de Janeiro, Braz., June 3–14, 1992, *Rio Declaration on Environment and Development*, Principle 15, U.N.Doc. A/CONF.151/26/Rev.1 (Vol. I), Annex I (Aug. 12, 1992).

B. Precautionary Principle in the European Union

In the same year as the Rio Summit, the precautionary principle was incorporated by the Maastricht Treaty into what is now Article 191 of the TFEU.⁶ Although the precautionary principle is written under the Title on Environment, it actually applies to EU action in all areas of health and safety.⁷ In fact, as explained below, it was prevalent in EU law long before it was formalised in any international instrument.

Prior to the Maastricht Treaty, the fundamental freedom of the free movement of goods⁸ was qualified by an exception for protection of human health. In *Sandoz*, the question arose whether the Netherlands government could restrict the sale of vitamin-fortified foods. It was known that excessive intake of vitamins A and D was harmful to health, but the science at the time could not say what amounts were dangerous.⁹ The Court of Justice ruled that in this condition of uncertainty, the member state had discretion to protect its citizens, as long as its actions were proportional to the attainment of a real need.¹⁰ This was, of course, the precautionary principle without the name.

Since *Sandoz*, the precautionary principle has become a basis for regulating all sorts of industry and consumer products, from pharmaceuticals to genetically modified organisms. The TFEU, however, makes reference to the principle but does not define it, so the institutions have been left to fill in the gaps. The most important case law of recent times has been the *Pfizer* judgement. It restated much of the existing law on the precautionary principle. In particular, it specified a procedure for handling scientific evidence prior to law making. It also defined the con-

⁶ Article 191(2) of the TFEU reads: "Union policy on the environment shall aim at a high level of protection taking into account the diversity of situations in the various regions of the Union. It shall be based on the precautionary principle and on the principles that preventive action should be taken, that environmental damage should as a priority be rectified at source and that the polluter should pay." Consolidated version of the Treaty on the Functioning of the European Union art. 191(2), May 9, 2008, 2008 O.J. (C 115) 47 [hereinafter TFEU].

⁷ Case T-74/00, *Artegodan GmbH v. Comm'n*, 2002 E.C.R. II-04945, ¶ 183.

⁸ Treaty Establishing the European Economic Community art. 30, Mar. 25, 1957, 298 U.N.T.S. 11 (as in effect in 1958) (now TFEU, art. 36).

⁹ Case 174/82, *Sandoz BV*, 1983 E.C.R. 2445, ¶ 11.

¹⁰ *Id.* ¶ 20.

cept of hypothetical risk, an evidentiary threshold for applying precaution. I will discuss both aspects of *Pfizer* in the following sections, but first, I must lay out a few assumptions that I use throughout this article.

1. The precautionary principle is a discretionary rule

Although the Rio Declaration reads as a negative rule, it has a powerful positive corollary: lack of scientific certainty *per se* cannot prevent a decision maker from taking protective actions.¹¹ In fact, discretion is integral to the precautionary principle. The gap between scientific uncertainty and protective action can only be bridged by human discretion. The Commission agrees that precaution is “an eminently political decision.”¹² It can include any action or no action at all, if that suits the political situation.¹³ The ECJ also recognises the political quality of precaution and gives wide deference to the Commission. For example, in *ex parte Fedesa*, the court stated that the standard of review of Commission decisions would be for manifest error or misuse of powers.¹⁴ That standard has since been confirmed in other cases. The court clearly acknowledges that political decisions such as precautionary actions are not very amenable to judicial review.¹⁵

2. The precautionary principle is grounded in fundamental doctrines of law

Even though precautionary actions are political decisions, they still have legal constraints. The Commission has identified some doctrines that govern the precautionary principle. These are: (1) that precaution must not be misused for corrupt purposes and (2) that precautionary decisions must follow general principles of EU law-making. From these doctrines, there derive a host of rules,

¹¹ Cf. Case T-13/99, *Pfizer Animal Health SA v. Council*, 2002 E.C.R. II-03305, ¶ 160.

¹² *Communication from the Commission on the Precautionary Principle*, § 5.2.1, COM (2000) 1 final (Feb. 2, 2000) [hereinafter *Communication on the Precautionary Principle*].

¹³ *Id.*

¹⁴ Case 311/88, *The Queen v. Minister of Agric., Fisheries and Food and the Sec’y of State for Health, ex parte Fedesa*, 1990 E.C.R. I-04023, ¶ 8.

¹⁵ Case T-13/99, *Pfizer*, 2002 E.C.R. II-03305, ¶¶ 447, 468, 480 (referring to the “political choice” and “broad discretion” of the Council.).

which form a nuanced and comprehensive precautionary principle.¹⁶

The first doctrine embodies a fear that raw political discretion leads to corruption. A precautionary decision, often a limitation on marketing or manufacturing of a product, could well be a kind of protectionism in disguise.¹⁷ In a real life example, it seems that one of the initial motives for banning rBST hormone in milk was to prevent an oversupply of milk in Europe.¹⁸ What was supposed to be a health and environment measure was influenced by an economic interest to keep milk prices high for EU producers. The rBST ban had the effect of blocking imports from major foreign sources, though that was not a stated purpose of that particular legislation.¹⁹

The second doctrine, to follow general EU legal principles, stands for the value that precautionary decisions must constitute good governance. Simply put, precaution should be informed, reasoned, and non-arbitrary. It should respect the common principles of proportionality, non-discrimination, and legal certainty.²⁰ The decision maker must consider all of the available scientific evidence,²¹ so as to gain a full knowledge of known facts. Furthermore, there should be a holistic cost-benefit analysis of economic and non-economic factors, in the short and long term, and there should be periodic on-going reviews.²² Finally, decisions should not be reactions to hypothetical dangers that are purely abstract and have no objective probability of occurring.²³ Such ground rules make the precautionary principle judicially reviewable, at least in procedure if not in substance. Political actions are difficult to scrutinise as a matter of law, but procedural requirements can bring enough transparency to allow political checks to do their work.

¹⁶ Jonathan B. Weiner, *Comparing Precaution in the United States and Europe*, 5 J. RISK RESEARCH 317, 322 (2002).

¹⁷ *Id.* at 339. Giandomenico Majone, *What Price Safety? The Precautionary Principle and its Policy Implications*, 40 J. COMMON MARKET STUDIES 89, 95 (2002).

¹⁸ Weiner, *supra* note 16, at 324.

¹⁹ *Id.*

²⁰ *Communication on the Precautionary Principle*, *supra* note 12, §§ 6.3.1–6.3.3.

²¹ *Id.* § 5.1.2.

²² *Id.* §§ 6.3.4–6.3.5.

²³ Case T-13/99, Pfizer, 2002 E.C.R. II-03305, ¶ 143.

So far, I have described but a few essential features of the precautionary principle. I hope they have been fairly uncontroversial. In the following sections, I will explain how the basic structure of the principle supports a fairly comprehensive policy. Furthermore, by following the apparent logic of the principle, I will offer answers to some outstanding questions in the academic literature.

III. WHAT LEVEL OF PRECAUTION EXISTS AT EU LAW?

Precaution generally comes in two varieties: weak and strong. Weak precaution is the approach that follows most logically from the face of the Rio definition. That is to say, a lack of scientific certainty should not preclude action. Preventative measures are valid, so long as they are cost-effective solutions to potentially serious problems. It would seem that weak precaution is similar to an ordinary cost-benefit analysis.

Strong precaution is a more conservative approach. It presumes that protective measures should be implemented unless and until evidence proves that it is not necessary. The essential difference between weak and strong precaution is in the burden of proof. Weak precaution defaults to inaction whereas strong precaution defaults to action. In-between the two varieties, there is a spectrum of possible approaches, of differing strengths of precaution. It is important, when we are applying a legal standard under EU law, to know where on the spectrum we are.

Elen Stokes has complained that different evidentiary thresholds are being used in different ECJ cases.²⁴ She compares the relatively weak approach in *Fornasar*²⁵ with the very strong approach in the *British BSE* case²⁶ and interprets the discrepancy as an unresolved conflict in the law. She even goes so far as to say that these arbitrary differences threaten to break down the integrity of the precautionary principle.²⁷ Stokes seems to imply that there should be one standard for all European cases.

²⁴ Elen Stokes, *The EC Courts' Contribution to Refining the Parameters of Precaution*, 11 J. RISK RESEARCH 491, 496 (2008).

²⁵ Case C-318/98, Giancarlo Fornasar and Others, 2000 E.C.R. I-4785.

²⁶ Case C-180/96, UK v. Comm'n, 1998 E.C.R. I-2265.

²⁷ Stokes, *supra* note 24, at 496–97.

I think this issue as presented is something of a false dilemma. While it is true that the court applies many levels of precaution, it does not mean that the application is arbitrary or wrong. The TFEU itself contains nothing about the strength of precaution, other than a general injunction to “aim at a high level of protection.”²⁸ Under EU law, the strength of precaution is an ad hoc political decision. In many cases, authorities in different member states are free to apply different risk tolerances to similar situations, to fit the needs of their own populations.²⁹ In other cases where the level of precaution is harmonised at the EU level, the intent will be written in the secondary legislation. Therefore, differences in practice at the EU level are not arbitrary because the standards are clearly set out in the various directives. We can demonstrate this by comparing two cases, *Pfizer*³⁰ and *Cockle Fishers*.³¹

Pfizer presents a fairly typical example of precaution under EU law. The case concerned the use of the antibiotic Virginiamycin in animal feed. The antibiotic was banned by the Commission when Pfizer applied for a re-evaluation. The Council passed a regulation to deny authorisation, citing concerns that overuse of the antibiotic might cause drug resistance in humans.³² Pfizer sued for annulment, and the court dismissed the application. The *Pfizer* judgement stands for many points of law, but for now, the important thing to understand is the legal basis for the Virginiamycin ban. The authority came from the Feedstuffs Directive, which controlled the use of additives in animal feed. It provided that antibiotics should be approved only if “for serious reasons concerning human or animal health its use must not be restricted.”³³ Thus, the language of the directive required a presumption against approval, and the burden to rebut that presumption was fairly high. The directive favoured a strong level of precaution and a broad discretion for the decision maker, which

²⁸ TFEU, *supra* note 6, art. 191(2).

²⁹ Vilaca, *supra* note 1, at 372 (citing Case 174/82, Sandoz BV [1983] ECR 2445). Also, the precautionary decision can change when public perception changes, without an accompanying change in science. *See id.* at 375.

³⁰ Case T-13/99, *Pfizer*, 2002 E.C.R. II-03305.

³¹ Case C-127/02, *Landelijke Vereniging tot Behoud van de Waddenzee v. Staatssecretaris van Landbouw*, 2004 E.C.R. I-07405 [hereinafter *Cockle Fishers*].

³² Case T-13/99, *Pfizer*, 2002 E.C.R. II-03305, ¶ 112.

³³ Council Directive 70/524, art. 6(2)(e), 1970 O.J. (L 270) 1, 3 (EC).

was consistent with long-standing practice under the Common Agricultural Policy.³⁴ The court gave deference to the Council in this case.

By contrast, *Cockle Fishers* presents an example of extremely strong precaution. In the case, the Netherlands government had granted seasonal licenses to dredge for cockles in the Waddenzee. The area was protected under the Habitats Directive. Environmental groups sued to stop the dredging of certain shore-bird feeding grounds. Unlike *Pfizer*, the *Cockle Fishers* judgment called for certainty of scientific evidence. The court ruled that fishing must stop, unless it could be proven to cause zero harm to bird habitats.³⁵ The opinion did not consider the weighing of obligations, political choices, costs and benefits, or any number of other factors that usually go into precautionary decision making. Rather, an extremely strong precautionary approach seemed to have a near absolute presumption for protection.

The level of precaution in *Cockle Fishers* goes beyond what is required by Article 191 TFEU. It actually comes from the language of the Habitats Directive, which says that, for projects likely to have significant effects on designated habitats, member states “shall agree to the plan or project only after having ascertained that it will not adversely affect the integrity of the site concerned.”³⁶ Therefore, as long as there is reasonable scientific doubt, “the competent authority will *have to refuse* authorisation.”³⁷ Now, it must be said that extreme precaution is generally undesirable as a matter of policy. Even the EU institutions agree that there is no such thing as “zero risk” and that it is impossible to prove an absence of risk.³⁸ That will be the subject of a later section. Nevertheless, it is easy to see that this instance of very

³⁴ Case T-13/99, *Pfizer*, 2002 E.C.R. II-03305, ¶ 166.

³⁵ “[T]he competent national authorities . . . are to authorise such activity only if they have made certain that it will not adversely affect the integrity of that site. That is the case where no reasonable scientific doubt remains as to the absence of such effects.” Case C-127/02, *Cockle Fishers*, 2004 E.C.R. I-07405, ¶ 59.

³⁶ Council Directive 92/43, art. 6(3), 1992 O.J. (L 206) 7, 11 (EC).

³⁷ Case C-127/02, *Cockle Fishers*, 2004 E.C.R. I-07405, ¶ 57 (emphasis added).

³⁸ Case T-13/99, *Pfizer*, 2002 E.C.R. II-03305, ¶ 130; *Communication on the Precautionary Principle*, *supra* note 12, § 2.

strong precaution has been explicitly required by secondary legislation.³⁹

Pfizer and *Cockle Fishers* teach us at least two things. First, the level of precaution under EU law is set by secondary legislation. Second, within a range of variation, precaution is likely to be on the strong end of the spectrum. It makes sense for the EU to have stronger precaution because weak precaution, with no presumption for or against action, is too much like an ordinary cost-benefit analysis.⁴⁰ If the precautionary principle is to have any added value, it must be of a stronger variety. That is presumably what the TFEU means when it calls for a “high level of protection.”⁴¹

Stokes has raised a concern that having varying levels of precaution blurs an important distinction between “precaution” and “prevention,” as those terms are used in Article 191 TFEU.⁴² I disagree. The difference between precaution and prevention is that the first applies in situations where risk is uncertain and the second applies where risk is certain.⁴³ Certainty or uncertainty is a totally independent question from the level of precaution. As explained later in this article, certainty is determined as a result of a risk assessment, and only *after* undertaking such risk assessment can precaution, at any level, be discussed.⁴⁴ I also disagree with Stokes that varying levels of precaution diminishes the value of risk assessment.⁴⁵ Risk assessment is absolutely necessary for

³⁹ The strict application of precaution in *Cockle Fishers* is directly according to the intent of the lawmaker. Nicolas de Sadeleer, *The Precautionary Principle in EC Health and Environmental Law*, 12 EUROPEAN L.J. 139, 146 (2006).

⁴⁰ Veerle Heyvaert, *Facing the Consequences of the Precautionary Principle in European Community Law*, 31 EUROPEAN L. REV. 185, 188 (2006) (“[Weak precaution is] hardly distinguishable from the general preventative, risk-based principles for decision-making.”).

⁴¹ Case C-127/02, *Cockle Fishers*, 2004 E.C.R. I-07405, ¶ 44.

⁴² Stokes, *supra* note 24, at 496 (“Inconsistency in the interpretation of evidential thresholds triggering regulatory intervention erodes the boundary between responses categorised as either ‘precautionary’ or ‘preventive.’”).

⁴³ *Id.* (“Whereas the principle of prevention operates in relation to hazards whose scale and impact can be statistically predicted, the precautionary principle is employed in the face of scientifically uncertain threats.”).

⁴⁴ “Precautionary action presupposes the identification of a potential harm and a comprehensive assessment thereof.” Case C-77/09, *Gowan Comércio Internacional e Serviços Lda v. Ministero della Salute*, 2010 E.C.R. I-13533, ¶ 75 [hereinafter *Gowan*].

⁴⁵ Stokes, *supra* note 24, at 496 (“[T]his inconsistency renders ambiguous the role of risk assessment in governing precautionary conduct.”).

knowing the proportionality of an action,⁴⁶ and proportionality, being a general principle of EU law, must always be present.

IV. WHAT LEVEL OF UNCERTAINTY TRIGGERS PRECAUTION?

The Rio definition of the precautionary principle states that a *lack of scientific certainty* is not to be an excuse for inaction. Clearly, the principle presupposes a level of scientific uncertainty. Elsewhere in the academic literature, uncertainty has been discussed as a sort of legal prerequisite for precautionary action.⁴⁷ In that case, what level of uncertainty triggers precaution?

One non-authoritative suggestion comes from the pleadings in *Danielsson*.⁴⁸ The case concerned the testing of nuclear weapons in French Polynesia. The petitioners argued that the Commission must ban tests “as soon as there is a strong suspicion of potential harm to health and environment.”⁴⁹ This argument has since been speculatively repeated in the literature, partly because, I think, it appeals to a desire to find a clear-cut rule for when the precautionary principle applies. However, the argument cannot be correct for at least two reasons.

First, the argument ignores all evidence on the other side that favours inaction. The Rio Declaration militates against improper excuses for inaction, like laziness or political bias, but it allows that inaction can be a valid response, so long as there is legitimate evidence to support it. The Commission, too, says that political discretion includes the choice not to act.⁵⁰ Even in the strongest example of precaution, the Habitats Directive, at issue in *Cockle Fishers*, acknowledged opposing evidence, since pros and cons would have been discussed when deciding which habitats should be covered.⁵¹

⁴⁶ See Case C-77/09, *Gowan*, 2010 E.C.R. I-13533, ¶ 75.

⁴⁷ See, e.g., Stokes, *supra* note 24, at 493.

⁴⁸ Case T-219/95, *Danielsson v. Comm'n*, 1995 E.C.R. II-03051.

⁴⁹ *Id.* ¶ 44.

⁵⁰ *Communication on the Precautionary Principle*, *supra* note 12, § 5.

⁵¹ The decision to select and designate protected habitats rests initially with the member state governments. Only upon such designation do the protections of the Habitats Directive apply. See Council Directive 92/43, art. 3(2), 1992 O.J. (L 206) 7, 10 (EC) (“[E]ach Member State shall designate . . . sites as special areas of conservation . . .”).

The second error of the above argument is that it does not weigh the costs of action. There are opportunity costs associated with action, just as surely as there are benefits. Cass Sunstein has written elegantly about the dangers of careless precaution, explaining that opportunity costs can be even greater than the harms avoided.⁵² Therefore, as a “general principle of Community law,”⁵³ the precautionary principle cannot have a hairpin trigger as the *Danielsson* petitioners suggest. Even an extremely strong precautionary approach should give at least some acknowledgement to costs.

I find it misleading to speak of the precautionary principle as having a legalistic “trigger,” as though it operates in some cases and not others. In my view, the precautionary principle is ever present. To understand, I must make clear the distinction between risk and uncertainty.⁵⁴ Risk is a known quantifiable value, which is mathematically calculable. It fits into a conventional cost-benefit equation under the ordinary mode of decision making, which the Commission calls the “prudential approach.”⁵⁵ By contrast, uncertainty is a condition where we have no quantifiable measures. It may arise because we do not know the potential risks or because there is so much divergence of opinion that we cannot reasonably agree on a quantity of risk.⁵⁶ In any case, most real life situations involve some uncertainty. Wherever there is uncertainty, even if it is small, precaution must be there to fill in the gaps.

The important question of policy is, when it is appropriate or inappropriate to act on a precautionary impulse? Even when experts disagree about risk, is the disagreement so small or so

⁵² Cass R. Sunstein, *Beyond the Precautionary Principle*, 151 U. PA. L. REV. 1003, 1024 (2003). Sunstein illustrates how increased regulation can kill more people on net by depriving people of potential benefits. *Id.* at 1027.

⁵³ Case T-74/00, *Artegodan*, 2002 E.C.R. II-04945, ¶ 184.

⁵⁴ See Stokes, *supra* note 24, at 494.

⁵⁵ *Communication on the Precautionary Principle*, *supra* note 12, § 5.

⁵⁶ Renn characterises precaution as a type of risk management in which the risk values are not known. Ortwin Renn, *Precaution and Analysis: Two Sides of the Same Coin?*, 8 EUROPEAN MOLECULAR BIOLOGY ORG. REP. 303, 303 (2007) (“Within the frame of precaution, risk is seen from the perspective of pervasive uncertainty, ambiguity and, in particular, ignorance. Precautious risk management therefore aims to ensure prudent decisions in situations where there is a high incertitude about probabilities . . .”). According to Gowan, uncertainty can arise because of “insufficiency, inconclusiveness, or imprecision of the results [of a risk assessment].” Case C-77/09, *Gowan*, 2010 E.C.R. I-13533, ¶ 76.

unimportant as to make the uncertainty trivial? To act on a triviality would violate the general EU principles of proportionality and non-arbitrariness.⁵⁷ So, if there is no genuine difference of scientific opinion, there can only be one course of action. Any other, by definition, would be disproportionate to the problem. For that reason, triviality is the real dividing line between valid and invalid precaution. Furthermore, the courts have the competence to differentiate between trivial and non-trivial uncertainty.

The courts have already addressed a subset of trivial uncertainty under the name of “hypothetical risk.” *Pfizer* defines hypothetical risk as that which is “founded on mere conjecture which has not been scientifically verified.”⁵⁸ That kind of risk cannot be the basis for a precautionary action.⁵⁹ Hypothetical risk is a type of trivial uncertainty where all reasonable scientific interpretations agree that risk is at or near zero. In such a case, risk, even if it exists, is very low, and any disagreement over the quantity of risk is, in my terminology, trivial.⁶⁰ *Pfizer* also explains a more typical situation “in which there is a risk . . . [that] has not yet been fully demonstrated.”⁶¹ There, scientists may have materially different opinions about how big the quantity of risk is. This would be a condition of non-trivial uncertainty, where it would be perfectly legitimate to make a political choice under the precautionary principle.

The major advantage of the “trivial uncertainty” test, as opposed to the “hypothetical risk” test, is that it can extend *Pfizer* reasoning to situations that the court has not yet addressed. For example, what if scientists agree that there is a low but non-zero,

⁵⁷ Case T-13/99, *Pfizer*, 2002 E.C.R. II-03305, ¶ 162 (“[A]rbitrary measures . . . cannot in any circumstances be rendered legitimate by the precautionary principle.”). The same paragraph seems to stand for the proposition that extremely strong precaution in every case would be undesirable because it would lead to arbitrariness. See also MICHAELS, *supra* note 4 (cautioning against the dangers of over-zealous precaution).

⁵⁸ Case T-13/99, *Pfizer*, 2002 E.C.R. II-03305, ¶ 143.

⁵⁹ *Id.*

⁶⁰ A real life example can be found in the Case 178/84, *Comm’n v. Germany*, 1987 E.C.R. 01227. In that case, the German government prohibited the use of the designation “beer” for any beverage not brewed exclusively from barley, hops, yeast, and water. The government cited no scientific health concern except for a general public suspicion of additives. Since the scientific consensus found harm to be non-existent, there was no non-trivial uncertainty, and Germany could not sustain the ban.

⁶¹ Case T-13/99, *Pfizer*, 2002 E.C.R. II-03305, ¶ 146.

non-hypothetical risk? Is it justified to take precautionary action? If the putative risks are sufficiently low, one has only to plug them into a cost-benefit equation and observe, say, that the costs of action outweigh the benefits in every conceivable case. Therefore, the prudential approach would dictate that the only choice is to take no action. Even if politicians were tempted to invoke the precautionary principle to achieve a different result, it is easy to see that such a decision would be arbitrary.⁶² Observe: that the risk is not hypothetical, but the uncertainty is too trivial to form a valid basis for precautionary action.

Trivial uncertainty can also help us when scientific opinion falls into a rather larger range. Even when risk estimates vary significantly, it does not necessarily mean that there is more than one legitimate result. Authors like Karl-Heinz Lardeur have feared that the precautionary principle gives the decision maker freedom to take *any* action as long as *any* disagreement persists.⁶³ But that should not be the case. Suppose that experts come up with a range of risk quantities, but all of them fall into an area that suggests no action. Proportionality requires that the decision maker must not act.⁶⁴ If the objective science is universally opposed to action, then there can be no action that is proportional to the threat.

A real life illustration of trivial uncertainty occurred in the *French BSE* case.⁶⁵ In that case, the French government continued to ban all imports of British beef, even after the Commission and its scientific committees had concluded that some imports were safe. France was concerned that undocumented beef could get into the country through unauthorised channels, but the Commission and the UK promised strict monitoring. France did

⁶² *Communication on the Precautionary Principle*, *supra* note 12, § 6.3 (“Precautionary principle is no excuse for derogating from the general principles of risk management.”).

⁶³ Lardeur, *supra* note 3, at 1470 (“[T]he Commission could take far-reaching decisions on all kinds of products as long as some experts might continue to argue that a certain risk beyond the merely hypothetical risk cannot be excluded.”).

⁶⁴ The British BSE case tells us that when choosing between several appropriate measures, the decision must always comply with proportionality principle. See Case C-180/96, *UK v. Comm’n*, 1998 E.C.R. I-2265, ¶ 96. The general principle is also recognised in the *Communication on the Precautionary Principle*, *supra* note 12, § 6.3 and in Case C-77/09, *Gowan*, 2010 E.C.R. I-13533, ¶ 81.

⁶⁵ Case C-1/00, *Comm’n v. France*, 2001 E.C.R. I-09989.

not trust the traceability of the beef, so it refused to cooperate. The court found, with few exceptions, that the EC had set up an unquestionably adequate and reliable tracing system, so the French action was not valid.⁶⁶ Where science uniformly supported *some* imports, France could not justify a ban on *all* imports.

To use the language of trivial uncertainty to describe the result of the *French BSE case*, we would say that uncertainty and valid political discretion lay within a range, but banning all imports was a result that fell outside of that range. As to the appropriateness of a total ban, there was no genuine uncertainty. Thus, the scenario that Lardeur feared, i.e. validating any action as long as France and the Commission disagreed even a little, does not seem to occur. The limiting principle of trivial uncertainty, combined with the principle of proportionality, guides EU law to solutions that are consistent with our instincts and with good policy.

V. WHAT IS THE ROLE OF SCIENCE?

A. *Science as a Basic Requirement*

Understanding science is crucial to the operation of the precautionary principle. It is scientific study that informs our knowledge of risks, and it is also fuller scientific investigation that allows us to put quantities on otherwise abstract risks. But scientific research forms only one half of the precautionary principle. The political half of the principle lets the law work even when science does not give a definitive answer. In my view, the political contribution is even more significant than the scientific one.

Even so, the role of science is not to be ignored. The courts have laid down a number of rules for its use, with the goal of ensuring reasoned decision making when precaution is exercised. The *Pfizer* judgement is the most significant authority on this issue. *Pfizer* elucidates at least two points: first, the proper standard of risk assessment, and second, how to treat scientific advice given by committees. First and foremost, risk assessment is a prerequisite for all precautionary actions.⁶⁷ Risk assessment

⁶⁶ *Id.* ¶¶ 134–35.

⁶⁷ Case T-13/99, *Pfizer*, 2002 E.C.R. II-03305, ¶ 155.

requires “the identification and characterisation of a hazard, the assessment of exposure to the hazard and the characterisation of the risk.”⁶⁸ The decision maker must act in light of the best available scientific information, based on the most recent results of international research.⁶⁹ Then, with a “full knowledge of the facts, [the authority should make] as thorough a scientific risk assessment as possible.”⁷⁰ Only having done this can the decision maker choose to take precautionary actions.

B. The Standard of Equal or Better Evidence

At the EU level, risk assessments are done by expert committees that advise the institutions on technical and scientific matters. The committees use the above principles to produce recommendations for or against precaution. The institutions are not strictly bound by the recommendations, but if they disagree, they must support their position with scientific evidence of equal or better quality, as compared to the committee’s.⁷¹ The latter requirement is a way of preventing frivolous concerns (e.g. media hype, in *Pfizer*⁷²) from trumping best available scientific evidence. Only evidence of a sufficient quality can generate genuine uncertainty and precautionary action.

Unfortunately, *Pfizer* itself was not the best illustration of this rule because it was not a particularly close case. But “equal or better” is probably a rough standard at best because courts are not well qualified to scrutinise the details of scientific studies. Nor are there any good non-technical proxy measures for scientific quality. A court would probably not, for example, look at university league tables and try to compare studies based solely on the ranking of the universities that produced them. These kinds of proxy measures do not get to the essential purpose of the “equal or better” standard.

⁶⁸ *Id.* ¶ 156.

⁶⁹ *Id.* ¶ 158. The standard of best available scientific information, like the precautionary principle itself, has become a popular principle in international law. For example, it is required for the purpose of sustainable fisheries management in the United Nations Convention on the Law of the Sea, Dec. 10, 1982, 1833 U.N.T.S. 3.

⁷⁰ Case T-13/99, *Pfizer*, 2002 E.C.R. II-03305, ¶ 162; see also Case T-74/00, *Artegodan*, 2002 E.C.R. II-04945, ¶ 198.

⁷¹ Case T-13/99, *Pfizer*, 2002 E.C.R. II-03305, ¶ 199.

⁷² *Id.* ¶ 190.

The essential purpose of the “equal or better” standard is to force the EU institutions to demonstrate genuine scientific uncertainty. The courts are not so much interested in particular results as ensuring that precaution is always exercised in response to non-trivial uncertainty. This fact is evident from the court opinion in *Fedesa*.⁷³ In that case, the Commission took precautionary measures against the use of certain hormones in livestock. The court did not try to decide whether the hormones were safe, but it did examine whether the Commission had shown a divergence of opinions. For that purpose, the court did not try to rank different pieces of evidence, but it satisfied itself that all of the evidence compared was of the same rough calibre. It is probably reasonable for us to assume that any study of an internationally recognised standard could be deemed “equal” with any other, *prima facie*. Any more detailed inquiry is not practical or even desirable for a court to perform.

Although *Fedesa* was decided more than twenty years ago, the courts have continued to view “equal or better” scientific quality at a fairly high level of abstraction. The *Pfizer* opinion asserted that it was not even necessary for the institutions to consult expert committees about every published study; it was only necessary that the institutions grasp the full scientific value of the studies.⁷⁴ Apparently, the institutions have a lot of self-responsibility when it comes to educating themselves. If consultation of committees is not even required as a matter of procedural formality, then there is no reason to think that the courts will be overly strict about comparing the quality of a committee’s science versus an institution’s science.

Caoimhin MacMaolain, for one, has criticised the court for letting the Commission ignore committee advice. He laments that in the future, one institution study could be enough to counter ten committee studies and invite wide political discretion.⁷⁵ I think MacMaolain may well be right, but the fact alone does not necessarily represent a failure of EU principles. The law is not so much aimed at counting numbers of studies⁷⁶ as it is deciding whether

⁷³ Case C-331/88, *ex parte Fedesa*, 1990 E.C.R. I-04023, ¶ 9.

⁷⁴ Case T-13/99, *Pfizer*, 2002 E.C.R. II-03305, ¶ 298.

⁷⁵ Caoimhin MacMaolain, *Using the Precautionary Principle to Protect Human Health: Pfizer v. Council*, 28 EUROPEAN L. REV. 723, 730 (2003).

⁷⁶ Lardeur, *supra* note 3, at 1470 (“Science does not imply a majority rule: there is no presumption that the majority is right and the minority is wrong.”).

there is genuine uncertainty. Uncertainty is for the court to decide on an ad hoc basis. If the public is uncomfortable with institutional discretion, that is rather a political problem. This article will discuss how the EU can improve political trust in a later section.

C. *The Increasing Importance of Science?*

Ever since the *Pfizer* opinion laid out in great detail the procedures for using scientific evidence, scholars have paid increased attention to the new jurisprudence. Some believe that the importance of science is growing.⁷⁷ However, I think that the sheer detail of the *Pfizer* opinion is misleading in this way. I have already described how many elements of the *Pfizer* prescription are no more or less than what was already required by EU law fundamentals. Therefore, the overall importance of science should not be overstated.

The political side of the precautionary principle is still strong. Politics is what takes action when science has no answer. Political discretion is also the most important value that the precautionary principle adds to the ordinary prudential approach. Much is still determined by politics. For example, the EU institutions and the member state governments decide what level of risk is acceptable to their respective constituents.⁷⁸ Even the most basic of cost-benefit decisions in democratic societies are subject to public opinion.⁷⁹ Politics remains an indispensable part of the precautionary principle.

The problem with political decisions is that they are not amenable to judicial review. For example, in *Fedesa*, the court was asked to review a precautionary measure taken under the Common Agricultural Policy, an area where the institutions have traditionally had very wide discretion. The court said that it could

⁷⁷ See, e.g., *id.* at 1462 (talking about the “rise of science in the process of risk evaluation and management”).

⁷⁸ Case T-13/99, *Pfizer*, 2002 E.C.R. II-03305, ¶ 151; *Communication on the Precautionary Principle*, *supra* note 12, § 5.2.1.

⁷⁹ See *Communication on the Precautionary Principle*, *supra* note 12, § 6.3.4; Majone has decried the counting of public opinion in cost-benefit analyses, saying that it is “an adjustable peg [that] can justify any measure.” Majone, *supra* note 17, at 100. While it is true that public opinion can skew rational decision making, it is also unfair to ask the political institutions to ignore public dissent. It is, after all, a government’s job to be attentive to its people.

not verify the accuracy of the science.⁸⁰ It could not even check that the action taken was rational and objective.⁸¹ The court could only review for manifest error or misuse of powers.⁸² Similar conclusions, not under CAP, were also reached in *Artegodan*⁸³ and *Gowan*.⁸⁴

Where substantive review of political decisions is impossible, it is even more important to have effective procedural reviews.⁸⁵ EU law has long placed emphasis on procedural values, especially on transparency and accountability, in the hope they will build more public trust.⁸⁶ In the context of the precautionary principle, scientific risk assessment is only the most visible and readily reviewable procedure. Through decisions like *Pfizer*, the courts have shown a desire to put limiting principles on political decisions, but it does not necessarily mean that the courts intend to shift the centre of gravity towards science. Science and politics are both important.

VI. IS THE PRECAUTIONARY PRINCIPLE GOOD POLICY?

The most troubling challenges to the precautionary principle are those that question the fundamental wisdom of the principle. Sunstein and Majone have written elegant criticisms arguing that precaution can lead to bad policy. Problems range from ignorant biases to logical fallacies. Not all of them are completely solvable. In the following sections, I describe the most significant of these challenges and some possible solutions based on principles of EU law.

A. Ignorance of Opportunity Costs

⁸⁰ Case C-331/88, *Fedesa*, 1990 E.C.R. I-04023, ¶ 9.

⁸¹ *Id.* ¶ 8.

⁸² *Id.*

⁸³ Case T-74/00, *Artegodan*, 2002 E.C.R. II-04945, ¶¶ 200-01 (concerning the use of an anorectic as a weight loss drug in humans).

⁸⁴ Case C-77/09, *Gowan*, 2010 E.C.R. I-13533, ¶ 82 (concerning the use of the fungicide fenarimol).

⁸⁵ Case T-13/99, *Pfizer*, 2002 E.C.R. II-03305, ¶ 171; *see also Stokes, supra* note 24, at 497.

⁸⁶ For instance, the EU has embraced public consultation, following the Aarhus Convention, as a means toward better decision making. *See Communication from the Commission Towards a Reinforced Culture of Consultation and Dialogue*, COM (2002) 704 final (Dec. 11, 2002).

Precautionary action brings with it a host of opportunity costs because it often acts by limiting or prohibiting the use of a human technology. Giving up potential advantages of technology is obviously costly.⁸⁷ Sunstein contends that a sensible approach to precaution should include the opportunity costs in the overall cost-benefit analysis,⁸⁸ but under strong precaution, where there is a presumption for bans, opportunity costs are not fully understood before action is taken.⁸⁹ To use Sunstein's example, drugs to treat human diseases are not given market access until all of the side effects are researched. If the side effects turn out to be minor, more harm may have occurred in the meantime from diseases gone untreated.⁹⁰ Finally, Sunstein argues that precaution is too often an overreaction to public fear that causes governments to make uneconomical decisions.⁹¹ He cites the example of asbestos, which is not always dangerous but has been aggressively eradicated at great expense.⁹²

I take Sunstein's examples to be accurate, but I do not agree with his interpretation that they necessarily represent bad practice. Side effects of a specific drug may not be known beforehand, but regulators may know statistically that side effects in trial drugs are common and intolerable. Asbestos eradication started because of a genuine danger, although public fear eventually became more serious than the actual danger. I am not convinced that Sunstein's post hoc criticisms should have changed either of the decisions at the time that they were made. The cost-benefit analysis is always going to be difficult wherever there is uncertainty. The key is to make justifiable decisions within the constraints of limited knowledge. The EU's procedural requirements, including best possible risk assessment and best available scientific evidence, maximise the chances of a well-reasoned decision.

B. Benevolence of Nature

⁸⁷ See Majone, *supra* note 17, at 101.

⁸⁸ Sunstein, *supra* note 52, at 1037.

⁸⁹ See *id.* at 1024.

⁹⁰ *Id.* at 1027.

⁹¹ *Id.* at 1047–48.

⁹² *Id.* at 1051.

Another of Sunstein's criticisms is the unwarranted trust in the "benevolence of nature."⁹³ Precautionary action often stops the progress of a human activity, so one may say that it keeps the world in a state of nature. But a state of nature is not necessarily optimal for human well-being. To use Sunstein's examples again, before modern medicine, people had short and sickly lives. The invention of modern medicines improved the quality of life. Also, the EU's resistance to genetically modified crops has denied market access to many African farmers, hurting their livelihoods and increasing their poverty.⁹⁴ It is impossible to justify a policy that categorically favours a state of nature.

I believe that the precautionary principle takes account of this problem. In fact, the preference for a state of nature is not indiscriminate. The Rio declaration specifies that precaution applies where there are "threats of serious and *irreversible* damage." In many cases, nature is especially hard to restore once damaged. To use the terminology of risk analysis, we would say that the losses are unbounded and that we cannot calculate expected values.⁹⁵ A conservative approach is warranted if the downside risk is unlimited. Of course, it would also be sensible to have a periodic review to ensure that the initial conservative approach stays relevant.

C. Re-evaluation and Absence of Time Limitation

An initial excess of caution ought to be accompanied by a periodic re-evaluation. The Commission has said: "[Precautionary] measures should be maintained as long as the scientific data are inadequate, imprecise or inconclusive and as long as the risk is considered too high to be imposed on society."⁹⁶ In other words, if science has progressed enough, precautionary measures should be withdrawn in favour of prudential measures. Notably, says the

⁹³ *Id.* at 1038.

⁹⁴ *Id.* at 1032–33.

⁹⁵ Renn, *supra* note 56, at 304 ("[T]he main purpose of precaution is to avoid irreversible decisions Majone concedes that it does have a role in risk analysis, namely where losses or utilities are unbounded and where it is clearly impossible to calculate expected values.").

⁹⁶ *Communication on the Precautionary Principle*, *supra* note 12, § 6.3.5.

Commission, “[progress] is not always linked to the time factor, but to the development of scientific knowledge.”⁹⁷

Majone argues that a lack of time limitation is problematic because it creates a vague standard that is hard for judicial bodies to enforce.⁹⁸ He says that such a policy was contrived by the Commission to give the EU maximum leeway in the aftermath of an unfavourable WTO ruling in the *SPS cases*.⁹⁹ It is impossible for a court to decide when a science has developed “far enough” or when a risk has finally become “acceptable” to the public. Majone says that the Commission’s policy makes cost-benefit analysis superfluous.¹⁰⁰

Indeed, it would be very hard for a court to adjudicate progress of science, in the way that Majone has framed it, because it mixes political elements (public perception) and legal elements (genuine uncertainty). The court can succeed if it sticks to the legal questions. Progress of science, as far as the court should be concerned, is nothing more than the evolution from scientific uncertainty to consensus. Thus, the court can reduce Majone’s query into the familiar one about trivial uncertainty, and it can make decisions within the bounds of its established institutional competence. On the whole, the Commission’s communiqué has not changed anything about the existing precautionary principle framework. All the Commission does is to re-emphasise its existing political powers, keeping the court’s power exactly as it is.

⁹⁷ *Id.*

⁹⁸ Majone, *supra* note 17, at 99–100.

⁹⁹ *See id.* at 99. *See also* Appellate Body Report, *European Communities—Measures Concerning Meat and Meat Products*, WT/DS26/AB/R, WT/DS48/AB/R (Jan. 16, 1998) (*adopted* Feb. 13, 1998). In the SPS cases, the US and Canada challenged Directive 96/22/EC for violating the Agreement on the Application of Sanitary and Phytosanitary Measures (the “SPS Agreement”). The directive generally banned the importation of meat from animals that were treated with hormones. The EC lost the case. Among other things, the WTO Appellate Body reaffirmed the version of the precautionary principle that was embodied in the SPS Agreement. Section 5.7 of the SPS Agreement allowed members to exercise precaution in light of scientific uncertainty, but “in such circumstances, Members shall seek to obtain the additional information necessary for a more objective assessment of risk and review the . . . measure accordingly within a reasonable period of time.” (emphasis added). Agreement on the Application of Sanitary and Phytosanitary Measures, § 5.7, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1867 U.N.T.S. 154.

¹⁰⁰ Majone, *supra* note 17, at 100.

D. Zero Risk and Minimax Approach

The Commission takes great pains to establish that precautionary actions are well reasoned and objectively justified. But there are two common practices that are incompatible with this ideal: the zero risk approach and the minimax approach.

The zero risk approach is similar to the extremely strong version of the precautionary principle. Under zero risk, the decision maker will not allow an activity until there is proven a total absence of risk. This is problematic as an instrument of policy because it is impossible to prove a negative, so a zero risk approach is tantamount to an outright ban on human activity.¹⁰¹ An outright ban is not a proportional response to ordinary risks,¹⁰² so a zero risk policy is *prima facie* suspect. The Commission has stressed that a precautionary approach should never be confused with a zero risk policy.¹⁰³

Nevertheless, some examples of zero risk do exist in EU law. *Cockle Fishers* is one that we have already mentioned. These kinds of cases flatly contradict the EU's own broader ideals. However, it is important to notice how zero risk is used in limited circumstances under specific conditions. These are: the danger of irreversible damage, lack of alternatives, and a limited time frame. In *Cockle Fishers*, the Netherlands government was worried about unsustainable damage to bird habitat and an inability to manage bird feeding grounds alongside commercial fishing. The beaches of the Waddenzee were so saturated with wildlife during certain seasons that any industrial scale fishing would be very harmful.¹⁰⁴ It did not appear that anyone offered a good compromise solution. With no ability to do anything more sophisticated, sometimes a ban is the only viable option in the short term.¹⁰⁵ The *Cockle Fishers* ban was reviewed every year, over fishing seasons of just four months.¹⁰⁶ Although there are not enough court cases

¹⁰¹ Sunstein, *supra* note 52, at 1023; *see also* Case C-77/09, Gowan, 2010 E.C.R. I-13533, ¶ 69.

¹⁰² *Communication on the Precautionary Principle*, *supra* note 12, § 6.3.1.

¹⁰³ *Id.* § 2; *cf.* Majone, *supra* note 17, at 92 (claiming that erring towards a more conservative precautionary approach will always lead to a zero risk policy).

¹⁰⁴ Case C-127/02, *Cockle Fishers*, 2004 E.C.R. I-07405, ¶ 9.

¹⁰⁵ *Communication on the Precautionary Principle*, *supra* note 12, § 6.3.1.

¹⁰⁶ By its decisions in 1999 and 2000, the national authority issued licenses for the period from mid-August through November of the respective year. Case C-127/02, *Cockle Fishers*, 2004 E.C.R. I-07405, ¶ 11.

to really define the boundaries of the Habitats Directive, we should assume that zero risk approaches are rare exceptions. They should tend to feature unlimited downside risk, no alternative solutions, and frequent re-evaluation.

Finally, the minimax approach might be the most serious pitfall of the precautionary principle. Minimax is the decision process whereby one tries to foreclose worst possible scenarios, no matter how small the actual likelihoods.¹⁰⁷ Activities that carry rare but catastrophic risks (a common example being generation of nuclear power) might be categorically ruled out. Minimax is undesirable as a policy because it fails to consider relative probabilities of risk. Without a real cost-benefit calculation, minimax can lead to decisions that are economically inefficient. It panders to public fears in the sense that it targets the most vivid risks that elicit the strongest emotions,¹⁰⁸ yet it does not balance the severity with the actual probability.¹⁰⁹ The minimax approach is not based on a system of objective reason.

Courts may be able to control the worst of the minimax cases under the doctrine of hypothetical risk. That is, if a risk is sufficiently remote, the court can rule that it is hypothetical and that it is not appropriate justification for precautionary action. But if a choice falls within the range of valid political discretion, there is nothing in the precautionary principle to prevent minimax reasoning. It will take new jurisprudence to regulate this area of the precautionary principle.

VII. INCREASING PERCEIVED LEGITIMACY OF THE PRECAUTIONARY PRINCIPLE

In this article, I have tried to show that the EU's approach to the precautionary principle is a scientifically reasoned and logically consistent system of decision making. Most of the questions and criticisms that are directed at the principle can be answered if we interpret the principle in accordance with fundamentals of EU law. There are problems at the fringes, but the precautionary principle on the whole is not as inconvenient as some scholars have feared. Even so, there is lingering uneasiness sur-

¹⁰⁷ Sunstein, *supra* note 52, at 1033.

¹⁰⁸ *Id.* at 1045.

¹⁰⁹ Majone, *supra* note 17, at 102.

rounding the principle, mainly to do with a lack of public trust and the vast political discretion that is still in the hands of the institutions. Political power has not been a major focus of court decisions because it is not easily reviewed, and yet, it is an unmistakable stumbling block for the precautionary principle.

Political discretion appears, for example, in the weighing of non-economic factors. The Commission reserves the power to consider things like public sentiment in addition to traditional economic indicators when making decisions.¹¹⁰ There is but one clear limit to political discretion: In a case of hypothetical risk, no precaution is allowed. Otherwise, it is very difficult for legal mechanisms to curb unwise political decisions. As we have said already, overreliance on unquantifiable measures can lead to sub-optimal results.

Some authors have complained that there is already too much discretion in play. Left unconstrained, the lawmaker can abuse the precautionary principle by making arbitrary, discriminatory, or corrupt decisions. Heyvaert, for one, argues that the courts have been much too permissive and that they will throw the precautionary principle into disrepute if they fail to strike down an action soon.¹¹¹ I would not disagree that the precautionary principle needs to have visible and meaningful boundaries, however, one can never really escape subjectivity, since even pure risk assessments belie value judgments other than science.¹¹² As long as the EU is committed to keeping the precautionary principle, it will have to make citizens comfortable with some inherent subjectivity.

Trust in the EU institutions can be increased. Students of EU law are all familiar with the debates about lack of transparency and accountability in the EU, or what we call the “democratic deficit.” These are problems that need to be fixed in order to increase political legitimacy. One solution in the short to medium term is to give a bigger role to the European Parliament. Because the Parliament is the EU’s sole directly elected body, it responds to a kind of mandate that the other institutions simply do not have. It is better positioned, at least in theory, to resist improper politi-

¹¹⁰ *Communication on the Precautionary Principle*, *supra* note 12, § 6.3.4.

¹¹¹ Heyvaert, *supra* note 40, at 201.

¹¹² Maria Lee, *Beyond Safety? The Broadening Scope of Risk Regulation*, 62 *CURRENT LEGAL PROBLEMS* 242, 248 (2009).

cal influences. The Parliament currently has no role in the implementation of precaution, and I cannot speculate as to what role it may gain in the future, but the Parliament's legitimising influence has already been seen in other traditionally executive areas.

In late 2009, the Council concluded to the first interim SWIFT agreement, whereby it agreed to pass financial transaction data to the US government to support the on-going hunt for terrorist suspects. It was clear that such sharing of private data was illegal under most member states' national laws, but national governments were afraid of being blamed by the Americans for security disasters if they did not cooperate.¹¹³ Only Germany did not support the final vote in the Council.¹¹⁴ The interim SWIFT agreement became one of the more infamous examples where the EU is said to have failed to defend basic rights of citizens.

In 2011, after the Lisbon Treaty entered into force, the Parliament was asked to vote on a permanent version of the SWIFT agreement. Despite direct and heavy pressure from senior American politicians, the Parliament rejected the agreement.¹¹⁵ The Parliament cited concerns about misuse of private information and violation of the rule of law and personal privacy. The Parliament showed that it could turn aside diplomatic pressures and respond to the concerns of citizens in a way that the Council did not. The Parliament felt free to live up to its reputation as being more democratically accountable, and in doing so, it achieved a result that was more in line with the ideals of EU law.

The Parliament can bring the same legitimising influence to the precautionary principle. The Parliament has been more willing, after Lisbon, to assert its voice. If it were to get involved with the implementation of precaution, there would be more credence to the claim that precautionary actions were working for the benefit of citizens. However, this will not be easy for the

¹¹³ Hans-Jürgen Schlamp, *Spying on Terrorist Cash Flows*, SPIEGEL ONLINE (Nov. 27, 2009, 04:17 PM), <http://www.spiegel.de/international/europe/spying-on-terrorist-cash-flows-eu-to-allow-us-access-to-bank-transaction-data-a-663846.html>.

¹¹⁴ Germany abstained, allowing the measure to pass as all other member states voted in favour. Jörg Monar, *The Rejection of the EU-US SWIFT Interim Agreement by the European Parliament: A Historic Vote and its Implications*, 15 EUROPEAN FOREIGN AFFAIRS REV. 143, 146 (2010).

¹¹⁵ *European Swift Bank Data Ban Angers US*, BBC NEWS ONLINE (Feb. 11, 2010, 13:59 GMT), <http://news.bbc.co.uk/2/hi/europe/8510471.stm>.

Parliament to do. First, the secondary legislation, as we have discussed before, must be changed to involve the Parliament in decision-making procedures. Then, the Parliament itself will have to acquire the resources and the expertise to be able to make meaningful policy contributions. The Parliament is probably not prepared to do so at the moment,¹¹⁶ but change may come if trust in the precautionary principle reaches a crisis point.

VIII. CONCLUSION

Studying the precautionary principle is like looking at EU law in miniature. Not only is it enshrined in the TFEU, it also implicates important values of EU law, such as proportionality, economy, and reasoned justification. That the precautionary principle has received so much attention shows that there is much at stake in its interpretation.

I think it is most accurate to interpret the precautionary principle as a collection of practices derived from a small set of fundamental principles. The generally strong level of precaution, the dislike of hypothetical risk, and the prescription for role of science all align with our generally accepted ideas of good law-making. Therefore, the precautionary principle is not so hard to understand, at least in its ideal form. Things are more difficult in reality because good policy is not always practicable, either technically or politically. Certain criticisms against the principle are still particularly hard to answer. Of these, the zero risk approach and minimax approach are the most serious. Good governance and strong public scrutiny are needed to ensure that discretionary powers are not abused. Finally, the precautionary principle suffers under the larger problem of the democratic deficit. Neither the precautionary principle nor the EU will improve its legitimacy until it is perceived to put the public first.

¹¹⁶ The Parliament is often the least prepared institution when it comes to technical and legal aspects of EU policy. Chalmers explains this in the context of Trilogue, the increasingly common procedure whereby the Commission, Council, and Parliament get together to hash out compromise legislation. In that setting, the Parliament is mostly unable to make a valuable contribution. Damian Chalmers, *Justifying Institutional Accommodation*, 2008 EUR. L. REV. 455, 455 (2008).

BOOK REVIEW
**Improving the International Law and Policy Regime:
Options for the Future,**
by Karl P. Sauvant & Federico Ortino

Reviewed by *Mark Feldman**

In 2013, the Ministry for Foreign Affairs of Finland organized a Helsinki Investment Seminar, held within the framework of the Helsinki Process on Globalization and Democracy, the global governance initiative launched in 2002. In support of the Helsinki Investment Seminar, Dr. Karl P. Sauvant, Resident Senior Fellow at the Columbia Center on Sustainable International Investment, and Dr. Federico Ortino, Reader in International Economic Law at King's College London, prepared an independent study on the international investment regime. The Ministry for Foreign Affairs subsequently has made that study available as a booklet.¹

As stated by the authors, the purpose of the study was “to outline the key features of the international investment regime, identify drivers of change, discuss critical issues, and describe some proposals for reform of the regime.”² With respect to the existing international investment regime, the authors conclude that “action is needed,” although they do not take a position on whether such action should involve “minor adjustments, more substantial recalibration or a paradigm shift.”³ Specifically, the authors maintain that the international investment regime “must” be improved to “take into account the profound changes in the

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¹ See KARL P. SAUVANT & FEDERICO ORTINO, *IMPROVING THE INTERNATIONAL INVESTMENT LAW AND POLICY REGIME: OPTIONS FOR THE FUTURE* (2013), available at <http://ccsi.columbia.edu/files/2014/03/Improving-The-International-Investment-Law-and-Policy-Regime-Options-for-the-Future-Sept-2013.pdf> (last visited Dec. 28, 2014).

² *Id.* at 7.

³ *Id.* at 16.

international investment law and policy landscape during the past fifteen years or so.”⁴

Such profound changes, according to the authors, include the emergence of more nuanced policy views held by both developed and developing States. For example, many emerging market investors, which have become “key players in the world FDI market,” now consider not only their host country interest in preserving regulatory space, but also their home country interest in securing protections and market access for investments abroad.⁵ Developed States also are taking a more balanced approach with respect to home country and host country interests, due in part to the sharp increase in inbound investment from “non-traditional investors”: actors that often are less transparent, state-controlled, and perceived to be pursuing non-commercial ends.⁶ Policy views on inbound FDI also have become more complex, as governments increasingly consider not only the quantity, but also the quality, of FDI inflows.⁷

Important changes also have been seen with respect to the number of investment treaty disputes (which has increased sharply), views on the existence of a causal relationship between investment treaties and FDI flows (which have become more skeptical), and the greater influence of civil society organizations and home State governments on the evolution of international investment law and policy regime.

Recognizing the many important, and recent, changes that have occurred within the international investment regime, the authors identify several “critical issues”⁸ to be addressed. Such issues include the difficulty in identifying the central purpose of the regime; for example, whether the regime primarily aims to protect foreign investment, promote the economic development of the contracting parties, promote the sustainable development of the contracting parties, or some alternative goal.⁹ Additional critical issues identified by the authors include the need to clarify the scope of international investment agreements (including

⁴ *Id.* at 49.

⁵ *Id.* at 35.

⁶ *Id.* at 35–36.

⁷ *Id.* at 38.

⁸ *Id.* at 9.

⁹ *Id.* at 54.

definitions of foreign “investor” and “investment” in those agreements) and the content of substantive obligations (the precise scope of which remains “controversial”¹⁰).

Having identified significant changes in the international investment regime and critical issues to be addressed, the authors turn to a “range of options”¹¹ for improving the regime. Notably, the authors do not evaluate the merits of the respective options, but rather offer them as “a menu to assist in the identification of priority actions that could be pursued.”¹²

The first option would be to hold consultations among a range of stakeholders, including “governments, the private sector, trade unions, other civil society organizations, and academia,” to discuss “concerns and considerations.”¹³ “A small panel of eminent persons” could consider the respective submissions and then produce a report that, “at a minimum, would reflect the range of views” presented.¹⁴ This option recalls recent stakeholder consultations that have been held by the U.S. Government in connection with the development of the 2012 U.S. Model BIT, and by the European Commission in connection with the EU-China investment relationship and the potential inclusion of an investor-State dispute settlement mechanism in a Transatlantic Trade and Investment Partnership agreement (TTIP).

Providing a platform for the expression of divergent views on the international investment regime certainly can help to clarify key areas of disagreement among stakeholders. At the same time, however, the often polarized nature of such divergent views can leave policymakers with very few opportunities for compromise, much less consensus. As one example, in the context of the consultation process that led up to the 2012 U.S. Model BIT, some stakeholders maintained that the minimum standard of treatment obligation should apply only to a “few areas” of treatment (in particular, full protection and security and denial of justice), while other stakeholders maintained that the obligation

¹⁰ *Id.* at 65.

¹¹ *Id.* at 92.

¹² *Id.*

¹³ *Id.* at 93.

¹⁴ *Id.*

should be “unqualified.”¹⁵ Ultimately, the U.S. Government made no adjustment to the minimum standard of treatment obligation in the 2012 U.S. Model BIT.

A second option identified by the authors would be to develop a restatement of international investment law, similar to the restatements developed by the American Law Institute (ALI) on many areas of U.S. law. Such a restatement could “become a source of inspiration and guidance for IIA negotiators” as well as “an authoritative second source of law for arbitrators.”¹⁶

On two occasions, similar projects have been undertaken by the International Law Commission (ILC), but on a much narrower scale. In 1978, following years of work, the ILC adopted a set of draft articles on most-favored-nation clauses.¹⁷ Building on that earlier work, the ILC more recently established a Working Group (2007) and a Study Group (2008) on the “Most-Favored-Nation Clause,”¹⁸ and continues to study the topic. Thus, in both the 1970’s and over the past several years, the ILC has devoted a very significant amount of time to the relatively narrow issue of most-favored-nation provisions. That experience suggests that a project aimed at restating the entire body of international investment law would, at a minimum, require very substantial resources.

A third option for reform identified by the authors—establishing Working Groups aimed at reaching consensus on specific issues—could build on the recent success of the UNCITRAL Working Group on Arbitration and Conciliation. That Working Group, within a few years, was able to achieve consensus on a delicate and divisive issue: transparency in investor-State arbitration. The UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration took effect earlier this

¹⁵ Advisory Committee on International Economic Policy (ACIEP), *Report of the Subcommittee on Investment of the Advisory Committee on International Economic Policy Regarding the Model Bilateral Investment Treaty*, (Sept. 30, 2009), <http://www.state.gov/e/eb/rls/othr/2009/131098.htm>.

¹⁶ Sauvants & Ortino, *supra* note 1, at 95.

¹⁷ See Int’l Law Comm’n, *Draft Articles on Most-Favored-Nation Clauses*, 33 U.N. GAOR Supp. No. 10, at 16, U.N. Doc. A/33/10 (1978), reprinted in [1978] 2 Y.B. Int’l L. Comm’n 187, U.N. Doc. A/CN.4/SER.A/1978/Add.1 (Part 2).

¹⁸ See Int’l Law Comm’n, *Most-Favoured-Nation Clause (Part Two)*, http://legal.un.org/ilc/summaries/1_3_part_two.htm (last updated Sept. 23, 2014).

year. Notably, while the Transparency Rules provide strong guarantees with respect to public access to documents and public participation through written submissions, the Rules apply only to claims submitted under “future treaties,”¹⁹ *i.e.* treaties concluded on or after April 1, 2014, unless the disputing parties otherwise agree. As illustrated by the experience of the UNCITRAL Working Group on Arbitration and Conciliation, setting modest goals can significantly increase prospects for success, even with respect to contentious issues.

The authors also identify several “intergovernmental processes”²⁰ that could be undertaken in pursuit of “a legally binding and enforceable multilateral instrument.”²¹ Such processes might include an informal meeting of WTO ambassadors, discussions hosted by UNCTAD or the OECD, and/or the initiation by G20 of a “stand-alone intergovernmental process”²² to consider options for a multilateral framework on investment. At the same time, the authors recognize that several ongoing bilateral and multilateral investment negotiations “could lead to a certain harmonization in the substantive content and procedural approaches of IIAs.”²³

The potential for such harmonization warrants close attention. Major investment negotiations continue to advance on many fronts, including negotiations of a Trans-Pacific Partnership (TPP) agreement, a Regional Comprehensive Economic Partnership (RCEP) agreement, a Transatlantic Trade and Investment Partnership (TTIP) agreement, a US-China BIT, and an EU-China BIT. If completed, those agreements, collectively, would cover a very substantial share of global foreign direct investment.

Those agreements also might help to establish what could be characterized as an emerging global consensus on key investment treaty provisions. As stated by the authors, the ongoing negotiations of several major investment agreements “could lead to a narrowing in the differences of key provisions,” including

¹⁹ UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration, http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/2014Transparency.html.

²⁰ Sauvants & Ortino, *supra* note 1, at 126.

²¹ *Id.* at 130.

²² *Id.* at 134.

²³ *Id.* at 138.

substantive and procedural issues as well as provisions “delineating the contours of the right to regulate.”²⁴

Although the authors do not attempt to identify the particular kinds of provisions that could be harmonized through a new generation of major investment agreements, a set of such provisions might include the following: (i) national treatment and most-favored-nation treatment obligations that include market access protections; (ii) a minimum standard of treatment obligation that is tied to customary international law; (iii) an expropriation obligation that includes both direct and indirect expropriation while recognizing that non-discriminatory regulatory actions, undertaken in the public interest, generally are not expropriatory; (iv) a mechanism authorizing the denial of treaty benefits to shell companies; (v) a negative list approach with respect to reserved sectors; and (vi) at least some opportunity for public access to documents and public participation through written submissions.

The outcome of TPP, RCEP, TTIP, US-China BIT, and EU-China BIT negotiations could have a very significant impact on the State of the international investment law regime. If consensus on the six points set out above were to be reflected in several major investment agreements covering a large share of global foreign direct investment, there almost certainly would not be a need for “substantial recalibration”²⁵ of the international investment regime. Conversely, if these major agreements were to conclude with sharply inconsistent approaches to core substantive obligations, or not to conclude at all, the range of challenges to the international investment regime outlined by the authors would remain very significant.

The study undertaken by the authors provides a timely and comprehensive resource for addressing a dynamic, but embattled, area of international law. Given the scale of global foreign direct investment—which has ranged between \$1.2 trillion and \$2 trillion annually over the past decade—there is an unquestionable need for a stable, rules-based regime for resolving international investment disputes. With respect to that policy imperative, Sauvart and Ortino have made a very important contribution.

²⁴ *Id.* at 140–41.

²⁵ *Id.* at 16.

Whither the Next Chinese Judicial Reform on the Local Judiciary —Challenging the Government Under the Judicial Context

Zhou Yu*

ABSTRACT

Having noted the latest judicial reform proposal in China, this paper notes that the judicial reform touches upon the hardware of the judicial capacity and its multiple effects in addressing the concerns for judicial independence. After a thorough examination between the proposal and the practice in reality, this paper reveals a blind spot that the reform has avoided and has long been neglected by the Chinese scholarship—the judicial mandate of its review authority, especially the authority mandate for the local courts.

*With particular attention to the judiciary in government-as-a-party litigations, this paper demonstrates how the status quo of local judicial authority mandate stranded the role of Chinese judiciary in the dispute resolution mechanism, with a comparison to the high-profile case in United States, *Ralls Corporation v. CFIUS* where a Chinese corporate group has determined to challenge the order from President Obama and the government agency. The comparison reveals an overly deformed avoidance canon in the Chinese jurisprudence in opinion writing, especially when a private party challenges the legality of government actions and demands a legislation review.*

Taking the differences in political regimes and legal frameworks

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as a given, the writer directs the analysis and evaluation to the features of mechanism design and argues that breaking the shackles on the local judiciary mandate will be the next breakthrough if Chinese judiciary were to reach a meaningful level of judicial independence. Judicial review of legislations is a desirable as well as an achievable goal along the way of improving the judicial function. The claim is substantiated by answering in turn why it is necessary, and how the proposal is feasible and compatible with the political and legal regime. By addressing the concerns on local protectionism as well as concerns from judiciary per se, that the local authority mandate reform needs to be reinforced is reinforced.

Key words: *Judicial Authority Mandate; Local Courts; Judicial Reform; Legislation Review; Dispute Resolution Mechanism.*

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I. INTRODUCTION

The judicial performance in reviewing government actions including legislation acts as an important milestone for testing judicial independence. It also indicates the extent of judicial remedies for private parties who challenge government actions. This paper examines the Chinese judicial capacity in reviewing legislations. It assesses whether the Chinese court system provides adequate judicial remedies for a private party who challenges the government, revealing that the commonly applied avoidance canon in judicial interpretation has reached the level of preset bias and injustice.

Part III of the paper considers the cause for the deformed judicial avoidance. What are the factors influencing the local courts' choice in interpretation? Whether the restraints on the judicial review mandate are justifiable? What can be done to avoid the avoidance canon? This paper offers a solution of reforming the judicial mandate for local courts—by granting the local court system the power to review legislations.

Part IV argues that the judicial system is in the best position to conduct legislation review, and illustrates the shortcomings of the existing review system. Part V and VI further check on the imminent judicial reform proposed under Xi's leadership. The paper concludes that the upcoming reform will pave the way for the proposal for this paper, and on the other hand, the local judicial mandate will reinforce the effort of Xi's judicial reform; the expansion of local judicial mandate is justified under the Chinese constitutional framework.

II. CHALLENGING THE GOVERNMENTS THROUGH JUDICIAL DISPUTE MECHANISMS—AVOIDANCE CANON

Before digging into the issue of challenging the governments in courts in China, this paper shall begin with an interesting survey of wind farm projects in various countries, revealing the universality in using the court system as a channel to challenge government actions. This paper further directs its assessment to the practice of the Chinese courts in administrative lawsuits under which category private parties challenge government actions based on infringement of their legitimate interests. By

using a case where the local regulation was challenged, this paper reveals de facto avoidance canon in legislation review and interpretation that has been widely applied in judicial opinions.

A. Challenging the governments around the world

In local citizen's eyes, a wind farm project should not be granted by the state government because it could have endangered the unique landscape of the natural habitat which is subject to the protection of environmental act;¹ In another country, in a foreign investor's eyes, its acquisition of wind farm projects on a land next to a naval base was banned by the government unfairly, because the same national security reasons did not ban other similarly situated foreign investors and the evidences raised as national security concern were not contested;² In another government's eyes, the wind farm projects had become a potential waste of resources incompatible with the state industrial plan, and then it issued two documents, one calling a halt to the administrative approval process for wind process, the other ordering all the projects in construction to stop.³

When different parties in society hold conflicting views on one project/issue, what is the right thing to do to solve the problem? A proper system of rule of law should provide a neutral and capable dispute resolution mechanism as a solution to settle differences in interests, and there has been a long history in assigning the courts to do the job.

¹ Zachary Shahan, *New Zealand Environment Court Says No to Huge Wind Farm*, CLEAN TECHNICA (Nov. 9, 2009), <http://cleantechnica.com/2009/11/09/new-zealand-environment-court-says-no-to-huge-wind-farm/>.

² James O'Toole, *Obama bans wind-farm purchases by Chinese company*, CNN (Sep. 28, 2012, 6:39 PM), <http://money.cnn.com/2012/09/28/news/economy/obama-china-wind-farm/>.

³ *China to slow wind-power rush*, CHINA DAILY (Apr. 8, 2011, 12:55), available at http://www.chinadaily.com.cn/business/2011-04/08/content_12293095.htm; 肖蔷 (Xiao Qiang), 云南风电开发为何叫停? [*Why were the Yunnan Wind-power Projects Banned*], 中国能源报 [CHINA ENERGY NEWSPAPER] (Dec. 30, 2013, 09:53), available at http://www.gmw.cn/ny/2013-12/30/content_9963373.htm (revealing the direct basis for the ban is 关于暂缓建设在建风电项目的通知 [*Notice on Suspending the Wind-power Projects in Construction*] and 关于对全省投产风电场进行综合评估的通知 [*Notice on Conducting a Comprehensive Assessment of all Wind-power Projects in Yunnan Province*] issued by the Yunnan Provincial Development and Reform Commission.)

In this globalized world, the ideological and political differences surely exist across borders, nonetheless it does not really matter whether a judicial organ is supervised by a congress or by the court—one of the three separate branches; nor does it matter to the nitty-gritty whether a judge delegates little precedential power to the case law by following a Roman law statute-oriented approach or great precedential value to cases by applying a common-law approach *stare decisis*. As the former Chinese leader Deng Xiaoping's utilitarian saying goes, it does not matter whether a cat is black or white so long as it catches mice.

The judicial system is a good cat so long as it catches as many mice as possible—in other words, so long as it can hold justice for as many disputes as possible in observance with the maximum social consensus including fairness and adequacy, due process, protection of human right, etc. As we all enjoy good services of a good cat, this paper shall tell what it takes to be a good cat.

Back to the survey on wind farm projects, the complaining resident lives in New Zealand, and he filed a complaint to the local environment court petitioning a reexamination of the project approval; The investor, a gigantic state-owned enterprise in New Zealand, defended its investment in court; the local environment court ruled to vacate the project approval, and later the high court reversed based on another interpretation of the environmental law. The project owner finally withdrew the controversial project after so many days in courts, and announced that it shall look into other options for the site.⁴

The second story took place in the United States, and the unlucky wind-farm investor is from China; the Chinese investor filed a litigation against President Obama and the Committee on Foreign Investment in the United States (CFIUS) in a U.S. federal court recently; the Chinese investor lost the suit in the district court, but then won its appeal; and the appellee CFIUS has defended its position by oral arguments and written submissions and

⁴ Nina Fowler, *High Court battle over Project Hayes*, NAT'L BUSINESS REV., (June 22, 2010), <http://www.nbr.co.nz/article/high-court-battle-over-project-hayes-124999>; *Meridian wins Project Hayes appeal*, ONE NEWS (Aug. 17, 2010, 12:28 PM), <http://tvnz.co.nz/business-news/meridian-wins-project-hayes-appeal-3709473>.

still enjoys the right to appeal at the time the writer writes the story down.⁵

However, in the third story which took place in China, it is unheard of any dispute undergoing in the judicial system. The governmental ban in this case is abrupt and rough, the legal basis of which is debatable. Apparently there is no lack of investors in grief, neither is there a lack of injustice contravening the rule of law, but there is a lack of judicial function in dealing with these conflicts of interests. In the next section, this paper shall reveal the current situations of challenging the government in Chinese courts.

B. Challenging the Government in China

In 1998, the local congress of the Zhuhai city passed the Zhuhai City Road Traffic Safety Regulation (“Zhuhai Regulation”) to ban battery-powered bicycles (“e-bicycles”) on roads.⁶ The local road regulation requires that all non-gas-powered vehicles must be licensed and the government refuses to grant any license to e-bikes.⁷ A violation of the local law will result in a fine of RMB 20 to 100 yuan.⁸

In this e-bicycle case, the plaintiff was fined for 50 by the traffic police for riding an e-bicycle without a license.⁹ The case was brought before the Zhuhai District Court which ruled in favor of the local agency based on the finding of no preemption of the local ban by the 2004 central law;¹⁰ following the plaintiff’s appeal, the decision was affirmed by the Zhuhai Intermediate

⁵ *Ralls Corp. v. Comm. on Foreign Inv. in the U.S.*, 926 F.Supp.2d 71 (D.D.C 2013), *rev’d*, 758 F.3d 296 (D.C. Cir. 2014).

⁶ 珠海市道路交通安全管理条例 [Zhuhai City Road Traffic Safety Regulation] (promulgated by Standing Comm. Zhuhai City People’s Cong., May 30, 1998, effective Sept. 1, 1998) art. 15(2) [hereinafter Zhuhai Road Regulation]; *see also* 珠海经济特区道路交通安全管理条例 [Zhuhai Special Economy Zone Road Traffic Safety Regulation] (promulgated by Standing Comm. Zhuhai City People’s Cong., July 26, 2011, effective Oct. 1, 2011) art. 10.

⁷ Zhuhai Road Regulation, *supra* note 6, art. 16(1).

⁸ *Id.* art. 49(1), (2).

⁹ 姜红诉珠海市公安局交通警察支队香洲大队 [Jiang Hong v. Xiangzhou Branch, Traffic Dept. at Zhuhai City Police Bureau] (2004)香行初字第36号, (Zhuhai Xiangzhou People’s Ct. Dec. 26, 2004) CLI.C.41205 CHINALAWINFO.

¹⁰ *Id.*

Court.¹¹

The plaintiff challenged the fine by disputing the validity of the local statute, arguing that the local regulation was preempted by central legislation—the Law on Road Traffic Safety passed by the National People’s Congress Standing Committee (“NPCSC”) in 2004. The legislative preemption issue is whether the local legislation has been preempted by a later central legislation covering the same area of subject.

One of the plaintiff’s arguments also may concern the legislative intent of central legislature—whether it intends to give its nationals the right to ride an e-bicycle as an option that locality may deprive or a grant that the locality is instructed to enforce. There is no clear language in the national law prohibiting e-bicycles on the road. Instead it provides that the maximum speed of a battery-powered bicycle on a bicycle lane shall be 15 mile/hour.¹² Based on the absence of an express prohibition and the regulation on max speed, it is argued by the plaintiffs that the national law grants the e-bikes a right to movement.

The nature and scope of local legislative power becomes another issue. Conceding that Zhuhai City is one of the cities delegated by the National People’s Congress (“NPC”) the power to make law and make variations to national law in light of local conditions as a special economic zone,¹³ it is further argued by the citizens that the local prohibition conflicts the national permission. Such a conflicted legislation goes beyond the legislative authority to make adaptations.¹⁴ Thus the conflicted local legislation in 1998 should be preempted by the national road safety law in 2004.

However, none of these issues were addressed by the first-instance as well as appellate opinions¹⁵. The reasoning pat-

¹¹ 姜红诉珠海市公安局交通警察支队香洲大队 [Jiang Hong v. Xiangzhou Branch, Traffic Dept. at Zhuhai City Police Bureau] (2005)珠中法行终字第20号, (Zhuhai Interm. People’s Ct. Aug. 11, 2005) CLI.C.18184 CHINALAWINFO.

¹² 道路交通安全法 [Road Traffic Safety Law] (promulgated by Standing Comm. Nat’l People’s Cong., Oct. 28, 2003, effective May 1, 2004) art. 58, CLI.1.49962 CHINALAWINFO.

¹³ 立法法 [Law on Legislation] (promulgated by the Nat’l People’s Cong., Mar. 15, 2000, effective July 1, 2000) art. 81, CLI.1.26942 CHINALAWINFO.

¹⁴ *Id.*

¹⁵ *See* 姜红诉珠海市公安局交通警察支队香洲大队 [Jiang Hong v. Zhuhai

tern is: you have the right to make changes to the national law, so any change is authorized, and the court shall never answer you what accounts a change, or whether a change should be differentiated from re-legislation; and this is not the only case that applies the logic to dodge the real ball.¹⁶

C. A Deformed Avoidance Canon Widely Applied in Legislation Review

The e-bicycle case is an administrative case authorized by the Administrative Procedure Law against state organs based on an alleged infringement of people's rights and interests.¹⁷ The nature of delegated legislative power, the distribution of power between central and local governments and different branches of state organs, the limit and application of central legislation's preemption effect and the scope of individual civil rights are just a handful of issues that permeate the administrative jurisprudence. However, an avoidance canon in the abovementioned judicial decisions dodging these real issues renders the set-up of administrative law almost non-judicial.

However, with the most natural tie to constitutional questions such as the issue of central-local legislative conflicts (or to say central preemption), the DRM of administrative cases is imposed with the strictest limits in terms of jurisdiction, causes of action, and admissible case pools.

The mission of the Chinese courts in private administrative suit is to examine whether a concrete administrative action in-

City Police Bureau Traffic Department], *supra* note 9 (the first instance decision); 姜红诉珠海市公安局交通警察支队香洲大队 [Jiang Hong v. Zhuhai City Police Bureau Traffic Department], *supra* note 11 (the appeal decision).

¹⁶ *Id.* See also 张京正与珠海市公安局交通警察支队道路交通行政处罚案 [Zhang Jingzheng v. Traffic Dept. at Zhuhai Police Bureau] (2004) 珠中法行终字第 46 号, (Zhuhai Interm. People's Ct. 2004) (challenging the prohibition of battery-powered bicycles in the Zhuhai local Traffic Regulation); 周丹诉珠海市公安局交通警察支队行政处罚案 [Zhou Dan v. Traffic Dept. at Zhuhai Police Bureau] (2003) 珠中法行终字第 14 号, (Zhuhai Interm. People's Ct. 2003) (challenging the administrative punishment provisions of Zhuhai local traffic regulation based on the theory that it transcended its legislative authority by violation the national P.R.C. Administrative Penalty Law as of 1996).

¹⁷ 行政诉讼法 [Administrative Procedure Law] (promulgated by Nat'l People's Cong., Apr. 4, 1989, effective Oct. 1, 1990) art. 11, CLI.1.4274 CHINALAWINFO.

fringes upon the private plaintiff's rights and interests.¹⁸ A concrete action refers to administrative actions involving one or more concerned persons instead of an indefinite audience, including administrative punishments such as detentions and fines, administrative coercive measures, interference with the operations of enterprises, refusal to take action or perform an obligation, unlawful demands for performance of duties, and violations of personal rights or property rights.¹⁹ A fining ticket by the local traffic police is a concrete action and thus actionable in courts.

A court is refrained from reviewing an abstract administrative action as well as concrete actions of national defense and diplomatic affairs.²⁰ An abstract administrative action refers to legislations, regulation, and rules, etc. with general binding power on whoever that is within the applicable scope. In the instance of e-bicycle case, the Zhuhai local ban on e-bicycles was an abstract action by the local legislature in 1998.

The courts have to function as forum to resolve controversies between the parties who have properly invoked its authority.²¹ In this dilemma between the mission and the limited authority, the Chinese courts have been trapped in the one-way road of reasoning, avoiding interpretations that would result in a conclusion of legislative conflict, and thereby always maintaining the validity of local legislation. Thus in practice, the ban on the judicial review of abstract actions has been interpreted as an absolute bar in the judicial authority to review legislations. It should not have been so.

The lack of authority in overruling local legislation should not have been taken as an excuse for local courts to evade its function of settling private disputes. However, as revealed later on the costs of reporting to the Supreme People's Court (SPC) which is the only competent authority in legislation review, the local courts are more often than not but maintaining the force of local regulation.

As a result of the judicial avoidance in adjudicating legisla-

¹⁸ *Id.* art. 5.

¹⁹ *Id.* art. 11.

²⁰ *Id.* art. 12.

²¹ Thomas Muskus et al, *Courts*, 21 C.J.S. §1 (citing *Colo-Tell v. McElroy*, 566 P.2d 374 (Colo. App. 1977)).

tion conflicts (central-local preemption issues), the current DRM for central-local relationship remains more of the rule-of-central order, less of the rule-of-law.²² The bigger problem created by this rule-of-central-order model is that the affected private interests are left with inadequate or no relief. Not only wind-farm investors, but also other investors such as coal miners may have legislative interests in having a due process while their interests in the projects were taken away.²³

In light of the importance in having adequate judicial remedy in challenging governments, the next part goes on to examine the shackles that have tied up on the local courts in China.

III. THE MISSING KEY IN JUDICIAL AUTHORITY MANDATE CAUSING THE DEFORMED CANON OF AVOIDANCE

Ideally, the judiciary is in the best position to solve a case where both private interests and public interests are at stake. In a rough look, the SPC has been in the position of reviewing as well as overruling local legislations that were preempted by central

²² 冯兴元 (FENG XINGYUAN),论中国的地方保护主义问题与治理框架 [On the Problem of Chinese Local Protectionism and the Framework for Solution], in 中央与地方关系的法治化 [LEGALIZING CENTRAL-LOCAL RELATIONS] 214–222 (张千帆(ZHANG QIANFAN) & 葛维宝(PAUL GEWIRTZ) eds., 2009) [hereinafter “ZHANG & GEWIRTZ”] (despite regulatory framework provided by central authority on inter-province sales of goods and service, the enforcement rely heavily on central political order instead of judicial DRM to correct local violations.); 朱丘祥 (ZHU QIUXIANG), 以完善分税制改革为契机, 促进中央与地方关系的和谐发展 [On a Harmonious Development of Central-local Relations by Reforming the Tax-Sharing Regime], in ZHANG & GEWIRTZ 313–14 (pointing out that the decision-making process in the sphere of taxation is dominated by the central authority, without a democratic reflection of local will); 黄建军 (HUANG JIANJUN), 地域权利平等问题论纲 [On Problems of Cross-region Inequality], in ZHANG & GEWIRTZ 267–69 (illustrating the failure of judicial efforts in challenging the cross-region inequality of civil rights, and laying emphasis on actions from central authority and pressure on localities).

²³ 崔毅 (Cui Yi), 涉煤收费巧立名目 煤炭地方保护主义愈演愈烈 [Growing Local Protectionism on Coal Industry by Local Imposition of Extra Fee Items], 中国经营报 [CHINA BUSINESS JOURNAL], Feb. 19, 2005 (Guizhou Province issued a measure restricting local coal from exporting to other regions; Ningxia Region imposed additional fees on coal from Shanxi Province); 胡早 (Hu Zao), 山西纪检监察督办环境违法案件,处分敢于顶风建设的地方政府,震慑地方保护主义,上千违法企业被关停 [Thousands of Local Industrial Projects in Violation of National Environmental Protection Policies Were not Halted Until Central Political Pressure], 中国环境报 [CHINA ENVIRONMENT NEWSPAPER], Apr. 5, 2007.

national laws. Nevertheless, the examination of the local courts' role in the legislation review reveals an irreconcilable contradiction between the goal and the design of the judicial mechanism

A. No Authority to Comment on Local Legislative Validity: Incapacity for Transparency in Judicial Deliberation

An effective guideline by the NPCSC legislative work committee in 1988²⁴ provides that if there is a conflict between a local legislation and the central legislation by NPC, the applicable law should be the central law.²⁵ This position of honoring central laws has been confirmed positively by the SPC.²⁶ If the court is able to make a finding of a conflict between local and central legislations, the conclusion could be easily reached. However, such a finding could not be easily made due to the following struggles caused by the judicial authority mandate for local courts.

In SPC's instruction to lower courts, a local court can cite to the applicable law directly in the opinion,²⁷ and there is no requirement on laying down the hierarchy of legislations or cite

²⁴ 关于如何理解和执行法律若干问题的解答(一) [Collected Answers to How to Interpret and Implement Laws, Part I] (promulgated by Nat'l People's Cong. Law Commission, 1988), Question 18.

²⁵ *Id.*

²⁶ See the following Supreme People's Court instructions as examples: 关于人民法院审理行政案件对地方性法规的规定与法律和行政法规不一致的应当执行法律和行政法规的规定的复函 [On Legislative Conflicts between Local Legislation and National Law and Regulations in Administrative Law Cases] (1993); 关于人民法院审理行政案件对缺乏法律和法规依据的规章的规定应如何参照问题的答复 [On How to Cite for Governing Law in Light of Lack of Legal Basis in Administrative Law Cases] (1994); 关于对人民法院审理公路交通行政案件如何适用法律问题的答复 [On How to Apply Laws in Road Safety Administrative Law Cases] (2001); 对人民法院在审理盐业行政案件中如何适用国务院<食盐专营办法>第二十五条规定与<河南省盐业管理条例>第三十条第一款规定问题的答复 [Answer to How to Apply Law in Case concerning a Legislative Conflict between National Salt Law and Henan Salt Industry Regulation] (2003); 关于<秦大树不服重庆市涪陵区林业局行政处罚争议再审一案如何适用法律的请示>的答复 [On How to Apply Law in the Appeal of Administrative Penalty by Chongqing Forestry Bureau] (2003); 关于审理行政案件适用法律规范问题的座谈会纪要 [The SPC Meeting Minutes on How to Cite in Adjudicative Cases] (2004).

²⁷ 最高人民法院关于裁判文书引用法律、法规等规范性文件的规定 [Provisions of the Supreme People's Court on Citation of Such Normative Legal Documents as Laws and Regulations in the Judgments] (promulgated by the Sup. People's Ct., Oct. 26, 2009, effective Nov. 4, 2009) art. 7, CLI.3.122722 CHINALAWINFO.

to the lowest-ranking local law.²⁸ If a choice of disregarding the local law is made, do it quietly by citing the chosen law.²⁹ The more words that the court provided for explanation, the riskier for the judges—it may constitute a violation of the NPCSC and SPC instructions: no comment on the validity of legislations. Just like the e-bicycle case, were the court to find for the plaintiff, we can predict that in the opinion, there will be no judicial response to the arguments raised by the local agency defending the local ban; the opinion will jump to the conclusion that the central law is an applicable law, without any adequate reasoning why the Zhuhai regulation will be applicable or not.

Consequences followed when there were attempts that local judges rejecting local legislation by ample demonstration of their legal analysis and concluded on the inconsistency between statutes by express words.³⁰ With the greatest controversy, local congress acted feverishly and accused the judges of severe malpractice by acting far beyond authority,³¹ which generates undue and unreasonable pressure on the local courts.³²

To avoid such embarrassment from happening again, judges in administrative litigation departments are instructed in their manual not to make conclusions regarding validity of statutes.³³ Do it quietly is again reinforced from the very beginning of the training if the judge holds belief in the national legislation.

²⁸ *Id.* art. 5.

²⁹ *Id.* art. 7.

³⁰ 惠宝家电公司诉酒泉质量安全局 [Huibao Company v. Jiuquan City Quality Assurance Bureau] (1999) 甘行监字第 29 号, (Gansu High People's Ct. Sept. 1, 2000) (district court judge refused to uphold the administrative penalty prescribed by the Product Quality Regulation of the Gansu province, based on the finding that the local legislation prescribing penalty was beyond the scope permissible under the national Administrative Penalty Law); 河南种子案 [Henan seed case] (2003) 洛民初字第 26 号, (Luoyang Interim. People's Ct. 2003).

³¹ See 王宏 (Wang Hong), 法院岂可非议地方法规 [*How Dare the Court Criticize Local Legislation*], 人大建设 [CONGRESS CONSTRUCTION], issue 1, (2001) (Gansu Province's Congress made announcement of the case on their publication and required the High Court of Gansu Province to deal with this malpractice matter).

³² See *supra* Part V-B.

³³ 基层人民法院法官培训教材-实务卷-行政审判篇 [TRAINING MANUAL FOR JUDGES IN LOCAL PEOPLE'S COURT], at 332, 赵大光主编 (ZHAO DAGUANG ed., 2005).

B. Internal Reporting System to the SPC: Unpractical Option to Solve Pending Disputes

Ideally, besides the choice of avoiding a finding of central-local conflict, the local court can also choose to report to SPC to shove over the locally difficult decision to the big boss in the center.³⁴ A local court with such a piece of local legislation with potential conflict with central laws can report to its supervising level of courts level by level, and then the SPC, acting as a competent petitioning organ, may consult the NPCSC and then issue a statutory interpretation.³⁵ Until then, the local court with the present dispute may quote and apply the preemption finding to the instant case.

A huge gap exists between the huge pool of local protectionism cases³⁶ and the limited caseload that the SPC can take. Filing a report to the SPC does no good to solving the instant dispute before the court, especially when there are statutory limits of closing a case within three months for the longest. Even given prolonged period, the local courts are further pressed to close a case timely because of pressures from each judge's annual assessment of performance.

Admittedly, without seeking prior approval from SPC, a local court has certain discretionary power to make a judgment calling on whether a local legislation is in conflict with the superior law and whether it constitutes a valid applicable legal basis for the concrete action in concern.³⁷ Only when substantial interests are involved and diverged opinions exist among relevant state organs, SPC's approval is necessary to disregard the local legislation.³⁸

Without further clarification, we do not know what the pre-

³⁴ *Id.* at 332–33.

³⁵ *Id.* at 332.

³⁶ There are 34 units of sub-national localities at the provincial level, including 23 provinces, 5 ethnicity autonomous regions, 4 municipalities, and 2 special administrative region, Hong Kong and Macau, which means that the SPC takes cases from 34 local court systems who report directly to the SPC.

³⁷ 关于审理行政案件适用法律规范问题的座谈会纪要 [The SPC Meeting Minutes on How to Cite Laws and Regulations in Administrative Cases] (promulgated by the Sup. People's Ct., May 18, 2004, effective May 18, 2004), CLI.3.53301 CHINALAWINFO.

³⁸ *Id.*

cise boundary is for the “substantial interests.” Neither do the local courts. To report and ask for instructions from the upper level courts is what a local judge would advise his peer to do.³⁹ Naturally the reporting system of “substantial central-local interests” leaves great room for manipulation, for that any interests classified as insubstantial can be easily buried.

Moreover, particularly when local court have been long suffered from undue pressure from the local state authority in terms of the budget, appointment of judgeship, and local authority’s potential abuse of supervisory role,⁴⁰ it cultivates an undue tendency for local courts to opt for not-to-report or simply rule for the locality. This is also why local courts are often suspected and criticized for being protective of local interests.

C. Case Ruling without Precedential Value: Costly Individual Justice

The local court’s judicial authority in reviewing local legislation is further weakened by the NPCSC’s mandate on judicial interpretation. The document issued by NPCSC in 1981 (effective to date) makes arrangement regarding the authority mandate of statutory interpretation. In a nutshell, it reads as follows:

TABLE 1: STATUTORY INTERPRETATION AUTHORITY MANDATE⁴¹

Scope of Interpretation	(Legislative Branch)	(Judicial Branch)	(Executive Branch)
\	If need further clarification or supplementary rules	Application issues in Concrete Judicial Disputes Settlement	Application issues in non-judicial work (administrative work)

³⁹ 冯希 (Feng Xi), 行政法律规范冲突中司法权的限度与运行—从能动司法哲学观出发[*From the Perspective of Judicial Activism Philosophy: the Limit and Operation of Judicial Authority in Administrative Law Normative Conflicts*], 广州法院网[GUANGZHOU INTERM. PEOPLE’S CT.] (June 27, 2011, 11:48:11), <http://www.gzcourt.org.cn/fxtt/2011/06/1519310593613.html>.

⁴⁰ See *supra* Part V-A.

⁴¹ 关于加强法律解释工作的决议 [On Enhancement of Interpretation of Laws] (promulgated by Standing Comm. Nat’l People’s Cong., effective June 10, 1981), CLI.1.1006 CHINALAWINFO.

Laws, Regulations (central/national)	NPC & NPCSC ⁴²	Supreme People's Court & Supreme People's Procuratorate	State Council and the Responsible Ministries or Departments
Local legislations/regulations	Local congress & its standing committee	(Not Mentioned)	Local government and the Responsible Departments

The local courts below the SPC have no authority to provide interpretation of legislations with general binding power,⁴³ and the reasoning in a particular case binds the concerned parties. Only SPC can provide general binding interpretation of central legislation, as well as determine the validity of local legislation in case of conflicts with central legislation. When it comes to local legislative validity issues, local judicial opinions have no precedential value no matter which choice it makes unless it reports to the SPC for confirmation (approval) to its analysis of the validity of the local law.

SPC's over-paternalistic position may make sense in the past when it was acknowledged that the quality of local judgeship did not satisfy the task of important interpretational functions. Today, the discussion rests on the presumption that the Chinese legal profession is well-educated and has become capable and competent to conduct legal reasoning and analysis.

Inequality occurs in the application of local legislation due to the non-recognition of local courts' interpretation of local legislation. For example, Zhuhai Road Traffic Regulation applies to those who do not challenge the legislation in court. Meanwhile, the local judicial system provides a leeway for challengers who can afford the litigation costs and who is willing to take a chance. A successful challenger who luckily gets a brave local judge may avoid the fine by an opinion applying the national law directly, or by an opinion vacating the fine on evidence ground. The Zhuhai local court can repetitively rule in favor or against the Zhuhai Regulation for a thousand times in a thousand individual cases, but none of the decision shakes the validity ground for the Zhuhai

⁴² Procedures are provided in Legislation on Law, arts. 42–47.

⁴³ On Enhancement of Interpretation of Laws, *supra* note 41.

legislation. The public become the victim who pays the bill for the waste of judicial resources.

D. Avoiding the Avoidable Avoidance Canon

Avoidance of a difficulty (such as a hard constitutional question) is not uncommon in statutory jurisprudence.⁴⁴ However, what is closely related to the Avoidance Canon in the U.S. jurisprudence is the maxim that such avoidance should not “be pressed to the point of disingenuous evasion.”⁴⁵ The judicial prestige is able to maintain when the judicial discretion achieves the balance between the avoiding instability of legislative effect and upholding the consistency and uniformity in legislative hierarchy.

Yet, Chinese courts are almost overwhelmed by the temptation to avoid. It happens before the trial: there is the bargain/pre-trial mediation between administration agency and the private party.⁴⁶ It happens during the trial: when there is other ground such as procedural malpractice of the agency, overturn the administrative action on that procedural ground.⁴⁷ Other evasive ground also includes evidence reasons.⁴⁸ What if there is no evasive ground but a challenge based on the interpretational conflict?

In the e-bicycle case, the most important practical maxim of avoidance (perhaps in many occasions the only) has led to a

⁴⁴ See *United States v. Jin Fuey Moy*, 241 U.S. 394 (1939).

⁴⁵ *Moore Ice Cream Co. v. Rose*, 289 U.S. 373, 379 (1932).

⁴⁶ He Haibo, *Litigation without Ruling: the Predicament of Administrative Law in China*, 3 *TSINGHUA CHINA L. REV.* 257, 263–64 (courts showing a strong preference for mediation in administrative lawsuits).

⁴⁷ Feng Xi, *supra* note 39.

⁴⁸ 周丹诉珠海市公安局交通警察支队行政处罚案 [Zhou Dan v. Zhuhai Police Bureau Traffic Dept.] (2003)珠中法行终字第14号, (Zhuhai Interim. People's Ct. 2003) (the intermediate court upheld Zhuhai Traffic Legislation based on the broad legislative power to make “adaptations,” but still ruled in favor of the concerned person based on inadequate evidence for such penalty); 张先著诉安徽省芜湖市人事局乙肝歧视案 [Zhang Xianzhu v. Wuhu City Personnel Bureau] (2003)新行初字第11号, (Wuhu Xinwu District People's Ct) (the court upheld local rules on admission of public servants which allegedly violated upper laws and the constitution by discriminating persons with Serum Hepatitis virus, but the court vacated the administrative action based on evidence ground). Scholars believe the evidence ground was a “scape goat” ground for the judge to achieve corrective justice in an instant case.

dangerous and unreasonable signal: prohibition is one form of adaptation power to the national permission. Under the jurisprudence of Zhuhai local court, the definition of “conflict” between central and local legislation has been squeezed too narrow to be reasonable.

Under the current defective mandate for judicial authority, the courts might be able to uphold individual justice if they find other evasive grounds to remedy private interests. It may also happen if the court issued a quiet opinion by applying the applicable law directly. But none of these is what the operation of judicial DRM supposed to be.

The missing key in the judicial authority mandate should be fixed as soon as possible—granting the local courts the power to review the local legislation, allowing the central-local issues to be debated and deliberated to the whole society’s benefit—this is what the judicial reform needs exactly. It should allow for sufficient adversarial expression of interests from both private sector and common constitutional interests from state organs, stimulating transparency of judicial deliberation on central-local conflicts in opinions, and pursuing doctrinal clarity in the process of legal professionals reacting to loopholes of the legislative review framework. Why must it be done by the judiciary? Why cannot it be other state organs? The next part goes on to answer this question.

IV. WHY MUST THE JUDICIARY—INADEQUATE NON-JUDICIAL MEANS TO ADDRESS LEGISLATIVE REVIEW ISSUES

There are three proposals made by the leading Chinese constitutional scholar Prof. Zhang Qianfan to address the problem of legislative conflicts.⁴⁹ The first proposal is to adjust the judicial system, like what is advocated in this paper. The second way is to set up a legislation review committee within the legislature. The third way is to set up a legislation review committee external to the legislature. This part argues that the latter two proposals are not desirable just as the current Legislative Filing System prescribed by the Legislation Law, because to set up a review chan-

⁴⁹ 张千帆 (ZHANG QIANFAN), 国家主权与地方自治 [STATE SOVEREIGNTY AND LOCAL AUTONOMY], at 361 (2012).

nel independent from the court system does not solve the same old problem under the existing legislative review method. The problems are presented as follows.

A. Irresponsive to Real Conflicts

The prevalence of central legislation is the maxim of the Legislation Law.⁵⁰ The NPC establishes a set of internal filing procedures⁵¹ to clear legislative conflicts *ex ante*.⁵² This is a respectful goal however, the reality tells that the NPC registrar for filing is not an almighty organ being able to predict and clear all the conflicts beforehand.

The designed internal filing procedure requires the filing of local legislation to be done within 30 days of publication,⁵³ and the legislation offices (*fazhiban*) within local and central level function as the registrar for its subordinate state organs.⁵⁴ Legislations and regulations issued by NPC, NPCSC, and State Council including its subsidiary departments and ministries all fall into the category of central legislation with superior legal force.

Accordingly, local legislations are required to complete filings to State Council and the national Congress in Beijing. In the filing system, the NPC has the power to annul or alter inappropriate laws by NPCSC upon findings of conflicts under the Legislation Law.⁵⁵ The NPCSC has similar power checking on the State Council, central legislative and executive branch checking on the governments of provinces and autonomous ethnicity zones.⁵⁶ For conflicts between local legislations and State Council regulations, the State Council has the power to rule in favor of the local legislation enacted by congress of provinces. The NPCSC makes the

⁵⁰ See 立法法 [Law on Legislation], *supra* note 13; 法规规章备案条例 [Ordinance on the Archivist Filing of Regulations and Government Rules] (promulgated by the St. Council, effective Jan. 1, 2002), CLI.2.38114 CHINALAWINFO.

⁵¹ See 立法法 [Law on Legislation], *supra* note 13.

⁵² 谭波 (Tan Bo), 论我国中央与地方权限争议立法解决机制之完善 [On the Improvement of Chinese Legislative Settlement System between Central and Local Power Disputes], 法学论坛 [LEGAL FORUM], vol. 24, issue 3, at 203 (2009).

⁵³ 法规规章备案条例 [Ordinance on the Archivist Filing of Regulations and Government Rules], *supra* note 50.

⁵⁴ *Id.*

⁵⁵ 立法法 [Law on Legislation] art. 88(1)-(2), *supra* note 13.

⁵⁶ *Id.* art. 88(3)-(5).

final decision if the State Council intends to rule in favor of its departments.⁵⁷ Criticism is that the NPC should not be the judge of legislative conflict cases, for that NPC cannot be an impartial judge and a game player in the conflict case at the same time.⁵⁸

But the most fatal defect of the legislative filing system is its lack of responsiveness to legislative conflicts sprung after the filing and publication.

For example, the Provincial People's Congress in Hebei announced that it shall make several deletions of articles from existing regulations of HeibeI province including a clause of administrative penalty in Hebei Anti-unfair Competition Regulation.⁵⁹ The Hebei Anti-unfair Competition Regulations was enacted in 1998, and its article 43 provides that an action of unfair pricing shall result in a fine equivalent to an amount five times of the illegal income; for serious cases, the local Administration of Industry and Commerce can withdraw the actor's business license.⁶⁰ Then in 2005, the NPC passed the national Administrative Penalty Law, providing that the administrative penalty of withdrawal of business license can only be provided in central legislation by State Council or NPC/NPCSC.⁶¹ Thus, due to the conflict with the later central legislation, the article 43 of Hebei regulation had been de facto invalid from 2005 to 2013. This example makes several points.

Firstly, the legislative filing system cannot clear the preempted local legislation enacted anteceding the central legislation. The Hebei regulation was partially preempted by later national Administrative Penalty Law. Likewise, the e-bicycle ban

⁵⁷ *Id.* art. 88(2)-(3).

⁵⁸ 范进学 (Fan Jinxue), 中国违宪审查制度之建构 [On Construction of the Chinese Constitutional Review], 共识网 [COMMON VIEW NET] (Jan. 20, 2010, 20:31), available at http://www.21ccom.net/articles/zgyj/xzmj/article_201001207784.html.

⁵⁹ 河北省人大常委会关于修改部分地方性法规的决定 [Hebei Province Congressional Decision on Amending Certain Local Laws] (promulgated by Standing Comm. Hebei People's Cong., Sept. 27, 2013) (Oct. 4, 2013, 09:03:47), available at http://gov.hebnews.cn/2013-10/04/content_3518906.htm.

⁶⁰ 河北省反不正当竞争条例 [Hebei Anti-Unfair Competition Rules] (promulgated by Hebei Provincial People's Cong., effective June 27, 1998), CLI.10.11642 CHINALAWINFO.

⁶¹ 行政处罚法 [Administrative Penalty Law] (promulgated by Nat'l People's Cong., Mar. 17, 1996, effective Oct. 1, 1996) art. 15, CLI.1.167113 CHINALAWINFO.

enacted in 1998 could never be found by the superior registrar to be inconsistent with a later central Road Safety Law in 2004.

Moreover, the filing system is not efficient enough to track the local legislations after its implementation. Some conflict issues may not be spotted at the time of review immediately after filing, and if they do exist, there is no sufficient means to address them—after all, the petition parties under the Legislation Law article 90 have limited sources and exposure to each piece of legislation across the country.

Thirdly, without the judicial authority examining the local legislation's validity in a transparent manner, the local judiciary is not able to communicate with the legislature regarding the most updated conflict issues. A particular case and controversy in court could have been a perfect chance to clear the conflicts. We can reasonably imagine that any private party who were fined by the Hebei Unfair Competition Law could have and should have a chance to challenge the local fine inconsistent with the national administrative penalty law.

B. Lack of Transparency as well as Accountability to Public Interests

The public desires a scenario of (quasi-constitutional) judicial review where the validity of outdated legislations can be seen and remedies to the concerned parties can be provided.⁶² However, the public is blocked outside the door to participate in the central-local issues resolution. The public should have meaning-

⁶² For instance, it has been reported that the death of a young man under the *Shou Rong Qian Song Zhi Du* (a regulation on compulsory housing and repatriation of city wanderers) whose violation to individual's right to movement is a heritage from Chinese planned economy. The media coverage led to a public outrage and thereby the annulment of law, and it also led to public awareness of the concept of constitutional review since 2003. When the National People's Congress was confronted with the petition alleging the unconstitutionality of the regulation, there is no direct response announcing the violation of constitution. See 孙志刚: 用生命改写了一部法律 [*Sun Zhigang: Amendment to Law on the Sacrifice of His Life*], 法制周报 [LAW WEEKLY] (Aug. 29, 2008, 14:43), available at <http://news.sina.com.cn/c/2008-08-29/144316197172.shtml>; 城市流浪乞讨人员收容遣送办法 [Rules on Compulsory Housing and Repatriation of City Wanderers] (promulgated by St. Council, effective May 12, 1982, repealed Aug. 1, 2003), CLI.2.1288 CHINALAWINFO.

ful participation in the central-local dispute resolution which can act as a check on the accountability of central-local policies.

Besides the filing procedures, the NPCSC legislation office (the highest level of registrar in the legislative filing system) also accepts petitions from a number of authorized parties if there is a request for legislative conflict review. Qualified petition parties include State Council, Central Military Commission, SPC, Supreme People's Procuratorate, and Standing Committees of provincial congress.⁶³

Yet, citizens and social organizations only have a mere right to submit proposals to NPCSC for a preemption review of a local legislation.⁶⁴ It provides that an NPCSC agency shall study such proposal; only if necessary, it shall distribute such proposal to the relevant special committees for review and comments.⁶⁵ The legislative filing system alone does not provide remedies to parties in particular dispute, and does not provide quality and meaningful chance of public participation.

C. Want of Contribution from Judges and Lawyers

Legal professionals like judges and lawyers can play a crucial impact on government policymaking by their involvement in checking on government's compliance with the law.⁶⁶ Yet, the current judicial authority mandate for local courts do not provide enough motivation for the judges and lawyer to explore all the difficult ambiguities in legislative conflict, preemption of central legislation, and the central-local legal relationship.

For example, for the NPCSC who has the authority to provide official interpretation of laws⁶⁷ as well as the authority to vacate inappropriate laws,⁶⁸ the ambiguity in the scope of "adaptations" has not been clarified since the term was adopted in the

⁶³ 立法法 [Law on Legislation] art. 90(1), *supra* note 13.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ Diane A. Desierto, *Rewriting the New "Great Game": China, the United States, and their International Public Lawyers*, 1 PEKING U. TRANSN'L L. REV. 351, 370 (2013).

⁶⁷ 立法法 [Law on Legislation] art. 42, *supra* note 13.

⁶⁸ *Id.* art. 67.

Legislation Law.⁶⁹ The ambiguity in the legal question has remained as it is. As often challenged and heatedly discussed online, the Zhuhai Road Traffic Safety Regulation has not been reported to any review of Guangdong or central government's congresses. Comparing to professional legal scholars, judges and lawyers have a great treasure in them to contribute. Unfortunately, the judicial system to date has let the legal professionals down, because public issues like legislative compliance are not on the table for discussion.

Introduction of advocacy for local legislation as well as central legislation is also very important to the due process and it also can be enlightening many aspects. In the e-bicycle's instance, the e-bicycle case concerns more than one person who received the penalty. There is an industry valued over half billion RMB, and a huge demand on the market by those who either could not afford a motor vehicle or need it more than other conveyance. A post hoc judicial proceeding is able to bring more meaningful points, adding to the symmetry of information and improving the realization of due process.

D. The Courts as the Best Position Adjudicator

For the problem identified in the previous parts, an ideal institution to handle legislation review should carry at least the following features: (1) high responsiveness to central-local disputes or legislative conflicts; (2) easy access to the public in need; and (3) active involvement of legal expertise.

The three shortcomings of the existing Chinese procedure to resolve legislative conflicts can be rightly fixed by the expansion of local judicial review mandate. By improving the allocation of judicial review power within the judicial system, a judicial review of legislative conflicts is available to the public whoever has a case; deliberative of an issue which was also traditionally within review scope does not add to additional costs in enhancing the due process; and the advocacy proceeding as well as the delivery of an opinion with full judicial deliberation contributes

⁶⁹ 秦蓁 (Qin Zhen), 经济特区授权立法有关情况综述 [Review on Authorized Special Economic Zone Legislations], 中国人大网 [The Nat'l People's Cong.] (Apr. 14, 2009), http://www.npc.gov.cn/npc/zt/qt/dfrd30year/2009-04/14/content_1497664.htm.

to the wisdom and jurisprudence of this preemption field.

V. CHAIRMAN XI'S JUDICIAL REFORM IN REBUILDING THE LOCAL JUDICIARY—REMOVING THE UNDUE INFLUENCES FROM LOCAL LEGISLATURE

The imminent judicial reform is featured by the de-localization in judicial administration.⁷⁰ By identifying the influence dynamic between the local judiciary and the local governing authority, this part, on the one hand, elaborates the channels through which the locality undue influence inflicts, on the other hand, runs a check on the reform proposals under the Chinese leadership of Chairman Xi and predicts the potential effect.

A. Over-Synchronized Interests based on the National Organization of Courts System

China has only one national court system led by the SPC.⁷¹ The composition and the status of the SPC are purely central in terms of institutional structure, speaking for the national holistic interests and the unification.⁷² The rest courts are called local courts. They are set up according to the political map of provinces and autonomous districts. There is no cross-region courts of neither first nor second instances.

1. Dual Identity of Local Courts

A provincial-level high court covers the jurisdiction of a province only, in a similar vein, a city-level intermediate court covers an entire city, a county-level court an entire county. While local courts rely heavily on local resources ranging from appointment of judgeship to financial assistance,⁷³ the synchroniza-

⁷⁰ *Judicial reform guideline underlines independent trial*, XINHUA NEWS (July 10, 2014), http://www.china.org.cn/wap/2014-07/10/content_32911741.htm.

⁷¹ 法院组织法 [Court Organization Law] (promulgated by the Nat'l People's Cong., July 1, 1979, effective Jan. 1, 1980) art. 2, CLI.1.81825 CHINALAWINFO.

⁷² *Id.* art. 35.

⁷³ 蒋先进 (Fan Xianjin) & 郑军 (Zheng Jun), 司法审判中地方保护主义的成因的法社会学剖析 [A Sociology View into the Cause of Local Protectionism], 理论前沿 [THEORY FRONTIER], issue. 16, at 14 (2000) (pointing out the phenomenon now in China that the local judiciary belongs to local population, and makes the Tax-sharing system an example—the interests of local taxation

tion between a local court jurisdiction map and a local political map resulted in the locality's pressure on the local courts which would never occur to the SPC.

A local court in China has a dual identity in this judicial system. A local court, including the provincial-level courts and the below, functions not only as an agency of the central court SPC, but also as a part of the local state organ responsible for local interests and democratically accountable to the local legislature.⁷⁴ Maintaining loyalty to central legislations will entail a very difficult time with the bread-feeders—the local government.⁷⁵

Thus comes the Avoidance Canon in practice, by easy manipulation of judicial reasoning, the choice in the dilemma is made. Then the entire local court system below the SPC level, subject to the same stake-holder from the same province, all play deaf and dumb. As a result, local courts suffer from a trust crisis from non-local parties in disputes.

In a vicious cycle, it has no power to adjudicate legislative preemptive issues; then with the restraint from administration and finance, the local courts are suspected of local protectionism; because of the judicial local protectionism, the local courts are not trusted to adjudicate preemption issues. Thus the proposed de-localization in judicial administration is one of the key chain in breaking the vicious cycle.

2. Two-tier System of Hearing

An additional point on the national court structure, the court of second instance will be the final court hearing a non-death penalty case, or to say, a losing party only has one chance to appeal.⁷⁶ There are two levels of courts below a provincial high court. It means that the life cycle of a case from the first instance decision to the appeal is within the same locality, and there is no cross-province circuit courts hearing a central preemption issue.

closely affects the budget source of a local court—such a relation has implications on a court's decision).

⁷⁴ 法院组织法 [Court Organization Law], *supra* note 71.

⁷⁵ Ting Gong, *Corruption and Local Governance: the Double Identity of Chinese Local Governments in Market Reform*, 19 THE PAC. REV. 85, 87 (2006).

⁷⁶ 法院组织法 [Court Organization Law] art. 11, *supra* note 71.

Therefore, an element of diversity is missing everywhere, no matter in the judgeship appointment procedure (administered by the local legislature), the pool of candidate for the judgeship (statistic showing a high rate of localized candidates), community support, and the sources financial grants from the locality. The interpretation avoidance canon and decisions favoring local legislation usually prefer local development over national overall considerations. Local benefits being maximized, all the benefits are very much likely to be translated to the real financial benefits of the local courts.⁷⁷ In this way, a local judge is to some extent an interested party in a case of alleged local protectionism. Fortunately, this is going to change.

The new reform has listed the de-localization of the court administration on the reform proposal list.⁷⁸ Though the guideline has not been very specific, the principle has been that the local courts' budget shall be under the control of central level, removing as much as local influences as possible.⁷⁹ Many scholars argue that the localization of local courts contributes greatly to the local judges' assessment of cases in favoring the locality.⁸⁰

While a dualistic court system bifurcating provincial and central court systems⁸¹ in China may be too far from realization, there is some positive speculation that the Chinese leadership mulls over the possibility of establishing a cross-province circuit appellate court.⁸² If it comes true, it shall address this channel of

⁷⁷ 廖振云 (Liao Zhenyun), 从法院组织体系地方化看审判独立 [On adjudicative Independence from the Perspective of Localized Court Organization], 中国政法大学硕士毕业论文 (Master Thesis, China University of Political Science and Law), at 16 (2007) (conducting field investigation into several locality to evidence the issue of highly localized financial dependence).

⁷⁸ 中共中央关于全面深化改革若干重大问题的决定 [Important Decisions on Deepening the Reforms] (promulgated by Third Plenary Session of the Eighteenth Central Comm. of the Chinese Communist Party, Nov. 12, 2013) art. 32, CLI.5.213067 CHINALAWINFO [hereinafter CPC Decisions].

⁷⁹ Feng Xi, *supra* note 39.

⁸⁰ 贺卫方 (He Weifang), 中国的法院改革与司法独立——一个参与者的观察与反思 [Chinese Court Reform and Judicial Independence—A Participant's Observation and Reflection], 科学中国人 [SCIENTIFIC CHINESE], issue 5, at 18 (2002).

⁸¹ 焦洪昌 (Jiao Hongchang), 从法院的地方化到法院设置的双轨制 [Dualism from Court Localization to Court Organization], 国家行政学院学报 [NATIONAL ADMINISTRATION ACADEMY JOURNAL], issue.1, at 73 (2000).

⁸² 田飞龙 (Tian Feilong), 司法区划改革或现跨省司法大区 [Possible Cross-province Circuit in the Judicial Administration Reform], 法制晚报 [LEGAL

concern effectively.

B. The Local Legislature's Appointment and Removal Power of Judgeship

Local legislature has the appointment power over the judgeship in local courts.⁸³ Presidents of local people's courts at various levels are elected by the local people's congresses at corresponding levels, and their vice-presidents, chief judges and associate chief judges of divisions, and judges are appointed and removed by the standing committees of the local people's congresses at corresponding levels.⁸⁴

In the Henan Seed case, it was reported that local legislature abused its removal power against a judge who ruled in favor of national legislation.⁸⁵ The seed case is about a breach of seed contract, and an issue of the calculation of damages was raised which brings about the issue that which is applicable law.⁸⁶ The legislative conflict exists in the pricing method of seeds.⁸⁷ National Seed Law adopts the market price method whereas the Henan congress passed legislation to implement a government guidance pricing.⁸⁸ Being outraged by the disgrace, the local congress claimed the declaration of invalidating a judicial decision as an invasion to the legislative power and thereby an illegal decision.⁸⁹ Later they passed the removal proposal of the judge

MIRROR NEWS] (Dec. 17, 2013), available at http://www.fawan.com.cn/html/2013-12/17/content_468765.htm.

⁸³ 法院组织法 [Court Organization Law] art. 34, *supra* note 71.

⁸⁴ *Id.*

⁸⁵ 最高法院副院长称法官因维护法律得罪地方被罢免 [Vice-chancellor of the SPC Stating that A Judge being Removed by the Locality for Upholding National Law], 中国青年报 [CHINA YOUTH], Mar. 13, 2006; See also “种子”案引发法律法规冲撞 [Case Analysis of the Henan Seed Case], 宪法教学课件 [CONSTITUTION LAW COURSEWARE] (2006), available at <http://www.crup.com.cn/UploadFiles/bookavr/D1067/html/case06.htm> (last visited Dec. 28, 2014).

⁸⁶ 河南种子案 [Henan seed case], (2003)洛民初字第 26 号判决书 (Luo Civil Law Division No. 26).

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ 关于洛阳市中级人民法院在民事审判中违法宣告省人大常委会通过的地方性法规有关内容无效问题的通报 [Announcement on Luoyang City Intermediate Court's Case Decision Declaring Provincial Law Invalid] (issued by Henan Provincial People's Cong., Oct. 18, 2003).

who issued the opinion.⁹⁰ This case was appealed to the Henan High Court (the intermediate court enjoyed the original jurisdiction), and the Henan High Court reported the case to the SPC for confirmation. The decision was affirmed by SPC,⁹¹ and the removal decision was not implemented due to the public pressure.⁹²

A view regards the seed case as a victory as well as a milestone for judicial independence. However, the case did not bring about the expansion of local judicial authority to review local legislation transparently, nor did it fix the problem of local legislature abusing the removal power to protect the local judicial independence.

Even more to the contrary, the deterrence effect to the local courts has survived from the incident. Not every decision ruling against the locality can be as lucky as the seed's judge to get media attention. Thanks to the broad media coverage, the removal power now becomes a much well-known hand hanging upon local judiciary's hat. It will add to the courts' tendency to endless avoidance.

Luckily enough, the reform proposal by Communist Party of China ("CPC") leadership aims to solve the issue as well.⁹³ A successful reform will institutionalize the insulation of the local judiciary from local legislature's appointment, and the judge's position will no longer contingent upon media coverage and public attention.

C. Abusing the Supervisory Power to Reopen a Case Threatening Judicial Decisiveness

Chinese legislature has a general supervisory role over the judicial department's job.⁹⁴ The role can be taken up by the

⁹⁰ *Id.*

⁹¹ 关于河南省汝阳县种子公司与河南省伊川县种子玉米种子代繁合同纠纷一案请示的答复 [Answer to Issues in Henan Seed Case] (issued by the Sup. People's Ct., Apr. 23, 2004).

⁹² 韩俊杰 (Han Junjie), 河南李慧娟事件再起波澜宣称省人大一条例部分无效的法官未被撤职 [*Judge Li on the Henan Seed Case Not Removed from Position*], 中国青年报 [CHINA YOUTH], Feb. 6 2004.

⁹³ CPC Decisions, *supra* note 78.

⁹⁴ 宪法 (2004 修正) [Constitution (2004 Revision)] (promulgated by the Nat'l People's Cong., effective Dec. 4, 1982) art. 67, 104, CLI.1.51974

legislature through seven ways, including hearing reports from the court, removal of judges, etc.⁹⁵ However, the legislative supervisory role has developed a trend of the individual case supervision approach by commanding the local court to reopen closed cases.⁹⁶

The exercise of the supervisory power has very often crossed the line of judicial independence.⁹⁷ The courts who issue dispositive judgment enjoy the conclusive power in particular cases.⁹⁸ The prohibition of retroactive legislative power is one of the most fundamental legal principles honoring the court decisions.⁹⁹ The legislature should have no power to command the judiciary to reopen a case outside the judicial appeal procedure.

The lack of legal expertise of the congressional representatives causes many cases of undue interference to the judicial function.¹⁰⁰ The practice of Chinese legislature in either commanding a reopening¹⁰¹ or a particular outcome¹⁰² is an illegiti-

CHINALAWINFO.

⁹⁵ 各级人民代表大会常务委员会监督法 [Supervision Law of Standing Committees of People's Congresses at Various Levels] (promulgated by Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jan. 1, 2007) ch. 2-8, CLL.1.78894 CHINALAWINFO.

⁹⁶ 蔡定剑 (Cai Dingjian), 全国人大代表进行的一起马拉松监督案 [A Marathon of Individual Case Supervision by a National Congressman], 人大与议会网 [CPCS.org], <http://www.e-cpcs.org/NewsInfo.asp?NewsID=9647> (last visited Dec. 28, 2014) (case reopened for 14 times due to repetitive proposals from congressional representatives on the same case which was dismissed on jurisdiction ground due to limitations of administrative law cases).

⁹⁷ 王利民 (Wang Limin) & 姚辉 (Yao Hui), 人民法院机构设置及审判方式改革问题研究 [Study on Reforming People's Court Organization and Adjudication Pattern], 中国法学 [CHINA LAW STUDY], issue 3, at 1 (1998); 周道鸾 (Zhou Daoluan), 对个案监督的质疑及建议 [Questioning and Improving Individual Case Supervision], 人大研究 [CONGRESS STUDY], issue 3, at 2 (2004), available at <http://www.people.com.cn/GB/14576/14841/2469349.html> (last visited Dec. 28, 2014); Paul Gewirtz, 庭审案件的立法监督 [Case Supervision from Legislature], at 2, available at <http://www.law.yale.edu/documents/pdf/CHINESE.pdf> (last visited Dec. 28, 2014); *Plaut v. Spendt hrift*, 514 U.S. 211 (1995) (U.S. Supreme Court discussion on Congressional Overturn).

⁹⁸ Frank H. Easterbrook, *Presidential Review*, 40 CASE W. RES. L. REV. 905, 926 (1990).

⁹⁹ 立法法 [Law on Legislation] art. 84, *supra* note 13. (providing that no retroactive legislative effect unless it is more favorable to private or legal person).

¹⁰⁰ Paul Gewirtz, *supra* note 97, at 2.

¹⁰¹ Cai Dingjian, *supra* note 96.

mate and improper exercise of their state power.

As general as the current reform guideline is, we have all the reasons to look forward positively into the efforts on removing undue channels of local influence as the subject has been on the reform list of the Third Plenary Session of the Eighteenth Central Committee of the CPC.¹⁰³ This paper does not hold the one-cut view that any influence from the locality is undue; it takes the position that the rule of law should encourage each voice to come in under due process. What can count as a right outcome will be the writer's next paper.

VI. THE HARDWARE RE-CONFIGURATION (COURT ADMINISTRATION) AND THE ON-CALL SOFTWARE UPGRADE (JUDICIAL MANDATE)

There is no indication yet the upcoming judicial reform will touch on the aspect of judicial review authority. As the previous parts have argued the necessity in having the local courts to do legislation reviews, this paper holds the view that the expansion of the local judicial review authority operates per se as a solution to resist local partiality. In addition, the expansion of judicial review is authorized under the current constitutional framework.

A. *Indispensable Software Upgrade on the Judicial Authority Mandate*

A judicial reform is like reconfiguring a computer to a certain extent, as it rearranges the computer system or its network accordingly by the nature, the interconnections, or reassigned characteristics of each functional unit. A rearrangement plan could refer to both hardware reconfiguration and a software configuration.

¹⁰² 蔡定剑 (Cai Dingjian), 宁武市人大对一起承包案的监督 [A Case Supervision from Ningwu City Congress to a Construction Dispute], 人大与议会网 [CPCS.org], <http://www.e-cpcs.org/NewsInfo.asp?NewsID=9647> (last visited Dec. 28, 2014).

¹⁰³ CPC Decisions, *supra* note 78. See also 十八届三中全会公报 [Public Report on the Third Plenary Session of the Eighteenth Central Committee of the Chinese Communist Party] (promulgated by the Central Commission of Communist Party of China, Nov. 22, 2013), available at http://news.xinhuanet.com/politics/2013-11/12/c_118113455.htm.

In a similar vein, the hardware of a legal system concerns the management of judgeship, construction of courthouses, funding for judicial administrative support, the setup for court maps, etc. which are right in the upcoming reform menu. The judicial software concerns how judges perform their judicial function in individual cases, what they can hear in the parties' day in court and what they cannot do, how they interpret and apply the laws and how they maintain the rule of law by upholding the social justice when one party claims to be in grief.

The judicial independence has long been impaired by the lack of hardware capacity in administration as well as the downgraded software of judicial authority. The problem of undue local intervention, and a defective judicial mandate are the key elements in the vicious circle of judicial localism.

Thus, on the one hand, the latest reform proposal in China will minimize the undue influences from the local provincialism ever, enabling the legal system to reach an optimal deployment of its human resources; on the other hand, the bottle neck on the software—the mandate for judicial review authority—remains tight and unreasonable, which has blocked the way to social justice. For a successful reform in the long run, reforming the judicial review authority is dispensable.

B. Justifying the Reform under the Chinese Constitutional Context

There may be arguments that the delegation of legislation review to the judiciary is an unconstitutional attempt to westernize the Chinese political regime, leading to judicial institutional independence like U.S. separation of power, jeopardizing the constitutional power of NPC. It is an unnecessary concern. The response goes as follows.

1. Optimal Internal Adjustment for SPC and Local Courts Functions

Firstly, such a proposal does not break the existing framework for the judicial authority mandate. The SPC has been exercising the de facto power to rule in case of legislative conflicts,

and it has done so in the past practice.¹⁰⁴

Given the constrained capacity of the SPC and increasing need for legislation review, what we are asking for here is to expedite the process, enabling the judicial system as a whole to address the central-local legislative conflicts.

Interpretation and implementation of the Constitution is an even more sensitive topic requiring more deliberation from the decision makers. For the time being and for the purpose of having a peaceful progressive reform in the judicial system, it may be understandable for the judiciary to expand the power to review conflicts between local laws and central laws only, instead of the authority to review cases of alleged conflict between any law and the Constitution. It is desirable to have a short-term compromise so long as we are aware of the long-term goal of complete judicial function. If it is to lobby such a reform proposal, the expansion of local judicial power could also be advertised as an internal adjustment of adjudicative functions, optimizing the process by granting provincial-level high courts the power to interpret and evaluate legislations within its jurisdiction.

2. Undisrupted Power Checking on the Judicial Branch

Further, there is no constitutional conflict between the judicial review mechanism over legislations and the NPC being the supreme power organ in the regime.¹⁰⁵ The independent adjudicative power is provided in the Chinese constitution,¹⁰⁶ when the NPC's esteemed status is provided in the same document.

It is only a game of words for the purpose of refusing changes, when one tries to argue how the wording in the Constitution does not cover this or that power. In any case, to enable local courts to sit on central-local legislative disputes is a legitimate step in the legal framework, and it is a much-needed solution to the hanging disputes with mixed public and private issues.

In addition, the goal of the proposal is to maintain a bal-

¹⁰⁴ See *supra* note 26.

¹⁰⁵ See 张千帆 (Zhang Qianfan), 认真对待宪法—论宪政审查的必要性与可行性 [*Taking Constitution Seriously—On the Necessity and Feasibility for Constitutional Review*], 中外法学 [PEKING UNIV. L. J.], issue. 5, 2003.

¹⁰⁶ 宪法(2004 修正) [Constitution (2004 Revision)] art. 126, *supra* note 94.

anced central-local relation between the country's unification and local autonomy by allowing the judiciary to solve the disputes and flag central-local issues along the way. The means taken is to optimize the internal distribution of judicial authority, enabling local courts to amplify the SPC's function in deciding local-center disputes. Neither the goal, nor the means of the proposal requires a breakthrough of the existing constitutional limits of judicial power. The proposal does not make the SPC an independent branch from the central legislature if this is one of the concerns for the Chinese policymakers.

Neither does the expansion of the judicial power offend a postulate of the Chinese rule of law just as deeply rooted in Chinese political regime as those we have mentioned—the fundamental leading role of Communist control. No matter from a textualist view or any other interpretation methods, it has been undeniable that the leading role of Communist Party in Chinese politics has been written into the constitution. Any expansion of power in the judiciary in implementing the constitution means a strengthened judicial position in defending the constitutional communist party policies.

VII. CONCLUSION REMARKS

Rome was not built in one day. It takes patience, determination and relentlessness for China to break the vicious cycle for judicial independence. Hardly will there be a one-stop solution for all these problems.

As discussed in the body of this thesis, three features ensures a capable court function on central-local relation case: high responsiveness to disputes with mixed private and public issues, transparency and accountability resulting from public participation in the judicial open procedures, as well as intellectual contribution from the legal professional expertise in the adversarial proceedings. That is why non-judicial means is less desirable as the judicial mechanism for solutions on central-local disputes.

The author is aware of this presumption of benevolence in the central authority and central legislation,¹⁰⁷ and this paper's

¹⁰⁷ 胡鞍钢 (HU ANGANG), 中国国家能力报告 [REPORT ON CHINESE NATIONAL CAPABILITY], at 98 (1993).

proposal is likely to strengthen the preemptive effect of central legislations. In the central-local government relationship dynamics, it has been the central government who dominates the dialogue on central-local power relationship and who is able to initiate big reform.¹⁰⁸ Though local governments may use their different bargaining and negotiating leverage in the process of shaping national policies.¹⁰⁹ The central government is still in power for that it is able to push the reform despite resistance.¹¹⁰

In response to this view, this paper wishes to underline that the proposal of reforming local judiciary is more about strengthening the value of due process. The judiciary's hearing in the future may not be limited to challenges to local governments only; when the rule of law system in the realm of legislation review is launched, we can reasonably expect that there will be challenges to the central authority as well. By the rule of law, it is not the prestige or the scale of power of the central authority that finally determines what is justice; it is the rules of law that provides a just outcome as well as the legitimacy.

Nevertheless, no matter how the pros and cons of judicial review of legislations are phrased, this paper calls for a due process that both state authorities and private parties can participate. Back to the comparison to computer system and software, the system needs a better quality of legal service/user experience, the system needs a better application taking advantage of the upgraded hardware, and the system needs the user to grant the local judiciary greater authority to do the action.

¹⁰⁸ *Id.*

¹⁰⁹ Zheng Yongnian, *Power to Dominate, Not to Change: How China's Central-Local Relations Constrain its Reform*, EAST ASIA INSTITUTE WORKING PAPER, issue 153, at 4, available at <http://www.eai.nus.edu.sg/EWP153.pdf> (last visited Dec. 28, 2014).

¹¹⁰ MAX WEBER, *ECONOMY AND SOCIETY: AN OUTLINE OF INTERPRETIVE SOCIOLOGY* 53 (Ephraim Fischhoff et al. trans., 1978).

ANNEX
Bluebook Supplemental Rules for Chinese Sources
Peking University Transnational Law Review

Rule 1 Statutes**Rule 1.1 The Constitution**

- 宪法 [Constitution] <article>, <section>, <CLI number> <CHINALAWINFO>.
 - 宪法(2004 修正) [Constitution (2004 Amendment)] art. 33, § 2, CLI.1.51974 CHINALAWINFO.
- 宪法修正案(year of amendment) [Amendments to the Constitution (year of amendment)] <article>, <CLI number> CHINALAWINFO.
 - 宪法修正案(2004) [Amendments to the Constitution (2004)] art. 24, CLI.1.51973 CHINALAWINFO.

★ NOTE:

Codification. The United States has published the official United States Code (U.S.C.). However, China does not have such official codification system. Instead, we have the CLI number that is provided by the electronic database Chinalawinfo (<http://pkulaw.cn/fbm/>). Using CLI number is the most efficient way to locate Chinese statutes.

Rule 1.2 Laws

- <Shortened name of the statutes in Chinese>
[<Shortened English translation of law name,
according to Lawinfochina if available>]
(promulgated by <enacting/adopting authority>,
<promulgation date>, effective <effective date>)
<article cited>, <CLI number> CHINALAWINFO
- 立法法 [Law on Legislation] (promulgated by
the Nat'l People's Cong., Mar. 15, 2000,
effective July 1, 2000) art. 3, CLI.1.26942
CHINALAWINFO.

★ NOTE:

Omit “中华人民共和国” in Chinese name and “of the People's Republic of China” in the shortened translation name.

Rule 1.3 Regulations and Rules

- <Regulation or rule name in Chinese> [<Shortened English translation of regulation or rule name>]
(promulgated by <enacting/adopting authority>,
<promulgation date>, effective <effective date>)
<article cited>, <CLI number> <CHINALAWINFO>.
1. Administrative regulations issued by the State Council
 - 机动车交通事故责任强制保险条例(2012 修订)
[Regulation on Compulsory Traffic Accident Liability Insurance for Motor Vehicles (2012 Revision)] (promulgated by the St. Council, Mar. 30, 2012, effective July 1, 2006) art. 8, CLI.2.172967 CHINALAWINFO.

2. Administrative rules issued by departments under the State Council

- 中国人民银行关于加强跨境汇款业务反洗钱工作的通知 [Notice of the People's Bank of China on Strengthening the Anti-Money Laundering in Cross-Border Remittances] (promulgated by the People's Bank of China, Aug. 12, 2012, effective Aug. 12, 2012) art. 5, CLI.4.187252 CHINALAWINFO.

3. Local regulations

- *See generally* 北京市公共服务网络与信息系统安全管理规定 [Provisions of Beijing Municipality on Security Administration of Public Service Networks and Information Systems] (promulgated by the Beijing Municipality, Nov. 11, 2005, effective Jan. 1, 2006) CLI.11.68791 CHINALAWINFO.

Rule 1.4 Legislative, Administrative, and Judicial Interpretations

- <Shortened interpretation name in Chinese>
 [<English translation of interpretation name>]
 (promulgated by <enacting/adopting authority>,
 <promulgation date>, effective <effective date>)
 <article cited>, <CLI number> <CHINALAWINFO>.

1. Legislative interpretations

- 全国人大常委会关于《香港特别行政区基本法》第五十三条第二款的解释 [Interpretation of the Standing Committee of the National People's Congress on Paragraph 2, Article 53 of the Basic Law of the Hong Kong Special Administrative Region] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 27, 2005, effective Apr. 27, 2005) CLI.1.58051 CHINALAWINFO.

2. Judicial interpretations

- 最高人民法院关于审理劳动争议案件适用法律若干问题的解释(四) [Interpretation (IV) of the Supreme People's Court of Several Issues on the Application of Law in the Trial of Labor Dispute Cases] (promulgated by the Sup. People's Ct., Jan. 18, 2013, effective Feb. 1, 2013) art. 2, CLI.3.194209 CHINALAWINFO.

3. Administrative interpretations

- 国务院办公厅对《城市维护建设税暂行条例》第五条的解释的复函 [Letter of Reply of the General Office of the State Council on Interpretation of Article 5 of the Provisional Regulations on City Maintenance and Construction Tax] (promulgated by the General Office St. Council, Feb. 27, 2004, effective Feb. 27, 2004) CLI.2.52256 CHINALAWINFO.

Rule 1.5 Treaties and Conventions

➤ **Bilateral:**

<Shortened treaty name in English>, <abbreviated names of parties to agreement>, <subdivision cited>, <date of signing>, <CLI number>
<CHINALAWINFO>.

- Treaty of Peace and Friendship, P.R.C. -Japan,
art. 2, Aug. 12, 1978, CLI.T.3003
CHINALAWINFO.

➤ Multilateral (China is one of the parties):
<Shortened treaty name in English>, <subdivision cited>, <date of signing>, <one international treaty source>, <CLI number> <CHINALAWINFO>.

- *See generally* United Nations Convention on
the Law of the Sea, Dec. 10, 1982, 1833 U.N.T.S.
397, CLI.T.3446 CHINALAWINFO.

★ NOTE:

If the author cites the multilateral treaty in
English, we should follow Bluebook Rule 21.4.

Rule 2 Chinese Cases

➤ <Case name in Chinese> [<English translation of
case name>] <Chinese official case codification>,
(<court abbreviation> <date of decision>) <CLI
number if available > <CHINALAWINFO if available>.

- 吴英集资诈骗案 [*In re Wu Ying Fraudulent
Fund-Raising*] (2010) 浙刑二终字第 27 号,
(Zhejiang High People's Ct. Jan. 6, 2012)
CLI.C.811474 CHINALAWINFO.

- 腾讯公司诉奇虎 360 公司不正当竞争纠纷案 [Tencent Co. v. Qihoo 360 Co. on Illicit Competition] (2011)二中民初字第 12237 号, (Beijing Second Interm. People's Ct. Sept. 14, 2011) CLI.C.875373 CHINALAWINFO.

Rule 3 Chinese Books

- <Author's name in Chinese> (<AUTHOR'S NAME IN SMALL CAPS PINYIN>), <title of the book in Chinese> [TITLE OF THE BOOK IN SMALL CAPS ENGLISH], at <page cited> (<edition, if more than one>, <publisher, if more than one edition>, <year of publication>).
- 周小川 (ZHOU XIAOCHUAN), 重建与再生——化解银行不良资产的国际经验 [RECONSTRUCTION AND REGENERATION—INTERNATIONAL EXPERIENCE OF RESOLVING NON-PERFORMING ASSETS OF BANKS], at 1 (1999).

Rule 4 Chinese Periodicals

- <Author's name in Chinese> (<author's name in pinyin>), <title of the article in Chinese> [*title of the article in italic English*], <journal name in Chinese> [ABBREVIATED JOURNAL NAME IN SMALL CAPS ENGLISH], <volume or issue number>, at <specific pages cited> (date of publication).
- 魏国雄 (Wei Guoxiong), 对不良贷款的再思考 [*Rethinking of the Non-Performing Loans*], 银行家 [THE CHINESE BANKER], issue 1, at 70–71 (2011).

Rule 5 Chinese Newspaper

- <Author's name in Chinese> (<author's name in pinyin>), <title of the article in Chinese> [*title of the article in italic English*], <newspaper name in Chinese> [ABBREVIATED NEWSPAPER NAME IN SMALL CAPS ENGLISH], <date>, at <page on which article appears>.
 - 陆娅楠 (Lu Yanan), 货运改革, 铁路走向市场的关键一步 [*Freight Reform, A Key Step for Railways Moving toward the Market*], 人民日报 [PEOPLE'S DAILY], June 17, 2013, at 5.

Rule 6 Chinese Report

- <Institution name in Chinese> [INSTITUTION'S NAME IN ABBREVIATED ENGLISH], <title of the report in Chinese> [TITLE OF THE REPORT IN SMALL CAPS ENGLISH], at <page cited> (<date>), <URL if available>.
 - 中国东方资产管理公司研发中心 [CHINA ORIENT ASSET MGMT. CORP. R&D CTR.], 2009: 中国金融不良资产市场调查报告 [2009 REPORT OF CHINA'S NON-PERFORMING ASSETS MARKET], at 40 (Apr. 2009), <http://www.coamc.com.cn/yjfx/dqbg/200904/P020090416334441825823.pdf>.

Rule 7 Chinese Internet

- <Author's name in Chinese> (<author's name in pinyin>), <title of the article in Chinese> [*title of the article in italic English*], <website name in Chinese> [ABBREVIATED WEBSITE NAME IN SMALL

CAPS ENGLISH], (<date of publication>), <URL>
<editors last visited date>.

- 黄蒂 (Huang Di), 欧盟的中国考题 [*The Chinese Test for European Union*], 财新网 [CAIXIN.COM], May. 31, 2013, <http://international.caixin.com/2013-05-31/100535888.html> (last visited June 13, 2013).