



# DOING BUSINESS IN CHINA

August 2011



EVERYTHING MATTERS

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# INTRODUCTION

In the wake of the most punishing economic downturn in 70 years, China features prominently in the plans of investors and companies searching for growth. Having successfully navigated the financial tsunami, China's continued dynamism and increasingly sound economic management track record prove attractive to managers, investors, entrepreneurs, and consultants alike.

However, opportunity is never without risk. An increasingly competitive business environment, coupled with growing friction in the global trading system, signals the rise of new transnational challenges. On a local level, corporations must understand, implement, and adhere to a continuously evolving rule of law.

While China's appeal continues to grow, a new dynamic is emerging, promising a profound shift for the international economic and business landscape. It's no longer just an eye-catching market 1.3 billion individuals strong – locally-born businesses are eager and poised to take on the world. Be they domestic startups with humble beginnings or well-established multinationals that span the globe, China is demonstrating its value as a partner and multiplier for businesses.

DLA Piper readily awaits an increasingly fast evolution in China's legal, regulatory, and commercial environments. Dramatic changes, heightened motivation, and a growing willingness to assume the role of a major financial and trading partner shape China's progression in both policy and practice.

The fifth edition of "Doing Business in China" emphasises our commitment to enabling clients' success by providing comprehensive, current industry knowledge and insightful future

forecasts. Positive feedback to earlier editions has demonstrated its constructive value when planning and executing business and investment strategies.

Written with our broad range of clients' interests in mind, the guide's approach is extensive yet comprehensive. Beginning with economic and regulatory insights – such as China's commitments to the World Trade Organisation – we offer practical tips for managing a multitude of situations, such as setting up a business, protecting intellectual property rights and obtaining financing (IPOs, venture capital, and private equity funds). We also evaluate laws affecting employment, the environment, taxation, and real estate. In response to readers' and clients' requests for advice on navigating China's corridors of power, our government affairs team drew upon their extensive experience to formulate tips and tactics for effectively liaising with officials.

DLA Piper closely follows recent developments affecting clients' businesses. The addition of three chapters provides analysis and approaches for responding to the newly-implemented Anti-Monopoly Law, insolvency and restructuring, and Corporate Social Responsibility (CSR). Compliance with CSR guidelines and the production of a CSR report will be compulsory for state-owned enterprises by 2012, signaling the government's increasing prioritisation of the issue. An amplified focus on sustainability and anti-corruption provisions are significant developments impacting all businesses engaged in China, irrespective of structure or origin.

I would like to thank all who contributed to this guide, especially our China experts who are our partners, lawyers, and professional support staff. Developed from practical experience and genuine knowledge, their inspiring thoughts reinforce our success as one of the leading international law firms in Asia.



A handwritten signature in black ink that reads "Alastair da Costa".

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Managing Director, Asia  
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A handwritten signature in black ink that reads "Liu Wei".

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## ABOUT THE PUBLISHER

DLA Piper is one of the largest global law firms in the world. Globally, we have over 4,200 lawyers in more than 76 offices in over 30 countries across Asia, Europe, the Middle East and the US.

DLA Piper has maintained a presence in Asia since 1988 and now has offices located in Beijing, Bangkok, Hong Kong, Shanghai, Singapore and Tokyo. In addition, we have country practices that focus on Indonesia, Korea and Vietnam, as well as experience in other jurisdictions within the region, including India and Malaysia.

Engaging in these dynamic markets requires a first-hand knowledge of local legal and regulatory environments. Around 80% of our lawyers are local lawyers, so our legal solutions reflect pragmatic assessments of risk and reward, based on real understanding of local law and business.

For more information, please visit us at [www.dlapiper.com](http://www.dlapiper.com)

## CHINA E-NEWSLETTER

DLA Piper “China Trends” e-newsletter is an informative, reliable and up to date electronic publication produced by our team of China practice lawyers based around DLA Piper’s global network. Each edition features a round up of legal developments that have taken place, and that will have an impact on business and industry in China.

You can register to receive the China e-newsletter by sending us a request at: [chinatrends@dlapiper.com](mailto:chinatrends@dlapiper.com)

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## ECONOMIC AND REGULATORY INFRASTRUCTURE

# LATEST ECONOMIC DEVELOPMENT

### CURRENT ECONOMIC DEVELOPMENT

China's economy has averaged a staggering 9% growth per year over the last two decades. Although China's economy slowed since 2008 due to the global recession, with the help of liberal credit and fiscal policies, the Government forecasts a 8% growth for China this year. This, coupled with the government's economic reform initiatives and its increasingly welcoming stance towards foreigners, will undoubtedly lead to increased foreign interest in the country.

This economic boom is supported by both fixed asset investment and retail consumption. Growth in retail consumption has been stimulated in part by the provision of consumption credits and lengthened holidays as well as a continued increase in disposable income. In the context of the international financial crisis, the Chinese Government has launched a series of revitalisation measures including an RMB 4 trillion fiscal stimulus package, announced in November 2008, to boost infrastructure spending as well as to promote consumption.

### GROWING CONSUMER SOCIETY

China has developed purchasing power and is fast becoming a magnet for consumer goods. Personal consumption is changing in terms of both quantity and quality of the goods consumed. The rapid development of the Chinese economy also means that the type of goods being purchased now has changed, with a marked increase in spending on residential property, passenger cars, personal communication devices, education, international tourism, luxury goods and cosmetics and beauty services.

Despite increased personal spending on major items such as housing, China has had the highest national savings rate in the world since the 1970s. With this trend set to continue, China's domestic market of 1.2 billion consumers poses a tremendous opportunity for foreign investors.

### FOREIGN TRADE AND INVESTMENT

China has been the largest recipient of foreign direct investment among all developing countries since 1993. According to statistics from the Organisation for Economic Cooperation and Development, it finally overtook the US as the world's top recipient of foreign direct investment in 2003. This influx was directly related to China's accession to the World Trade Organisation (WTO) on December 11th 2001, as membership was preconditioned on bringing about a more open market and a more transparent regulatory regime. Since then, China has put in place most of the scheduled market-opening measures.

The main sources of investment include Hong Kong, Japan, the US, Taiwan, Singapore, South Korea, UK and Germany. In a bid to attract high-quality overseas investment and introduce high technology and know-how to upgrade its industrial infrastructure, the Chinese central government has introduced tariff-free and VAT-exempted imports of capital equipment for projects within the energy, agriculture, transport, infrastructure and raw materials production sectors as well as in tertiary industries.

Though the financial crisis is slowing growth in foreign direct investment in 2008 and 2009, China remains an attractive destination for

foreign investors due to its dynamic economy. Over the past few years, relaxed rules on foreign ownership have made it easier for wholly foreign-owned companies to conduct business, giving them a measure of confidence that proprietary technology could be protected. After years of heady economic growth and burgeoning trade surpluses, the Government has decided to shift industrial policies from developing labour-intensive industries in the first two decades of reform to capital-intensive, high-tech industries. Based on the Chinese Government's blueprint, the next phase of development will be driven by innovation-intensive industries that introduce advanced technology or have significant research and

development components. This is a more balanced approach to development that is consistent with China's social, economic and environmental policy priorities.

[External trade is also expanding quickly in China. The export-processing trade in particular has been thriving. In addition to exports of machinery, electrical and electronic products that have always been the mainstay of Chinese external trade, trade in light consumer goods, such as garments, has also been performing well. China's top trading partners are the European Union, US, Japan, ASEAN, Hong Kong, South Korea, Taiwan, Australia, Russia and India.]



## ECONOMIC AND REGULATORY INFRASTRUCTURE

# HOW CHINA IS REGULATED

State power within the PRC is divided among three bodies: the Communist Party of China, the State and the People's Liberation Army.

The National People's Congress ("NPC"), or parliament, is the highest organ of state power in China. Its powers include the enactment of laws, the selection or removal of state organs, policy formulation and the supervision of other governing organs. It also supervises the implementation of the Constitution it adopted in 1982, and has made significant and ongoing efforts to promote the rule of law. Since the Constitution was enacted, several hundred laws and regulations have been promulgated, the majority of which are commercial in nature. The Supreme People's Procuratorate, the Supreme People's Court and the State Council are supervised by the NPC.

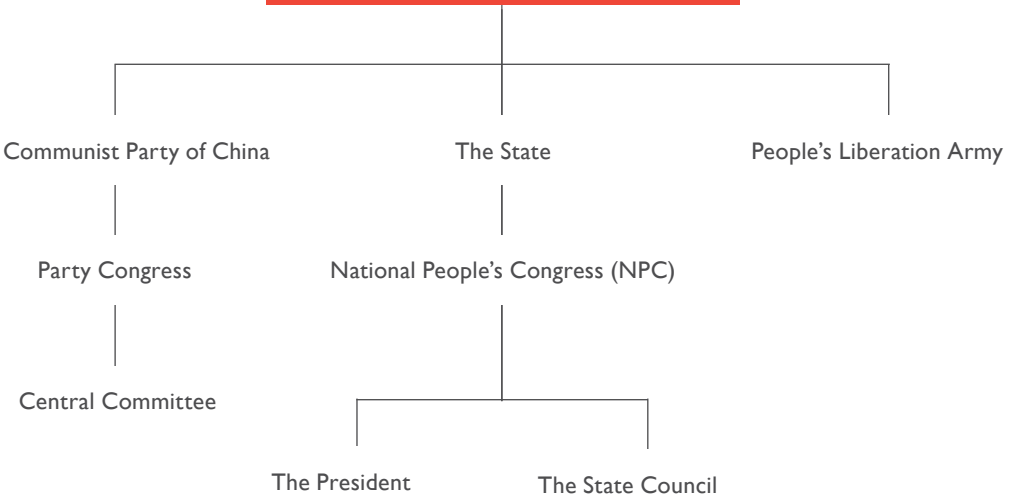
The President of the People's Republic of China is the Head of State, as well as the supreme representative of China both internally and externally. China has a system of collective leadership and the president is subordinate to the NPC. The State Council is the highest executive body of the Chinese Government. It consists of ministries (government departments), commissions (administrative and policymaking bodies), subordinate institutions and administration offices of the State Council (supervisory and regulatory bodies) and ministry-level corporations and companies.

These may in turn contain or supervise various bureaus, and may have representation at both national and local level. The State Council has reformed its organisational structure in the past few years to increase efficiency and advance

the market-orientated economy. Recently, the following reforms have taken place:

- establishment of coordination mechanisms among National Development and Reform Commission ("NDRC"), Ministry of Finance and PRC People's Bank to strengthen macro-economic regulation;
- establishment of the National Energy Bureau which is a working office under the NDRC;
- establishment of the Ministry of Industry and Information Technology ("MIIT") to integrate the NDRC's functions on industry and trade management, the functions of the Commission of Science, Technology and Industry for National Defence except that on nuclear power management, and the functions of the Ministry of Information Industry and the State Council Informatization Office;
- establishment of the Ministry of Transport to integrate the functions of the Ministry of Communications and the General Administration of Civil Aviation and the Ministry of Construction's functions on urban passenger transport management;
- consolidation of the Ministry of Personnel and the Ministry of Labour and Social Security into the Ministry of Human Resources and Social Security;
- establishment of Ministry of Environmental Protection replacing the State Environmental Protection Administration.

## STATE POWER WITHIN THE PRC



This chart above illustrates the structure of the State's power within the PRC.

## ECONOMIC AND REGULATORY INFRASTRUCTURE

# ACCESS TO MAINLAND CHINA THROUGH HONG KONG

The advances in Mainland China's economy have precipitated dramatic changes in its culture, infrastructure and legal regime. As the historical gateway to the Mainland, Hong Kong has not stood still either, constantly transforming itself to adapt to the Mainland's changing needs. While Mainland China has transformed itself into the pre-eminent destination for foreign investment, Hong Kong remains a key launch point for investing in Mainland China, as well as the surrounding Asia-Pacific region. For example, Hong Kong continues to act as a point of access for outsourcing China-made products, and is the place where some of the most experienced Chinese business partners are located. Hong Kong also provides a convenient location for foreign investors to hold and administer their China investments (including foreign investment enterprises), set up regional head offices and direct pan-Asia operations.

### **BUSINESS, FINANCIAL AND REGULATORY INFRASTRUCTURE**

Besides its geographic location on China's doorstep, Hong Kong also offers a solid infrastructure able to cater to the many needs of foreign business operators. It provides a dynamic business environment in which funds can be raised for investments in China. It is both a duty free port and an international financial centre, where many major foreign banks and local banks are present. Moreover, Hong Kong does not impose any restrictions on currency trading. The Securities and Futures Commission ("SFC"), an independent non-governmental statutory body, is responsible for regulating the securities and futures markets in Hong Kong. The SFC is similar to the corresponding structures existing in the UK and US.

Hong Kong also enjoys a reputation for having an efficient civil service and streamlined, non-invasive bureaucracy. It provides the option of bilingual communications in both Chinese and English, including audio-visual and print media in both languages as well as advanced telecommunications and information technology.

### **LIFESTYLE**

Quality of life is an important consideration for multinational corporations wanting to set up regional offices abroad and seeking a suitable location for their expatriate staff. Hong Kong offers a variety of residential accommodation and schooling options and social, recreational and cultural facilities to suit an expatriate's needs. The public transportation system is wide-reaching and efficient. The city's central geographic location in the Asia Pacific region and its state-of-the-art airport allow easy access to all key cities in the region for business and recreational travel.

### **RULE OF LAW**

Hong Kong has a common law system, broadly based on the English model, with rule of law as its core concept. This legal system is separate and distinct from the legal system of Mainland China. The Basic Law (a statute enacted by the National People's Congress of the People's Republic of China) ensures that this separation shall continue for 50 years beginning from the 1997 Handover of Hong Kong to the People's Republic of China.

Hong Kong possesses a legal tradition based upon the freedom of corporations to structure their investments and operations according

to their business needs. It also features comprehensive regulations governing intellectual property, an enforcement system for the protection of intellectual property rights, and an institutionalised respect for individual civil liberties. All of these characteristics make Hong Kong a sound forum for the execution of contracts or the resolution of disputes by an independent judiciary, or by the experienced and internationally renowned arbitration centre, the Hong Kong International Arbitration Centre.

## **TAXATION**

Hong Kong's taxation system is based on the principle of territoriality – that is, only profits that are regarded as having been derived from the conduct of a trade, businesses, or profession in Hong Kong are subject to taxation (excepting profits arising from the sale of capital assets, which are specifically exempt from taxation under Hong Kong law). Under the territoriality principle, the residence of a particular taxpayer is irrelevant to the determination of the assessability of its profits to tax. For instance, a Hong Kong private limited company that derives profits from outside of Hong Kong may avoid taxation on those profits, provided that it can demonstrate that the relevant transactions giving rise to such profits took place outside of Hong Kong. What's more, Hong Kong's corporate profits tax rates and individual income tax rates are (at the time of this writing) internationally competitive and favourable compared to other jurisdictions, particularly Mainland China.

In addition, Hong Kong does not impose any payroll tax, turnover tax, sales tax, value added tax, gift tax, nor (as mentioned above) capital

gains tax. Furthermore, dividends received from a corporation which are chargeable to Hong Kong profits tax are not taxed.

Recently, Hong Kong concluded a double taxation agreement with Mainland China. Under this double tax agreement, qualifying Hong Kong tax residents may enjoy preferred withholding tax rates on dividends, interest, and royalties, as well as capital gains (upon the disposition of an investment in Mainland China). The double tax agreement also facilitates group operations between Hong Kong and Mainland China by offering clear permanent establishment rules. However, before structuring any investment into Mainland China via a Hong Kong vehicle, it is important for foreign investors to consult tax advisors and lawyers in all relevant jurisdictions to ensure that any Hong Kong or Mainland investment does not have any impact on their overall international tax position or generate any other potential liabilities in any jurisdiction.

## **ESTABLISHING A BUSINESS VEHICLE AND STRUCTURING CHINA PROJECTS THROUGH HONG KONG**

There are various ways a foreign investor can set up a business presence in Hong Kong. It may establish a representative office, a branch office of an overseas company or incorporate a Hong Kong private limited company. Generally, the Hong Kong private limited company offers the most flexibility and is the most commonly used business vehicle. Partnerships and acquisitions of existing businesses are also possible. There is no general restriction on a foreign investor's ability to hold shares in, or be directors of, a Hong Kong private limited company.

A Hong Kong private limited company is relatively fast and simple to incorporate, and the regulatory requirements governing its administration are relatively uncomplicated. Investors seeking a simpler route to setting up operations in Hong Kong may also consider purchasing, a so-called “shelf company,” which is a ready-made company that was previously incorporated for the sole purpose of sale.

A Hong Kong private limited company can be held by a sole shareholder and administered by a sole director. These need not be Hong Kong residents and may be one and the same individual or corporation, except that a company which is a member of a corporate group to which a listed company is a member, may not have a corporate director. All Hong Kong companies are also required to have a company secretary to assist with maintaining its books and records (amongst other responsibilities). Unlike shareholders and directors, the company secretary must ordinarily reside in Hong Kong (in the case of an individual) or have its registered office or place of business in Hong Kong (in the case of a corporation).

A foreign investor planning to set up operations in Mainland China may begin by establishing a Hong Kong private limited company. This might be a joint venture with a local Hong Kong partner with experience in Mainland China in the relevant field, or its own subsidiary in Hong Kong (“HK Co.”). The joint venture or subsidiary could then act as the holding company for the China project. Subject to the requirements of Chinese laws and regulations, the HK Co. could establish a foreign investment enterprise in China in the form of a Sino-Equity Joint Venture (“EJV”) or Co-operative Joint Venture (“CJV”) with a local Chinese partner, or a Wholly Foreign-Owned Enterprise (“WFOE”),

which would be a 100% subsidiary of HK Co.

One of the key benefits of using such Hong Kong-based investment structures is that it may serve to accommodate the administration of the investor’s regional corporate group and the rights and obligations of shareholders close to the location of the China project. This can make both logistical management and communications easier to handle than if conducted from the investor’s home jurisdiction. At the same time, it allows the investor to benefit from all of Hong Kong’s underlying advantages.

A multinational corporation that uses third party distribution networks for its products in China and other parts of Asia may find Hong Kong an excellent location in which it can base its pan-Asia distribution structure. A Hong Kong subsidiary can act as master distributor for Asia, linking up its various distribution agreements with Asian distributors under a master distribution agreement with the Hong Kong subsidiary.

Furthermore, through the Closer Economic Partnership Arrangement between Mainland China and Hong Kong (“CEPA”), the Mainland accords Hong Kong preferential treatment in accessing its market through trade in products and the establishment of foreign investment enterprises providing services in the Mainland. Foreign investors establishing manufacturing facilities, or who have already established service companies in Hong Kong, may benefit from the concessions to market access to Mainland China available under CEPA, provided they comply with CEPA requirements.

## ECONOMIC AND REGULATORY INFRASTRUCTURE

# ANTI-MONOPOLY LAW OF THE PRC

China's Anti-Monopoly Law (the "AML") was promulgated by the National People's Congress on 30 August 2007 and came into force on 1 August 2008.

The AML includes similar elements to those covered in many other systems of antitrust or competition law around the world:

- Merger Control;
- Monopoly or restrictive Agreements;
- Abuses of Dominant Position.

### MERGER CONTROL

Under the AML, all concentrations have to be notified to MOFCOM if the parties involved meet certain turnover thresholds (see below). A "concentration" includes any one of the following circumstances:

- A merger of two or more previously independent undertakings;
- Acquisition of control of another undertaking through an acquisition of shares or assets;
- Acquisition of control or acquiring the ability of exercising decisive influence over other undertakings by contract or other means.

The creation of a joint venture to falls within the definition of a "concentration", at least where it gives rise to a jointly-controlled economic entity which has a degree of sustainability and independence from its parents. Where such conditions are not met, it would appear that a joint venture should be analysed as a "monopoly" agreement between the parent companies.

It should be noted that concentrations taking place outside China that restrict or eliminate competition in the Chinese domestic market will fall under the AML.

If either of the two thresholds below is met, a pre-merger notification must be filed with MOFCOM otherwise the concentration is prohibited:

- The total worldwide turnover in the previous accounting year of all undertakings involved in the concentration exceeds RMB 10 billion (approx. US\$1.460 billion or Euro 1.36 billion\*), and at least two of such undertakings each has a turnover of more than RMB 400 million (approx. US\$ 58.6 million or Euro 41.5 million\*) within China in the previous accounting year; or
- The total turnover in China in the previous accounting year of all undertakings involved in the concentration exceeds RMB 2 billion (approx. US\$ 292 million or Euro 207 million\*), and at least two of such undertakings each has a turnover of more than RMB 400 million within China in the previous accounting year.

MOFCOM will have 30 days to conduct a preliminary review of the transaction. Such period can be extended by 90 days, and in certain circumstances, by an additional 60 days.

At the end of the review period, MOFCOM may prohibit the concentration or may attach conditions to the implementation of the concentration. If it makes no decision at the expiry of the review period, the parties are free to implement the concentration.

\* Note: The thresholds are in RMB. Approximations are provided in other currencies at January 2010 conversion rates for convenience only

## MONOPOLY AGREEMENTS

The AML defines “monopoly agreements” as being “agreements, decisions or other concerted behaviour that eliminate or restrict competition” within the PRC. However, the AML also applies to monopoly agreements concluded outside the PRC which have the effect of “eliminating or restricting competition” in the domestic market of the PRC.

Certain types of horizontal agreements (i.e., agreements between competitors) are forbidden in the law, where they have an effect in the market notably:

- Price fixing;
- Output or sales restrictions;
- Market sharing;
- Restrictions on purchase of new technology or new facilities or on development of new technology or new products;
- Collective boycotts.

In the case of vertical agreements, fixing resale prices and restricting minimum resale prices are both forbidden.

## ABUSE OF DOMINANT POSITION

It is an infringement when a company with a dominant market position abuses that position, by taking certain actions to eliminate or restrict competition.

“Dominant market position” is defined in the AML as the market position that is held by undertakings in the relevant market which enables those undertakings to control the price and quantity of goods or other trading

conditions, or to block or affect the entry of other undertakings into the relevant market.

According to the AML, a rebuttable presumption of “dominant market position” arises where:

- One company holds 50% or more of the relevant market;
- Two companies jointly account for 66.6% or more of the relevant market; or
- Three companies jointly account for 75% or more of the relevant market.

Behaviour that may be considered as an “abuse” includes:

- Selling goods at unfairly high prices or buying at unfairly low prices;
- Selling goods at prices below the cost without justified reasons;
- Refusing to deal with another party without justified reasons;
- Requiring another party to trade exclusively without justified reasons;
- Tying products or imposing other supplementary unreasonable trading conditions without justified reasons; and
- Using discriminatory pricing and other discriminatory trading conditions without justified reasons.

## ADMINISTRATIVE MONOPOLY AND STATE-OWNED ENTERPRISES

The AML also prohibits the abuse of government administrative powers. State Owned Enterprises or enterprises controlled by State Owned Enterprises are prohibited from using their dominant positions or exclusive dealing positions to harm consumers’ welfare.

## ENFORCEMENT AGENCIES

The Anti-Monopoly Commission under the State Council will be responsible for coordinating and guiding anti-monopoly work. Its duties will include researching and drafting policies and guidelines, organising investigations and assessing the overall competition status in the market.

However, enforcement of the AML is entrusted to the following three enforcement agencies each of which is responsible for a different area of the law:

- MOFCOM will be responsible for Merger Control;
- National Development and Reform Commission (“NDRC”) will be responsible for price-related Monopoly Agreements and price-related Abuses of Dominant Position; and
- State Administration for Industry and Commerce (“SAIC”) will be responsible for the non-price related Monopoly Agreements and non-price Abuses of Dominant Market Position.

## FINES AND PENALTIES

Infringement under the AML can lead to severe penalties. Fines range from 1% to 10% of total turnover during the last (fiscal) year. The AML also provides that violations may result in the confiscation of illegal gains.

Individuals and companies who refuse to provide relevant materials or information, or who provide false or misleading information,



destroy evidence or obstruct the investigations by the enforcement agencies, may be liable to criminal sanctions.

## PRIVATE ACTIONS

The AML also envisages private enforcement actions by third parties against violators who cause losses to others.

There have been a number of such actions brought in China since the AML came into force on August 1, 2008.

## LENIENCY

Where a party voluntarily reports relevant information concerning monopoly agreements and provides important evidence, the enforcement agencies are empowered to mitigate or exempt the punishment of such a party involved in the agreement.

It is vital, therefore, that companies implement and run an effective compliance program, to be able to detect potential infringements at the earliest possible moment.

## ECONOMIC AND REGULATORY INFRASTRUCTURE

# PRC BANKRUPTCY PROVISIONS

The 23rd Meeting of the Standing Committee of the 10th National Peoples Congress (NPC) of the People's Republic of China (PRC) passed new insolvency legislation on August 27, 2006. The Enterprise Insolvency Law (“EIL”) took effect on June 1, 2007.

### FRAMEWORK

#### Applicability and Accessibility

The EIL applies to all entities that hold legal person status, including private companies, foreign enterprises, limited liability companies, and companies limited by shares, as well as state owned enterprises (SOEs).

With regard to financial institutions such as banks and insurance companies, the relevant authority of the State Council may apply for their restructuring or bankruptcy pursuant either to the EIL or other relevant laws. However, financial institutions are very important to the economy, as well as being commonly subject to unique concerns, such as special licensing, regulation, and supervision rules that do not apply to other enterprises. That is why it would be preferable for the insolvencies of financial institutions to be dealt with through a separate law or through additional, clearly formulated regulations that would supplement the EIL.

#### Reorganisation, Liquidation, and Settlement

The EIL offers three different types of bankruptcy proceedings: liquidation (bankruptcy), restructuring, and settlement with creditors. It also allows for the conversion of restructuring and settlement proceedings into bankruptcy proceedings, which in turn can be terminated if the debtor or a third party has repaid all the debtor's debts.

#### Commencement of Bankruptcy Proceedings

Under the EIL, a creditor, the debtor, or, in the case of a financial institution, the relevant authority of the State Council may petition the People's Court to bankrupt or restructure a debtor.

When a creditor has petitioned for the bankruptcy of a debtor, the debtor or an investor, whose capital contribution accounts for more than 10 percent of the debtor's registered capital may petition the People's Court for restructuring, prior to a declaration of bankruptcy. However, only the debtor may apply for a settlement agreement and must do so before the Court declares the debtor bankrupt. Once it receives an application, the People's Court has 15 days to decide whether to accept the bankruptcy petition.

This gives the People's Court a great deal of leeway in deciding whether to accept a bankruptcy petition.

#### The Test for Insolvency

Once the People's Court decides to assume jurisdiction, it must decide whether the debtor in question is insolvent. An enterprise must meet two criteria to be deemed insolvent:

- the enterprise must be unable to pay its debts when due; and
- the enterprise's assets are not sufficient to repay all of its debts.

That is, the EIL seems to require an enterprise to meet both a liquidity test and a balance sheet test when determining insolvency, if the debtor wishes to make the application to court.

The EIL also refers to situations in which the enterprise is “likely to become insolvent”. Whilst the legislation does not define what that means, it gives the court some leeway.

A creditor can petition where it can establish just one of the criteria – that the debtor cannot pay its debts as they fall due.

### **Moratorium and Suspension of Proceedings**

The EIL allows the People’s Court to impose a temporary stay on all ongoing civil proceedings and arbitrations relating to the debtor from the time the Court decides to accept the bankruptcy petition (not the date of application) until the administrator takes over the management of the debtor’s property and assets. This in practice meaningless, as the People’s Court is required to appoint an administrator upon accepting the bankruptcy petition. Once a petition is accepted there is no period of protection in which a settlement or restructuring could take place – an Administrator is appointed immediately.

In other jurisdictions, the period of the stay typically lasts from the date the petition for bankruptcy is filed until the declaration of bankruptcy and thereafter, or the last date for compliance with a restructuring plan in the case of a court-based restructuring or the dismissal of the bankruptcy proceedings.

It was perhaps a missed opportunity that a broader moratorium on creditor enforcement action was not incorporated in the EIL in order to give restructuring efforts some realistic hope of success by providing the debtor enterprise with a limited breathing space from creditor actions to formulate a restructuring plan.

### **Management**

The EIL does not give creditors a voice in choosing the administrator or setting the administrator’s remuneration. The People’s Court appoints the administrator that takes custody of the debtor’s property and administers the business and estate of the debtor. Either the debtor can remain in possession for the implementation of a restructuring plan similar to Chapter 11 in the United States or the administrator can manage the restructuring under a system similar to that followed in the UK and Australia.

The administrator must carry out its duties and report to the People’s Court and is subject to monitoring and supervision by the creditors. The creditors may petition the People’s Court to replace an administrator if they think the administrator is unable to carry out its duties in a lawful or impartial manner or if there are circumstances that would prevent the administrator from carrying out its duties competently. An administrator can also resign, but only for good reason, and must obtain prior approval from the Court. In all instances, final discretion involving administrators rests with the People’s Court and not with the creditors.



### Appointment of an Administrator

As already stated, the Court is required to appoint an administrator upon acceptance of the bankruptcy petition. Article 24 of the New Bankruptcy Law permits the following to be the administrator:

- the “liquidation committee” composed of personnel from relevant departments and agencies;
- an intermediary organisation established in accordance with the law, such as a law firm, accounting firm, or bankruptcy liquidation firm.

The local courts maintain a panel of qualified professional institutions from which they chose the administrator, which includes “reputable individuals with relevant professional qualifications”. Foreign firms are not included on these panels.

### Creditors and the Creditors’ Committee

The EIL provides for the establishment of creditors’ meetings and creditors’ committees. The creditors’ meetings allow unsecured creditors to participate in the following activities:

- verifying creditors’ claims;
- petitioning the People’s Court to replace the administrator and examine its expenses and remuneration;
- supervising the administrator;
- electing and replacing members of the creditors’ committee;
- deciding on the continuation or cessation of business of the debtor;

- adopting restructuring plans and settlement agreements;
- adopting plans for the management of the property of the debtor;
- adopting plans for the sale of the debtor’s assets; and

passing and adopting plans for the distribution of property in bankruptcy.

Secured creditors may vote on all of the above matters except for voting on settlement agreements and plans for the distribution of the debtor’s assets, unless they waive their right to priority.

A resolution will be passed by a majority of the creditors present at the meeting holding 50 percent or more of the total unsecured claims. Resolutions passed at these meetings are binding on all creditors (other than secured creditors), though any creditor may, within 15 days of the passing, ask the People’s Court to nullify resolutions that violate legal provisions or harm that creditor’s interests. This leaves significant room for the process to become bogged down.

The creditors’ meeting may also appoint a creditors’ committee of no more than nine members and delegate some of its powers to the committee. Notably, however, the creditors’ committee must include a representative of the workers’ union of the debtor. The members of the committee are required to be approved by the Court.

### Collection, Preservation, and Disposition of Property

The EIL puts into effect measures to protect the assets and business of debtors particularly by the appointment of an administrator. The debtor must comply with quite onerous,

obligations to hand over assets, seals, and books to the administrator. Additionally, a debtor is required to be present or cause its representative to be present at all creditors' meetings and to truthfully answer all questions from administrators, creditors, and the People's Court. The debtor's representative may not move from his or her residence or hold any director or senior management positions in any other enterprise once bankruptcy proceedings have begun.

### **Treatment of Contractual Obligations**

The administrator has discretion to perform or terminate contracts entered into by a debtor prior to the acceptance of the bankruptcy petition. The administrator must provide notice to the other contracting parties of its decision. Failure to do so within two months of the acceptance of the bankruptcy petition by the People's Court will result in the deemed termination of the contract.

This requirement puts an obligation on the administrator to make some relatively quick decisions, often based upon very limited information. This could result in the deemed termination of valuable contracts by default, of which the administrator is unaware.

### **Treatment of Fraudulent or Preferential Transactions**

Administrators upon petitioning the People's Court have the power to reverse certain transactions involving property of the debtor taken within one year before the Court accepts the bankruptcy petition. These include gifts, transfers at an undervalue, security given for unsecured debts, early repayment of debts that have not fallen due, and abandonment of rights to repayment.

Similar provisions exist to void transactions that occurred within six months of the acceptance of the bankruptcy petition when the debtor was insolvent and continued to pay creditors. In these circumstances, the administrator may petition the court to revoke these transactions.

Certain acts involving the debtor's property are automatically invalid. Those acts are the concealing or transferring of property to avoid debts and the fabrication of debts or acknowledgment of debts that are not genuine. The New EIL empowers administrators to recover property obtained as a result of such transactions.

Other related provisions include the ability to require shareholders to fully pay their shares, the barring of debtors from making distributions to their shareholders during restructuring unless approved by the People's Court, and the recovery of irregular income and corporate property improperly acquired by directors, supervisors, and senior managers of the debtor.

### **Director and Officer Liability**

The EIL does not expressly address director and officer liability for insolvent trading (i.e., engaging in business when an enterprise is already insolvent). However, it does impose civil liability on directors, supervisors, and senior managers who commit a breach of their obligation of loyalty or due diligence, causing the enterprise to go bankrupt. The punishment includes being prohibited from acting as a director, supervisor, or senior manager of any enterprise for three years from the day of the conclusion of bankruptcy procedure.

## Stakeholder Rights, Priorities, and Recourses

A much debated provision of the EIL relates to the priority of employee claims. Under previous bankruptcy law, employee claims were paid first before any other creditors. The EIL, however, preserves the priority of secured creditors in relation to their secured assets.

By way of a compromise, the EIL provides that employee claims that were incurred prior to the passing of the EIL (August 27, 2006) are to be paid from the secured assets in priority to secured creditor claims to the extent they cannot be satisfied out of the debtor's unsecured assets. This is of diminishing relevance as time goes by.

Additionally, a special type of bankruptcy called "policy bankruptcy" is no longer available. Policy bankruptcy was introduced in 1994 specifically for SOEs and was meant to give the highest priority to the welfare of workers during bankruptcy proceedings. Workers had to be paid first with the proceeds from the sale of assets, with secured creditors coming second. If there were insufficient assets to pay off workers, the government would then assist with paying off the workers. Policy bankruptcy was available for about 2,100 SOEs if they closed down prior to June 1, 2007. After that date, policy bankruptcy no longer existed, even for SOEs.

The EIL provides additional recourse for creditors in bankruptcy proceedings within two years of the conclusion of the bankruptcy procedure. During that period, if it is discovered that additional property exists—for instance, property that has been transferred to the directors, concealed, or sold at an undervalue—the creditors may petition the People's Court to effect an additional distribution.

It is expressly provided that, after the conclusion of a bankruptcy procedure, creditors may still pursue guarantors of the debtor and other joint debtors for amounts owed under the guarantees, as one would expect. However, amounts paid under the guarantee will not be recoverable by guarantors against the debtor after the bankruptcy has concluded.

## RESTRUCTURING

### Commencement and Period of Restructuring

A creditor or a debtor may directly petition the People's Court to restructure the debtor. The basis upon which an application is made is that the debtor is insolvent and its assets are insufficient to discharge all its debts or it clearly lacks or there is a marked likelihood that it lacks, the capacity to discharge them. When a creditor has already petitioned for the bankruptcy of a debtor, the debtor or a shareholder holding one-tenth or more of the registered capital may also file an application to restructure the debtor. The restructuring period lasts from the day which the People's Court approves the restructuring until the termination of the proceedings and would appear to be unrestricted, subject to the stipulations in the restructuring plan.

### Formulation, Approval, and Implementation of a Restructuring Plan

The EIL places the responsibility for preparing the restructuring plan on either the debtor or administrator, depending upon which the Court has decided should manage the business and property of the debtor when restructuring is applied for. The EIL does not provide guidance or criteria for the People's Courts

to use in deciding whether the debtor should remain in possession or whether an independent administrator should be in control of the restructuring. Relevant criteria would include whether the debtor has acted honestly in the pre-restructuring period, but the People's Court is left with a very wide discretion.

Once the People's Court orders the restructuring of the debtor, a restructuring plan must be submitted to both the court and the creditors' meeting within six months. A three-month extension is available on legitimate grounds. The People's Court is then obliged to convene a creditors' meeting to vote on the plan within 30 days of receiving it.

The EIL requires specific matters to be included in the proposed restructuring plan. These include:

- debtor's business plan;
- classification of debts;
- debt adjustment scheme;
- debt repayment scheme;
- time limit for execution of the plan;
- time limit for monitoring and supervising the execution of the reorganisation plan (supervision period); and
- other schemes beneficial to the debtor's restructuring.

The EIL categorises creditors into different classes. While the People's Court has the ultimate authority to approve a restructuring plan, subject to some quite detailed guidelines, the main aim is to obtain the approval of the restructuring plan by all classes of creditors. Shareholders can only vote in respect of the restructuring plan if their rights will be adjusted in the restructuring plan.

The EIL recognises distinct classes of creditors and requires that creditors cast their votes by on the draft restructuring plan. A resolution is passed when a simple majority of the creditors attending the meeting of a particular agree to the proposed plan and when the amount of the debt they hold exceeds two-thirds of the total of the debts in the same class. The classes are:

- secured creditors;
- such work entitlements as wages, medical and disability subsidies, and old-age insurance;
- taxes; and
- unsecured creditors.

There is an option for the People's Court to establish a sub-class of small claims within the category of unsecured creditors.

The restructuring plan may be approved by the Court even if some classes refuse to vote or vote against it, provided that secured creditors, workers, and the tax authority are fully paid, unsecured creditors are no worse off than if the debtor went to liquidation, and the plan is practicable. The administrator is given the power to lobby members of a class that has voted against the plan to try and get them to change their minds. Once a plan is approved, it becomes binding on the debtor and all creditors.

The debtor is responsible for the implementation of the plan, once it has been approved by the Court. At this point, if the administrator is in control of the debtor's affairs, it must hand over all property to the debtor. The administrator's role is to then supervise the implementation of the plan. The debtor is required to report to the administrator on implementation throughout this supervision

period. Finally, when the supervision period has expired, the administrator submits a supervision report to the People's Court and its duties terminate on that date.

### **Termination of the Restructuring Plan**

During the restructuring period, the People's Court may declare the debtor bankrupt upon an application made by the administrator or a materially interested party if:

1. the debtor's business position and the status of its property continue to deteriorate and there is little prospect of a turnaround;
2. the debtor engages in fraud, reduces its property in bad faith, or commits other acts that are clearly adverse to the creditors; or
3. the administrator is unable to perform his/her duties due to acts by the debtor.

The People's Court may also declare a debtor bankrupt when no restructuring plan is submitted to the Court and the creditors' committee within the six-month period referred to above or during the additional three-month extension period. Equally, the debtor will be declared bankrupt when the restructuring plan is not approved by the Court, following the holding of creditors' meetings. If the debtor is unable to implement the restructuring plan or fails to implement it, the administrator or a materially interested party may apply to the People's Court, which is required to terminate the implementation of a restructuring plan and declare the debtor bankrupt.



## **Moratorium for Secured Creditors**

Under the EIL, secured creditors are expressly precluded from exercising their security rights during a restructuring. They may, however, exercise their rights if they can show that their security may be damaged or its value greatly diminished.

Subject to this exception, the EIL does erode secured creditors' rights. Secured creditors appear to have no greater voting rights than unsecured creditors and can be locked out of their security even if they vote against the plan but the Court still approves it. Secured creditors are not permitted to stand outside the restructuring process as they are in liquidation (unless they agree otherwise). This is a departure from the usual position of secured creditors. Notably, most other jurisdictions (except the US) are reluctant to bind secured creditors to restructuring plans without their consent.

## **Stabilising and Sustaining Business Operations**

Whilst the EIL does not explicitly recognise priority funding for the ongoing and urgent business needs of a debtor during the rescue process, it does permit an administrator to borrow on the security of the debtor's assets.

## **Discharge of a Plan**

When the People's Court terminates a restructuring, promises made by creditors to forgive debt as part of the plan are no longer binding on the creditor. Any repayments made to the creditors as a result of the restructuring plan remain valid and the unpaid amount is treated as debt in bankruptcy. Creditors may continue to receive distributions only when other creditors of the same rank as theirs have been repaid the same proportion/percentage

of their debt. Also, any security given for the restructuring plan shall remain valid.

## **Settlement Agreements**

Whilst the EIL makes no specific mention of informal workouts or alternative procedures such as debt write-offs, rescheduling, and debt-equity conversions, settlement provisions exist that might make these possible. Once the debtor and creditors have arrived at a settlement agreement, only the debtor may apply to the People's Court to accept jurisdiction over the matter. The debtor may also apply for settlement after the Court has accepted jurisdiction over the matter but before a declaration of bankruptcy. Once the requisite approvals have been obtained from the People's Court, the creditors' meeting must vote on the settlement. A resolution adopting the settlement must be agreed to by a majority of the creditors attending a creditors' meeting, and the amount of the debt they represent must exceed two-thirds of the total debts unsecured by property. Once the creditors' meeting and Court have approved a settlement agreement, it becomes binding on all parties.

Settlement agreements are not without some risks. Secured creditors must abandon their priority repayment right in order to vote on settlement agreements. Once the Court allows the settlement, the rights of secured creditors with regard to their security is restored. If a debtor is unable to implement the settlement agreement, the People's Court may, upon the request of the creditors, order the termination of the settlement agreement and declare the debtor bankrupt. That is, once an informal workout arrangement becomes formalised into a settlement agreement, a debtor would expose itself to possible liquidation if a creditor applies to court.

## Discharge of a Settlement

When the People's Court terminates a settlement, promises made by creditors to adjust debt as part of the settlement become invalid. Any repayments made to the creditors as a result of the settlement remain valid and the unpaid part is treated as debt in bankruptcy. The creditors may continue to receive distribution only when other creditors of the same ranking as theirs have been repaid up to the same ratio. Also, any security given for the settlement shall remain valid.

## INSTITUTIONAL AND REGULATORY FRAMEWORK

### Role of Courts and its officers

The People's Court retains original jurisdiction on all bankruptcy matters. There is no specialised bankruptcy court or specialised division within the People's Court qualified to adjudicate specifically on insolvency matters. The court used is the court local to the business. The judges of the People's Court do not have special qualifications or training to handle bankruptcy proceedings. The EIL prescribes trial procedures for bankruptcy cases. Unless otherwise specified, China's civil procedure law applies to bankruptcy cases. The EIL does not include provisions to allow for the ready access to Court records or hearings. There are provisions, however, that require the disclosure of information on the debtor.

### Integrity of the Participants

Penalties exist for those failing to comply with the EIL. The People's Courts now have the power to penalise senior executives for mismanagement of insolvent enterprises. Members of senior

management also can be held civilly liable for the failure to carry out their duties, and they may be forbidden from holding director or senior management positions in any future enterprise for a period of time. Furthermore, related personnel of debtor enterprises may be held personally liable for failing to attend creditors' meetings, for refusing to submit or submitting untrue statements, or for concealing assets or engaging in other activities that prejudice the creditor's right to receive payment from its debtors if the debts occurred within a year of bankruptcy. Similar penalties exist for administrators that are not diligent, responsible, truthful, and honest. Notably there are no provisions to ensure the integrity of creditors.

### Administrators

The administrator plays various roles during the course of bankruptcy proceedings including a provisional role prior to the creditors' meeting, a different role after the meeting, a different role after approval of a restructuring plan, a different role in a settlement plan, and a different role in liquidation. In each of these phases, the role of the administrator changes, and it is necessary to clarify how these powers and duties change during each stage as well as the appropriate qualifications for each phase, to ensure appropriately qualified administrators are performing these roles. Administrators are expected to be diligent, fully responsible, truthful, and honest in the performance of their duties; they may be fined by the People's Court and may have to compensate creditors, debtors, or any third parties for causing loss and damage.

## ECONOMIC AND REGULATORY INFRASTRUCTURE

# CLOSER ECONOMIC PARTNERSHIP ARRANGEMENT (CEPA)

Upon its accession to the WTO in December 2001, China agreed to a progressive timetable for the liberalisation of access to its market for WTO member states. As part of its commitments, in June 2003, the first phase of the Closer Economic Partnership Arrangement between Mainland China and Hong Kong (“CEPA”) was executed by the governments of Mainland China and Hong Kong (individually the “Side” and collectively the “Sides”). Since then, further phases of CEPA have been progressively executed. CEPA was executed to provide enhanced mutual market access for each Side in one another’s territory. It also contains provisions dealing with general facilitation measures for bilateral trade and investment between the Sides. Since Hong Kong imposes few restrictions on foreign trade and investment, CEPA’s liberalisation measures have largely consisted of concessions granted by the Mainland with respect to products originating from Hong Kong and various service sectors. These concessions accelerate or, in some cases, increase Hong Kong’s access to the Chinese market compared to other WTO members.



CEPA takes the form of a free trade agreement and is the first such instrument to be executed between the Sides. It is, however, an arrangement between two separate Customs jurisdictions as opposed to a bilateral agreement between two nations since the Sides are part of one state, the People’s Republic of China.

### PRODUCTS

Products originating from Hong Kong and which comply with the relevant CEPA rules of origin, as certified by a CEPA Certificate of Origin (“CEPA CO”), are eligible for importation into Mainland China from Hong Kong at zero tariffs. This concession is not granted to any other WTO member state (at the time of writing). The product categories listed in CEPA cover nearly all Hong Kong products, with the exception of certain products prohibited from being imported into the Mainland. Such prohibited products include electrical, medical and chemical waste products as well as wild animal products (such as tiger bone).

### SERVICES

CEPA also grants concessions within specified service sectors to CEPA-qualified service providers (including foreign-owned and managed Hong Kong companies). These are known as Hong Kong Service Suppliers under CEPA (“HKSS”). The concessions conferred on them by CEPA relate to the establishment of foreign investment enterprises as well as other aspects of access to the Mainland Chinese market.

CEPA service sectors include distribution (wholesale, retail, franchising and commission agency services), advertising, banking and

financial services, securities and futures, information technology, telecommunications, airport services, insurance, legal and accounting services, logistics, transportation, warehousing and storage, real estate and construction, trademark and patent agency, tourism, human resources recruitment services, audio-visual, convention and exhibition, printing and publishing, research and development, medical and dental and management consultancy. As individual HKSS, eligible Hong Kong professionals in certain professions may qualify to practise or carry out certain activities related to their profession on the Mainland, depending on the nature and extent of the specific CEPA concessions for each profession.

Generally speaking, for a Hong Kong Company to qualify as a CEPA HKSS the main requirements are:

- Incorporation in Hong Kong: the company must be incorporated in accordance with the Companies Ordinance (Cap. 32) and has obtained a valid business registration certificate and licence to provide the services in question, if any such licence is required in the service sector concerned. The Hong Kong branches of overseas companies are excluded from this since they are not incorporated in Hong Kong.
- Three to five years of substantive business operations in Hong Kong in the relevant service sector: this depends on the sector concerned. The nature and scope of the Hong Kong services must encompass the nature and scope of the services intended to be provided in the Mainland. Liaison offices and so-called “mail box companies” are excluded due to their lack of substantive business.

- The company must have fulfilled its profits tax payment obligations (if any) in accordance with the laws of Hong Kong during the above described period.
- Compliance with requirements relating to local staffing: over 50% of the staff used to carry out the substantive business must be residents staying in Hong Kong without limit of stay, or Mainland Chinese holding one-way permits for Hong Kong.
- Compliance with requirements relating to business premises: the scale of the business premises must be commensurate with the scope and scale of the business operations.

This demonstrates CEPA’s relevance not only to large corporations but also to Small and Medium Enterprises (“SMEs”), since compliance with the HKSS definition does not necessarily relate to size. Instead, it requires a rational link between the extent of the business facilities and the nature and scope of the business being operated. Administratively, it is even possible for a Hong Kong company to utilise the business history of its wholly owned subsidiaries to fulfil the above requirements.

The following are examples of benefits which have been granted to HKSS through CEPA:

- CEPA has given qualified HKSS a head start in the establishment of Wholly Foreign-Owned Enterprises (“WFOEs”), or allowed higher foreign shareholdings in sino-equity joint ventures, in certain CEPA service sectors. For example, since 11 December 2004, Mainland China has largely opened up its distribution sector pursuant to its WTO commitments. HKSSs, however, enjoyed a general first move advantage, ahead of this date, in the



establishment of distribution WFOEs (excluding the distribution of certain restricted products). Restrictions on the distribution of some restricted products are also gradually being removed under subsequent phases of CEPA.

- HKSS banks have benefited from reduced registered capital requirements and other financial requirements for the establishment of Mainland branches.
- CEPA has allowed Mainland branches of HKSS banks to engage in insurance agency business.
- CEPA has granted HKSS access to the Mainland market in the logistics sector (a sector which does not in fact appear in the Mainland's WTO schedule of service sector concessions).
- In the professional job placement sector, HKSS can establish a joint venture with a majority foreign shareholding, whereas other foreign investors are restricted to a minority shareholding as at the time of writing.

## **TRADE AND INVESTMENT FACILITATION**

CEPA also contains provisions on Trade and Investment Facilitation ("TIF") between the Sides in order to improve and streamline bilateral trade and investment. The seven areas covered by the TIF provisions are: (i) trade and investment promotion; (ii) customs clearance; (iii) product quarantine and inspection, food safety and quality assurance; (iv) e-commerce; (v) transparency in laws and regulations; (vi) SMEs; and (vii) Chinese medicines and medical products.

## **AN ORGANIC AGREEMENT**

CEPA is a flexible, continuously expanding instrument. Due to its flexible nature, various forms of co-operation between the Sides that have not been specifically written into the text have been grouped under the umbrella of CEPA. Such measures have served to boost both the Mainland and Hong Kong's economy.

## ECONOMIC AND REGULATORY INFRASTRUCTURE

# GOVERNMENT AFFAIRS IN CHINA

### INTRODUCTION

In China, support from national and regional government can play a significant role in establishing, developing and operating any enterprise. The role of government is also considerable in determining market access for products, in mergers and acquisitions, and in terms of the general management of risk, including legal/regulatory and commercial risks.

As a result, for Government to recognise and endorse an organisation and its operations is perhaps a more significant benefit in the Chinese context than it would be in other jurisdictions. With ongoing economic transition in China, the influence of the Government cannot be underestimated, as the Government can effectively determine the size, and even the existence, of any given market.

Businesses seeking to enter China need to develop a comprehensive understanding of the Government and its constituent institutions, as well as the various tiers of local government authorities and other stakeholders. Business leaders need to understand the Chinese political, social and economic contexts in order to manage their business activities appropriately.

Microsoft's Bill Gates provides a notable example of a western business leader who invested a significant amount of corporate and personal time in building a strategic understanding of the Chinese context. Mr Gates visited China on numerous occasions in order to build relationships at various levels within the Chinese government and its institutions. Coinciding with Microsoft's Chinese investment programme, he did this to develop the corporation's understanding of China, as well as to disseminate reciprocal

knowledge about the Corporation and its objectives in China amongst political and business communities – in short, to engender trust in the organisation and its intentions in China.

As another example, Kodak China has also developed a formidable government affairs capability in China. This has enabled the organisation to surmount a series of major obstacles to its commercial objectives. It also enabled the development of a largely exclusive investment in the sensitisation sector in 1998, when digital technology had not been widely adopted. These examples, and countless others, illustrate that a proactive, strategic and comprehensive approach to managing government and other stakeholder relations in China can help foster the development of advantageous policy and legal environments that can enhance a company's success in the Chinese market.

### BUILDING RELATIONSHIPS WITH GOVERNMENT

The evolution of the Chinese Government's role from that of central command and management to effectively a facilitative role – from management to service – has brought with it an increasing requirement for dialogue between commercial organisations and the Government. Organisations must develop a strategic understanding of the challenges faced by the Government and the way in which it responds to such challenges, in terms of development and implementation of policy. This understanding should inform corporate objectives and strategies.

## **Actively Communicate with the Departments of Government**

Businesses seeking to operate in China are well advised to initiate active contact with the appropriate departments of Government at the earliest opportunity, and to maintain this contact whenever possible. This will enable companies to understand pertinent policies as they emerge, as well as influence proposed revisions of existing policies. This process can help organisations to understand how best to position themselves to assist the Government in achieving its own objectives.

There are a number of channels through which businesses can communicate with relevant audiences within the Government, including publications and research, news reports, forums and public relations activities. Simultaneously, senior management should be proactive and regularly invite relevant Government departments to visit their business, or hold meetings with key personnel to gain a better understanding of the Government's guiding policies and objectives. This understanding can enable a company to be more confident when formulating its own strategies by ensuring that they will resonate with regulators and policymakers. In addition, businesses can keep Government informed about their development, enabling a mutual exchange of understanding and knowledge.

Finally, multinational businesses can also communicate their international experiences to the Chinese Government. This knowledge sharing can prove beneficial to Chinese policymakers considering the overall regulatory environment and the formulation of future policy.

## **Establish Mutual Trust with the Government**

Businesses should respond to Government requests for assistance in the delivery of its social objectives and should also be proactive in offering such assistance. For instance, after Procter & Gamble's entry into China, the company made a significant contribution to the establishment of the 'Hope Schools'. This was in part to acknowledge and emphasise the company's commitment to its social responsibilities in China. In turn, this gesture was an important factor in building trust within the political and local communities.

## **Share Reciprocal Benefits with the Government**

The role of the Chinese Government is continually evolving into that of regulator, facilitator and in some cases, business partner. Whilst true in many jurisdictions, nowhere is it more appropriate than in China for commercial organisations to contemplate the Government's interests and priorities when conducting their operations, in addition to their own commercial objectives. Many multinational organisations already assist the Government in meeting social and economic challenges by participating in key Government technological projects and social welfare undertakings, with a view to establishing a positive mutual relationship.

## **Localised Communication**

For cultural and organisational reasons, communication mechanisms with the Chinese Government are different from those in Europe, the US and other western countries. In most western cultures, business government relations tend to be predominantly issues-led. In China, however, interaction tends to be sustained on a general level in order to cement long-term

relationships, rather than unilateral ‘lobbying’ on a specific issue when it arises. Understanding this cultural distinction is important in ensuring successful government relations activity in China.

A further consideration arises in relation to the significant geographic size of China. This size brings with it huge diversity from region to region. Consequently, the interests of the national and regional governments cannot necessarily be treated as identical. Therefore a business not only needs to consider the policies of central Government but also the policies of the regional governments in order to be effective in its activities across China.

### **Public Welfare Activities – Corporate Social Responsibility**

Issues of corporate social responsibility are now established on the international corporate agenda. This is true in China also. Whilst positive actions in their own right, supporting social public welfare activities are also effective means of building up a positive profile for an organisation. Public welfare acts can be associated with particular regional development issues, providing aid to appropriate charitable undertakings and supporting China’s numerous education programmes. In addition, any responsible corporate citizen would assist in responding to humanitarian and environmental disasters. Such acts will demonstrate the organisation’s recognition of its social responsibilities; qualities which are highly prized by Chinese Government, businesses and consumers. Only by recognising and being sensitive to the unique Chinese business culture, and adapting activities appropriately, can multinationals truly prosper in China, building strong reputations, popularity and customer loyalty.

### **GLOBAL GOVERNMENT RELATIONS – A PRACTICE OPERATING IN CHINA**

Global Government Relations is the government relations and strategic communications practice of DLA Piper, the global law firm. The practice, which has offices in China, UK, Brussels and the USA, has a proven track record in providing government and regulatory affairs, media relations and crisis management advice at all political levels.

Global Government Relations Beijing was established in May 2006 to further develop DLA Piper’s specialist government relations offering to international clients wishing to establish, operate and manage their political and stakeholder relationships in China. Areas of particular expertise include financial services and insurance, telecoms and e-commerce, as well as energy and natural resources. The services available to clients in China include:

- Monitoring and advising on the regulatory legislative and political environment at national and regional level;
- Relationship and network-building, through targeted contact programmes, event management, identification of opportunities to support government initiatives, and organisation of sector specific ‘marketing’ delegations to regional and national governments;
- Campaign strategy development and implementation;
- Coalition-based lobbying and alliance building; and
- Advice on ‘sub-legal’ matters: licensing, procurement and tender activity.

Investment from any country or territory outside the PRC Mainland, which includes Taiwan or the Special Administrative Regions of Hong Kong and Macau, constitutes foreign investment in China. Although China has encouraged foreign investment for over 25 years, the legal framework still contains significant restrictions for investors and mandates a wide range of government approvals and requirements that may be unfamiliar to enterprises doing business in China for the first time.

### LIMITATIONS ON FOREIGN INVESTMENT PROJECTS

The Provisions for Guiding the Direction of Foreign Investment categorise foreign investment projects as “encouraged”, “permitted”, “restricted” or “prohibited”. Specific types of foreign investment that fall into the “encouraged”, “restricted” and “prohibited” categories are listed in the Foreign Investment Industrial Catalogue (the latest version was revised on 31 October 2007, and



was effective from 1 December 2007). The catalogue should be consulted at an early stage of an investor’s China business plan. In general:

- projects that involve advanced or new technology are encouraged;
- projects in areas that are technologically backward, or belong to certain sectors that;
- China is in the process of gradually opening up (e.g. banking, telecommunications, legal services), are restricted;
- projects that threaten public interest and national security or that may cause serious environmental pollution are prohibited; and
- projects not listed in the Catalogue are generally considered permitted and do not require special approval.

### APPROVAL AUTHORITY

Foreign investment in China is subject to a system of multi-tiered approvals.

Several factors may determine which government authority has jurisdiction over a particular company establishment. For example, if the total investment of a Foreign Invested Enterprise (“FIE”) is sufficiently high, approvals from both the National Development and Reform Commission (“NDRC”) and the Ministry of Commerce (“MOFCOM”) would be needed, as opposed to MOFCOM alone. Moreover, the investment amount may also determine whether the provincial, municipal or district-level MOFCOM office will be the approval authority over a given project.

Additionally, if the FIE is in a specific business sector, special approvals of the FIE’s business scope may be necessary. Chinese enterprises

are required to have narrowly defined business scopes, and if the business described falls under the supervision of a particular government agency, an approval from that body may be required in addition to a general approval from MOFCOM. For example, a FIE that manufactures pharmaceuticals would need its business scope approved by the State Food and Drug Administration (“SFDA”), while a FIE engaged in certain kinds of information technology work may require an approval from the Ministry of Information Industry (“MI”).

A single project will usually involve the approval of more than one governmental agency, even if the FIE will not engage in a specially-regulated business sector. With the assortment of authorities involved, bureaucratic supervision is found almost everywhere. For foreign exchange issues, the approval of the State Administration of Foreign Exchange (“SAFE”) or its local counterpart is required. For land use and real property matters, approval by the State Land Administration Bureau or its local counterpart is necessary. For Joint Ventures where a Chinese State-owned Enterprise (“SOE”) is to contribute its tangible assets as its capital contribution into your JV, then the State-owned Assets Administrative Commission will be involved in approving the asset appraisal and contribution. Specific and preferential tax treatment is approved by the State Administration of Taxation (“SAT”) along with the State Council.

It is important that the appropriate government approval is secured. Some local governments may offer certain preferential treatment and approvals but may not have the legal authority to grant those rights. A FIE that has been improperly approved may be subject to

invalidation at a later time. Thus it is always important to ensure that all required governmental approvals have been obtained from the proper level and proper agency of the Chinese government.

## FOREIGN INVESTMENT STRUCTURES

Foreign investment in China typically takes the form of either a Joint Venture (“JV”) or a Wholly Foreign-owned Enterprise (“WFOE”). JVs were the first investment structure allowed and were therefore the most common vehicle for many years. Since China began to liberalise its investment policies, and particularly after its accession to the World Trade Organisation (“WTO”), WFOEs became the preferred FIE structure in most unrestricted industries.

JVs and WFOEs each have their own benefits and disadvantages. Many foreign investors are attracted to the WFOE structure because it allows the foreign party to have complete control over the management of the enterprise, major financial decisions, and the use of intellectual property rights. JVs allow inexperienced China investors to work closely with a local partner that may have significant contacts with the local business community, specific geographic or industry knowledge, and experience with government relations.

Joint Ventures can be either Sino-Foreign Equity Joint Ventures (“EJVs”) or Sino-Foreign Cooperative Joint Ventures (“CJVs”). In the past, the foreign party was required to provide at least 25% of the equity of JVs. Although joint ventures with foreign ownership

of less than 25% are legally possible, the aggregate foreign equity interest in the JV must amount to 25% or more to enjoy certain kinds of preferential treatment.

### Equity Joint Ventures

An EJV is an independent legal person with limited liability. The JV partners contribute capital to the enterprise and enjoy rights to a percentage of the profits equal to the paid-in capital. Capital contributions may be in cash or in-kind (e.g. land use rights, buildings, intangible assets or equipment). It is a legal requirement that cash contributions represent 30% or more of the registered capital and the in-kind contributions undergo a valuation so that the parties' respective equity contributions may be determined. This is crucial in determining the equity contribution of each JV partner.

The JV Contract must also set out a schedule for contributions of registered capital, which may be in one lump sum (injected within six months from the issuance of the EJV's business licence) or in instalments (the first instalment must be at least 15% of each party's total registered capital, cannot be lower than the minimum amount of registered capital of the company, and must be contributed within 90 days from the date of issue of the business licence). During the term of the EJV, the parties may not withdraw their contributions to the registered capital, nor transfer or assign their equity interests without prior governmental approval. Any transfer of equity interest is also subject to the consent of the JV partner.

The management and operations of an EJV is governed by a Board of Directors (the highest authority of an EJV) and the managerial staff,

who are responsible for the day-to-day operations of the EJV. The Chairman of the Board, who is the EJV's legal representative, may be either a Chinese or foreign national, and the Vice Chairman is traditionally appointed by the party that does not appoint the Chairman.

Managerial staff consists of a General Manager in addition to other board-appointed officers, such as a Chief Financial Officer or Deputy General Manager. It is common that if one party has the right to nominate the General Manager, the other party will have the right to nominate the Chief Financial Officer.

EJVs must prepare quarterly and annual accounting statements for distribution to the JV partners, the local tax bureau and other Chinese authorities, including the original approving authority. Such statements must be audited by a Chinese registered accounting firm. While the foreign party has the right to conduct a separate audit of the EJV's accounts (at its own expense), such audits are not binding under Chinese law.

Profit distribution is based on the computation of the after-tax net profits of the EJV, from which amounts are deducted for allocation into the EJV's reserve fund, bonus and welfare fund for the EJV's employees and an enterprise expansion fund. The actual amounts to be allocated may be determined by the board of directors and are usually calculated as a fixed percentage of the after-tax net profits. Any sums remaining after such deductions may be distributed to the parties in accordance with the ratio of their equity ownership in the EJV, though profit distributions are not compulsory and profits may be retained for distribution in later years.

The term of an EJV can be as long as 50 years depending on the commercial consideration of the investors and the EJV's business scope. An EJV will expire at the end of its term unless the parties and the approval authority agree to extend the term, or if the EJV has elected to either liquidate the enterprise prior to the end of its natural term, or otherwise restructure the enterprise.

### **Cooperative Joint Ventures**

The essential characteristic of a CJV is its flexibility. A CJV is often established as a company with limited liability and legal person status, but the law allows it to be a non-legal person enterprise without the protection of limited liability. It should be noted, however, that although it is legally feasible to establish a CJV without legal person status, in practice it is very difficult to obtain government approval to do so because currently there are no applicable taxes or other related laws or regulations regarding the non-legal person entity in China.

Compared to an EJV, the legal regime offers more flexibility to the investors of a CJV, where the profit-sharing ratio does not necessarily have to reflect the ownership interest ratio of each investor but may be freely decided by the investors based on their contractual agreements. The parties may provide cooperation conditions instead of injecting capital contributions into the joint venture. The latitude inherent in the structuring of the CJV also permits flexibility in its management, assets and profit- and loss sharing.

A CJV's management structure is generally unitary with either a Board of Directors or a Joint Management Committee. It is likely that the limited liability-type CJV would have a

Board of Directors and its management system would be similar to that of an EJV. A CJV without legal person status is required to establish a Joint Management Committee. There must be at least three members on the Board of Directors or Joint Management Committee.

CJV accounts must be audited and verified by an accountant (engaged individually or jointly by the parties) registered in China. A CJV without legal person status must keep unified account books and the parties must also keep their own separate account books. Profits and losses may be shared in accordance with a contractual formula that may or may not reflect the parties' corresponding capital contributions to the registered capital of the CJV. Unlike in the case of EJVs, there are no provisions for the term of duration of the CJV. Like the EJV, the duration of the CJV may be renewed based upon the parties' agreement and the approval of the relevant government authorities.

A foreign party's investment in a CJV may be repatriated, in full or in part, prior to the expiration of the term of the joint venture, as long as the joint venture contract provides that ownership of all of the fixed assets of the CJV shall revert to the Chinese party upon expiration of the joint venture term. Thus, CJV contracts commonly include a clause providing for this reversion of assets. In other cases, the liquidation procedures follow those applicable to EJVs.

The primary differences between EJVs and CJVs are: firstly, the risk and return of a CJV is based on a pre-negotiated contractual formula, while that of an EJV is based on the ratio of capital contribution to registered capital; and

secondly, the CJV mechanism of investment is centrally intended for large investments and therefore may not be typically well-suited for smaller investments.

### **Wholly Foreign-owned Enterprise (WFOE)**

Currently the most frequently utilised foreign investment vehicle in China is the WFOE. A WFOE typically takes the form of a limited liability company, though other forms of liability are not excluded and may be used upon approval by the relevant governmental authorities. The equity interest in a WFOE is entirely owned by its foreign investor or investors. Historically, a WFOE was permitted only to be used as an investment vehicle if it either utilised advanced technology or exported a minimum of 50% of its products. These restrictions are no longer in place, and WFOEs may be established in a wide variety of industry sectors. In the latest revision to the Foreign Investment Industrial Catalogue, the total number of “encouraged” items, which would allow for WFOE activity, increased 37% compared to the previous version.

The day-to-day operations of a WFOE are controlled solely by its management, with the highest authority being a meeting of the shareholders, and a WFOE need not have a Board of Directors. However, the production and operating plans must be filed with the relevant Chinese entity responsible for monitoring the activities of the WFOE. Such filings are for recording purposes only, and legislation provides expressly that interference in the operation and management activities of a WFOE conducting its business in accordance with its articles of association is prohibited.

Accounting rules applicable to WFOEs are similar to those of EJV. All accounting records must be kept in Chinese, and for those written in a foreign language, notes in Chinese

must be included. Only Chinese-registered accountants may verify annual financial statements. WFOE account books must be maintained within China, and annual financial statements must be submitted for the record to the local financial and tax authorities.

Allocations to a reserve fund and a bonus and welfare fund for employees must be made, with a mandatory 10% of after-tax profits to go to the reserve fund for a certain number of years.

The foreign investor has the right to remit its profits abroad, though WFOEs may not distribute profits until they have made up for losses, if any, in preceding years.

A WFOE may be terminated prior to the end of its natural term according to the same general procedures applicable to EJV, with the important exception that all decisions regarding termination, sale or restructuring can be made by the WFOE’s shareholders as well as the relevant governmental approval authority.

### **REPRESENTATIVE OFFICES (“REP OFFICE”)**

A Rep Office may be established in China by a foreign company or other economic organisation. As with FIEs, the establishment of a Rep Office in China requires the approval of the relevant governmental authority. Upon approval, the Rep Office must register with such authorities as the State Administration for Industry and Commerce or its local office (SAIC), the public security bureau, the tax administration and customs. A Rep Office is not a legal person and may not engage in direct business (profit-making) operations. The Rep Office can operate as a business liaison and perform marketing and market research activities on behalf of a foreign enterprise.

## ALTERNATIVE FOREIGN INVESTMENT VEHICLES

The Chinese government has taken steps in recent years to facilitate Renminbi denominated investments by foreign parties, in large part to encourage successful local industries to list on Chinese stock exchanges, as opposed to the offshore listings in the U.S. and Hong Kong favour. As a result, several new vehicles are available to foreign corporations and funds for structuring their investments in local Chinese companies.

### Foreign Invested Venture Capital Enterprise

A Renminbi fund may now be established pursuant to the Foreign-Invested Venture Investment Enterprise Administrative Regulations (“FIVIE Regulations”). Pursuant to the FIVIE Regulations, a foreign venture capital fund may establish a fund with one or more Chinese partners. The fund, referred to as an FIVCE, is a Chinese entity and its investments are denominated in the local currency, Renminbi.

The principle advantage to the FIVCE investment vehicle is that it can deploy funds directly and quickly to Chinese portfolio companies without establishing an offshore structure, and such portfolio companies are eligible for listing on the Chinese stock exchanges. However, such an entity may not be listed on an offshore stock exchange such as NASDAQ or the Hong Kong Stock Exchange, and there are uncertainties regarding the tax treatment of the foreign fund upon exit from the investment.

For the foregoing reasons, while a number of foreign funds are investigating the advantages and disadvantages of establishing a Renminbi fund, to date only a limited number of funds have actually done so.

### Foreign Partnerships

On November 25, 2009, the State Council released the Administrative Measures for Establishment of Partnerships within China by Foreign Enterprises and Individuals (外国企业或个人在中国境内设立合伙企业管理办法) (the “Foreign Partnership Measures”), which will become effective on March 1, 2010.

While still in its early stages, the Foreign Partnership Measures introduce new investment structuring flexibility that is attracting significant interest from the investment community in China. Once the Foreign Partnership Measures go into effect on March 1, 2010, a foreign entity or individual will be permitted to establish a Foreign Invested Partnerships (a “FIP”) in China with one or more other foreign parties or by partnering with domestic individuals, entities or other organisations.

In addition, an FIP may be established with the approval of the State Administration for Industry and Commerce (“SAIC”) and its local counterparts (collectively as “Registration Authorities”) and does not require prior approval from MOFCOM. Foreign investors in an FIP may make their investments either in exchangeable foreign currencies or in legally acquired Renminbi. The Partnership Law provides substantial flexibility in terms of ordering the partners’ commercial relationship. For instance, under the Partnership Law, profit distribution can be arranged according to the partnership agreement, and the ratio does not need to correspond to the partners’ respective capital contributions.

It is important to note that the Foreign Partnership Measures do not explicitly replace or invalidate existing laws and regulations

concerning foreign investment, such as the Foreign Investment Industrial Guidance Catalogue. Instead, existing restrictions and regulation of foreign ownership in certain industries will still apply to FIPs, as do provisions concerning taxation, foreign exchange, customs and other matters that apply for Foreign Invested Enterprises (“FIEs”) in general. Additionally, detailed implementing regulations for the Foreign Partnership Measures have not yet been announced, and the inter-play between the Foreign Partnership Measures and overlapping laws and regulations concerning foreign investment has not yet been confirmed. As such, careful consideration should be taken and advice sought before proceeding with a FIP.

### **COMPENSATION TRADE**

Compensation trade has been rapidly developing in recent years. Popular between Hong Kong companies and Chinese enterprises, particularly in the Guangdong province, these have usually involved natural resources, chemicals, light textiles and electronics. Compensation trade is essentially a barter transaction whereby the Chinese party produces a product with foreign machinery, equipment or technology provided by the foreign party. The product serves as the foreign party’s compensation in return for its contribution to the process. Advantages include tax advantages, flexibility in the structure of the agreement and the absence of China labour

issues for the foreign party. There is no single comprehensive piece of legislation governing this form – the applicable laws come from the Contract Law of China, licensing regulations and tax and customs laws. However, the Chinese party must be an enterprise or other economic entity with foreign trade authority and cannot be an individual.

### **PROCESSING AND ASSEMBLY ARRANGEMENTS**

These arrangements are where a Chinese party processes materials or assembles parts supplied by a foreign party. In most cases, the foreign party also provides the manufacturing equipment. Under this arrangement, the foreign party retains title to all imported materials and the final processed product, with the Chinese party receiving a fee or a portion of the finished goods for on-sale for its work. Whether the Chinese party retains the manufacturing equipment at the end of the term of the arrangement is negotiable. The foreign party is permitted to conclude such processing and assembly arrangements with qualified “operation units” only. Other than approvals from commercial authorities, operation units must also comply with Customs requirements pertaining to the submission of relevant documentation and recording of subsequent imports of parts, materials and equipment in their Registration Handbooks.



Over the past 6 years, China has opened franchising to foreign investment with significant changes to the laws/regulations applicable to the business of franchising.

In June of 2004, China brought into effect the “Measures for the Administration on Foreign Investment in Commercial Fields” (“Commercial Measures”) to permit foreign investors to establish Foreign Investment Enterprises (“FIEs”) in China that are able to conduct franchise activities. Although the provisions in the Commercial Measures applicable to franchising are general in nature, the Commercial Measures were a first step to allow foreign investment in the franchise business sector.

China followed up issuance of the Commercial Measures with implementation of the “Administration of Commercial Franchise Procedures” (“2005 Franchise Measures”) in February of 2005. The 2005 Franchise Measures were of significant importance as it replaced the antiquated domestic franchise regulations issued in 1997, and it also brought in new rules that apply to both foreign and domestic franchising activities in China.

As the 2005 Franchise Measures like the Commercial Measures were general in nature. In February 2007, China’s State Council, one of China’s highest governing institutions, issued the “Regulations on the Administration of Commercial Franchise” (“2007 Franchise Regulations”) that were made effective on 1 May 2007. The 2007 Franchise Regulations were similar in content to the 2005 Franchise Measures but did make some significant changes to address concerns voiced by the domestic and the international franchise business community to the Chinese regulatory authorities.

As the 2007 Franchise Regulations made provision for franchisor filing and information disclosure to franchisees, in April 2007, the China Ministry of Commerce (“MOC”), the governing regulatory agency, issued the “Administrative Rules on Commercial Franchise Filing” (“Filing Rules”) and the “Administration Measures for the Information Disclosure of Commercial Franchises” (“Disclosure Rules”), also made effective on 1 May 2007.

With the implementation of the 2007 Franchise Regulations, the Filing Rules and the Disclosure Rules, China has finally constructed a solid

base for the franchising business sector. The 2007 Franchise Regulations are applicable to all “franchise business” types of activities within the territory of the Peoples Republic of China but the Ministry of Commerce has indicated that cross-border franchising is permitted.

The 2007 Franchise Regulations define “franchise business” to mean enterprises which own the operational resources such as registered trademarks, company logo, patents and know-how (“Franchisors”) and by signing a contract, authorise other operators (“Franchisees”) to use such operational resources. Franchisees conduct their business activities under a uniform business system and pay franchise fees to the Franchisor in accordance with contractual stipulations.

In addition, a Franchisor engaged in the “franchise business” must:

1. own a well-developed business format and have the capability to continuously provide operational guidance, technical support, business training and other relevant services to the Franchisee; and
2. shall own and operate at least two directly operated outlets for more than one year (such outlets can be located anywhere in the world and units of affiliated companies will be considered on a “case by case” basis to meet the “2-1” requirement).

The 2007 Franchise Regulations do not restrict the type of franchising models that can be used in China. Both individuals and enterprises can conduct franchise activities as a Franchisee, but only an enterprise can conduct Franchisor activities either as a master Franchisor or sub-Franchisee that has been given the right to grant sub-franchises.

The 2007 Franchise Regulations provide that the Franchisor gives the following information to the Franchisee at least 30 days before the signing of the franchise contract:

1. Franchisor’s corporate details
2. Details of the Franchisor’s intellectual property such as trademarks and logos
3. Franchise fee particulars
4. The products and the services the Franchisor will provide to the Franchisee, inclusive of prices and payment terms
5. Details concerning training, operational support and operational guidelines
6. Investment budget for the franchise business
7. Details concerning the Franchisor’s activities in China
8. A summary of the Franchisor’s financial reports for the preceding two years
9. Details concerning any litigation or arbitrations the Franchisor has been involved in during the preceding five years
10. Notice of any material illegal activities attributed to the Franchisor or the Franchisor’s Legal Representative
11. Any other information required by MOC

The arrangement between the Franchisor and the Franchisee establishing the franchise arrangement must be set out in a written contract signed by both parties and provide for the following:

1. The basic information about the Franchisor and Franchisee
2. The contents and history of the franchise

3. The type, amount of funds and expense payment method for the Franchise
4. The details concerning Franchisor support and training services
5. How the quality of products and services will be maintained for the operation of the Franchise
6. Protection of consumer rights and interests and liability for compensation claims against the Franchisee
7. Promotion and advertising related to the franchise
8. Amendment, termination and cancellation of the contract
9. Liability for breach of the contract

10. Settlement of disputes
11. A provision that the Franchisee may terminate the contract unilaterally after a specified period of time (Article 12)
12. Such other provisions agreed upon by both parties

Within 15 days of the Franchise Contract being signed by the Franchisor and the Franchisee, the Franchisor must file notice of the franchise contract with MOC together with all supporting documentation.

The 2007 Franchise Regulations provide penalties and fines for non-compliance that include administrative orders, fines ranging from 10,000 RMB to 500,000 RMB and, in the case of severe breaches of the regulations, criminal sanctions.



## EMPLOYMENT LAW CHALLENGES

### FOR FOREIGN COMPANIES SEEKING TO ESTABLISH A BUSINESS OR EXTEND THEIR OPERATIONS IN GREATER CHINA

On 1 July 1997, the PRC resumed the exercise of sovereignty over Hong Kong, which became the Special Administrative Region (“HKSAR”) of the PRC. The Basic Law of the HKSAR (“Basic Law”) came into effect on 1 July 1997 and is the constitutional document for the HKSAR. It contains the concept of ‘one country, two systems’ and expressly provides that the laws previously in force in Hong Kong, that is, the common law, rules of equity, ordinances, subordinate legislation and customary law continue to be maintained. The exception to this is any laws that contravene the Basic Law. The Basic Law expressly states that the HKSAR courts may refer to precedents of other common law jurisdictions when making decisions. Further still, it states that the Courts of Final Appeal and the judiciary of the HKSAR are given the power to invite judges from other common law jurisdictions to participate in the judicial process. Given the marked similarity between much of the legislation in the HKSAR and legislation from England and Wales, in practice this means that there is very heavy reliance upon the authority from the English courts in the field of employment law.

The Hong Kong Employment Ordinance (Cap. 57) (**Employment Ordinance**) sets out a statutory framework to govern many aspects of the employment contract by incorporating a number of key terms and conditions into every contract of employment which falls within its coverage. The Employment Ordinance is fairly inflexible in its drafting and difficult in places to understand. For example, the provisions of the Employment (Amendment) Ordinance which came into effect on 13 July 2007 provide for a revised calculation of an employee’s

wages in relation to payment for the relevant statutory entitlements by calculating the employee’s average daily (or monthly) wages in the 12 months prior to the specified date. The revised calculation would arguably include such payments as a one-off sign-on bonus which may have a significant impact on an employee’s average daily wages in the first few months of employment.

The PRC’s employment laws are complex, meaning that employing in the PRC can be unpredictable and difficult to assess in terms of risk. Difficulties arise for employers out of the complex legal system which varies from region to region and differs not only in legal content but also in terms of local enforcement.

Employers are still grappling with two significant pieces of legislation which came into effect from 1 January 2008, the PRC Labour Contract Law (**LCL**) and the Employment Promotion Law (**EPL**), which have been implemented in different ways from region to region.

Another key problem for foreign companies is that only a PRC entity can enter into effective labour contracts in the PRC. This means that a representative office of an overseas company is forced to construct its employment contracts using the artificial layer of a labour agent such as the Foreign Enterprise Service Company (**FESCO**). This leads to an unusual arrangement, whereby the employer in law is frequently far-removed from the day to day control of its employee who, in all but name, is employed by the representative office of the foreign company. There are many practical issues that arise out of this arrangement, not least the challenge that the foreign company

faces in protecting its confidential information and intellectual property, when formally it does not have a direct employment relationship with the individual working.

Against this background, there are some unusual elements of Hong Kong and PRC employment law which frequently cause difficulties for employers. We have summarised some of these below.

## TERMINATION

In contrast to many other jurisdictions, including Australia, employers in Hong Kong are not bound by any statutory procedural formalities in relation to carrying out terminations of employment. Further, there is no ‘unfair dismissal’ regime in Hong Kong to provide a remedy for employees whose employment has been unfairly terminated simply as a matter of process. However, the Employment Ordinance does provide remedies to employees whose employment contracts have been terminated in a manner which does not comply with the requirements of the Employment Ordinance or whose employment has been unreasonably terminated in order to extinguish or reduce a right, benefit or protection awardable under the Employment Ordinance. However, these protections are fairly limited. Unusually, in Hong Kong, either party (not just the employer) can terminate the employment contract by making a payment in lieu of the notice period.

By contrast, in the PRC, even terminations by mutual agreement trigger economic compensation. If mutual termination is not an option due to lack of agreement with the

individual, it is difficult to bring the relationship to an end and even poor performers are heavily protected under PRC law. An employer who wishes to terminate on poor performance grounds needs to invest considerable time and effort to increase the likelihood of such a termination being deemed lawful. This includes establishing that the individual does not meet the role requirements, engaging in significant efforts to retrain the individual and seeking other employment options within the employing organisation. Even if all this fails, any termination requires 30 days’ notice or payment in lieu, along with payment of economic compensation. In addition, the LCL provides that if the employer terminates the labour contract of the employee in the wrong way, the employer has to pay double economic compensation to the employee. This means that getting dismissal wrong becomes even more economically damaging to the business.

Given the difficulties of terminating labour contracts in the PRC, the end of a fixed term contract provides a convenient and lawful way to bring employment relationships to an end. However, the LCL also makes this a difficult option for employers as individuals whose fixed term labour contracts are renewed on two occasions will be able to require that any new contracts are on a non-fixed term or indefinite basis with all the protection this brings with it. In addition, economic compensation is payable upon the expiration of a fixed term contract. This means increased financial burdens for employers and greater difficulty in bringing unsatisfactory labour contracts to an end.

## HOLIDAYS AND ANNUAL LEAVE

In Hong Kong, employees are entitled to 12 paid Statutory Holidays under the Employment Ordinance. However, it is not uncommon for employers in Hong Kong to enhance this entitlement and allow employees to take General Holidays – which are the 12 statutory holidays plus an additional five holidays – as paid holidays. The number of public holidays in PRC increased from 10 to 11 days on 1 January 2008.

In Hong Kong, anyone employed under a continuous contract of employment for a minimum period of 12 months is entitled to paid annual leave. This is calculated on a sliding scale from seven days up to 14 days depending on length of service. There is also a clear implementation of annual leave entitlements in the PRC. So long as an employee has at least one year's continuous service, he or she will be entitled to paid annual leave of between five and 15 days depending on length of service, in addition to public holidays. If employees are unable to take their annual leave entitlement due to business needs, employers are required to pay employees 300% of their daily salary, for each day of untaken annual leave. Certain employees will not be entitled to annual leave at all. These include employees who are entitled to a winter and summer vacation (where the total days' vacation is more than their annual leave entitlement), employees who have taken at least 20 days' fully paid personal leave in any leave year, or employees who have taken a certain period of sick leave (depending on continuous service).

## DISCRIMINATION

Discrimination legislation in Hong Kong provides similar protections to employees as those that exist in Australia. The Sex Discrimination Ordinance (Cap. 480) (SDO), Disability Discrimination Ordinance (Cap. 487) (DDO), the Family Status Discrimination Ordinance (Cap. 527) (FSDO) and the Race Discrimination Ordinance (Cap. 602) (RDO) prohibit certain forms of discrimination in the workplace and elsewhere in Hong Kong. The SDO renders unlawful acts which discriminate against persons on the grounds of sex, marital status, pregnancy and sexual harassment as well as victimisation. The DDO makes unlawful acts which discriminate against a person on the ground of disability. Harassment, victimisation and vilification on the ground of a person's or a person's associate's disability (defined as a person's spouse, a person living with a person on a genuine domestic basis, relative, carer, or another person who is in a business, sporting or recreational relationship with the person) are also unlawful. The definition of a disability is very wide and includes a disability that: presently exists; previously existed but no longer exists; may exist in the future; or is imputed to a person. The FSDO renders unlawful acts which discriminate against persons on the grounds of family status (i.e. the status of having responsibility for the care of an immediate family member). The RDO came into force on 10 July 2009 and makes it is unlawful for employers to discriminate on the grounds of race (which includes colour, descent or national or ethnic origin of a person but interestingly, grounds such as nationality, citizenship, resident status, length of stay or indigenous villager status of a person are not grounds of race under the RDO).

In the PRC, several laws and regulations have been drafted, revised or passed concerning the protection of the rights of some groups, for example, women, the disabled, HIV carriers and Hepatitis B Virus carriers. The protection of equal rights in employment is included in these laws or regulations. The EPL states that the employee shall not be discriminated on the basis of nationality, race, sex or religious belief. It also extends the anti-discrimination protection to rural workers who are employed in cities who should be granted the right of employment equal to that of urban workers and carriers of infectious diseases (but who are otherwise healthy and whose condition does not affect their ability to work). Perhaps most importantly, under the EPL, employees in the PRC are given a legal basis to bring a civil claim for unlawful discrimination against their employers in the People's Court.

## TRADE UNIONS

Although Hong Kong residents have the right and freedom to form and join trade unions, the level of participation in trade unions is relatively low and, in fact, Hong Kong enjoys a relatively harmonious climate of industrial relations. At the end of year 2008, there were 796 registered trade unions, consisting of 752 employees' unions, 19 employers' associations and 25 mixed organisations of employers and employees.

The PRC Government believes that it is important to establish all levels of trade unions to represent and protect the legal rights of employees. Therefore, PRC companies are facing increasing pressure from the government and the local federation of labour union to set up a labour union. However, strictly under the Trade Union Law, a labour union is to be established by the

employees rather than the employers. Once the labour union is established, the employer must contribute and pay funds to its labour union in an amount equal to two percent of its total wages on a monthly basis. In addition, the labour union will be involved in collective negotiations and must be informed of any unilateral termination made by the employer.

## BENEFITS

The Employment Ordinance in Hong Kong sets out a rather unusual entitlement to sick leave – there is an entitlement to accrue 'sickness allowance' at a rate of two paid sick days each month in the first year of employment and four paid sickness days each month thereafter. The maximum accumulation at any one time is 120 days. These accrued days are paid at a rate of four-fifths of the employee's average daily wages (calculated over the previous 12 months) but payment is only due when an employee is off sick for four consecutive days or more. Once the employee is off for at least four days all the sickness days are deemed subject to the sickness allowance up to the accrued maximum.

In the PRC, subject to local requirements, employers and employees are generally required to make contributions on a monthly basis for social security benefits in retirement, illness, unemployment and housing. Further, employers are required to contribute towards social security benefits for work-related injury and child-bearing. In total, the employer's contribution towards all the social security benefits generally amounts to around 40% of the employees' monthly salary (although the employees' monthly salary is limited at three times the local average salary).

## WORKING HOURS

With the exception of certain cleaning and security workers who are covered by voluntary provisions, there are currently no formal legal requirements in Hong Kong with regard to minimum wages. However for the first time in Hong Kong's legal history, a Minimum Wage Bill ("Bill") was introduced into the Legislative Council in June 2009 and if passed, will apply to all employees, subject to limited exceptions including some students and live-in domestic workers. The Bill is intended to set a statutory minimum hourly wage in Hong Kong. Further, apart from the mandatory provision of rest days, there is no regulation on maximum working hours in Hong Kong (except in regard to the employment of children and young persons) although the Bill will impose upon employers an obligation to keep records of the total number of hours worked by an employee in a wage period. There is no requirement to

pay overtime as long as the obligations with regards to the payment of the minimum wage are complied with.

Under PRC labour law, standard working hours means eight hours a day, 40 hours a week. In relation to work done in excess of the standard working hours, employers in the PRC must pay employees a specified overtime rate (of between 150% and 300% of the employee's daily salary rate or hourly salary rate depending on when the employee carried out the overtime). The exception to this is work carried out on a rest day which can be compensated with time off in lieu. However, overtime worked during a normal working day or on a public holiday must be compensated for with money, not time. The maximum overtime which can be claimed by an employee is three hours per day and 36 hours per month. These inflexible overtime requirements are often ignored and not fully adhered to.



The principle employment laws in China are the PRC Labour Law, effective 1 January 1995, and the PRC Labour Contract Law, effective 1 January 2008. The PRC Labour Law, PRC Labour Contract Law and other laws and regulations issued by the central government are generally applicable nationwide. There are also local regulations and rules issued by provincial, municipal and other lower level authorities that are only applicable to relevant local regions.

## **EMPLOYMENT CONTRACTS**

All enterprises in China, including both domestic enterprises and enterprises with foreign investment, are required to have written employment contracts with their employees.

The employment contract is required to include the following information:

- name, domicile and legal representative or main person in charge of the employer;
- name, domicile and resident ID card number or other valid identity document of the employee;
- term of employment;
- job description and place of work;
- working hours, rest and leave;
- remuneration;
- social insurance; and
- labour protection, working conditions and protection against occupational hazards.

A probation period can also be stipulated in the employment contract. The permissible term of the probation period depends on the term of the

employment contract but cannot, in any event, exceed six months. Employment contracts are required to state the term of the contract, which can be open, fixed or a term to end upon the completion of a project. Fixed or project based terms are generally preferable to open term contracts, as it is very difficult for employees to unilaterally dismiss employees.

Once an employee has completed two fixed-term contracts, an open-term contract should be concluded in certain circumstances. Additionally, if an employee has been working for an employer for at least 10 years and proposes or agrees to renew his or her employment contract, an open-term employment contract is required.

Unlike most other entities in China, representative offices are not allowed to employ staff directly. They must hire the services of individuals through designated labour agencies under a third-party arrangement. In this situation, the representative office will enter into a service contract with the labour agency for the services of an individual with the labour agency having the actual employment relationship with the individual.

It is common practice for the representative office to have a separate side agreement with the employee covering issues such as confidentiality obligations.

## **TRAINING CONTRACTS**

An employer may impose a minimum service period on an employee if it provides “special funding” to provide the employee with “professional technical training”. If an employee leaves before the service period ends,

he or she can be required to repay the employer for the costs of the training. Repayment of costs is limited to those costs allocable to the unperformed service period.

## REMUNERATION AND BENEFITS

Employees are required to be paid at least once per month in readily available funds (i.e. payment in kind is not permitted). Wages are required to be paid directly to employees or to any other person designated by an employee. Local authorities determine the minimum wage standards, which differ from city to city.

The only deductions that an employer may make from wages are as follows:

- individual income tax of the employee;
- the portion of social insurance that shall be borne by the employee;
- alimony or other sums determined by the court; and
- other fees in accordance with the laws and regulations.

All employers and employees are required to contribute to basic social insurance and housing fund schemes. Mandatory social insurance consists of pension, medical, maternity, unemployment and occupational injury insurance. The amount the employer and employee must contribute every month is stipulated by local regulations.

## PERMISSIBLE HOURS OF WORK

There are three classifications for permissible hours of work, namely the Standard Working Hours System, the Flexible Working Hours System and the Comprehensive Working Hours System.

Under the Standard Working Hours System, working hours shall not exceed eight hours per day and 40 hours per week. The employer must allow employees at least one rest day per week.

Under the Comprehensive Working Hours System, working hours are comprehensively calculated on a periodic basis. However, the average working hours per day and per week are required to be similar to that required under the Standard Working Hours System. Prior approval from the local labour authority is required before an employer may implement the Comprehensive Working Hours System.

The Flexible Working Hours System allows an employer to require certain employees, such as senior managers, salespersons and others whose work cannot be measured under the Standard Working Hours System, to work in excess of 40 hours per week without paying overtime compensation. Prior approval from the local labour authority is also required before an employer may implement the Flexible Working Hours System.

An employer may extend working hours to meet production or operational needs after consulting with the labour union, if any, and employees. Overtime is generally limited to one hour per day; however, in special circumstances, overtime can be extended to three hours per day as long as it does not exceed 36 hours per month. The above limitations to overtime do not apply in the following circumstances:

- in emergencies, when the life and health of the employees and property are threatened due to natural disasters, accidents or other causes;

- urgent repairs that are necessary when production equipment, transportation lines or public facilities are in danger, and are affecting production and public interests; and
- other cases as provided for by law or administrative decrees.

## OVERTIME ISSUES

An employee working under the Standard Working Hours System is entitled to receive overtime pay as follows:

- for overtime worked during normal working days, 150% of the average hourly wage of the employee for each hour of overtime worked;
- for overtime worked during rest days (e.g. Saturday and Sunday) and if no extra rest can be arranged thereafter, or in lieu thereof, 200% of the average hourly wage of the employee for each hour of overtime worked; and
- for overtime worked during statutory holidays (i.e. public holidays), 300% of the average hourly wage of the employee for each hour of overtime worked.

## LEAVE

Employees are entitled to a minimum amount of annual leave, ranging from five days to 15 days, based on the total number of years they have been in the workforce (not just the number of years worked for the current employer). Other types of leave employees are entitled to include the following:

- medical leave;
- marriage leave;

- bereavement leave;
- home leave; and
- maternity leave.

## TERMINATION OF AN EMPLOYMENT CONTRACT

An employee has the right to unilaterally terminate an employment contract for any reason upon giving his or her employer 30 days' advance written notice. In certain circumstances, an employee may terminate an employment contract immediately without notice. Such rights, however, have not been granted to the employer. An employer may only unilaterally terminate an employment contract in certain limited circumstances, namely where the employee:

- is proven not to satisfy the conditions for employment during the probationary period;
- materially breaches the employer's rules and regulations;
- commits serious dereliction of duty or practices graft, causing substantial damage to the employer;
- has additionally established an employment relationship with another employer which materially affects the completion of his work with the employer, or refuses to rectify the matter after the same is brought to his or her attention by the employer;
- causes the employment contract to be invalid due to use of deception, coercion or taking of the employer's difficulties, to cause the employer to sign the employment contract;
- is prosecuted for criminal liability;



- can engage neither in his or her original work nor in other work arranged for him or her after the set period of medical care for an illness or non-work-related injury;
- is incompetent and remains incompetent after training or adjustment of his or her position; or
- is unable to reach an agreement with the employer on amending the employment contract where a major change in the objective circumstances relied upon at the time of conclusion of the employment contract renders it un-performable.
- the parties mutually agree to terminate the employment contract after such termination was proposed by the employer;
- the employment contract is terminated by the employer on any grounds requiring 30 days' prior notice to the employee;
- the employment contract is terminated by the employer as part of a collective dismissal;
- the employment contract is a fixed-term contract that ends, unless the employee does not agree to renew the contract after the employer offers to do so on the same or better terms;
- the employer has its business license revoked, is ordered to close down or decides on early liquidation;
- other circumstances prescribed by law.

In the last three situations, the employer is required to provide the employee with 30 days' advance notice.

## SEVERANCE

Employees are entitled to statutory severance in the following circumstances:

- the employment contract is terminated by the employee for certain types of violations by the employer;

Severance is payable at a rate of one month's average monthly wage for each year of service with an employer. For periods of service of

less than six months, half month's average monthly wage is payable to an employee. Severance is capped at three times the average municipal monthly wage in the location of employment and is capped at 12 months' wages in certain circumstances.

## NON-COMPETITION RESTRICTIONS

An employer can require certain employees, such as senior management, senior technicians and other employees with confidentiality obligations, to be subject to non-competition restrictions. The scope, territory and term of the competition restriction must be agreed between the employer and the employee. The post-termination non-competition term cannot exceed two years and the employer is required to pay reasonable compensation to the former employee on a monthly basis during such period.

## COMPANY RULES

Adoption or revision of company rules that have a direct bearing on the immediate interests of employees require:

- discussion with all employees or an employee representative congress;
- proposal and comments being put forward to the employer by the employees or employee representative congress;
- consultation with the labour union or employee representatives; and
- the rules to be adopted or revised be publicly communicated to employees.

## EMPLOYMENT AND RESIDENCY REQUIREMENTS FOR EXPATRIATES

Expatriates are required to meet the following basic criteria in order to work in China:

- be at least 18 years of age and in good health;
- have the professional skills and appropriate vocational experience required for the intended position;
- have no criminal record;
- have a definite employer; and
- have a valid passport.

The position for which an employer recruits an expatriate must be one for which there are special requirements and for which, for the time being, there are no suitable domestic applicants. Before employing an expatriate, an employer must first apply for an employment licence and the expatriate must first obtain employment and residence permits.

## LABOUR UNIONS

All labour unions in China are organised under the leadership of the All China Federation of Trade Unions (ACFTU), which is the only legal labour union in China.

Under the ACFTU, there are local federations of labour unions at the provincial, municipal and county levels, and labour unions by sector/industry. Below the local federations are the labour unions established at the company level.

The PRC Labour Union Law provides the legal basis for employees to organise unions within companies.

Once a labour union is established at the company level, the employer's major obligations will include:

- making a monthly payment of 2% of the total wages (including salary, bonus, allowance and subsidies) of all employees to the labour union fund;
- maintaining the employment of the labour union's full-time chairman, deputy chairman and committee members during the periods they remain in their positions, subject to certain exceptions;
- giving advance notice to the labour unions of the reasons for unilaterally terminating an employee's employment. If the labour union believes that the company has violated the law or provisions of the employment contract, they can request that the matter be investigated. The employer is required to consider their views and notify the labour union in writing as to the subsequent handling of the matter;
- seeking the views of the labour union when considering important operational management and development issues. This means that employers need to allow labour union representatives to attend board meetings if issues that affect the personal rights and interests of the employees will be discussed (e.g. wages, welfare, labour safety and social insurance); and
- consulting with the labour union regarding proposed rules and regulations of the employer which directly involve the personal interests of employees.



## SETTING UP YOUR BUSINESS

# DISPUTE RESOLUTION

As an increasing number of foreign investors penetrate the Chinese market, commercial disputes are expanding quickly both in number and in scale. If a dispute cannot be settled through negotiation between the parties, the case must be submitted for litigation or arbitration. Mediation is not a mandatory instrument for resolving disputes in China.

### LITIGATION IN CHINA

There are four levels of courts in China: the basic People's Court, the Intermediate People's Court, the High People's Courts and the Supreme People's Court. Most major cases involving a foreign party fall under the jurisdiction of the Intermediate People's Court. Court decisions may be appealed once, but the judgment of the second instance is final and binding upon the parties immediately.

Although it is certainly necessary for foreign investors to take note of the peculiarities of the Chinese judicial system before becoming involved in a dispute, the court system in China will work reasonably fairly with the assistance of experienced counsel. The loyalty of the judiciary to the government should be kept in mind. When "sensitive" cases (meaning cases considered to affect government policies and interests or certain individuals or entities favoured by the government) are brought to court, great pressure is placed on the judges not to embarrass the government or cause any inconvenience to the favoured party with an adverse judgment.

However, lawyers should be informed in advance if the case is to be handled as a "sensitive case" and steps can be taken to diffuse the sensitivity.

The plaintiff must pay a fee stipulated in the court rules and calculated as a percentage of the amount at issue in the claim. The defendant must pay a similar fee if any counter-claim were filed. This fee is kept by the court regardless of the result of the case. Additional fees will be charged if the court hires any witnesses, expert advisors, translators, valuers or any other specialists whom the court feels could be helpful in the resolution of the case. Pursuant to the PRC Civil Procedure Law, all evidences generated /obtained outside China including the Power of Attorney in the litigation proceedings shall be notarised and authenticated.

A case involving a foreign party is usually heard by a panel of three judges. All of the arguments and evidence must be in Chinese according to the PRC Civil Procedure Law. The hearing will also be in Chinese, and translation may be provided at the request of the parties concerned at their expense. Foreign parties wishing to retain lawyers as agents to bring an action on their behalf must appoint PRC lawyers from local firms.

During the course of the court proceedings, the judges will usually make an attempt to mediate the case. If a mediation agreement is reached by and served to the parties, it will become legally effective. If the mediation effort fails, the court shall render a judgment without delay.

### ARBITRATION IN CHINA

The past few decades have witnessed the dramatic evolution in Chinese arbitration, with many promising improvements in arbitration systems and services.

Arbitration in China is regulated by the Arbitration Law, the PRC Civil Procedure Law, the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (“New York Convention”) and various judicial interpretations issued by the Supreme People’s Court. The arbitration rules of the China International Economic and Trade Arbitration Commission (“CIETAC”) and other arbitration institutions are not legally binding but also play an important role in China.

## ARBITRATION INSTITUTIONS IN CHINA

In the past, Chinese arbitration commissions were divided into foreign-related arbitration commissions and domestic arbitration commissions. Only CIETAC and the China Maritime Arbitration Commission (“CMAC”) had the capacity to accept foreign-related cases. It was only after June 1996, when the State Council promulgated the Notice Concerning Clarification of Several Issues Regarding the Implementation of the PRC Arbitration Law, that the local arbitration commissions were permitted to handle foreign-related arbitration cases. CIETAC also amended its Arbitration Rules in 2000 to expand its jurisdiction to domestic disputes. However, pursuant to the PRC Civil Procedure Law, PRC Arbitration Law and CIETAC Arbitration Rules, domestic arbitration cases and foreign-related arbitration cases are subject to different procedural administration and judicial supervision.

Foreign investors frequently refer disputes to CIETAC, which has established a reputation for fair and efficient dispute resolution services and handles 800 to 1,000 cases per year. CMAC

is also particularly well regarded for its ability to resolve various types of contractual and non-contractual maritime matters, including domestic, foreign related and international disputes.

Domestic arbitration institutions number over 200 thus far and are situated in all the major cities in China. Procedures at such forums tend to be more informal and much less predictable than those of CIETAC or CMAC.

## 2005 CIETAC ARBITRATION RULES

The current CIETAC Arbitration Rules, effective as of 1 May 2005, primarily focus on improving the quality of CIETAC’s arbitration services, from respecting the parties’ autonomy in selecting arbitrators, improving the efficiency of the procedures, to expanding the discretion exercised by the arbitral tribunal. These rules bring CIETAC further in line with international arbitration practices. The most notable changes are as follows:

### Appointment of arbitrators

To the elation of many foreign companies, CIETAC’s rules do away with the restrictive arbitrators’ list requirement. Parties are allowed to select arbitrators outside of CIETAC’s panel subject to the confirmation of the CIETAC Chairman. In choosing the presiding or sole arbitrator, the parties may each recommend up to three arbitrators as candidates, bearing in mind the following:

- (i) where there is only one common candidate in the lists respectively provided by the Claimant and the Respondent, such candidate shall be the presiding or sole arbitrator jointly appointed by the parties;

- (ii) where there is more than one common candidate in the lists respectively provided by the Claimant and the Respondent, the CIETAC Chairman shall choose the presiding or sole arbitrator from among the common candidates based on the specific nature and circumstances of the case;
- (iii) where there is no common candidate in the lists, the presiding or sole arbitrator shall be appointed by the CIETAC Chairman from outside of the lists of recommended candidates; and
- (iv) where the parties have failed to jointly appoint the presiding or sole arbitrator, the CIETAC Chairman shall appoint one.

## Hearing

The arbitral tribunal shall examine the case in any way that it deems appropriate unless otherwise agreed by the parties. The arbitral tribunal may, if necessary, issue procedural directions and lists of questions, hold pre-hearing meetings and preliminary hearings, produce terms of reference, etc unless otherwise agreed by the parties.

## Evidence gathering

The principle is that each party has to bear the burden of proving the facts it relies on. However, according to the inquisitorial tradition of Chinese legal institutions, the arbitral tribunal is given broad powers to investigate and collect evidence on its own, namely when the parties and their representatives cannot collect the evidence because of objective reasons or simply when the arbitral tribunal deems it necessary for the hearing. Due to the lack of extensive rules on evidence gathering in the Arbitration Law, Chinese arbitral tribunals will often refer

to the rules applicable before Courts, leading to a pretty restrictive way of handling evidence.

## Applying alternative arbitration rules

The CIETAC rules address the possibility of selecting other arbitration rules to govern the arbitration. Therefore, unlike the previous version of the rules, CIETAC's approval is no longer a prerequisite for applying alternative arbitration rules such as UNCITRAL arbitration rules. However, the parties' agreement on the application of other arbitration rules or on the modification of the CIETAC rules will not prevail if the said agreement is inoperative or in conflict with the mandatory provision of the law of the place of arbitration.

## Statutory time limits

The period for rendering the arbitral award in foreign-related cases is six months from the date on which the arbitral tribunal is formed. However, this deadline will in practice often be extended.

## Dissenting opinions

The CIETAC rules allow dissenting opinions to be attached to the awards, though these will not constitute a part of the award.

## 2006 NEW JUDICIAL INTERPRETATION ON ARBITRATION LAW

The Supreme People's Court promulgated its interpretation on several issues relating to the application of Chinese Arbitration Law (the "Judicial Interpretation") on 8 September 2006. The Judicial Interpretation consolidates the opinions in previous separate judicial interpretations and focuses on the judgment of the validity of arbitration agreement and challenges to arbitral award.

## Validity of Arbitration Agreement

According to Chinese Arbitration Law, a valid arbitration agreement must designate the name of the arbitration institution. The new Judicial Interpretation makes such requirement flexible by providing that even if an arbitration institution is not expressly designated, the arbitration agreement will not be invalid if the arbitration institution can be ascertained under the applicable arbitration rules stated in the arbitration agreement.

## Foreign Institutional Arbitration in China

Under PRC Arbitration Laws, only the bodies named under the Laws will be allowed to conduct arbitration proceedings. It has been uncertainty and heated debate for number years as to whether or not the PRC courts will enforce an award granted by a foreign arbitration tribunal /body which conducted its proceedings in China and whether such award will be regarding as a domestic award or a foreign award. The Judicial Interpretation keeps silent on this issue. In a recent case in 2009, the Ningbo Intermediate People's Court ruled that an ICC award issued by a Beijing seated tribunal as non-domestic award which can be enforced under the New York Convention. The uncertainty remains as the Supreme People's Court in Beijing has not issued an opinion on this issue before or after the ruling of the Ningbo Intermediate People's Court.

## Recognition of the principle of Kompetenz-Kompetenz

The Judicial Interpretation provides that once an arbitration institution has decided on the validity of an arbitration agreement, the People's Court will not accept any application

to challenge such decision. However, it is just a partial recognition of the principle of Kompetenz-Kompetenz. In the event that one party contests the competence of the arbitral tribunal and files a request with the People's Court to decide on the validity of the arbitration agreement, while the other party requests the arbitration institution to confirm its competence, the People's Court's jurisdiction over the competency issue is given priority.

## REMAINING DEFICIENCIES OF ARBITRATION IN CHINA

### Arbitration Agreement

According to the Chinese Arbitration Law, arbitration agreements have to expressly refer to an "arbitration commission", otherwise they will be considered invalid. This requirement has two major effects: ad hoc arbitration is not admitted in China, although foreign arbitration awards rendered in ad hoc proceedings abroad may be recognised in China based on the New York Convention. Foreign arbitration institutions are not yet officially allowed to operate in China, due to the fact that they do not constitute "arbitration commissions" in the sense of the Arbitration Law.

### Provisional Measures

Under the Chinese Arbitration Law, a party may apply before the arbitration commission (not the arbitral tribunal) for preservation of the evidence, and the arbitration commission shall then further submit this application to the Intermediate People's Court in the place where the evidence is located. Besides this power to grant preservative measures, Chinese legislation makes no mention of any other mechanism in which an arbitral tribunal or arbitration

commission may request the state courts' support in the taking of evidence or otherwise protect the status quo of the dispute.

## **ENFORCEMENT OF AWARDS**

In China, the system of enforcement of arbitral awards is threefold, depending on the domestic, foreign-related or foreign nature of the arbitral awards. The enforcement of foreign arbitral awards, i.e. awards rendered by an arbitral tribunal with its seat outside China, is ruled according to the New York Convention, which China adopted in 1986. However, the enforcement of "foreign-related" awards, i.e. awards rendered in an international arbitration by an arbitral tribunal with its seat in China, and the enforcement of domestic awards are ruled by the Chinese Arbitration Law. One must note the special treatment given to "foreign-related" arbitral awards. The courts examine only the procedural aspects of a foreign-related arbitral award, whereas for domestic arbitral awards both procedural and substantive issues are scrutinised. However, despite the favourable treatment granted to foreign-related awards, the practice of scrutiny is still not totally compliant with the standard of scrutiny established for foreign awards in the New York Convention. Foreign investors should note that there is a time limit of 2 years for the enforcement pursuant to the Amendment of Civil Procedure Law which is effective on 1 April 2008.

## **MEDIATION IN CHINA**

Mediation is not a mandatory proceeding to resolve the dispute. The whole process of mediation must be conducted under the consent of the parties. The mediation process

stops immediately where one of the parties refuses to continue. Unlike arbitration, where the arbitral tribunal is entitled to arbitrate the dispute and render an award if an arbitration agreement has been reached by the parties even where one party later refuses to submit their dispute to arbitration, the settlement of mediation is completely based on the consent of the parties, and mediators have no capacity to render a decision without the agreement of the parties. The three types of mediation in China are court mediation, arbitration mediation and administrative mediation.

### **Court mediation**

This is also called judicial mediation. Based on the principle of party autonomy, judges in China routinely attempt to encourage the parties to settle their dispute, frequently in the later stage of a court proceeding. The mediation procedure is essentially a supervised settlement negotiation. If the mediation is successful, the parties will reach an agreement stating the details of the settlement. The agreement thus issued by the court is binding on the parties and is enforceable as a judicial judgment. However, if no mediation agreement is reached or if one party revokes the settlement before it is served, the court must render a judgment without delay.

### **Arbitration mediation**

An arbitral tribunal is also entitled to conduct mediation before or after the commencement of arbitration upon the consent of the parties. Where the parties have reached a settlement agreement before the arbitration procedures, they may request the arbitration institution to constitute an arbitral tribunal to render an

arbitral award in accordance with the terms of the settlement agreement. If a settlement is reached through mediation during the course of arbitration, the arbitral tribunal will render a consent arbitral award in accordance with the terms of the settlement agreement. In both situations, the arbitral award will be binding upon the parties. If the parties failed to settle their dispute through mediation, however, the arbitral tribunal must resume arbitration procedures immediately.

### **Administrative mediation**

Administrative mediation refers to mediation that is conducted with the involvement of administrative authorities such as the People's

government, the public security authority (for disputes related to injury or damage suffered as a result of a traffic accident), or the marriage registration authority (for marital disputes).

### **CONCLUSION**

Foreign investors may resolve their disputes in China through litigation, arbitration and mediation. However, in view of the unresolved problems existing in the Chinese judicial system, including the intervention of the government, delays in judgements or local protectionism, it would be more advisable for the foreign investor to select arbitration or mediation as the method for dispute resolution.



The Chinese are known to be energetic negotiators of contracts, and what was agreed upon yesterday may not always apply today. The PRC Contract Law (“Contract Law”) provides legal recourse for those faced with the occasional business partner that fails to honour a contract. In addition, the Supreme People’s Court released an Interpretation II on Several Issues Concerning the Application of the Contract Law (“Interpretation II”), which became effective on 13 May 2009. This is a significant move of the Supreme People’s Court aimed at further protection of business contracts in order to help maintain a steady development of the economy in China amid the global financial crisis.

In addition to setting forth the various technical requirements for contracts of all types, the Contract Law also delineates a number of instances where a document that appears to be a contract can be either void (i.e. have no legal validity at any time), rescinded freely at the option of a party, or valid but unenforceable in China.

One aspect of the Contract Law that is often overlooked by foreign investors is that certain contractual deficiencies – such as lack of fairness and violation of social norms, which may not be significant in other jurisdictions – can render a contract unenforceable in China.

### **THE FAIRNESS REQUIREMENT**

Article 5 of the Contract Law requires that the parties to the contract adhere to the “principle of fairness”. A Chinese judge or arbitrator would typically have the discretion to decide what is or is not fair, and these need not be the same as the standards customarily used by

the parties. An important point to bear in mind is that Chinese standards of fairness may not necessarily be the same as those of a foreign investor. At a minimum, a fairness requirement must be included in the wording expressing the rights and obligations of the parties to the contract. A contract lacking such wording could be deemed by the judge or arbitrator handling the dispute to be void, rescindable at the option of the innocent party, or unenforceable against the innocent party.

Standard contracts in particular are required to be fair to the party who is not permitted to negotiate the terms of the contract. Some guidance can be gleaned from the provisions in the Contract Law concerning standard contracts as to what Chinese legislators consider to be “fair”. Specifically, it is considered unfair to exempt oneself from liability or to increase the liability of the other party in circumstances where the other party is not given the opportunity to negotiate such terms.

### **STANDARD CLAUSES**

The Contract Law requires a party providing standard clauses which have the effect of exempting itself from liabilities or limiting its liabilities to draw the other party’s attention to such clauses in a reasonable manner. It is also required to explain such clauses to the other party if the other party so requests. Pursuant to the Interpretation II, if the party who provided standard clauses including the exemption or limitation of liabilities has highlighted the points with special wordings, symbols or fonts, and has explained the standard clauses based on the other party’s requests, the people’s courts will consider the requirement of “reasonable manner” in Article 39 of the

Contract Law to have been fulfilled. Further, if there is more than one possible interpretation of a standard clause, the interpretation in favour of the other party should apply. In the event of discrepancies between a standard clause and a non-standard clause in a contract, the non-standard clause should prevail.

A standard clause is void (i.e. not binding at any time) if it purports to do or involves any of the following:

- exempting the party providing the clause from liability, increasing the liability of the other party and depriving the other party of a major right;
- using fraud or coercion to conclude a contract, harming the interests of the State (as understood by the State);
- engagement in malicious conspiracy to harm the State, or collective or third party interests;

- an illegal objective being disguised in legal form;
- harming the interests of the public; or
- violation of mandatory provisions of law (if only a part of the contract is non-compliant, and that part is severable, it is possible that only the non-compliant part will be void; at the same time, if enough of the clauses are non-compliant, the entire contract could be considered void).

Article 9 of the Interpretation II provides that if a party providing standard clauses fails to fulfil its obligations of alerting and explanation under Article 39 of the Contract Law, resulting in the other party failing to note the terms on the exemption or limitation of its liabilities, and the other party applies for cancellation of the relevant standard clauses on that basis, the people's court will uphold such application.



## EXEMPTION CLAUSES

An exemption clause, whether standard or non-standard, is void (i.e. not binding at any time) under the Contract Law if it purports to do any of the following:

- excluding liability for bodily harm caused to the other party; or
- excluding liability for property losses due to wilfulness or gross negligence.

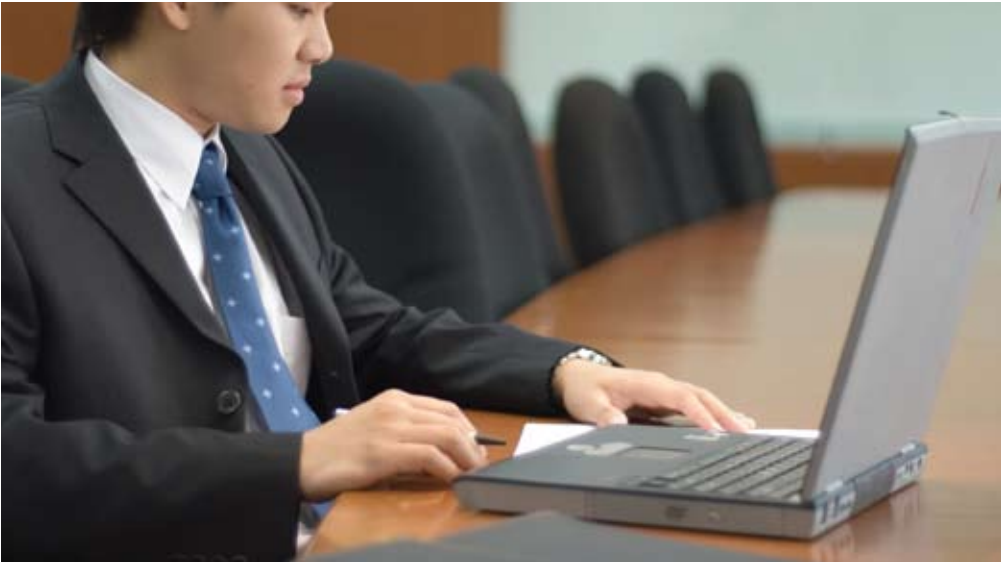
## THE SOCIAL ACCEPTABILITY REQUIREMENT

Article 7 requires that the parties to a contract respect public morals and avoid disturbing social or economic order or harming the interests of the public. The article also requires the parties to comply with laws and administrative regulations; however, it is difficult to determine

when a contract becomes unenforceable due to a violation of an applicable law. Where the main purpose of a contract involves the violation of law, the entire contract is naturally rendered invalid. However, where the violation is deemed only a minor infraction, or the non-compliant portion of the contract can be severed, either the entire contract or the valid clauses of the contract may remain in force.

## DAMAGES UNDER AN INVALID CONTRACT

If a contract, or a portion of a contract, is rendered invalid, the party in violation may be liable for damages to the other party or even third parties as a consequence of acts undertaken in performance of the contract. This disallows a contracting party from benefiting from its violation of the law.



# PROTECTING YOUR INTELLECTUAL PROPERTY RIGHTS

## INTRODUCTION

Intellectual Property (“IP”) laws have been in place in the PRC for more than two decades, but it was the PRC’s accession into the World Trade Organisation (“WTO”) in 2001, which has led the PRC State Council and its affiliated governmental bodies to toughen its stance in protecting the rights of IP owners. More recently, the PRC State Council issued the National IP Strategy in June 2008, with the view of committing to the PRC government to remedying the shortcomings in its IP regime. Changes have already been made to the PRC Patent Law and more changes are expected to come.

## LEGISLATION

The primary legislation governing IP in the PRC is as follows:

- the PRC Trademark Law;
- the PRC Copyright Law;
- the PRC Patent Law; and
- the PRC Anti-Unfair Competition Law.

Each of these laws are accompanied by implementation rules which clarify how the law is put into practice, along with more specific rules issued by other relevant departments and authorities at various state, provincial or municipal levels.

To facilitate the PRC’s accession into the WTO and to help the PRC meet its obligations under the Agreement on Trade-Related Aspects of Intellectual Property Rights (“TRIPs Agreement”),

each of these laws were amended in 2000 and 2001 to bring the PRC’s IP laws inline with international norms with the view of:

- increasing the scope of protection available to IP owners;
- broadening the range of enforcement mechanisms available, and
- increasing the penalties for infringement of IP rights.

Since the first round of amendments in 2000 and 2001, the IP regime in the PRC has been undergoing additional changes as a result of the State Council’s announcement of the National IP Strategy in 2008. The Patent Law was recently revised in December 2008 and came into force on 1 October 2009. The PRC Trademark Law and Copyright Law are currently undergoing consultations for revisions.

## PRC Trademark Law

Trademark rights in the PRC are based on a first-to-file registration system, meaning that whoever files for a trademark first will have the exclusive right to it. An application must be filed in Chinese with the Chinese Trademark Office (“CTO”) where the trademark application is examined. If the trademark application passes this examination phase, the proposed trademark will be published in the PRC Trademark Gazette for three months, where any entity/citizen will have the opportunity to oppose the registration of the trademark. If no opposition arises during this period, the application will be approved and the filed trademark will be registered.

The validity term of a registered trademark is 10 years which can be renewed for subsequent 10-year periods without limitation. Any party can seek to cancel a registered trademark if it has not in fact been in use in the PRC during a three-year continuous period.

### **PRC Copyright Law**

Any form of written, oral, musical, dramatical, choreographic, acrobatic, fine art, architectural, photographic, cinematographic, drawings, sketches and computer software works are protected under the Copyright Law. Generally, the author of the work is considered the copyright owner. If the work is created by an employee acting in official capacity and the work was created with the employer's resources, pursuant to the statutory legal provisions or contractual provisions, the commercial rights to exploit the copyright (excluding the authorship) will likely vest in the employer. Where a work has been commissioned, ownership of the copyright may be contractually dictated by the parties. Copyright owners who are individuals enjoy ownership from the date they create the work until 50 years after their death. If the copyright owner is a corporation, or if the work is computer software, photographic, cinematographic, televised, or audio-visual in nature, the copyright will only last for 50 years from the date of first publication.

Copyright may be registered in the PRC but registration is not mandatory. However, prior registration can serve as primary evidence of ownership in case of subsequent enforcement actions commenced against an infringer. Software copyrights can also be separately registered in the PRC. The China Copyright Protection Centre is responsible for the registration of software copyrights and the administration thereof, including examining

applications, receiving deposits of code and issuing registration certificates. There are certain options for the applicant to protect the confidential information of the source code submitted for the registration of software copyrights; for example, the applicant may request that certain contents of the submitted source code be masked or that the application documents be stored under seal.

Measures have been introduced which have the effect of permitting a copyright owner, who discovers that all or part of their work has been infringed by another party posting it on the Internet, to file a complaint to the relevant Chinese Internet Service Provider ("ISP") requesting the ISP take immediate steps to remove or delete the infringing content from the website. The failure of the ISP to act upon the copyright owner's complaint can lead to the ISP itself receiving administrative penalties and fines.

### **PRC Patent Law**

The PRC Patent Law permits inventions, utility models and designs (each an "Invention Creation") to be patented. An Invention Creation is patentable in the PRC if it is novel, inventive and useful. The term for an invention patent is 20 years, which is calculated from the date of the filing of the patent application. The term for utility model and design patents is 10 years. A patent application in the PRC must be filed in Chinese with the State Intellectual Property Office ("SIPO").

If the Invention Creation is created by a person acting in the capacity of an employee by carrying out his work duties or making use of the employer's material conditions, the right to apply for a patent falls with the employer. Registered patents are assignable, but all

assignments must be registered with the SIPO. Assignment of a patent is effective from the date it is registered with the SIPO.

The latest round of amendments were made to the Patent Law in December 2008 (effective from 1 October 2009). Amongst the changes brought by the revised Patent Law, one of the most important changes introduced was that an international novelty test is applied rather than a local use test.

### **PRC Anti-Unfair Competition Law**

Under this law, trade secrets (including know-how), unique product names, packaging and decoration are protected in China. A party infringing upon another party's trade secrets or unique product name, packaging and decoration shall assume administrative, civil and even criminal liabilities.

## **ENFORCEMENT OF IP RIGHTS**

There are two primary ways IPR owners in the PRC can enforce their rights against IP infringement:

### **Administrative**

Each IP law in the PRC gives the State Council and other relevant authorities the power to establish administrative bodies to enforce the laws.

Owners of IP rights may file complaints and also request these administrative bodies to conduct investigations against alleged IP infringers.

In recent years, PRC governmental authorities have taken steps to reduce or eliminate the flow of pirated/counterfeit goods through the economy by seizing infringing goods and imposing fines against wrongdoers. They have also sought to educate the public about IP infringement through several highly publicised publicity campaigns.

While administrative action or the seizure of infringing goods can provide a swift and cheap remedy for IP owners, it does not provide IP owners with any permanent injunctive protection, and fines paid for violating such rights are paid to the authorities not the IP owner.

### **Judicial**

The People's Courts have been granted greater power to hear and decide civil disputes related to IP rights. The courts provide IP owners the right to seek civil remedies such as damages and injunctions for IP infringement. Please note that even if one obtains a favourable People's Court ruling, the amount of damages assessed by the People's Court is likely to be somewhat small by international standards.

In 2004, the Supreme People's Court and Supreme People's Procuratorate jointly promulgated the *Interpretations of the Supreme People's Court and the Supreme People's Procuratorate on the Several Issues of Application of Laws When Hearing the Criminal Cases of Infringing on the Intellectual Property Rights* ("Interpretations"), which for the first time set out and clarified the thresholds for criminal IP infringement cases.

In 2007, a second set of Interpretations were issued jointly by the Supreme People's Court and Supreme People's Procuratorate ("Second Interpretation") which aimed at improving the criminal IP regime in the PRC. Noticeable improvements were made under this Second Interpretation. Most importantly, the threshold requirement to prosecute IP infringers has been significantly lowered. The Second Interpretation also fixed the amount of fines levied for IP crimes. The criteria on convicting and sentencing against entities and individual offenders have also been unified.

Over the past decade China has experienced exponential growth of the advertising business sector fuelled by China's rapidly expanding economy.

In accordance with its World Trade Organisation commitments, China opened the advertising business sector to foreign investment by way of joint ventures with Chinese companies (March 2004) and wholly foreign-owned enterprises (December 2005). The entry requirements for such investment vary from region to region but in most cases such requirements are not too onerous for foreign investors. Such investment and the development of the domestic advertising industry has prompted the Chinese authorities to issue a growing list of laws in a number of advertising sectors to address advertising issues.

The basis for all advertising laws in China is the "Advertising Law" that was issued in 1995 ("the Advertising Law"). Although the methods and technical means by which advertising is conducted in China has changed dramatically since issuance of the Advertising Law, the Advertising Law is still the foundation for guiding the advertising industry in China.

The Advertising Law defines advertising as "commercial advertising in which a commodity dealer or service provider directly or indirectly promotes his own commodities to be marketed or services to be provided at its own expense, through a certain medium and in a certain form".

The Advertising Law also defines "advertiser" as a legal person, other economic organisation or individual that designs, produces and disseminates advertisements on its own or that commissions another person to design, produce and disseminate advertisements in order to

market commodities or provide services, "advertising operator" as a legal person or other economic entity or individual that provides advertising design, production and agency services on commission and "advertising disseminator" as a legal person or other economic organisation that disseminates advertisements for an advertiser or advertising operator commissioned by an advertiser.

The Advertising Law applies to advertisers, advertising operators and disseminators that engage in advertising activities in China. The important provisions of the Advertising Law are as follows:

1. all advertisements in China are subject to the general principle that they must benefit the physical and mental health of the people, enhance the quality of the commodities and services and safeguard the interest of the consumers.
2. restricts advertisements that use state symbols, obstruct public order or act against good social customs.
3. advertisements cannot contain contents that discriminate on the basis of nationality, race, religion or sex or contain obscene, superstitious, terrifying or violent contents.
4. use of comparative advertising requires substantiation and must not denigrate the products or services of other producers or dealers.
5. provides basic guidelines concerning the advertising of pharmaceuticals and medical apparatus.
6. advertisers must not conduct unfair competition activities.

7. advertising personnel must be qualified and properly licensed.
8. advertisements in certain business sectors must be approved in advance releasing the advertisements for public viewing.
9. the China State Administration of Industry and Commerce (“SAIC”) is the governing regulatory authority.
10. SAIC can issue fines and penalties upon non-compliance with the Advertising Law.

In addition to the Advertising Law China has released a number of supporting laws that deal with: formation of advertising agencies, control of outdoor advertising, medical advertisements, printed advertisements, ambush marketing and Internet advertising.

China does not have a self-regulatory structure but most advertisers rely upon in-house expertise or that of its advertising agencies and media buyers to ensure compliance with regulatory rules and procedures.

In 2004, in accordance with China’s World Trade Organisation commitments, China opened the advertising business sector to foreign investment and at this time such investment can be by way of either a wholly foreign-owned enterprise or Sino-foreign joint venture. The entry requirements vary from region to region but are not too onerous for foreign investors with the important requirements being as follows:

1. to establish a Wholly Foreign-Owned Enterprise (“WFOE”) the investing party must be an enterprise that operates

advertising as its main business, and the investing party must have been established and in operation for at least three years prior to entering the Chinese market.

2. to establish a Sino-foreign Joint Venture (“JV”), the investing parties must be enterprises that engage in the advertising business, have been established/operating for at least two years and have a good performance record in the advertising industry.

An advertising foreign invested enterprise that wants to set up a brand office must have first paid the full amount of its registered capital and have an annual advertising turnover of not less than RMB 20 million.

With respect to the registered capital, it shall not be less than the amount needed to establish the operations of the company as set out in the feasibility study filed by the investor when it applies to set up its operations in China.

China is currently drafting a new “advertising law” that will expand the regulatory control of advertising and establish more accountability for advertisers. It is anticipated that the new advertising law will be issued in the next 1-2 years.



Science and technology industries are an increasingly important focus for the Chinese government. In a policy entitled The State's Program for Medium and Long Term Development of Science and Technology (2006–2020), the Chinese government identified several top priority areas for development including energy, water and mineral resources, the environment, agriculture, manufacturing, transportation, information technology, social medicine, city developments, public safety and national defence.

### **CROSS-BORDER TECHNOLOGY TRANSFER**

Both the import and export of technology (whether assigned or licensed) are regulated under the PRC's technology transfer regime. The main purpose of this regime is to prevent: (a) the indiscriminate import of foreign technology that is either unnecessary, has low energy efficiency, or pollutes the environment, and (b) the export of highly sensitive advanced technology. The regime classifies technology into three categories:

1. Unrestricted technology. Transfer of technology in this category only requires registration.
2. Restricted technology. Transfer of technology in this category is subject to Chinese governmental approval.
3. Prohibited technology. Technology in this category cannot be imported or exported. The Ministry of Commerce ("MOFCOM"), together with its local counterparts, is the administrative authority responsible for administering and regulating cross-border technology transfers.

### **MAJOR TECHNOLOGY SECTORS**

Some of the technology-related industries that represent investment opportunities for foreign investors are specified in the Catalogue for the Guidance of Foreign Investment Industries ("Catalogue"). These industries include, among others:

#### **Software Industry**

The Catalogue classifies the development and manufacture of software products as "encouraged". A foreign software company can easily establish a software development company anywhere in China in the form of a joint venture or a wholly foreign-owned enterprise. With the proper business scope, the Chinese enterprise would be permitted to distribute its own software products in China as well as those of third parties.

Instead of establishing a business presence in China, foreign software suppliers may wish to sell software products directly to their Chinese clients. In addition to the aforementioned cross border technology transfer regime that applies to the import of software products, foreign software suppliers should be aware that no person may deal with or sell software products in China that have not been properly registered with the Ministry of Industry and Information Technology ("MIIT"). It is usually the local importer of the foreign-made software products (rather than foreign exporters/suppliers) that is legally responsible for affecting the registration. Furthermore, due to foreign exchange controls in China, if a software license agreement is between a foreign licensor and a Chinese licensee, such agreement also needs to be registered with the National

Copyright Administration, so as to enable foreign exchange payments to be remitted to the foreign licensor.

Additional restrictions also apply to the import and sale of foreign-made encryption products in China. Certain foreign-made commercial encryption products can be imported to China by foreign-owned entities for their self-use only and cannot be sold or resold in China.

### **Telecommunications Services Industry**

Despite China's WTO accession commitments to allow foreign investors to hold strategic equity interests in Chinese telecommunications and Internet companies, telecommunications services in China remain in the "restricted" category and are heavily regulated by the government. For example, operating a website in China for commercial purposes, considered a telecommunications service, requires obtaining an Internet Content Permit. This permit will not be issued if foreign ownership in the company exceeds 50%.

### **Television, Broadcasting and Media Industry**

Dissemination of any media content is heavily regulated in China by the State Administration of Radio, Film and Television ("SARFT"). What is considered unlawful or inappropriate content under Chinese law is often very different from western standards.

Most broadcasting and media-related services in China are in the "prohibited" category of the Catalogue, though there are some exceptions. The operation of cinemas, for example, is under the "restricted" category, so that the majority of the equity interest in the entity must be held by a Chinese partner, whilst the import of digital TV technologies for use in China is actually "encouraged".

In an effort to open up the media market, SARFT issued regulations in 2004 permitting foreign investment in joint venture television, radio and film production companies. However, the scope of these permitted joint ventures is very limited and the Chinese government has recently tightened its control over the industry by issuing more restrictive regulations. SARFT has also extended its jurisdiction to cover video dissemination over the Internet.

### **Medical and Biotech Industry**

In general, development in the medical and biotech sector in China (which covers, among other things, genetic engineering, commercial production of anticancer drugs and traditional Chinese medicine) falls under the "encouraged" category in the Catalogue.

To bring drug production standards in line with international standards, the Chinese government has recently brought into effect new laws and measures to regulate the production of pharmaceuticals and health supplements (as well as their manufacturing, distribution, packaging, pricing and advertising). The State Food and Drug Administration ("SFDA"), is the government body that is responsible for monitoring and supervising pharmaceutical products and medical appliances and equipment in China. The SFDA has implemented new Good Manufacturing Practice ("GMP") standards for the manufacture of pharmaceutical products.

Clinical drug research activity in China is also becoming increasingly popular for foreign pharmaceutical companies due to lower costs and the availability of large pools of potential patients and high-quality hospitals to use as clinical study centres.

Foreign pharmaceutical companies must contend, however, with lengthy approval processes to conduct their clinical trials. The SFDA is in the process of improving this process as well as developing and implementing more transparent regulations.

### **Personal Data Protection**

Although China’s laws or regulations do not specifically address data protection, the PRC Civil Law General Rules do contain references to the protection of individual personal rights. Additionally, there are various internal rules or administrative notices regarding data protection in specific industries, such as the financial sector and general personal data protections in relation to employee data.

Promulgation of a PRC Personal Data Protection Law (“PDP”) has been taken into consideration in recent years. A draft PDP was proposed to the Legal Committee of the National People’s Congress on 29 December 2006 at the 10th Conference of the NPC committee. However, the time frame for implementation of the draft PDP is uncertain. The draft has not been officially published, but reports on the contents suggest that it will include mobile telephone numbers, residential addresses, medical records and career data. A specific government department will be created to administer and enforce the PDP.



Severe destruction of the environment has, regrettably, long accompanied China's economic growth. Increased public awareness in recent years, coupled with greater media coverage of community health concerns, has led the Chinese government to adopt more stringent legislation emphasising preventative procedural controls, with an aim to curtail the negative impact of commercial activities on the environment. These are intended to replace the "pay for pollution" policies that were previously in effect.

Foreign investors should always conduct comprehensive legal and financial due diligence to carefully evaluate the pitfalls related to environmental issues. Without this simple precaution, investors face the risk of grave damage to their reputation in China, where corporate social responsibility – particularly that of foreign entities – is increasingly being scrutinised by the Chinese government.

Since the Regulation on Administration of Environmental Protection of Construction Projects was issued by the State Council in 1998 ("EIA Regulation"), China has set up a comprehensive environmental impact assessment mechanism affecting the establishment, expansion and renovation of business facilities. Under the EIA Regulation, the environmental impact of a construction project must be assessed at several key stages: during the initial project proposal stage; as an accompaniment to feasibility studies; at the design stage; during construction; and finally, prior to project completion. The PRC Environmental Impact Assessment Law ("EIA Law"), issued by the National People's Congress and effective on 1 September 2003, tightens the

rules. According to the EIA Law, the Chinese government has also required government plans to meet these environmental impact assessment requirements. The EIA Law requires all investors, business operators, construction companies, technical consultants and governmental departments to pay increased attention to environmental compliance. Environmental impact assessments form a substantial portion of the due diligence necessary before investing in China.

Under the EIA Law, environmental impact assessments are meant to provide an analysis, forecast and assessment of the potential environmental impact of building plans and construction projects once they are implemented. The law sets forth the measures and countermeasures that would prevent or mitigate any adverse environmental impact, and the methods and systems for monitoring it.

Foreign investors are most directly affected by the provisions in the EIA Law relating to construction projects, which include not only the construction of new facilities but the renovation or expansion of existing facilities as well.

The EIA Regulation and EIA Law set forth three levels of environmental impact assessment. If there is the potential for a major impact, an environmental impact report is required, along with a comprehensive assessment of the anticipated impact. Additionally, the project developer must conduct a public hearing (unless national security is implicated) or otherwise collect feedback from the public and various experts before submitting applications to commence construction for governmental approval. If the

potential impact is likely to be slight, an environmental impact report form alone is sufficient, together with an analysis or special assessment of the resulting environmental impact.

If the potential impact is likely to be very minor, only the filing of an environmental impact registration is necessary. The PRC Ministry of Environmental Protection (“MEP”) can provide foreign investors with current standards for classifying potential environmental impacts of construction projects, along with a detailed list of examples.

The environmental impact report or report form must be prepared by a qualified professional environmental impact assessment institution. The project developer has the right to choose the institution that will conduct the assessment on its construction project.

For any given construction projects, the competent department for environmental protection administration will conduct the examination and approval of the environmental impact assessment documents. The MEP is responsible for the examination and approval of certain significant construction projects, such as nuclear facilities; projects of a top secret nature; construction projects that cover multiple provinces, autonomous regions or municipalities directly under the central government; and construction projects that are examined and approved by the State Council or the relevant government agencies authorised by the State Council. All other projects are examined and approved by the authorities at the level of the province autonomous region or municipality directly under the central government or their local counterparts.

Construction of a particular project is not allowed to commence prior to receiving approval of the environmental impact assessment documents from MEP or its local counterparts. In the event of non-compliance, the authorities have the right to issue a cessation order and impose penalties ranging from RMB50,000 to RMB200,000 (approximately US\$7,300 to US\$29,300). The individuals directly responsible for the construction project may also be subject to administrative penalties.

If major changes are made to a project’s nature, scale, location, production process or to the measures that have been put in place to prevent pollution and ecological destruction after approval has been obtained for the environmental impact assessment, the project developer must resubmit the environmental impact assessment documents to the authorities and obtain approval for such changes. The EIA Law also provides that, if construction on a project has not commenced within five years from the approval date of the environmental impact assessment, re-examination by the original approval authority must take place. Penalties similar to those mentioned above may be imposed for non-compliance with such resubmission and re-examination requirements.

During the process of a construction project, the project developer must adhere to the environmental impact report or report form and the environmental protection countermeasures raised in the examination and the approval opinion. If the actual impact of the construction or operation differs from that outlined in the approved environmental impact documents, the project developer is required to assess and correct the difference, and to file a

report in this regard with the original environmental impact assessment authority and project approval authority. MEP or its local counterpart shall continue to follow up on the environmental impact generated once the project is put into production or use.

In addition to the penalties mentioned above, the PRC Environmental Protection Law (“EP Law”) imposes administrative, civil and criminal liabilities in the case of violation or non-compliance with the EP Law.

If a project is commissioned or put into action where the facilities for the prevention and control of pollution have not been completed, or fail to meet the requirements specified in state provisions, MEP or the local counterpart that approves the environmental impact assessment document may issue a cessation order and may even impose penalties. Furthermore, if an enterprise fails to eliminate or control the pollution by the deadline given by MEP or the local counterpart, it will be

required to pay a fee for excessive discharge. An additional penalty may be imposed on the basis of the damage incurred or the enterprise may be ordered to suspend or close down its operations.

An enterprise that has seriously polluted the environment is obligated to clean up the pollution and pay compensation to parties that have suffered direct losses as a result of the pollution. Affected parties may file a lawsuit within three years after the party becomes aware, or should have become aware, of the losses resulting from the pollution.

If a violation of the EP Law causes a serious environmental accident, leading to massive losses to public or private property, human injury or death, those directly responsible for the accident shall be investigated for criminal liabilities according to the PRC Criminal Law. They may also bear legal liabilities for any damage caused to natural resources such as land, water, flora and fauna.



## OBTAINING FINANCING IN CHINA

# OBTAINING FINANCING

It is often difficult for foreign investors to obtain local financing in China, especially when a company is newly established and has no track record or financial statements. Unless the new company is part of a multinational company supported by international financial institutions that have branch offices in China, it may take some time for the new company to build up a track record that will satisfy the credit requirements of local financial institutions.

In order to assist the new company in obtaining immediate local financing, it is not uncommon for the parent company to request its banker in its home country to issue a bank guarantee or standby letter of credit supporting the credit facilities extended by a financial institution in China to the new company.

If the new company is export driven, many financial institutions in China may provide export credit facilities such as an export letter of credit, negotiation, factoring, Documents against Payment (“D/P”) or Documents against Acceptance (“D/A”) discounting as well as account receivable financing. Once the new company becomes financially independent, it may gradually reduce the support of the bank guarantee or standby letter of credit issued by the banker of its parent company. This has proved to be a very effective way of facilitating the new company in obtaining local financing in China at its initial stage of development. As an increasing number of international banks are being approved to handle RMB business in China, such banks may grant both foreign and local currency loans to its borrowers.



# INITIAL PUBLIC OFFERINGS

The capital market in China is still developing. During the last several years, the capital market in China underwent a number of reforms including the major amendments to two laws – the Company Law and the Securities Law.

The amended Securities Law, which came into effect on 1 January 2006, forms the legal framework governing the initial public offer of the stock of a PRC joint stock limited company.

The amendments to the laws are consistent with the Chinese government's objective to improve and further develop the capital market in China and to attract foreign investments into China's securities market. In recent years, an increasing number of securities companies in China have been jointly owned by Chinese and foreign entities and more qualified foreign institutional investors, who are allowed to invest in A shares, have been entering the market.

## CRITERIA FOR THE ISSUE OF NEW SHARES IN PUBLIC OFFERING

While the amended Securities Law does not clearly define the term "public offering", it does stipulate that an offering shall be deemed to be a public offering if any of the following occurs:

- (i) an issue of securities to an indefinite number of offerees;
- (ii) an issue of securities to more than 200 designated offerees; or
- (iii) any other issuing activities as prescribed by laws and administrative regulations.

Under the amended Securities Law, the criteria for the issue of new shares have been relaxed. In accordance with Article 13 of the amended Securities Law, companies which issue new shares publicly shall:

- have a well-established and well-operated structural organisation;
- have continuous profit-making capability and be in good financial condition;
- have no record of false information in their financial and accounting documentation for the last three fiscal years and not have undertaken any other material illegal activities; and
- fulfil other conditions as prescribed by the securities supervisory authority and as approved by the State Council.

## APPLICATION FOR A PUBLIC OFFERING

Once a joint stock limited company is established and intends to carry out a public offer, it is required to submit the following documents to the China Securities Regulatory Commission ("CSRC"):

- (i) the company's articles of association;
- (ii) the agreement concluded between the promoters of the company;
- (iii) the capital verification certificate relating to the capital contributed by promoters;
- (iv) its prospectus in relation to the public offer;

- (v) the names and addresses of receiving banks;
- (vi) the names of underwriters (together with the underwriting agreement); and
- (vii) a sponsor's letter (if the public offer is required to be sponsored under the Securities Law).

The sponsor's role is to ensure that their clients satisfy legal requirements and to independently investigate and verify information contained in their clients' prospectuses. The amended Securities Law adopts a stricter approach to information disclosed to the market in connection with the public offer. The object is two-fold: first, to ensure that all information pertinent to the offer is available in the market and second, to hold the sponsors/advisors accountable for information that they verify. This improves reliability of the information disclosed to the market and will, thus, bolster investors' confidence in the market.

## CRITERIA AND APPLICATION FOR THE LISTING OF SECURITIES

Under the amended Securities Law, shares and other securities that are publicly offered are required to be listed and traded on authorised stock exchanges. Listing applications are now to be filed with stock exchanges for examination and approval, a responsibility that will take over the role previously handled by the CSRC. Listings will also be governed by listings' agreements between the applicants and the relevant exchange. At present, there are two stock exchanges in Mainland China – the

Shanghai Stock Exchange (established on 26 November 1990) and the Shenzhen Stock Exchange (established on 1 December 1990). In addition to the main boards in these exchanges, China recently added ChiNext, a new NASDAQ-like board for start-ups and high growth enterprises, to the Shenzhen Stock Exchange.

A joint stock limited company wishing to apply to list its shares must fulfil the following general criteria, which may change depending on the stock exchange and the board on which listing is being applied:

- the public offer of its shares must be approved by CSRC;
- the total capital of the company shall not be less than RMB30 million (which was RMB50 million before the amendment of the Securities Law);
- the shares under the public offer must represent more than 25% of the total shares of the company, or more than 10% of the total shares of the company (if the total capital of the Company exceeds RMB 400 million);
- the company must not have undertaken any material illegal activities or have any false records in its financial and accounting reports for the three preceding years.

Assuming the listing requirements are satisfied, the applicant must submit the following documents to the relevant stock exchange:

- (i) the listing application;
- (ii) the shareholders' resolution of the company approving the application for listing;

- (iii) the company's articles of association;
- (iv) the company's business licence;
- (v) the company's financial and accounting reports for the three preceding years, which have been certified by authorised entities;
- (vi) a legal opinion and sponsor's letter;
- (vii) the latest prospectus; and
- (viii) any other documents required under the listing rules.

### **LIABILITIES FOR THE DISSEMINATION OF MISLEADING INFORMATION AS PART OF THE PUBLIC OFFERING**

The amended Securities Law widens the classes of persons who are liable for disseminating false or misleading information or material omission

and now includes directors, supervisors and senior managers of listed companies as well as the issuer, sponsor and underwriters. The use of mass media to publish misleading commentaries on securities is prohibited and those publishing such information are liable to investors for the losses they suffer as a result.

### **THE ISSUE OF DERIVATIVE SECURITIES**

The amended Securities Law permits for the first time trading in derivative products, subject to separate regulations to be issued by the CSRC.



The PRC has become one of the premier destinations for large pools of investor capital. Investments in Chinese companies have been amongst the top performers globally in terms of capital returns to investors. Companies like Baidu.com, Focus Media, New Oriental and Fuqi International have demonstrated that funds with a China presence can provide substantial returns to investors (for example, the initial investors in Baidu.com enjoyed returns of greater than 100 times the amount of invested capital, representing an internal rate of return of 131%).

Venture fundraising in China saw a record high in 2007 and again in 2008, with investments in China and China-related businesses reaching US\$3.25 billion for 2007 – eclipsing figures from previous years by a wide margin. During this period, 440 Chinese companies received VC investment.

This trend continued during 2008, with venture investments reaching US\$4.21 billion according to Zero2IPO Group’s 2008 annual survey, a 29.75% increase from 2007. In addition, 116 new funds raised US\$7.31 billion in 2008, with US\$4.97 billion raised in foreign currencies and the remainder in RMB-denominated funds.

Despite the influx of foreign capital into China, the PRC regulatory system governing foreign investment in China is not always fully transparent or designed to encourage foreign venture capital or private equity investment. Although the Chinese government has taken steps to improve the existing regulatory environment, some challenges still remain for investors.

## REGULATORY RESTRICTIONS

A number of key industries remain classified as “restricted”, meaning that any foreign investment in the sector is heavily regulated by the Chinese government. Although PRC regulations governing these sectors are beginning to liberalise, the progress continues to be slow. In particular, foreign investment remains restricted in the telecommunications, new media, wireless applications and Internet sectors. Content-driven industries such as IPTV broadcasting, new media publishing and digital content streaming, for example, are all “hot” industries, but are difficult for foreign investors to access without guidance from innovative legal and business counsel.

In addition, certain recent PRC laws that attempt to address the increase in foreign investment have actually created greater ambiguity with regard to their implementation and enforcement. For instance, in 2005, the State Administration of Foreign Exchange’s (“SAFE”) issued the notorious Circular 75, which imposes registration requirements on all PRC residents prior to the establishment of an offshore holding company. Circular 75 itself replaced two circulars issued earlier in the year by SAFE that had had the perhaps unintended effect of freezing venture capital investment into China for a period of six months.

In 2006, the Ministry of Commerce and several other regulatory bodies jointly issued the Provisions on the Merger and Acquisitions of Domestic Enterprises by Foreign Investors (“M&A Rules”), effective on 8 September 2006. The M&A Rules introduced the long-awaited share swap mechanisms, which permit foreign investors to acquire domestic Chinese companies

using publicly traded shares as consideration. Unfortunately, the M&A Rules also included a number of ambiguous provisions concerning the establishment of offshore special purposes vehicles, resulting in additional regulatory approvals in connection with private equity and venture capital transactions. To date, interpretative regulations on the M&A Rules have not been released.

More recently, in the wake of the world-wide financial crisis, the Chinese government moved quickly to adopt measures intended to bolster employment, boost domestic demand and encourage foreign investment. The government's actions during 2009 have generally been favourable towards foreign investment.

The most significant step taken from the perspective of venture capital investors may have been the adoption by the Ministry of Commerce ("MOFCOM") of the *Circular on Further Improvement of the Examination and Approval Process Regarding Foreign Investment* [Shang Zi Han No. 7](2009) ("**Circular 7**"), which became effective on March 5, 2009. Circular 7 was adopted on the heels of a more general statement of policy announced by MOFCOM on March 4, 2009 setting forth general principles and public policies targeted at encouraging additional foreign investment as well as promoting key domestic industries.

Pursuant to Circular 7, MOFCOM delegated its approval authority over a number of categories of investments and merger and acquisition activities to its local counterparts. If an investment or acquisition is under certain financial thresholds and relates to industries identified by the government as encouraged or

permitted, such transaction can now be approved by MOFCOM's local counterparts.

As a result, many investments or acquisitions that previously would have been required to be submitted to central MOFCOM can now be approved locally, which historically greatly shortens and simplifies the corresponding approval process.

## CURRENCY EXCHANGE

If a venture backed company will have Chinese resident shareholders, prior registration by the Chinese shareholders with China's State Administration of Foreign Exchange is required as a condition to closing the investment. Such registration is critical as if it is not obtained, the company's operating subsidiary may have difficulty in the future in repatriating dividends or other distributions to its offshore holding company and the offshore holding company may not be able to consolidate the financial results of the Chinese subsidiaries.

Though foreign exchange restrictions continue to present obstacles for foreign capital in China, it is widely believed that the continued loosening of the Renminbi's tie to the US dollar will further benefit the investment climate. With the continued relaxation of currency exchange controls, obtaining liquidity from investments made in China should gradually become easier for foreign investors.

## TAXATION

Although China's tax laws are less established than those of more developed nations, sufficient regulations and laws exist that, so long as a foreign investor is well advised with respect to

various tax provisions, taxation issues can be managed effectively.

The Chinese government has not adopted specific tax schemes to encourage for venture investments, which are generally treated in the same fashion as other forms of investment by offshore investment vehicles such as joint ventures or wholly-foreign owned subsidiaries.

### High-technology Enterprise Tax Incentive Scheme

The PRC tax regime does provide certain tax incentives to encourage and facilitate the development of venture capital enterprises for local Renminbi denominated funds investing in high-technology enterprises, including for funds structures as co-investments by foreign funds.

Specifically, according to the PRC Enterprise Income Tax (“EIT Law”) and its implementation rules, as well as Guoshuifa [2009] No. 87, domestic and foreign invested venture capital companies established in China are now allowed a tax deduction equal to 70% of their investment in non-listed small and medium-size hi-technology enterprises after two years of investment. In addition, unused deductions are eligible to be carried forward and used in subsequent tax years upon the satisfaction of certain criteria.

In order to qualify for the foregoing tax incentives, the venture capital enterprise must meet the following criterion:

- It must be an enterprise or other economic organisation established in China pursuant to the “*Interim Measures for Administration*

*of Venture Capital Enterprises*” or “*Provisions on Administration of Foreign-Invested Venture Investment Enterprises*”;

- It should have an industrial and commercial registration as a “venture capital limited liability company” or a “venture capital joint stock company”; and
- A small and medium-sized hi-tech enterprise invested by venture capital enterprise shall (i) be recognised as a hi-technology enterprise in accordance with the *Measures for the Administration of the Recognition of Hi-tech Enterprises* and its implementation guidelines, and (ii) meet the requirements that its number of staff does not exceed 500, its annual sale revenue does not exceed RMB 200 million and its total assets do not exceed RMB 200 million

In addition, a venture capital enterprise formed as a legal person enterprise in China is considered a tax resident in China for tax purposes and as such is subject to enterprise income tax on its worldwide income, a major disadvantage that, until its application to foreign funds and their non-China portfolio companies is clarified, will continue to discourage participation in such investment vehicles by foreign venture capital funds.

### EXIT STRATEGIES

The investment exit remains a primary concern for foreign investors, and identifying the appropriate investment exit for a particular investee enterprise is critical. While public offerings on an offshore stock exchange

continue to be a favoured exit approach for many venture and private equity funds due to higher perceived valuations, trade sales and secondary portfolio sales have gained in importance as access to the capital markets has been negatively impacted by both the financial crisis and new regulatory hurdles introduced by the Chinese government to encourage listings on the local Chinese stock exchange.

### Offshore Listings

In particular, since the promulgation of the M&A Rules, offshore listings of venture-backed companies, while still legally permissible, have been confronted with additional layers of approval at the Ministry of Commerce and the China Securities Regulatory Commission. As such, only a small number of venture-backed companies established after 2006 have been able to list overseas, and in the majority of such limited cases such listings were effected through reverse take-overs or similar arrangements.

### Trade Sales

In general, putting commercial considerations aside, the most efficient way to exit an investment in China is via an offshore trade sale whereby the investor transfers its equity interest in the holding company at the offshore level, thus by-passing certain of the more burdensome Chinese regulatory, taxation and foreign exchange issues noted above.

## STARTING A VENTURE CAPITAL FUND IN CHINA

The most common investment structure for a foreign venture capital fund is still an offshore limited partnership, often established in the

Cayman Islands or a similar offshore jurisdiction. The fund then invests directly in its portfolio companies, the majority of which establish an offshore parent company to receive the funds and to serve as the holding company for operations located in China.

The Chinese government has also adopted regulations permitting foreign firms to establish investment funds within China. The Foreign-Invested Venture Investment Enterprise Administrative Regulations (“FIVIE Regulations”) were jointly issued by various Chinese governmental authorities with the goal of facilitating foreign venture capital and private equity investment into China through the creation of new special purpose investment called a foreign invested venture capital enterprise, or FIVCE. An FIVCE can hold interests in multiple enterprises simultaneously using well-established foreign investment vehicle structures.

Depending on its structure, an FIVCE may be either a legal person FIEVCE or a non-legal person FIEVCE. Legal person FIEVCEs have a separate legal personality from their investors under Chinese law and can be established in the form of a Joint Venture (“JVs”) or Wholly Foreign-Owned Enterprise (“WFOE”), each of which have been commonly used investment vehicles for foreign direct investment.

In addition to regulation in the jurisdiction of incorporation of the fund, a venture fund investing in China needs to take particular care to take account of “permanent establishment” considerations when setting up its local office as well as where its investment professionals reside and sign the definitive documentation for each investment. In particular, this may occur

if the venture fund engages in investment management or consulting businesses directly instead of through a separate Chinese fund management company.

As such, venture funds considering a Renminbi-denominated fund will typically engage a local management company, which then must meet certain requirements, including that:

- it must be engaged in venture investment management as its primary business;
- it must have at least 3 venture investment professionals each with at least 3 years of investment experience;

- it must have registered capital or total contributed capital of at least Renminbi 1 million (or equivalent in foreign exchange); and
- it must have an adequate internal control system.

If due care is not taken, the foreign fund may become subject to onerous taxation rules for venture capital enterprises operating in China and worse still, may expose their world-wide income to China taxation under PRC Enterprise Income Tax Law and its implementation rules.



## CONTINUING LEGAL REQUIREMENTS

# IMPORT AND EXPORT

Import and export in China is regulated by the China Customs, a ministerial department under the State Council of the PRC. The PRC's General Administration of Customs ("GAC") is the leading authority of Customs administration in China and is responsible for the united administration of all Customs activities throughout the country.

China's accession to the WTO and its dramatic increase in import and export trade volumes mean that China Customs is now playing an exceedingly important role in the development of foreign trade and investment in the Mainland.

### IMPORT TO CHINA

China Customs, as part of its ongoing reform, has adopted uniform Customs clearance procedures at all levels, which has led to a dramatic improvement in the predictability and certainty of this process throughout China. The documentation requirements for importing products into China, which are similar to those required in many other countries, include the following:

- declaration form
- required attachments to the declaration form
- bill of lading/manifest or other shipping list
- commercial invoice or a pro forma invoice
- packing list
- contract
- licensing documents (if applicable)

The Customs clearance procedure essentially involves five basic steps that are jointly performed by the provincial customs district and the local

Customs office. First, the importers or Customs brokers will fill out the declaration in writing. Then, an authorised company in the local Customs office will transmit the data electronically through the EDI system to the "electronic data examination centre".

Customs brokers, who can be hired to help process the declaration, are required to pass a national examination and register with Customs to become a lawfully established declaration entity. They have different responsibilities depending on the situation:

Where a Customs broker is handling the Customs declaration procedures under the name of that consignee or consignor, they must submit a power of attorney signed by the consignee or consignor to Customs. The broker is also required to conduct a rational examination and investigation of the authenticity of the circumstances provided by the consignee or consignor.

The Customs broker is required to "truthfully, correctly and entirely" keep all declaration records for a minimum of three years.

Next, the electronic data examination centre will automatically check the format of the data, and then transfer it to different Customs officers according to the specific type of goods declared. The Customs officers will check the valuation and classification of each entry, which will be released and sent back to the local Customs house.

Third, the importer or its Customs broker will provide the Customs officer at the local Customs port with the paper declaration form along with all other required documents.

The Customs officer will manually check the authenticity of the attached documentation and confirm that they are consistent with the declaration form. Subject to a risk analysis of the goods, the local Customs office will determine whether a physical examination is necessary or not.

Fourth, China Customs will either examine the goods or take samples from them. The examination can be performed at a contained examination station, a Customs facility or, if the appropriate arrangements are made, at the importer's premises. Other border agencies, such as the State Administration on Quality Supervision Inspection and Quarantine, may also inspect goods within their jurisdictions. The good news is that, in recent years, examinations conducted for non-transparent reasons have decreased. The previously mandatory physical examination requirement for certain sensitive goods (such as vehicle components) has now been abolished, and the overall examination rate is expected to drop further with the introduction of risk management mechanisms.

Finally, it is possible that the imported goods will complete the above procedure and be released on the same day that the Customs declaration is made, as long as all duties and taxes are paid. However, goods can be released prior to the completion of Customs formalities if the importer provides a security.

As a result of WTO accession, China now charges basically four import tariffs: general tariffs, Most-Favoured-Nation tariffs, preferential tariffs and a special preferential tariff.

China has in recent years made substantial tariff reductions in many sectors. The average import tariff is reduced from 10.4% in 2004 to the current rate of 9.8%. China has committed to keep this 9.8% average import tariff through the year of 2010.

There are special concessions covering tariffs on goods exported from Hong Kong and Macau to China.

For import tariffs, Value-Added Tax (VAT) and consumption tax (but only for some products) are charged. All importers of goods into China must pay value-added tax. The normal VAT rate is 17%, except for certain goods (e.g. cereal and edible vegetable oils, books, newspapers and magazines, tap water, heaters, air-conditioning, hot water, coal gas, liquefied petroleum gas, natural gas, biogas and coal products for residential use) whose import is subject to a 13% rate).

## **BORDER PROTECTION AND ENFORCEMENT FOR INTELLECTUAL PROPERTY RIGHTS**

In recent years, China Customs has attached great importance to the border protection of Intellectual Property Rights ("IPR"). Customs enforcement of IPR protection in China has proven effective and efficient for IPR holders.

Customs' IPR protection essentially covers three types of IPR: trademarks, copyrights and patents. Even though IPR registration is not mandatory under the Customs' IPR border protection regime, it is crucial if the IPR holder wants to ensure Customs enforcement of their IPR.

China Customs normally only enforces active protection measures (“the enforcement on duty protection”) on IPR that have been registered with the GAC. Unless specifically requested by the IPR holder, China Customs will not initiate any action against pirated products or other goods suspected of IPR infringement if the IPR has not been registered.

Under the IPR Regulation and the Implementing Measures on IPR Regulation, there are two major enforcement systems for China Customs IPR protection: “enforcement on duty” and “enforcement upon request”.

Depending on the enforcement of each of the two IPR protection systems, Customs and the rights holder have different responsibilities. The major differences between the two systems are:

- when an IPR holder applies to China Customs for protection of their rights and detention of the goods, the holder is not required to register the IPR with the GAC. Although the IPR registration is not a pre-condition for the IPR holder to apply with China Customs for IPR protection, when the IPR holder applies to detain the goods, the holder is still required to submit relevant certificates evidencing that it has the ownership of the IPR;
- in addition to presenting the written application for detaining the goods and providing the security (which must be equal to the value of the goods) to Customs, the IPR holder is also required to provide certain information and evidence relating to the IPR infringement;

- the most significant difference between the two systems is that under the “enforcement upon request” approach, Customs does not conduct any independent investigation into the suspected IPR infringement of the imported or exported goods and instead merely follows the court’s decision at every step. Therefore, the IPR holder has to play a more active role to initiate the court proceedings to protect their legitimate IPR.

## EXPORT OUT OF CHINA

In China, Customs requirements applicable to importers are similarly applied on exporters. For example, exporters must go through the same declaration procedures with Customs and submit the relevant documents. It must also provide evidence necessary for confirming the classification of goods, dutiable value and origins. The translation requirements of documentation associated with the export declaration are the same as that for import procedures.

In addition, the exporters are also required to truthfully declare the name; tariff number, specifications and type; price; charge for carriage, insurance and other relevant charges; origin; and the quantity of the exported goods. Customs will then examine said declarations, and may also conduct a procedural examination on the declared contents and a substantive verification after the goods are released (post-exportation audit).

Nonetheless, China Customs traditionally adopts a comparatively lenient approach towards export declarations than import

declarations in practice, as most exported goods do not result in the levy of duties. The overall examination rate for export goods is declining.

The Customs clearance procedure is comparatively simple and efficient throughout the country. However, problems do arise when, under certain circumstances, an exporter seeks to apply for Customs duty refund after exporting defective goods that were previously imported. In such a case, the exporter must fulfil the following conditions:

- there must be problems with the quality or specifications of the imported goods;
- the goods must be re-transported out of the Customs territory;
- the goods must be in their original state; and
- the application for duty refunds must be submitted within one year from the date of duty payment.

To prove that they fulfil the above conditions, the company should provide the following evidence:

- the inspection certificate from a local Administration of Quality, Supervision, Inspection and Quarantine (“Local AQSIQ”);
- notarised photograph and video records to show the original state of the goods;
- the agreement between the importer and the original exporter on return of the goods; and
- an export declaration form.

China Customs is currently transitioning from arbitrary discretion and uncertainty to rule-based administration, and the legal system governing

it is gradually evolving into a modern Customs administrative practice. It will take time for China Customs to streamline and optimise its regulatory system and implementing procedures.

A comprehensive, well-prepared and pre-emptive Customs compliance strategy is essential for a multinational enterprise hoping to ensure successful trade and investment performance in China. Equal importance should be attached to both the China Customs regulatory system and its implementing practices.

Establishing a long-term, effective interactive communication mechanism with the GAC and the provincial Customs district is very helpful for multinational companies in carrying out their business strategies in China.



Of the many types of taxes levied in China, those that most affect Foreign Investment Enterprises (“FIEs”) and Foreign Enterprises (“FES”) are:

- enterprise income tax;
- individual income tax;
- business tax;
- value added tax;
- consumption tax;
- real estate tax;
- urban land use tax;
- stamp duty;
- deed tax;
- land value added tax;
- vehicle and vessel purchase tax;
- vehicle and vessel use tax;
- city maintenance and construction tax; and
- resources tax.

## **ENTERPRISE INCOME TAX**

Enterprise Income Tax (“EIT”) applies to enterprises with income derived from production and business operations and other income in accordance with the Income Tax Law of the People’s Republic of China. Effective from 1 January 2008, the new Income Tax Law of the People’s Republic of China (“New Income Tax Law”) unifies the old income tax laws applying to foreign and domestic enterprises in China and a single set of laws shall then apply to all enterprises (including domestic enterprises, FIEs and FEs) for tax purposes.

## **Resident Enterprise and Non-Resident Enterprise**

Under the New Income Tax Law, all enterprises will be classified as either a “Resident Enterprise” or a “Non-Resident Enterprise”.

A Resident Enterprise refers to (i) an enterprise which is incorporated in China pursuant to PRC law, or (ii) an enterprise which is incorporated pursuant to the laws of a foreign country but has its actual place of management in China. A Resident Enterprise shall be subject to EIT on income derived both from sources inside and outside of China.

A Non-Resident Enterprise refers to an enterprise which is not incorporated in China nor has an actual place of management in China (but has an establishment in China). A Non-Resident Enterprise shall be subject to EIT on its PRC-sourced income as well as any overseas income that has an actual connection to its establishment(s) in China.

## **Taxable income**

FIEs, which are categorised as a Resident Enterprise pursuant to the New Income Tax Law, are subject to EIT on their worldwide income sourced in and outside the PRC. A foreign tax credit is allowed for income tax paid in other countries with respect to foreign sourced income derived by the overseas subsidiaries and/or branches of a FIE. The foreign tax credit is, however, limited to the PRC EIT payable on the same amount of income.

A Non-Resident Enterprise is subject to EIT only with respect to income sourced from the PRC. The taxation of a Non-Resident Enterprise also depends on whether it has

a “permanent establishment” in China. A Non-Resident Enterprise with a permanent establishment in the PRC would be subject to EIT on all income sourced from the PRC and attributable to the permanent establishment, while FEs without a permanent establishment in the PRC would be subject to a withholding tax on such income as dividends, interests, rentals, royalties, capital gains and other passive income sourced from China.

### Tax rates

Effective from 1 January 2008, all enterprises are generally subject to EIT at a standard rate of 25% on the taxable income. Reduced tax rates may be available for those enterprises engaging in specific industries, which will be discussed below.

The withholding tax rate applying to interests, rentals, royalties, capital gains and other passive income derived by FEs (with no PRC establishments) in China is 10% which may be further reduced according to the applicable double tax treaty concluded between mainland China and other countries.

### Tax incentives available to FIEs

Under the New Income Tax Law, most of the existing preferential tax treatments available for foreign investment enterprises pursuant to the old income tax laws would be abolished. The New Income Tax Law streamlines the current system by switching to more industry oriented incentives. These include the following:

#### Tax exemption/reduction

- Enterprises engaged in key infrastructure projects supported by the government (a three-year EIT exemption followed by a two-year 50% deduction on EIT rate);
- Enterprises engaged in eligible environmental protection, energy or water saving projects (a three-year EIT exemption followed by a two-year 50% deduction on EIT rate);
- Small-scale and low profit enterprises (a preferential rate of 20% applies);
- Qualified high and new technology enterprises (a preferential rate of 15% applies);
- Enterprises deriving income from agriculture, forestry, livestock, fishing industry (full or half EIT rate reduction);
- Venture capture enterprises investing in small and medium-sized high technology enterprises (extra deduction of 70% of the investment amount after holding the investment for two years).

### Additional deduction

The New Income Tax Law also provides the following deductions:

- Super deduction of R&D expenses for the development of new technology, new products and new production processes;
- Super deduction of salaries paid to disabled workers and other employees who are encouraged to be employed by the government;
- Accelerated depreciation on fixed assets by means of shortened depreciation lives or accelerated depreciation methods, for technological advancement reasons if necessary; and
- Tax credit based on certain percentage of the investment in special equipment purchased for purposes of protecting the environment, reducing the consumption of energy or water, increasing manufacturing safety, etc.

## Tax treaties

China has double tax treaties with a number of jurisdictions that seek to avoid taxation of the same income in more than one jurisdiction. In other words, any tax paid in one contracting state with respect to an income shall be allowed as a credit against the tax on that income payable in the other contracting state. Generally, double tax treaties cover any income tax (including both enterprise income tax and individual income tax), but not turnover taxes (e.g. business tax, value added tax, etc) that may be payable.

Currently, China has entered into double tax treaties with around 90 countries and regions (including Hong Kong Special Administrative Region), the majority of which have been effective.

## OTHER TAXES

### Business tax

Business Tax (“BT”) is levied on enterprises and individuals that provide labour services, transfer intangible assets or sell immovable property in China. BT is generally levied at the rate of 3% or 5% depending on the type of taxable activities performed by the enterprises or individuals in China:

(i) BT is levied at 5% on income earned from the transfer of intangible assets, sales of immovable property in China, or the provision of services related to the financial and insurance industries, agency, the hotel industry, food and beverage industries, tourism industry, warehousing industry, leasing industry, advertising industry and other non-vatable services industries;

(ii) BT is levied at the rate of 3% on income arising from the provision of services related to the transport industry, construction industry, post and telecommunications industries, culture and sports; and

(iii) BT is levied at the rate of 5% to 20% on income earned from the provision of services related to entertainment business.

### Value added tax

Value Added Tax (“VAT”) is imposed on enterprises and individuals that sell goods, provide processing or repair and replacement services or import goods into China. The standard VAT rate for goods sold or imported by the taxpayers (except for certain goods which are subject to VAT at a lower rate, e.g. 13%) and processing or repair and replacement services provided by the taxpayers is 17%.

In calculating the net VAT liabilities, please note that the amount of VAT on purchases for the current period (“Input VAT”) can be offset against the amount of VAT on sales (“Output VAT”) for the relevant period. The formula for calculating the net VAT is as follows:

**Net VAT payable = output VAT – input VAT**

In addition, input VAT paid on importation/ local purchase of materials for the production of exported goods can be fully or partially refunded in accordance with the prevailing export VAT refund policy. The refund rate may vary from 5% to 17% depending on the type of goods exported from China.

### Consumption tax

Consumption Tax (“CT”) is imposed on enterprises and individuals that produce, entrust third parties with processing or import consumer goods specified in the relevant rules and regulations on CT in China. Some of the examples of those consumer goods include tobacco, alcoholic beverages, cosmetics, gasoline and automobiles. CT is usually calculated at a fixed rate according to the price or at a fixed amount according to the quantity or the mixture of the above two methods.

## REAL ESTATE TAX

Real Estate Tax (“RET”) is payable by the individual or corporate owners of the properties situated in China. RET is calculated based on the original value of the property or, if the property is leased out, the rental income of the property.

If RET is calculated based on the original value of the property, a statutory deduction of 10% to 30% of the original value will be allowed. URET will then be levied at the rate of 1.2% of the net value. The specific rate of deduction shall be determined by the local government and may vary from city to city.

If the property is for rent, URET can be calculated based on the rental income at 12%.

### Stamp duty

Stamp Duty (“SD”) is levied on enterprises and individuals that conclude or receive any of the following documents:

- (i) documents issued for a purchase and sale transaction, process contracting, property leasing, commodity transportation, storage and custody of goods, loans, property insurance, technology contracts, engineering project reconnaissance and design contracts, construction and installation project contracts and other documents of a contractual nature;
- (ii) documents involved in the transfer of property by purchase, sale, inheritance, gift, exchange or division;
- (iii) documentation of rights or licences; and
- (iv) other documents declared to be taxable by the tax authorities. SD is calculated at a fixed rate according to the contract

amounts (ranging from 0.005% to 0.1% depending on the nature of the taxable documents) or at a fixed amount per document. Specific SD exemption may be available to certain types of contracts or documents.

## INDIVIDUAL INCOME TAX

Individual Income Tax (“IIT”) is imposed on all individuals (including local PRC and foreign nationals) residing in or earning income from the PRC in accordance with the Individual Income Tax Law of the People’s Republic of China (“IIT Law”) and the Detailed Rules for the Implementation of the Individual Income Tax Law of the People’s Republic of China (“Detailed Implementing Rules”).

### Taxation of individuals working in China

An individual who is domiciled in China is subject to IIT on all of his worldwide income regardless of type (i.e. wages and salaries, capital gains, dividends, interest, rent, etc). The Detailed Implementing Rules define the term “wages and salaries” to include cash awards, bonuses, allowances, subsidies and other compensations received by an individual for the tenure of employment.

An individual who is not domiciled in China is subject to IIT on “PRC-sourced income” mainly depending on how long the individual stays in the PRC. For the purpose of determining the individual’s tax liability, only the days on which the individual was actually present in China are counted. The day on which the individual leaves, enters, enters and leaves, or makes multiple entries shall be counted as a whole day for this purpose.

Notwithstanding the above, certain types of PRC-sourced income (such as royalty, interest or rent) are subject to IIT irrespective of whether the individual spends any time in China during a calendar year.

### **Taxable income**

An individual who is not domiciled in China, i.e. foreign nationals residing in China for not more than five “full” consecutive years (a foreign individual who is based in the PRC but spends more than (i) 30 days on a single trip or (ii) 90 days in the aggregate outside the PRC during any calendar year will not be considered to have spent one “full” year in PRC for tax purposes) is generally subject to IIT on “PRC-sourced income”. The term “PRC-sourced income” is defined to include “income from personal services provided inside the PRC because of the tenure of office, employment, the performance of a contract, etc”.

In addition, the following items, among others, derived by foreign nationals working in China are “temporarily exempted from IIT”:

- (i) reasonable allowances for housing, meals and laundry services received in a non-cash form or on a reimbursement basis;
- (ii) reasonable one-off relocation costs on a reimbursement basis;
- (iii) reasonable allowances for business trips both inside and outside the PRC;
- (iv) allowances for the expatriate’s language training, and children’s education in China, provided the costs are supported by valid invoices and approved as reasonable by PRC tax authorities; and

- (v) home leave pay for the expatriate, whereby the expenses are restricted to the expatriate’s travel expenses and shall not exceed two trips to return to his/her home (including the residence of his/her spouse or parents) during a single calendar year.

### **Tax rates**

IIT is charged at a progressive rate from 5% to 45%. Foreign nationals with PRC-sourced income can now deduct RMB 4,800 (the standard deduction being RMB 1,600 and the extra deduction amounting to RMB 3,200) each month against his/her monthly income effective from 1 January 2006.

### **Tax withholding obligations**

Any entity or individual that pays income on which IIT is payable must act as a withholding agent. If a withholding agent fails to withhold or collect tax as required, tax authorities will pursue with the taxpayer the tax that should have been withheld or collected, as well as the corresponding interest, penalties and/or surcharges. At the same time, a penalty will also be imposed on the withholding agent in this regard.

Since 1 January 2000, the withholding requirement has also applied to wages and salary payments made by the parent or affiliated company outside of China to expatriate employees of the entity in China. Accordingly, the entity in China is obligated to withhold taxes on wages and salary payments made to the PRC and expatriate employees by either (i) the parent or affiliated company outside of China; or (ii) the entity in China.

## CONTINUING LEGAL REQUIREMENTS

# SUPPLY CHAIN

As China opens up its distribution and retail sectors, the legal regime affecting the supply chain in China continues to change rapidly, affecting both suppliers and customers alike in a large number of industries.

With China's accession to the WTO in 2003, China took a major step in opening its distribution and retail sectors to foreign investors through the promulgation of the Measures for the Administration of Foreign Investment in Commercial Sector ("Commercial Sector Measures"), made effective on 1 June 2004.

### DISTRIBUTION (WHOLESALE)

A foreign investor wishing to conduct business activities in China out of a fixed location is required to first establish a registered presence at that location (e.g. a representative office, or a Foreign Investment Enterprise ("FIE") such as a Wholly Foreign-Owned Enterprise "WFOE") or a Sino-foreign joint venture). Each registered entity must be given an approved business scope which is stated on its business licence, and is only approved to conduct activities within the business scope.

Prior to 11 December 2004, wholesale and retail sectors in China were largely closed to foreign investors (with the exception of large investments, such as hypermarket chain stores). Foreign investors were only allowed majority ownership through Chinese foreign joint venture wholesale enterprises. Thus, government approval authorities could not grant a WFOE with a business scope that permitted the WFOE to conduct pure wholesale activities. A FIE was essentially only allowed to sell (including domestic and export sales) what it made. This created inefficiencies in the supply chain. For

example, two FIEs belonging to the same group of companies but making different products in the same product line could neither sell each other's products, nor sell imported products without any manufacturing value added. Thus, separate sales teams had to be maintained for the sale of the respective products manufactured in China and also for the imported goods.

Over time, a number of solutions were developed in the market, but none were perfect. The two most commonly used vehicles for distribution prior to 11 December 2004 were the establishment of Bonded Zone Trading Companies ("BZTCs") and Holding Companies ("HoldCo").

The establishment of a BZTC essentially enables a FIE to conduct buy/sell activities with any Chinese or foreign company.

Nonetheless, one of the major drawbacks of using the BZTC vehicle is that it lacks the capacity in its business scope to conduct so-called "domestic trading" activities, i.e. the purchase and subsequent resale by a BZTC of goods made in China without involving an import/export company.

Among the various preferential treatments available for HoldCos is the limited right to distribute products (i.e. buy/sell products) in China: for example, buying and reselling goods produced by their FIE manufacturing subsidiaries, and importing and distributing products from their parent companies for trial sale. However, HoldCos were not given full rights to conduct domestic trading until after 11 December 2004. In any event, they are not an ideal choice of vehicle for foreign investors wishing to distribute because of the high threshold of investment required (US\$30 million of registered capital).

Since 11 December 2004, it has been possible for a foreign investor to establish a Foreign Invested Commercial Enterprise (“FICE”) in the form of a WFOE, which is permitted to conduct “pure” distribution/ wholesale activities (“Wholesale FICE”), namely merchandise wholesaling, commission agency (excluding auctioneering), import and export of merchandise, and related ancillary services, in China.

Essentially, a Wholesale FICE can perform the following distribution/wholesale functions without the involvement of third party agents/ organisations:

- buy/sell goods through a Chinese company (including another FIE) and issue/offset value added tax invoices;
- buy/sell goods with a foreign company (i.e. import/export), and attend to Customs clearance and procedures itself directly; and
- conduct general aftersales service (repair and maintenance), and buy/sell parts and components incidental to such services.

In view of the above, the PRC market is now more open to foreign investors contemplating engaging in procurement and after-sale services in China than ever before.

It must be noted that the Commercial Sector Measures still prohibit foreign investors from engaging in the wholesale of chemical fertilisers, processed oil and crude oil before 11 December 2006. The wholesale of salt and tobacco is expressly prohibited. In the past, the minimum registered capital requirement for setting up a Wholesale FICE was approximately US\$60,000. However, this capital requirement generally may vary

depending on the individual requirement of the local governments. Although the Commercial Sector Measures stipulate that the application must be approved by the Ministry of Commerce (“MOFCOM”), a recent MOFCOM notice has allowed the delegation of some of its approval authority to its provincial level counterparts and the Administrative Commission of the State level Economic and Technical Development Zones (collectively referred to as “local approval authorities”) from 1 March 2006.

## RETAIL

Like wholesale businesses, foreign investments were permitted only through majority ownership through Sino-foreign joint ventures in the retail sector prior to 11 December 2004. Since then, it has become possible now for a foreign investor to establish a FICE in the form of a WFOE engaging in retail business (“Retail FICE”).

According to the Commercial Sector Measures, a Retail FICE will be permitted to perform the following activities in China:

- retailing;
- import of the merchandise that it sells;
- sourcing and procuring China-produced goods for export;
- telemarketing, mail order sales, internet sales and vending machines sales; and
- related ancillary services.

It should be borne in mind that if a single foreign investor has 30 or more retail stores in China and distributes books, newspapers, periodicals, pharmaceuticals, pesticides, mulching film,

chemical fertilisers, grain, vegetable oil, sugar, cotton, etc. of different brands and sourced from different suppliers, the foreign investor's equity interest in the foreign invested retail enterprise will be limited to 49%.

In the past, the minimum registered capital requirement for establishing a Retail FICE was approximately US\$36,000. However, this capital requirement generally may vary depending on the individual requirement of the local government. Approval authorities are the same as for Wholesale FICES. However, local approval is still not permitted with respect to applications for distribution sales by means of television, telephone, mail order, internet and vending machines.

## **EXPANSION OF BUSINESS SCOPE TO INCLUDE WHOLESALE AND RETAIL BUSINESSES**

In addition to allowing the establishment of new Wholesale/Retail FICES, the Commercial Sector Measures allow foreign investors with existing FIEs (other than Wholesale/Retail FICES) to apply to expand the business scope of their FIEs to engage in wholesaling, retailing, franchising and/or commission agency business. For instance, a WFOE engaged in manufacturing can now not only distribute its self-manufactured goods, but also goods sourced from the other wholesalers provided that it obtains an approval for the expansion of business scope to include wholesaling.

As of 1 March 2006, local approval authorities may also approve applications for the expansion of business scopes to include distribution business by non-FICE entities.

## **FRANCHISING**

The Commercial Sector Measures have permitted foreign investors to establish joint venture franchising enterprises since 1 June 2004 and Wholly Foreign-Owned Franchising Enterprises (“Franchising WFOE”) since 11 December 2004. To further regulate franchising activities in China, the Measures for the Administration of Commercial Franchise Operations (“Franchising Measures”) were promulgated by the State Council on 6 February 2007 and took effect on 1 May 2007.

The Franchising Measures define “commercial franchising operations” as “an arrangement whereby a franchisor, by contract, authorises a franchisee to use its operational resources, such as trademark, trade name, patent, know-how etc, and the franchisee conducts business in accordance with the franchisor’s standardised business model and pays franchising fees in accordance with a franchising agreement.

A franchiser must meet the following qualifications:

- it must be an enterprise;
- it must be capable of providing the franchisee with long-term operational guidance, training support and business training;
- it must have two or more directly operated stores that have been operating for at least one year; and
- it must have a mature operation model.

According to the Commercial Sector Measures, approval to establish a Franchising WFOE must be made by MOFCOM.

The Franchising Measures require that a franchise contract entered into between a franchisor and franchisee should contain specific provisions, such as contents and term of the franchise rights, franchise fees, etc.

If an existing FIE wishes to carry on franchising activities in China, it will be required to apply to the original approval authorities that approved the establishment of the FIE for the inclusion of “engaging in commercial activities using the franchising business model” to its business scope.

## **DIRECT SELLING**

When China acceded to the WTO, it committed to lift the ban on direct selling within three years (i.e. by 11 December 2004). However, it was not until 1 December 2005

that the Regulations for the Administration of Direct Selling (“Direct Selling Regulations”) were promulgated by the State Council, one year behind the WTO schedule.

The long-awaited promulgation of the Direct Selling Regulations and the Regulations on the Prohibition of Pyramid Selling (“Anti-Pyramid Regulations”), promulgated by the State Council on 23 August 2005 and effective as of 1 November 2005, have only partially lifted the ban on direct selling. Pyramid selling is still restricted.

The term “direct selling” is defined in the Direct Selling Regulations as a method of sales whereby a direct seller recruits direct salespeople and the direct salespeople promote products directly to end consumers somewhere other than in a fixed place of business.



The scope for direct selling products is currently as follows:

- cosmetics (including personal care products and hairdressing products);
- health foods (with the Health Food Approval Certificate issued by relevant authorities);
- cleaning products (personal hygiene products and cleaning products for daily use);
- health instruments and devices; and
- small kitchenware.

There is no longer a requirement that direct sellers should be established as manufacturing type enterprises. The Direct Selling Measures narrow down the source of products by requiring that the direct sellers sell products produced by themselves or by their parent or holding companies.

It has yet to be clarified whether products produced by the affiliated companies of the parent or holding companies of direct sellers can be the subject of direct selling. The interpretation of this provision may have a significant impact on some direct sellers and should be taken into account when choosing the entity to act as the parent or holding company of a new direct seller in China.

Licensing requirements continue to be imposed on all direct sellers. To apply to become a direct seller, the following conditions shall be satisfied:

- the investor(s) have a good commercial reputation, and do not have a record of a major violation of the law in the five years immediately preceding the application; a foreign investor shall additionally have at least three years' experience in direct selling activities outside China;

- the registered capital of no less than RMB80 million must have been paid in;
- a bond must have been paid in full at a designated bank (see further discussions below); and
- information submission and disclosure systems must have been established in accordance with provisions.

According to the Commercial Sector Measures, approval to establish a WFOE engaging in direct selling must be approved by MOFCOM. When a direct seller or a branch thereof recruits a direct salesperson, it shall execute a sales' promotion contract with him/her and ensure that he/she engages in direct selling activities only in a region where a service outlet has been established in the administrative territory of a province, autonomous region or municipality directly under the central government where one of its branches is located.

In order to operate direct selling in a certain city or area, the direct seller must establish a branch in the applicable province (if the enterprise is not registered in that province), which must meet the requirements of the local county/district government or relevant higher level authority.

In addition to branches, the direct seller is required to set up certain service outlets (for the purpose of providing information regarding pricing and return policies and post-sales' services) where they operate. Again, the establishment of the service outlets must meet the requirements of the local county/district government or relevant higher level authority.

## ANTI-DUMPING AND COUNTERVAILING DUTY

While Chinese products are often targets of anti-dumping and countervailing duty investigations in global markets, Chinese producers also have the ability to protect themselves by requesting that the Chinese government initiate anti-dumping and countervailing duty investigations against products imported into China. With the elimination of most import quotas and the reduction of many tariff and non-tariff trade barriers, Chinese producers face increasing competition from foreign imports, particularly from chemical products and other basic inputs. Chinese industries, like their counterparts in other countries, have increasingly sought to strike back by invoking the country's anti-dumping and countervailing duty provisions.

China initiated six anti-dumping investigations in 2008 and eight antidumping investigations and three countervailing duty investigations in 2009. This clearly shows a trend of increase comparing with the number of initiations in 2006 and 2007.

Chinese anti-dumping actions are designed to address circumstances in which imports are being sold at less than their "normal value" to the extent that they are causing, or threaten to cause, material injury to the domestic Chinese industry, or will materially retard the establishment of a domestic industry. Where this is deemed to be the case, special antidumping duties are imposed on future imports from the targeted country at the level of the dumping margin. In certain cases, these special duties are so high that they effectively close off the Chinese market to foreign imports. As dumping margins are usually assigned specifically to each exporter, it is vital

that companies defend themselves in the case to obtain the lowest dumping margins to give them a competitive edge over their rivals.

Chinese countervailing duty actions are designed to address circumstances in which the exporters are subsidised by its home country government and therefore export their products at an unfair price to the extent that they are causing, or threaten to cause, material injury to the domestic Chinese industry, or will materially retard the establishment of a domestic industry. Where this is deemed to be the case, special countervailing duties are imposed on future imports from the targeted country at the level of the subsidy margin. Same as dumping margins, subsidy margins are usually assigned specifically to each exporter.

The prevailing law governing Chinese anti-dumping actions is the Anti-dumping Regulations of the People's Republic of China ("AD Regulations"), and the Countervailing Duty Regulations of the People's Republic of China ("CVD Regulations") for countervailing duty actions, the most recent amendments of which became effective on 1 June 2004. The AD Regulations and CVD Regulations are very similar in nature to the provisions of the WTO Anti-dumping Code and Countervailing Duty Code, but contain much ambiguity. By drafting the rules in this way, China follows an approach taken by many WTO members. As a result, transparency in China's investigative procedures remains a concern for foreign investors. It appears that the decisions of antidumping investigations and countervailing duty investigations are some time affected by the political atmosphere.

Under the current Chinese legal regime, Chinese anti-dumping and countervailing duty actions are jointly conducted by two departments of the Ministry of Commerce (“MOFCOM”) the Bureau of Fair Trade for Import and Export (“BOFT”), which is responsible for the initiation, investigation and determination of anti-dumping and countervailing duty actions, and the Investigation Bureau of Industry Injury (“IBII”), which is responsible for investigating the economic injury suffered by the domestic industry. MOFCOM is the ultimate authority in charge of the investigations, and makes all of the official announcements.

## GENERAL PROCEDURES

First, MOFCOM will announce its decision to initiate an anti-dumping and/or countervailing duty investigation upon its own initiation or in response to a petition from interested parties. BOFT and IBII will then issue questionnaires and require the companies exporting the subject product to China to submit their response, including a Chinese translation, within 37 days. Subsequently, BOFT and IBII may issue supplemental questionnaires to the respondents or hold public hearings on specific issues. They will then convene a meeting for interested parties with MOFCOM officials before a preliminary determination is made. Similar to US and European practices, MOFCOM officials may also perform on-site verification at the respondent companies’ premises to verify the completeness and accuracy of the information provided in the questionnaire and supplemental responses. The final determination is made within 12 to 18 months from the initiation of the anti-dumping and/or countervailing duty

investigation. At that time, MOFCOM will assign individual anti-dumping duty and/or countervailing duty rates for each respondent company, and Chinese Customs will begin the collection of import anti-dumping duty and/or countervailing duty on the imported subject products.

Four basic conditions must be established in a Chinese anti-dumping and/or countervailing duty investigation for the authorities to determine that a dumping duty and/or a countervailing duty shall be imposed:

- the product must have been sold to China at “dumping prices” or have been subsidised by the exporting country government;
- economic injury must have been suffered by the Chinese industry producing the like product;
- the “dumping prices” or “subsidised prices” must have caused economic injury; and
- the imposition of anti-dumping duties and/or countervailing duties must be in accordance with China’s public interests.



Exporters can influence these proceedings by (i) registering with the Chinese government agencies; (ii) compiling and supplying supporting information in response to government “questionnaires”; and (iii) appearing at government hearings. By being actively involved in the anti-dumping and countervailing duty investigation process, producers and exporters may be able to establish that they are not dumping and/or not subsidised and/or that the Chinese industry is not suffering from material economic injury, and therefore no dumping duties or countervailing duties should be imposed. Even if dumping or subsidy is found, the individual exporter’s input of information on the record may result in the lowest dumping margin or subsidy margin possible.

With respect to anti-dumping and countervailing duty actions filed in jurisdictions outside of China, foreign investors seeking to establish export oriented manufacturing businesses in China should take into account the increasing threat of antidumping and countervailing duty actions against China-made products brought by foreign governments, such as the United States and the European Commission. A key disadvantage for exporters of products produced in China is that China is still considered a Non-Market Economy (“NME”) by the US and the EU. Therefore, failure to obtain “market economy status” (in an EU anti-dumping case) or a “separate rate” (in a US anti-dumping case) will result in a much higher dumping margin than that imposed on exporters from market economy countries.



## CONTINUING LEGAL REQUIREMENTS

# REAL ESTATE

Land in China is owned by the State (described as “ownership by the whole people”), except for land in rural areas, which may be owned by collectives.

Prior to 1988, it was only possible to acquire the right to use land by way of administrative allocation by the State (“Allocated Land Use Rights”), and it was not possible to directly transfer Allocated Land Use Rights between different land users. Then, in 1988, the Chinese Constitution was amended on the basis of a newly recognised distinction between the “right of ownership” of land (which remains with the State or collectives) and the “right to use” land (“Land Use Rights”) which may be assigned, leased or mortgaged.

Instead of allocating land by administrative order, the State may “grant” (sell) Land Use Right (“Granted Land Use Rights”) for a certain period in return for a payment of “consideration” or a “premium”. Land users that were allocated Land Use Right under the old system may continue to use the land, but are not able to assign, lease or mortgage the land unless they go through the relevant procedures to obtain Granted Land Use Rights under the new system by purchasing such rights from the State.

Land Use Rights granted by the State for consideration can be privately owned. The PRC Property Law which came into force in October, 2007 (“Property Law”) provides for private ownership of Land Use Rights.

## GRANTED LAND USE RIGHTS

A grant of Land Use Rights refers to the act by which the State grants the right to use land for a certain period of time to a land user in return

for the payment of a substantial land grant premium. Granted Land Use Rights are granted by the local Land Administration Bureau by public listing and/ or auction or tender.

In order to obtain Granted Land Use Rights from the State, the land user enters into a land grant contract with the local Land Administration Bureau. The land user is required to pay the land grant premium in full within a specified period after the execution of the land grant contract. Usually the user must also develop the land within a certain period, and may only utilise the land for the purposes stipulated in the contract. Throughout the term of Granted Land Use Rights, the land user may sell, assign, lease or mortgage the rights and the pertaining property subject to the fulfilment of certain conditions.

The maximum term of the Land Use Rights granted depends on the intended use of the land. This breaks down to 40 years for commercial use, 50 years for industrial use, 70 years for residential use and 50 years for educational, health and cultural use. Upon the expiration of the stipulated term of the Granted Land Use Right, the government will recall the use rights and take possession of all real estate, such as buildings or fixtures, on the relevant piece of land without compensation. The term of the Granted Land Use Rights may, however, be extended subject to certain conditions and approval by the land authorities. Under the Property Law, Granted Land Use Rights for commercial use will automatically extend upon expiry of the 70-year term. The law is however silent on whether there will be any additional land premium payable for the extension.

## ALLOCATED LAND USE RIGHTS

Allocated Land Use Rights are Land Use Rights that are administratively acquired without consideration and with certain time limits. The authorities only allocate Land Use Rights for the construction of particular facilities for public interests, such as government, military, urban infrastructure, commonwealth, energy sources, transportation and water conservancy amenities. Allocated Land Use Rights cannot be assigned, leased or mortgaged unless converted into Granted Land Use Rights first. Where Allocated Land Use Rights are assigned without approval, the Land Administration Bureau may take back the land, confiscate the illegal revenue and/or impose a fine depending on the seriousness of the case.

## OTHER METHODS FOR ACQUIRING LAND USE RIGHTS

There are other ways to acquire Land Use Rights available in China, such as through lease or contribution by the government. These are relatively rare.

## DOCUMENTS OF TITLE

There has been a registration system implemented by local land authorities for registration of Land Use Rights and property ownership, which may vary from region to region. Land users and property owners must apply to the relevant authorities to obtain a property ownership certificate and/or a land use certificate. In most cities in the PRC, the land registration system and property registration system are maintained separately. However, in Shanghai, Shenzhen and other major cities, the two systems have been

consolidated and a single composite housing and land title certificate will be issued evidencing the ownership of both the Land Use Rights and the buildings located on the pertaining land.

Pursuant to the Property Law, China will establish a uniform real estate registration system. Registration of ownership with the local registry so established will be the exclusive evidence of title to a property including the Land Use Rights pertaining to it.

## COOLING-DOWN MEASURES

Since mid-2006, the Chinese Government has introduced a series of new rules and measures aimed at cooling down what is considered by it as an over-heated real estate market. This brings about great impact on foreign investment into the market. Pursuant to the cooling-down regime, offshore acquisition of properties in China is no longer allowed; foreign investors have to establish a business entity in China to be able to engage in real estate transactions.

Moreover, foreign exchange authorities have ceased to register any foreign debt created for real estate projects, which means, without such registration, repayments of offshore loans, whether granted by shareholders or by financial institutions, can no longer be lawfully remitted outside of China.

However, despite the Government's cooling down efforts, real estate remains a lucrative business sector in China and foreign investors and their professional advisors are geared to structure real estate transactions creatively in order to maintain a market share in the new regulatory environment.

## REAL ESTATE INVESTMENT TRUSTS

The China property market has undergone significant growth in recent years. Since 2001, real estate has emerged as one of the most appealing investment areas for domestic as well as foreign investors. This rapid development has attracted foreign investors from around the globe, initially from Hong Kong, Singapore and Taiwan, and more recently from the US, Europe and Australia. Among these, the number of institutional investors has also been increasing.

Beijing and Shanghai have naturally become the gateways for foreign investors to enter the China property market, although some foreign investors have also been moving recently into secondary cities to seek more exciting opportunities.

In terms of asset classes, the China property market presents a variety of choices for foreign investors, including residential developments, office and retail, industrial developments, serviced apartments, hotels and non-performing loan portfolios.



### REAL ESTATE INVESTMENT TRUSTS (“REITs”)

In the past 10 years, the PRC properties have been positioned for growth and despite its already large percentage gains, it seems that there still remains additional growth potential, and there will no doubt be considerable interest in REITs that invest in properties in China.

On the other hand, from the year of 2006, the Chinese Government has been increasing efforts to prevent the property sector from over-heating, introducing a series of new rules and regulations in an attempt to cool down the property market in China, including lifting the threshold of setting up foreign invested real estate company (“Real Estate FIEs”), restricting Real Estate FIEs from borrowing foreign debt, restricting Real Estate FIEs’ effective ability to borrow from local bank.

As a result, the PRC property market is intent on seeking funds through REIT. However, mainland China has yet to issue REIT-related regulations or listing rules. In addition, the legal taxation regime of mainland China does not present any benefit for REITs to become a sensible investment vehicle, which otherwise is the major reason why REITs are an attractive means of investment in the United States.

In 1999, the Monetary Authority of Singapore (“MAS”) promulgated the Guidelines for Property Funds in Singapore and it amended Securities and Futures Acts in 2001 to further provide REIT listing rules of Singapore Exchange (“SGX”). In 2005, the Securities and Futures Commission (“SFC”) in Hong Kong amended its code on REITs to allow REITs authorised by the SFC to invest in properties outside Hong Kong. Indeed, various investment bankers are currently busy forming their China property portfolios in preparation for a REIT listing in Hong Kong or Singapore.

## VARYING LEGAL STRUCTURES FOR REIT IN VESTMENTS IN CHINA

Generally speaking, the main decisions required for structuring a REIT are:

- whether the REIT will purchase property directly or purchase shares in an entity that owns the property; and
- if the REIT holds a property directly using a corporate entity, whether the corporate entity should be incorporated inside or outside of China. However, due to the cooling down regime, from mid-2006 holding properties in China via an offshore purpose vehicle is no longer possible, which means a REIT has to either incorporate or acquire a real estate company onshore to be able to effect investments in properties in China.

The optimal structure will depend on a combination of factors, including PRC regulatory issues such as exchange control, taxation and the existing property holding structure.

Tax is one of the important factors in deciding what legal structure to use as different tax implications may apply. Property transactions in China involve various taxes, such as business tax, deed tax, land value appreciation tax, land use tax and stamp duty. The amount of the applicable tax will vary depending on the location of the property. Purchasing shares in an entity that owns a property should remove the need to pay deed tax, which is payable upon the transfer of the properties. However, the entity would need to be, or should be restructured so that it is, a “clean” entity free from any other assets or liabilities. The entity may be a foreign-invested enterprise or a domestic company. The transfer of equity interest from or into a foreign-invested enterprise is subject to the approval of the relevant PRC government authority.



## **INTRODUCTION**

*“In the context of legal compliance and the market economy, corporations with no sense of social responsibility will lose their license to operate in the community.”*

*Liu Shaoyang, CEO China Southern Airways, in the company's 32 page CSR Report*

Liu Shaoyang does not overstate the necessity to make Corporate Social Responsibility (CSR) a key component of company strategy in China in 2010. Compliance with CSR Guidelines and the production of a CSR report will be compulsory for State Owned Enterprises (SOE's) by 2012. If they fail to comply with the regulations they will be criticised by their governing body, SASAC and their license to operate will be withdrawn. Compliance with CSR Guidelines will not be a legal obligation for foreign companies in China but they will be incentivised in other ways to make it a priority.

## **A. WHY CSR WILL BE IMPORTANT TO CHINA IN 2010**

The Government will promote Corporate Social Responsibility in China in 2010 for three reasons:

- To reduce the risk of instability arising from wealth disparity;
- To ensure appropriate corporate contribution to natural disasters; and
- To promote China as a responsible global citizen as it competes internationally.

### **1) Wealth Redistribution**

China lacks a ‘middle class’. There is a vacuum of volunteer institutions to redistribute resource

e.g. NGO's and philanthropic and religious societies. Through CSR, companies are being called upon to fill this vacuum. Recent media reports showed that 0.4 % of the population or the country's 450,000 millionaires, possess 70% of the Mainland's wealth. Resentment amongst the poor is growing. The first priority of Government is to use CSR to facilitate creative wealth redistribution to reduce the gap between rich and poor, urban and rural. The Government's 11th five year plan promised a ‘harmonious society by 2010’. CSR is seen as an instrumental part of its strategy to provide a bridge between the Government and the people.

### **2) Disaster Management**

The second use of CSR to the Government is to harness corporate resource efficiently in times of natural disaster. 2008 witnessed snowstorms at New Year, floods in the south and the earthquake in Sichuan. The Government realised that they alone could not tackle the increasing incidence of natural disaster (sometimes due to global warming) and have called upon companies and NGO's to play a combined role.

### **3) Global Profile**

CSR also plays an important role in helping Chinese companies to compete effectively in global markets. The Olympics, 60th Anniversary parade, Africa summit in Egypt and imminent EXPO show that China wants to be taken seriously in the global arena. CSR is seen as a way to generate soft power with foreign governments and to attract ethical investors.

## **B. HOW CSR COMPLIANCE WILL BE ENFORCED**

The Government may wish to encourage a CSR agenda but how will it be enforced? The answer very much depends on what type of company you are operating. There are a three types of company in China; State-owned-enterprises, private Chinese businesses and foreign businesses. Each are controlled by a separate ministry. SASAC (State-Owned-Assets Supervision and Administration Commission) for state-owned-industries. ACFIC (All China Federation of Industry and Commerce) for the private Chinese business and MOFOM (Ministry of Commerce for the People's Republic of China) for Foreign Companies.

SASAC, ACFIC and MOFCOM will use CSR as a determining factor for deciding whether to renew the practising licences of companies in China. CSR activities and reporting will be compulsory for all SOE's within the next two years. Those that do not comply with "The Guideline on Fulfilling Social Responsibility" issued by SASAC on Dec 29 2007, will be criticised on SASAC's website and could lose their license to operate.

A similar guideline was issued by a subsidiary of MOFCOM for foreign companies operating in China. It is unlikely that it will become legally binding but it will certainly be influential in governing MOFCOM's annual decision to renew your company's practicing license. For example the Ministry of Justice asked DLA Piper to prepare a report on its CSR activities during our license renewal process last year.

## **C. WHAT FACTORS SHOULD COMPANIES CONSIDER WHEN UNDERTAKING CSR IN CHINA?**

Companies need to consider the following issues when setting up a CSR strategy in China:

### **1) Government focus**

The Government in China is adept at understanding the social issues that matter most in each province. Start with the 'Five year plan' and select a social issue that is of current concern e.g. climate change, unemployment reduction, education or healthcare. If you tackle a Government priority issue they will guarantee you the profile as the Government is the media. This will provide shareholder payback for social investment by the company.

### **2) Disaster relief**

Ensure your company has a strict policy of how it will react in times of natural disaster in China. Who will make the contribution? With which NGO will you cooperate? Will you give cash, corporate or human resource? Will the CEO make a statement? What will happen to workers in your firm from the affected region? How will you create a sustainable response in the case of an ongoing emergency?

### **3) Leverage Core Resource**

Use the core resource of your company to contribute to the country's social agenda. Just adapt it for the new situation. For example Cisco Systems provides healthcare via webcam to remote regions of China. Microsoft provide IT training for unemployed migrant workers. Mohammad Yunnus 'down-scaled' banking to reach the poor. Citibank and JP Morgan followed

suit with their own forms of micro-credit. ‘Micro’ your product for the poor masses rather than the rich few to cultivate tomorrow’s customer in developing economies.

#### 4) Non-profit engagement

Non-profit activity is increasingly encouraged in China. There are three types – Government charity, Foreign NGO’s and local Grassroots NGO’s. Select one that is well recognised and run. Develop a relationship with the management to provide a consistent quality of pan-China CSR delivery.

#### 5) Pilot projects

Start small. Consult local staff about what project they want to do. Get the CEO to lead it from the front once a project is selected. Learning from past experience refine and adapt the program for other locations and cultures. If possible ‘network’ the projects to produce global connectivity and a sense of international achievement.

### D. WHAT ARE THE CSR GUIDELINES FOR FOREIGN COMPANIES IN CHINA?

It is very unlikely that the Chinese Government will legislate for CSR for foreign companies but given that it is to become compulsory for SOE’s it is commercially sensible to align your company with Government strategy. In late August 2008 the Chinese Academy of International Trade & Economic Cooperation (“CAITEC”), a subsidiary of MOFCOM issued draft Guidelines on Corporate Social Responsibility Compliance for Foreign Invested Companies (“CSRC”). CSRC are voluntary guidelines and not law. However they are an indication that the Chinese Government may be

favorably disposed towards foreign companies which it considers to be Corporate Social Responsibility (“CSR”) compliant. The local Government in Pudong already provides tax incentives for companies which engage in CSR.

FIE’s are advised to comply in the following three areas:

- Operational needs: abide by laws, regulations and business ethics;
- Stakeholder engagement: assume a holistic approach to management decisions taking employee and community impacts into account; and
- Pro-active contribution to development: actively engage in projects that are in the interest of social, economic and environmental development.



Implementation is recommended as a top down approach. First, the company vision should be aligned with CSR philosophy. Secondly, boardroom decisions about business growth should be balanced with considerations of social progress and environmental impact. At an operational level, employees should be guaranteed equal opportunities; supply chain partners with good CSR track records should be given priority; intellectual property should not be over-protected at the expense of wider social development and the company should actively engage in public welfare programs.

It is possible that the Chinese Government will give preference in awarding contracts to companies who are CSR compliant in accordance with CSRC. Practical steps that FIE's may take to become CSR compliant include the following:

- Imbue vision statement with CSR philosophy;
- Appoint internal CSR, Risk Management and Ethics Committees;
- Switch marketing strategies from direct advertising to raising brand awareness via social engagement projects;
- Integrate CSR strategy into business functions including performance management review criteria;
- Create partnerships with NGO's and Chinese Government Charities to execute environmental, social and educational projects; and
- Update Employee handbooks to anticipate equal rights and disability awareness legislation.

## E. COMMERCIAL BENEFIT OF CSR COMPLIANCE IN CHINA

The most rapidly expanding companies in developing countries like China use CSR as a strategy to engage tomorrow's consumer. Log onto the corporate website of Cisco Systems [www.cisco.com](http://www.cisco.com), look up CSR and you see a video of the CEO, John Chambers informing you that "we will have to rethink the definition of capitalism to include how companies benefit the community." In another online clip, Cisco manage to get the word 'community' and 'shareholder' in the same sentence. This is the work of a company that knows that their shareholders actually live in the communities their CSR programmes enhance in China.

Cisco is light years ahead of the competition that confines CSR to disaster donations. They make CSR core to product development and placement and ultimately brand profile. Whilst some companies prevaricated over whether to donate after the earthquake in Sichuan, Cisco donated US\$45M to help Sichuan education authority rebuild state of the art classrooms utilising their latest technology. This won them the patriotic profiling that traditional forms of media cannot reach in China. Cisco understand that is you care about the issues that matter to the people in China, then in turn they will care about your product.

The most convincing reasons to make CSR core to corporate strategy in China are as follows:

### 1) Cultivate tomorrow's consumers

One billion people live on less than US\$1 a day. Companies use CSR to gain first entry advantage to new markets. Today's impoverished will be tomorrow's purchasers.

## 2) Recruit and retain the best

CSR tackles global issues: healthcare, climate change and social development. Globally minded graduates will be attracted and retained by companies with inspiring CSR programs.

## 3) Post credit-crunch branding

CEO's no longer want to be profiled boarding a corporate jet on the front of Fortune magazine. It looks greener, leaner and more aligned with the times to be seen holding a shovel in Sichuan.

## 4) Corporate Development Social Responsibility

Danone v Wahaha is a salutary story for foreign companies in China. Wahaha was a mini-grocery in Hangzhou set up in 1986. Wahaha sold goods at schools. The name is meant to mirror children's laughter. When foreign foods company Danone entered the China market they formed a joint venture. Wahaha focused on taking the J-V products inland in China adapting them to the tastes of the poorer provinces. Danone sued for the theft of intellectual property or 'brand extension'. Wahaha won the court case. The baseline fact is that the Chinese Government want companies to 'Go West' and sell their products inland to the less developed region. Foreign companies that confine strategies to the rich coastal cities like Shanghai are unlikely to win court battles.

Corporate social responsibility in China is a component of the government push for economic empowerment in the west of China. Foreign corporate concerns count less than

immediate social priorities to the PRC Government. Companies literally must give away some of their intellectual property in order to enrich the country's rural regions. Microsoft are very savvy in this regard. Countless university students copy their windows products but Microsoft resists suing poor people who cannot pay court fines (although they strategically sue corporate offenders for IP theft). Instead Microsoft focus on computer training CSR classes for unemployed migrant workers. Companies need to profile themselves in the right locations in China. Suing Chinese companies in court is bad advertising. Creating IT learning classrooms for the underprivileged pays dividends in the long run.

## 5) Online brand building

There are 338 million netizens (online citizens) in China. Most people get their newsfeeds from their favorite blogs. Newspapers report on 'netizen democracy' or 'what the people think of your product'. The China chatrooms have no geographical boundary. There is a flourishing Chinatown in every world class city. Think of how quickly China supporters were mobilised around the world to protect the '2008 relay torch runners' or to protest against the 'Free Tibet' movement. Netizens are vocal, global and informed. They are capable of determining the capacity of your brand to sell to China. A strategic proactive CSR strategy can help attract patriotic purchasers, retain recruits and promote shareholder value especially in times of natural disaster when the commitment of foreign companies to China is called into question.

## 6) Risk Management

The Sichuan earthquake revealed seismic cracks in the CSR strategies of most companies in China. If CSR was central to the company strategy they reacted quickly, proportionately and compassionately.

CSR savvy companies had:

- Experienced CSR staff to advise on response strategy;
- Existing relationships with non-profits in China to receive donations;
- CSR projects from other countries that could be adapted for Sichuan;
- Established relationship with Government officials in rural China;
- Knowledge of proportionate and sustained response to rebuilding;
- Provided the right combination of personnel, product and profit to rebuild;
- Empathised with staff originating from Sichuan and offered counseling; and
- Sent their CEO to the earthquake site to show moral leadership from the front.

Companies for whom CSR was a sideline issue gave too little too late and their share price was adversely impacted in a country of patriotic purchasers.

## CONCLUSION

Companies that are courageous in designing their CSR strategies in China, rather than merely focusing on minimum compliance will reap the commercial rewards. Use the core resource of your company to tackle the pressing social issues and the Government will acknowledge your contribution. Look at the example of the state sector in fulfilling legal compliance requirements in the field of CSR. Be strategic in planning, promoting and profiling your CSR initiatives. Leverage your core resource, consult local employees and ask the CEO to promote the initiative. Spend time with local Governments to understand their concerns and be flexible with your corporate offering. Appoint dedicated managers to respond in times of natural disaster. In the current environment foreign companies that do not actively promote CSR may not 'lose their license' to operate in the community but they may lose the goodwill of patriotic purchasers which can be just as costly.

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The legal system in the People's Republic of China changes daily. Please note, therefore, that even as this guide goes to press, relevant laws may have changed.

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