The 2010 Dechert Guide to Foreign Investment in China

Dechert
LLP

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I. INTRODUCTION

A. Overview

This guide provides an overview of the regulations governing foreign investment in mainland China. In 2008 and 2009 alone, inbound foreign direct investment totaled more than US$200 billion in China. In the years between 2005 and 2008, foreign investment in China totaled almost US$337 billion. As of 2009, China surpassed Germany to become the world's third-largest economy, after only the United States and Japan. Notwithstanding China's status as one of the world's largest economies, and the massive amounts of foreign money invested in China, the basic laws and rules in China governing foreign investment remain mysterious for those accustomed to Western legal systems. We have designed this guide to provide a basic overview of foreign investment in China, and to answer many of the background questions we regularly hear from our clients on doing business in China.

This guide is divided into five parts. Part I, this introduction, provides a brief discussion of the effect of the recent global economic crisis on foreign investment in China. This introduction also provides an overview of the Chinese legal system and international treaties relevant to foreign investment.

The next two parts of the guide cover the two main mechanisms by which foreign companies invest in China. Part II covers forming a PRC corporate presence (such as a wholly owned subsidiary or joint venture) from scratch. Part III covers mergers with and acquisitions of existing PRC entities. The next part, Part IV, provides an overview of PRC tax, labor, environmental, and other laws that govern foreign-invested enterprises on a continuing basis. In Part V, we offer a brief conclusion.

B. China and the Current Economic Environment

After 30 years, during which the Chinese economy has grown at an average rate of 9.8% per year, investors had begun to take China's growth, and the opportunity it represents, for granted. In the past two years, however, China's continuing growth has faced a significant challenge from the continuing global economic crisis that began in August 2007.

This initial conventional wisdom was that China was insulated from the global economic crisis. Chinese banks did not invest heavily in mortgage-backed securities, and Chinese enterprises were not heavily dependent on borrowing from international financial institutions. China had US$1.9 trillion in hard currency reserve funds to cushion it against economic difficulties. Excess capital in the international financial system lead to elevated valuations in China, as elsewhere, but China had little direct exposure to the types of investments and market conditions that severely undermined the international financial system and the global economy.

By January 2009, it had become clear that the Chinese economy had been significantly affected by the global economic crisis. China's economy depends to a significant extent on exports to Western countries now mired in recessions. About 40% of China's exports go to the US and Europe. The manufacturing sector accounts for 43% of China's GDP, and economists began to express doubt that domestic consumption could make up for declining demand from damaged Western economies.

By late 2009, the results of the global economic crisis became apparent in declining trade numbers and an overall slowdown in the growth of the Chinese economy. After five years of average annual growth rates above 10%, the economy's growth rate for the first nine months of 2009 was 7.7%. As an article of faith, the Chinese government considers eight percent growth per year to be the minimum growth rate necessary to avoid serious social problems. On a positive note, the growth rate has increased quarter to quarter in 2009, from a low of 6.1% in the first quarter to 10.7% for the fourth quarter of 2009.

The Chinese government has implemented a number of policies to ward off further weakening of the economy. In November 2008, it announced a RMB 4 trillion (about US$600 million) stimulus package. Notwithstanding the size of the package, critics complained that it contains a significant amount of infrastructure investment and other spending that had already been planned. However, much of the existing

infrastructure spending had been planned for the next five years, and has now been brought forward to the next two-year time frame. The initial reports of the effect of the stimulus package have been positive, and economists credit the stimulus package in part for China's ability to weather the financial crisis better than many other economies. In part as a result of the stimulus package, economists are confident that China will exceed the eight percent growth target overall for 2009.

In some ways, the global economic crisis may in fact present opportunities for foreign investors in China. For investors with the capital, crisis may mean opportunity. We expect that the Chinese government may loosen restrictions on foreign investment and enterprise in general in an effort to stimulate the economy. The massive stimulus package may offer opportunities for foreign companies, especially those with infrastructure expertise. Moreover, we have seen companies which have completed all of the preparatory work for public offerings—corporate restructuring, governance reforms, and auditing—only to have the transactions quashed by the financial crisis. These companies are ripe for new deals because much of the reform and restructuring work that would otherwise be required to acquire a local company have already been completed.

C. The PRC Legal System

Since Deng Xiaoping announced an "open door policy" for China's economy in December 1978, China's legal system has evolved rapidly. Today, China has a body of written statutes governing commercial interaction, including a labor law, contract law, company law, and antimonopoly law. There exists an even larger body of implementing regulations and circulars issued by governmental authorities. The law in China often evolves in a piecemeal fashion, with certain regulations applicable experimentally only in certain geographic regions or with the issuance of temporary "interim" regulations that nevertheless have the force of law. The written statutes and regulations are often pitched at a relatively high level of generality, leaving significant discretion to implementing officials. Questions of law are resolved generally directly by the administrative agencies in charge of enforcing those laws, rather than by the courts.

The PRC legal system more closely resembles civil law systems than common law systems. China has no centralized mechanism for reporting decisions by administrative agencies or courts, and no concept of a common law. Even published decisions by China's highest court, the Supreme People's Court, are of advisory rather than precedential force in future cases, even for lower courts. Ambiguities in the written regulations are most often addressed, not by reviewing court precedents, but by directly consulting the government officials with jurisdiction over the matter. Informal guidance offered by government officials is usually reliable, but cannot generally be enforced against the officials if they change their minds.

Under the Constitution, the highest entity of state power in China is the National People's Congress (NPC), which passes the fundamental governing laws. A regulation that includes the phrase "Law of the People's Republic of China" in its name is generally one that has been passed by the NPC. Under the Constitution, China's president and State Council are subordinate to the NPC. The State Council consists principally of executive agencies called ministries—such as the Ministry of Commerce and the Ministry of Information Industry—and other executive commissions, administrations, and agencies, which themselves have the power to issue regulations and circulars with the purview of their subject area jurisdictions. Each executive body often has corresponding provincial and local level branches that handle much of the day-to-day enforcement and decision-making, and provinces and municipalities also have the power to issue binding regulations.

D. The WTO and International Treaties

The drive to join the WTO and comply with WTO commitments has been an important impetus for reform of China's business law environment. China agreed to three main categories of domestic reform in order to join the WTO in December 2001: reduction of tariff rates, opening of additional sectors to foreign investment, and reforms to its legal system in areas such as intellectual property protection and foreign exchange control. China has made significant progress in these areas. China reduced the general tariff rate from 15.3% in 2002 to 9.8% in 2008. It has opened previously restricted areas to foreign investment, including in retail, wholesale and import-export. Services, such as financial services and insurance,

remain highly regulated but with increasing foreign participation. China has implemented a number of changes to the domestic legal system designed to increase transparency and enforcement of intellectual property rights.

One important consequence of China's accession to the WTO has been the execution of a Closer Economic Partnership Arrangement (CEPA) with Hong Kong. The execution of CEPA (which has occurred in various phases) was required for China to fulfill its WTO commitments. Although Hong Kong has been under Chinese rule since 1997, it remains under separate governance and a separate legal system. For most purposes, Hong Kong companies are considered "foreign" for the purposes of Chinese law. CEPA allows Hong Kong companies preferential access to the Chinese markets. For example, products with a certified origin in Hong Kong may be sent to the mainland free of any tariff. Hong Kong companies may sometimes establish subsidiaries in sectors or on terms not available to companies established in other WTO countries. Because of Hong Kong's free market system, low taxes, and the preferential arrangement with mainland China under CEPA, Hong Kong often represents a good platform for foreign companies to launch their China operations.

In addition to the CEPA with Hong Kong, China has a separate Closer Economic Partnership Arrangement with Macau. China is also a party to a number of multilateral and bilateral trade agreements, including with the member states of the Association of South East Asian Nations (ASEAN). China signed four new bilateral free trade agreements in 2008, with New Zealand, Chile, Singapore, and Peru.

II. FORMING A COMPANY IN CHINA

A. Overview

Foreign investors must carefully structure the corporate form of their investment, keeping both legal and commercial considerations in mind. Getting the structure right at the beginning can facilitate later development and avoid complications down the road. This chapter will introduce the basic corporate vehicles available for establishing a subsidiary in China, including the offshore structures through which ownership of such corporate vehicles is typically directed.

B. Representative Offices

Some foreign companies may be able to accomplish their goals in China without setting up a full subsidiary or joint venture. Chinese law provides for a "representative office." A representative office of a foreign company does not have limited liability or separate legal person status.

Chinese law limits what representative offices can do. Representative offices generally cannot engage in any direct business activities. Instead, they are limited to acting as a liaison for the head office, including by finding suppliers, finding customers, and researching the market in China. Foreign exchange in the PRC is regulated. Representative offices in most circumstances cannot issue bills or collect fees in local currency.

Representative offices can be established with relative ease. Generally, a foreign company need only register with the State Administration of Industry and Commerce (SAIC) to establish a representative office. No substantive government approval is required for most industries. Law firms, financial and insurance companies, and certain other industries are special cases requiring substantive approval. Representative offices may lease office space only in certain designated buildings. They may not directly employ Chinese nationals. Instead, representative offices must contract with labor service firms for Chinese staff. The labor service firm hires the Chinese national, and seconds that person to work at the representative office.

Although representative offices are not permitted to engage in profit-making activities for their own account, they are charged taxes on commissions and on a "deemed" rate of profit determined by the tax officials. Tax exemptions are available in certain cases.

There is no capital contribution for a representative office.

A representative office may be the best choice for some companies who do not require a significant local presence in China and who do not need to bill in local currency. But in order to enter the Chinese market in earnest, it is generally necessary to establish a subsidiary that can engage in direct business activities.

C. Offshore Structures

Establishing an entity in China almost always begins with a corporate vehicle established outside of the PRC. A typical structure consists of two layers. The investor first establishes a company in the British Virgin Islands, the Cayman Islands, or another appropriate tax-free offshore jurisdiction through which it holds the investment. The offshore company then establishes an intermediate Hong Kong company, which in turn makes the PRC investment.

One advantage of using offshore holding companies is flexibility in the capital structure. It is not generally possible to create different classes of equity in Chinese companies. Especially for private equity firms accustomed to investing by means of preferred shares, it is often helpful to have an offshore entity in which share classes are possible.

Offshore structures also facilitate equity transfers. Within the PRC, every transfer of equity requires government approval. When the onshore PRC entity is owned by an offshore entity, no approval is required for transfers of the equity of the offshore entity. The foreign investor can therefore change effective ownership of the PRC entity by selling shares in the offshore holding company. Notwithstanding the general rule that indirect changes in ownership are not subject to any kind of PRC government review, such indirect changes in ownership may require government approval if they implicate antimonopoly concerns.

Historically, another important reason to set up an offshore structure for PRC investments has been tax. Chinese law provides a special, lower rate of tax on dividends paid to Hong Kong companies. In most cases, a 10% tax applies to dividend payments. For Hong Kong investors, the rate is five percent. For this reason, many foreign investors have made their investments in Chinese entities through a Hong Kong intemediate company. The Chinese tax authorities have recently taken a stricter approach towards regulating offshore intermediate holding company structures, requiring that the intermediate holding company have a “reasonable business purpose,” i.e. independently of its use to reduce taxes.

Even absent the tax benefit, there may remain some reasons to continue to use Hong Kong intermediary companies for PRC investments. PRC officials often prefer investments by Hong Kong companies to those made by companies in other jurisdictions. The officials are more familiar with the paperwork and terminology used in Hong Kong. Because Hong Kong itself is part of China and a traditional launching point for investments in China, it is easier than in most other places to obtain the types of notarizations and authentication required to use corporate documents in the PRC. In some cases, Hong Kong companies may also enjoy preferential access under CEPA.

Hong Kong generally does not charge corporate income tax on non-Hong Kong sourced income. It does, however, charge a stamp duty on transfers of Hong Kong stock. As such, we often recommend that investors establish a Cayman Islands, British Virgin Islands, or other appropriate offshore company to act as the parent of the Hong Kong company.

D. Types of Foreign Investment Vehicles

After the offshore holding structure is established, the investor can establish the onshore legal entity. Chinese companies established with at least 25% foreign investment comprise a distinct category of PRC legal entity called foreign invested enterprises (FIEs). FIEs generally fall into one of two sub-categories, wholly foreign owned enterprises (WFOEs) and joint ventures.

As its name implies, a WFOE is a Chinese company wholly owned by foreign persons. For some sectors and types of businesses, WFOEs are not permitted. In these businesses, only joint ventures with at least partial Chinese ownership are allowed, or foreign companies are banned outright. When it is possible to set up a WFOE, most foreign investors prefer this option. Joint ventures do have some advantages. The foreign party gains access to the Chinese party’s local knowledge and connections. However, joint ven-

tures have historically run into difficulties when the parties have differing goals, management methodologies, and plans for the business. In general, most foreign investors now prefer their own wholly owned subsidiaries when possible.

An entity with some Chinese ownership, and at least 25% foreign ownership, is a joint venture. If an investor elects to establish a joint venture, either for business reasons or because a WFOE is not permitted, there are two basic forms from which to choose: equity joint ventures (EJVs) and cooperative joint ventures (CJVs). In an equity joint venture, board representation, profit distribution, and liquidation rights must strictly track each party's relative equity contribution. CJVs offer flexibility to distribute profit in proportions different from the proportions of the equity contributions. Despite this additional flexibility, EJVs remain far more common than CJVs. Unless there are compelling reasons to set up a CJV, most investors opt for the EJV structure to avoid complicating the negotiation process and because the authorities are generally more receptive to an EJV form.

The basic constitutional document of a WFOE is its articles of association. In addition to articles of association, joint venture companies also have a joint venture contract describing the basic terms of the cooperation between the parties. In practice, the articles of association and the joint venture contract for a joint venture company overlap significantly. In forming a joint venture, negotiating ancillary agreements relating to the use of technology and know-how, related party purchasing and supply, and intellectual property rights is often an important aspect of the transaction. Forming a joint venture therefore often involves agreeing to the terms of IP and trademark license agreements, purchase agreements, and supply agreements in addition to the joint venture contract itself.

In general, FIEs are separate legal persons with limited liability. One exception to this rule is that it is possible to establish a "contractual" CJV without limited liability, but this is very rare.

E. Characteristics of PRC Companies

1. Capital Structure

The capital structure of a standard FIE is divided into two components: registered capital and total investment. Registered capital is the amount of equity contributed to the company. In general, an investor's ownership interest in the company is determined by the proportion of the registered capital it contributes. For example, if the registered capital of an FIE is US$1,000,000, and an investor contributes US$500,000 to that capital, it owns 50% of the company.

The registered capital of a Chinese company must be fully paid up. There is no PRC equivalent to authorized but unissued equity. Investors have the option of paying up the registered capital in installments. The first installment, amounting to at least 15% of the total registered capital, must be paid within six months of the issuance of the FIE's business license. The balance must be paid within two years. Although the registered capital may be paid in installments, an investor may claim dividends only to the extent attributable to the amount of registered capital actually contributed. Each contribution to the registered capital must be verified by a certified Chinese accountant. The accountant will issue a document called a "capital verification report" attesting to the proper contribution of the capital.

A foreign investor may contribute to the registered capital in foreign currencies only. The law permits RMB denominated contributions only to the extent that the contributed RMB funds derive from prior investments in the PRC. The law also permits in-kind contributions, such as machinery, equipment, and intellectual property. In general, no more than 70% of the total registered capital of an FIE may be contributed in-kind. In-kind contributions must generally be valued at an appraised amount as assessed by a certified Chinese appraisal institution. As such, non-cash registered capital contributions tend to complicate efforts to specify the amount of the registered capital contribution of each party. Certain types of in-kind contributions, such as contributions of land use rights and state-owned assets, are subject to additional valuation rules and appraisal procedures.

The total investment of a company is the total amount of funding available to the company from both equity and debt. That is, an FIE may borrow generally only to the extent of the difference between its

total investment and registered capital. The portion of the total investment in excess of the registered capital may be raised by debt of any kind, including bank loans and shareholder loans.

Chinese law imposes requirements on the ratio of the total investment to the registered capital. The ratios are as follows.

Total Investment	Registered Capital
Up to US$3 million	At least 70% of the total investment
Between US$3 million and US$10 million	Minimum of US$2.1 million, and at least 50% of the total investment
Between US$10 million and US$30 million	Minimum of US$5 million, and at least 40% of the total investment
Over US$30 million	Minimum of US$12 million, and at least one-third of the total investment

As an illustration, an FIE with a total investment of US$750,000 would be required to have a registered capital of at least US$525,000. The remaining US$225,000 could be financed in debt.

The Articles of Association of an FIE must set forth the specific amount of the total investment and registered capital. Any changes to these figures must be submitted to the PRC authorities and approved before they become effective. Accordingly, foreign investors should carefully consider from the outset the amount of capital its enterprise will require.

2. Limited Liability

   Almost all FIEs are limited liability entities. They are considered separate legal persons, distinct from their parents, under PRC law. An investor's liability is generally limited to its registered capital contribution.

3. Business Scope

   Unlike companies in many Western jurisdictions, which are legally permitted to engage in any lawful business, an FIE is limited to a specific business scope. The type of business in which an FIE may engage is set forth in its business license and its Articles of Association. Foreign investors frequently discuss the business scope with the authorities as part of the approval process.

   Any action by an FIE outside of its approved scope of business may result in the invalidity or breach of a contract, and may also result in fines or other sanctions.

4. Corporate Governance

   The highest governing body of a WFOE or EJV is its board of directors, and each party's board representation must be strictly proportional to its registered capital contribution. Although directors have a statutory duty of loyalty to the company, in practice, a director will generally act at the direction of the investor that appoints him or her. An investor's control or influence over its subsidiary is therefore exercised in part by and through its appointed directors. For an EJV, Chinese law specifies certain corporate actions, including amendment of the articles of association, dissolution of the company, increase or decrease of the registered capital, and merger or division of the company, require unanimous board approval, providing protection to minority investors. Additionally, Chinese law specifies certain corporate actions that may only be undertaken by amending the articles of association and the joint venture contract. This requirement is also protective of minority investors, because all investors must sign off on any changes to these documents, no matter how small their relative registered capital contribution.

Board meetings must be held at least once a year, or more frequently if so specified in the company's articles of association. The attendance of over two-thirds of the board of directors is required in order to establish a quorum.

The chairman of the board of directors generally also serves as the company's legal representative—the natural person who has the power to bind the company to contracts and serves as the chief representative of the company to the government.

A CJV may be governed by a joint management committee, which functions similarly to a board of directors.

The PRC Company Law requires limited liability companies to have, in addition to a board of directors or joint management committee, a separate "board of supervisors." The board of supervisors consists in representatives of the shareholders and the employees, with the employees selecting at least one-third of the total number of supervisors. The board of supervisors is intended to serve as a check on the power of the senior officers and directors. The board's powers are largely limited to proposing changes rather than directly implementing them. The board of supervisors also has the legal authority to sue directors, supervisors, or senior officers who break the law or breach the articles of association of the company, thereby causing losses to the company.

The Company Law permits companies with relatively few shareholders (no specific number is given) to have a single supervisor or pair of supervisors, rather than a supervisory board, thereby obviating the requirement of employee representation. There are also variations from locality to locality as to whether the authorities require FIEs (as opposed to domestic companies) to comply with the requirement of having a supervisory board, and in some cases no supervisors are required. Even when present, the practical influence of the supervisory board is often not significant.

The management structures of FIEs vary. In most cases, the day-to-day operations of the FIE are under the direction of a general manager, and financial operations are under the direction of a finance manager. For joint ventures, the parties often negotiate a fairly detailed management structure as part of the FIEs establishment process. The joint venture contract typically specifies which party may appoint persons to specific senior management positions.

5. Term

In contrast to most Western jurisdictions, in which corporations are established for indefinite terms, FIEs have a limited term set forth in their articles of association. Depending on the degree to which an FIE's industry is regulated in China, the authorities sometimes approve terms of as long as 50 years or longer, although the norm is for shorter periods. It is possible to renew the term of an FIE with the approval of the relevant authorities.

6. Finance

FIEs must open both RMB and foreign currency bank accounts in the locality where established. After an FIE is established, it must apply to SAFE for a "foreign exchange registration certificate" and permission to open a foreign currency account.

FIEs are required to segregate their capital accounts from their current accounts. Foreign exchange can be released from the capital account only upon SAFE approval. SAFE oversees capital account distributions to police the capitalization requirements and other rules; FIEs that are not in compliance with PRC regulations may be blocked from accessing their capital accounts. Foreign exchange payments from the foreign exchange current account do not require SAFE approval, but there are still administrative procedures that must be followed for any such payment.

During the first year of an FIE's establishment, the FIE may keep up to US$200,000 in its foreign exchange current account. In future years, an FIE may maintain between 50% and 80% of its foreign exchange receipts in the current account, depending on how much foreign exchange was spent in the previous year.

7. Profit Distribution

All FIEs must keep financial records in compliance with PRC accounting regulations, even if they also keep records in compliance with other accounting principles. Taxes will be determined with respect to the PRC accounting methodology. China's fiscal year is the calendar year, from January 1 to December 31.

FIEs may not pay out dividends to investors until all taxes have been paid and all previous years' losses have been made up. FIEs also must make allocations to the following funds prior to distributing any profits:

a. Employee Bonus and Welfare Fund. This fund may be used by the company for employee-related expenditures, such as bonus schemes and housing allowances or subsidies.

b. Reserve Fund. This fund may be used to cover capital losses, fund expansion in production and business operations, and, subject to governmental approval, to fund increases in registered capital.

c. Enterprise Expansion Fund. This fund may be used for the expansion of an EJV's business.

A joint venture must contribute at least 10% of after-tax net profits to the reserve and enterprise expansion funds until the cumulative amount in the funds reaches 50% of registered capital. A WFOE need not maintain an enterprise expansion fund, but it must contribute at least 10% of after-tax net profits into its reserve fund until the cumulated amount in the reserve fund reaches 50% of registered capital. The extent of the employee and welfare fund allocations depend on the number of Chinese employees and provisions in the FIE's articles of association, as approved by the authorities.

SAFE approval is required for any dividend payments in foreign currency. The company must generally provide tax payment certificates, an audited financial report, a board resolution approving the distribution of profits, the foreign exchange registration certificate, and a capital verification report in order to obtain clearance for an overseas profit payment. SAFE may also request additional documents.

In addition to dividends, foreign investors sometimes profit by concluding agreements to provide management services, consulting services, technology, or intellectual property licenses to their FIEs. Fees paid under these agreements may be subject to taxation at a different rate from dividends. When an FIE pays out fees under agreements with foreign parties, including with a foreign investor, the FIE may have the obligation to withhold and remit PRC taxes on behalf of the payee.

F. The Approval and Registration Process

1. The Foreign Investment Catalogue

In the PRC, each foreign investment is subject to substantive government review. Different industry sectors are subject to differing levels of scrutiny. Investors should consult the Foreign Investment Industrial Guidance Catalogue (Amended 2007) (the "Catalogue") and the Guidance on Direction of Foreign Investment Provisions to determine the degree to which foreign investment in a given sector is regulated.

The Catalogue provides for four different categories of foreign investment: encouraged, permitted, restricted, and prohibited. The Catalogue expressly sets forth the encouraged, restricted, and prohibited categories. Any business not expressly listed in one of these three categories generally falls within the "permitted" category.

The most important consequence of a business's Catalogue classification is often the level of government at which an investor must seek approval for its investment. Lower levels of government (municipal and provincial authorities) generally provide more rapid review. They generally also actively seek foreign investment. Review at the central level of government in Beijing generally takes more time, and approval is more difficult to obtain. The following chart shows at which level of government ap-

proval must be sought, depending on a business's Catalogue classification and the size of the total investment:

Sector	Investment Amount	Approval Level
Encouraged or Permitted	Less than US$100 million	Provincial or local MOFCOM
	Greater than US$100 million and less than US$500 million	Central MOFCOM
	US$500 million and above	Central MOFCOM and the State Council
Restricted	Less than US$50 million	Provincial or local MOFCOM
	Greater than US$50 million and less than US$100 million	Central MOFCOM
	US$100 million and above	Central MOFCOM and the State Council

In "encouraged" and "permitted" sectors, a foreign investor generally may set up a WFOE. No partnership with a Chinese party is required. There are exceptions to this rule in which, notwithstanding an industry's "encouraged" status, only joint ventures are allowed. For example, automobile manufacturing is "encouraged" under the Catalogue, but only joint ventures with 50% or less foreign ownership are permitted. "Restricted" sectors are generally open only to joint ventures, and in some cases the joint ventures must be majority Chinese owned or contributed.

In the past, tax and tariff incentives were sometimes applicable to foreign investments in "encouraged" sectors. Most of these incentives have now been discontinued, however, an exemption from import tariffs for capital production equipment under certain circumstances remains available.

Under current law, a business in a "permitted" sector will be considered "encouraged" if 100% of the products are exported directly, and a business in a "restricted" sector will be considered "permitted" if at least 70% of its products are exported directly and with the approval of the local authorities.

2. The Basic Approval Process

FIEs may be established only with the approval of the Chinese government. The approval process for forming new entities or for acquiring existing companies (thereby converting them to FIEs) is largely the same. The approval process begins with a name reservation application to the relevant bureau of the State Administration for Industry and Commerce (SAIC) to check on the proposed name for the FIE.

After the company name has been reserved, the applicant must obtain substantive "examination and approval" of the investment by MOFCOM. Examination and approval by MOFCOM is the key stage in the approval process. It requires submission of the full definitive documents for the proposed enterprise to the government, and may also require a "Feasibility Study" describing background on the project, along with other supporting documents. MOFCOM has the flexibility to request documents not expressly set forth in the statutes if they believe such documents would be helpful to its decision.

After MOFCOM's approval, and the parties' payment of the initial installment of registered capital, the parties may register with SAIC for issuance of a business license. An FIE is officially established upon issuance of its business license. Even after the business license is issued, there remain additional registrations to complete (including with the local SAFE, labor, customs, and tax authorities).

As noted above, the level of SAIC and MOFCOM to which these applications must be made is determined by the size of the total investment and the classification of the business under the Catalogue.

3. Special Approvals

In some cases, the parties must also obtain certain special approvals, such as environmental approval, prior to applying to MOFCOM for examination. Environmental approval may be required for manufacturing enterprises, or for any investment project that entails a construction project. The State Environmental Protection Agency (SEPA) maintains a catalogue of projects that require prior environmental approval by SEPA itself. In other cases, environmental clearance can be secured from the local or provincial Environmental Protection Bureau (EPB). The clearance often involves retaining a certified Chinese environmental auditor to prepare an environmental impact assessment for the project. In addition to environmental clearance, investment projects involving new construction also require favorable opinions from the local zoning and land use authorities.

The approval of the State-owned Assets Supervision and Administration Commission (SASAC) will be required for investments involving state-owned assets, as discussed in greater detail in Part III, Section G.

Some typically regulated industries (including, for example, securities, banking, and insurance) involve special approval regimes in addition to, or in place of, MOFCOM examination and approval. The China Securities Regulatory Commission (CSRC) reviews applications to set up or acquire securities companies, the China Banking Regulatory Commission (CBRC) covers banks, and the China Insurance Regulatory Commission (CIRC) reviews insurance company applications.

Approval by the National Development and Reform Commission (NDRC), called “project verification,” is technically required for any foreign investment project, but as a practical matter the NDRC’s review is critical only in certain industries, such as the automotive industry.

G. Special Forms of FIEs

In addition to the standard WFOE and joint venture formats, there are two special forms of FIE: foreign-invested companies limited by shares (FICLS) and foreign-invested holding companies (FIHCs).

1. Joint Stock Companies

As noted above, the equity of an FIE is referred to as “registered capital,” and no shares as such exist. Only an FICLs has equity in the form of shares. An FICLS is the only type of FIE that can be directly listed on a stock exchange. As such, conversion to the FICLS form is required for an IPO on either the Shanghai or Shenzhen stock exchanges.

Chinese law defines as a joint stock company as a company whose capital is divided into equal shares and in which each shareholder’s interest is relative to the number amount of shares held by him. Chinese law therefore does not expressly allow for preferred shares or share classes of any kind.

An FICLS is required to have a board of directors of between five and 19 members, and a board of supervisors with a minimum of three members. The law further requires regular shareholder meetings. Certain important decisions require a two-thirds majority shareholder vote. The minimum share capital requirement for an FICLS is RMB 30 million.

An FICLS may be established by means of promotion or share offer. In either case, the entity must have a minimum of two, and no more than 200, promoters. At least one of the promoters must be a foreigner. Fifty percent or more of the promoters must be PRC persons. For establishment by promotion, promoters must subscribe for all of the shares. For establishment by share offer, promoters must subscribe for at least 35% of the shares and their holding is subject to a three-year lock-up period. In establishment by share offer, at least one promoter must be a legal entity that has been profitable for each of the preceding three years.

An FICLS is typically set up for listing purposes. Unlike other FIEs, an FICLS can issue shares to the public subject to approval. They may be listed on the Shanghai or Shenzhen stock exchanges or on an overseas stock exchange. A WFOE or a joint venture must convert into an FICLS before being able to list. Only a WFOE or a joint venture that has been profitable for three years may be converted into an FICLS.

In August 2008, the Chinese government relaxed the process for forming an FICLS, and for converting a conventional FIE to the FICLS form. In the past, formation of or conversion to a FICLS required central MOFCOM approval. In 2008, MOFCOM delegated this authority in most cases to provincial authorities. Because conversion to the FICLS form is required prior to an IPO, the delegation to provincial authorities facilitates pre-IPO reorganization.

2. Holding Companies

In most cases, FIEs cannot make equity investments or hold equity in other companies. An FIHC (sometimes also called an "investment company") is an enterprise especially authorized to hold equity in other FIEs. Investors use the FIHC form to have a single PRC entity to hold their other onshore companies, and to provide certain support services and other back-office functions for the subsidiaries.

A foreign investor seeking to establish a FIHC must have good credit standing and the financial capacity to establish and fund a holding company. There are two alternative tests under which an investor can qualify to set up an FIHC:

a. the investor must have total worldwide assets of at least US$400 million in the year preceding the application, and have established at least one FIE in China with a paid-in contribution of at least US$10 million to the registered capital of that single FIE; or

b. the investor must have set up at least 10 FIEs, with a paid-in contribution of at least US$30 million in the aggregate to the registered capital of those FIEs.

In either case, the minimum registered capital of a FIHC is US$30 million, which must be paid within two years of the issuance of the FIHC's business license. If the FIHC has a registered capital of greater than US$30 million, the first US$30 million must be paid within two years, and the remaining amount within five years. At least US$30 million of the FIHC's registered capital must generally be used for new spending, such as new investments or creating an R&D center. Acquiring equity in the invested companies from the parent does not count towards this requirement, but the US$30 million can be used for new increases in the capital of the invested companies. If the FIHC is an EJV, the Chinese party must be in good financial standing and have total assets of at least RMB 100 million.

FIHCs may invest in sectors where foreign investment is permitted, on the same terms as if the investment came directly from an overseas entity. FIHCs may also perform certain services for their subsidiaries. The services an FIHC may provide include:

a. assisting the invested companies, or acting as their agent, in sourcing equipment and raw materials;

b. providing after-sales services for an invested company's products;

c. managing invested companies' foreign exchange holdings, under the supervision of SAFE;

d. providing personnel services, staff training, and technical support;

e. assisting in raising loans, including by guaranteeing loans made to an invested company;

f. consolidating research and development by setting up research and development centers;

g. providing consulting services to the investors of the holding company;

h. acting as a subcontractor for services outsourced by the parent company; and

i. providing market information, investment advice, and other consulting services to the parent company and its affiliates.

There are two super-charged forms of FIHCs. The *Provisions on the Establishment of Investment Companies by Foreign Investors* (MOFCOM Circular No. 22, 2004) provides that an FIHC may take on additional, more substantive support roles if it meets certain requirements (chiefly having already paid in and invested the required US$30 million in registered capital) and obtains an additional approval from MOFCOM. These additional roles include acting as distributor in China and overseas for invested companies, and providing warehousing and transportation services.

The FIHC may take on still more functions for its invested companies if it applies for and obtains "regional headquarters" status. A FIHC may qualify for regional headquarters status under one of two tests:

a. its total paid up registered capital is at least US$100 million; or

b. its total paid up registered capital is at least US$50 million, the total consolidated assets of its portfolio companies in the year preceding the application amounts to at least RMB 300 million, and total consolidated profits for the portfolio companies equals at least RMB 100 million.

One of the most significant advantages of regional headquarters status is the right to apply to the CBRC to form a group financing company, which can provide loans and other financial services to affiliated companies.

Beijing, Shanghai, Guangdong, and Guangzhou recognize a form of entity sometimes called, a "local" regional headquarters. Regional headquarters status under these local rules is easier to obtain but carries fewer benefits.

For foreign companies with extensive China holdings, forming a FIHC may result in efficiencies by centralizing support functions, which in turn may lead to cost reductions.

III. MERGERS AND ACQUISITIONS

A. Overview

The main alternative of forming a Chinese subsidiary or joint venture from scratch is to acquire assets or equity in an existing Chinese company. Foreign investors typically acquire PRC entities either to obtain a presence in the PRC market or as a pure financial investment. This part provides an overview of the regulations governing mergers and acquisitions of PRC entities by foreign investors.

B. Due Diligence

According to a 2006 study by Ernst & Young, only 20 to 30% of letters of intent signed in China prior to due diligence resulted in signed definitive agreements after due diligence was completed. Internationally, signed letters of intent lead to definitive agreements as much as 70% of the time. One possible reason for this might be that Chinese companies often have hidden liabilities, or turn out to be less attractive after careful review, than previously believed. Careful due diligence is therefore extremely important in China.

At the same time that due diligence is of special importance in China, it is also difficult to accomplish. Publicly available records on many aspects of a Chinese company's business, such as the existence of pending litigation, liens and other security interests over assets, leases, title to capital production equipment, registration of intellectual property, and legal title to land use rights are often unavailable or difficult to obtain in reliable form. Corporate records often lack key documents, even as to principal assets and contracts. Tax avoidance, fraud, and self-dealing transactions remain more common than in many other jurisdictions.

Another challenge of due diligence is that Chinese companies are often reticent to part with information. They are often surprised at the extent of the due diligence requests of foreign acquirers. Chinese targets have been known to request reciprocal information disclosure from potential foreign acquirers in the belief that information disclosure is a burden that should be evenly shared. The documents disclosed by a Chinese target in response to a due diligence request will often be incomplete and less extensive that what may typically be provided in Western jurisdictions.

The actual due diligence process in the PRC usually begins with a due diligence checklist. The typical topics covered include establishment and approval documents, organizational structure, material contracts, land use rights and buildings, principal assets, finance, tax, labor, social insurance, intellectual property, products liability, environmental issues, antitrust issues, legal proceedings, and fraud, corruption, and related party transactions. In crafting due diligence requests, careful attention should be devoted to any special substantive regulations applicable to the target's business. For example, it is important to verify that the target's products have received any government certifications or licenses required for those products to be sold in China. In nearly all cases, acquirers will need to request supplemental documents after the first due diligence disclosure.

In almost all PRC transactions, there will be known risks that cannot be resolved through due diligence. These risks can be addressed to a limited degree through representations and warranties in the definitive agreements. In some cases, in transactions with state backing, it is sometimes possible to arrange for indemnities or waivers of enforcement for past breaches directly from local authorities. The enforceability of such indemnities, however, is at best questionable because, as a general rule, governmental bodies lack legal capacity to contract.

C. Offshore Structures, Offshore Transactions, and Round Trip Investment

For tax and other reasons, many foreign acquirers, like other foreign investors, set up special purpose vehicles offshore through which to direct their China investments. The typical offshore structure is discussed in Part II, Section C of this Guide.

If the Chinese target is already held through an offshore holding structure, then it may be possible to complete the transaction entirely offshore, by acquiring the overseas holding company rather than the onshore subsidiary. The Chinese government does not regulate indirect changes of control of this kind. Unlike onshore transactions, no PRC agencies or authorities need approve the transaction. As such, to the extent that it is possible to acquire a Chinese entity by acquiring its offshore holding company, that is the preferred course. Note, however, that offshore changes of control may require PRC government approval if there are antitrust implications, and that the target may also need consent for a change of control under its material contracts (including its financing agreements).

In the past, many PRC companies restructured such that they were held through offshore entities. Having an offshore holding structure facilitated acquisitions by foreign capital, and eased the path to an overseas IPO. Moreover, private equity investors in particular are accustomed to investing using preferred share structures. It is generally not possible to have preferred shares or share classes of any kind in a Chinese company. As such, these private equity deals could only be structured in the typical form by using an offshore structure.

However, recent changes in Chinese law complicate any effort by a Chinese person to own interests in a Chinese entity through an offshore structure. That is, Chinese law regulates "round trip investment," where a domestic person's control of a domestic entity is directed through a non-Chinese holding company.

The Chinese government became concerned with "round trip" holding structures for two main reasons. First, the government was concerned with tax enforcement. It was difficult to track income of mainland persons from the sale of their offshore equity interests. Second, the government has sought to build up the domestic private equity and financial industries, the domestic capital markets, and the related legal structures. The round trip investment rules are designed to keep the structuring of PRC deals onshore.

The government issued the first round trip investment rules in 2005. After two early attempts, SAFE issued Circular 75, which remains in effect. Circular 75 requires Chinese residents to register with their local SAFE branch prior to establishing or acquiring a controlling interest in an offshore special purpose vehicle with mainland assets. Failure to register may have severe consequences, including preventing the Chinese subsidiary from distributing profits outside of China.

In October 2006, several major state agencies involved in the regulation of foreign investment—including SAFE, MOFCOM, and several other agencies—jointly issued the Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the "M&A Rules"). The M&A Rules further restricted round trip investments. The M&A Rules require MOFCOM approval at the central government level for any acquisition by an offshore company that is "established or controlled" by a PRC resident of any PRC company that is "affiliated" with that PRC resident. As a practical matter, the requirement for central MOFCOM approval is tantamount to a prohibition. There have been basically no such approvals granted. In May 2007, SAFE further tightened restrictions on round trip investments and closed loopholes in the registration requirement with the issuance of Circular 106.

As a result of the M&A Rules and the related SAFE circulars it is now very difficult to have an offshore structure controlled by Chinese residents, or in which both PRC residents and foreign residents participate. There is a pipeline of previously SAFE-registered offshore vehicles controlled by domestic residents. However, in the absence of a previously registered offshore vehicle, a domestic PRC interest in a PRC company now must generally be reflected at the onshore level. The round trip restrictions have had a significant negative impact on the flow of offshore private equity deals and offshore IPOs for Chinese companies, and have increasingly caused investors to investigate onshore transaction structures. That being said, it now appears that in certain locations SAFE registration of the offshore interest can now be obtained.

D. Onshore Transaction Structures

Chinese law allows for both equity and asset acquisitions. The main factors in choosing between these two structures often involve balancing between liability and tax considerations.

As in other jurisdictions, an investor who acquires equity inherits the liabilities of the target company. An equity investor also inherits, however, the contractual rights and obligations of the target company, including its employment contracts with its key employees and labor force, its supply contracts, its sales contracts, and its financing agreements. An equity transaction is also more straightforward from a documentation and implementation perspective. Equity acquisitions take various forms, including direct acquisition of existing equity from the current owners or subscription to an increase in the registered capital of the company.

Given the inherent uncertainties involved in acquiring a Chinese company, an asset acquisition is often safer because the investor will not acquire most types of past liabilities of the target. However, asset acquisitions are often tax disadvantaged. An equity acquisition is subject to a single layer of taxation, the tax on income from the sale of the equity. Asset acquisitions sometimes involve two taxable events: the sale of the assets by the existing PRC entity is taxable to the entity, and any subsequent distribution of the profits to the sellers may be taxable to the sellers. As such, the Chinese sellers to a transaction in many cases prefer an equity structure.

Asset acquisitions are also more complicated from a contractual perspective, because Chinese contractual rights generally cannot be assigned or transferred without consent of the counterparty. As such, key employees and the labor force in general must consent to be transferred from their old employer, the seller, to the acquiring entity. These transfers may come at a cost. The counterparties to key supply and sales contracts must also agree to have the contracts transferred to the new entity. The lenders to the pre-existing business may also need to consent for the asset sale to proceed.

PRC law also allows for mergers, but Chinese companies can merge only with other PRC domestic companies or FIEs. As such, mergers are less frequent for foreign investors than equity or asset acquisitions. The M&A Rules in 2006 do permit, for the first time, PRC persons to exchange equity in a PRC company

for equity in a foreign company. Such "share swaps" are permitted only if the foreign company is publicly traded and has a 12-month trading history, or if the foreign company is a special purpose vehicle established in anticipation of an overseas listing of a PRC subsidiary. In the latter case, the offshore listing must be approved by the CSRC and completed within 12 months of the share swap.

E. Choice of Law and Language Versions

Certain contracts, such as a joint venture contract for a Chinese joint venture, are required to be governed by Chinese law. Even in cases where Chinese law is not statutorily required, the authorities will often expect and require that Chinese law govern agreements to the extent that they apply or must be enforced in China. However, except for contracts statutorily required to be governed by Chinese law, it is sometimes possible to select foreign law for contracts with a significant foreign connection.

Any contract that must be reviewed and approved by the Chinese authorities generally must be written in the Chinese language. For a merger or acquisition, the definitive agreements (e.g., equity transfer agreement, joint venture contract, and articles of association) all must be reviewed and approved, and therefore Chinese versions of these documents must be prepared. In most cases, the parties also prepare an English version and the contracts specify that each language version of the contract is equally authentic. In the typical case, the foreign party's attorneys prepare both the English and Chinese versions of the documents.

The Chinese authorities and courts are more focused on contract execution formalities than in many other jurisdictions. Original signatures or chops of both parties—not photocopies—must be submitted to the authorities. The contracts generally specify the number of originals to be executed by the parties, which number should be sufficient for each party to retain an original and for originals to be submitted to all of the relevant authorities.

F. The Approval and Registration Process

The general approval and registration process for an acquisition is the same as the process described in Part II, Section F, for forming a new FIE. All sales of equity in PRC companies must be approved by the authorities. When a foreign investor acquires more than 25% of the equity in a domestic enterprise, it is thereby converted to an FIE. For asset deals, a new entity will often need to be formed to acquire the assets. As such, the approval processes involved in acquisitions is generally the same as for forming new entities.

As noted in greater detail above, the basic substantive approval required is "examination and approval" by MOFCOM. Examination and approval involves entails full review of all of the definitive agreements for the transaction, including the equity transfer agreement in an equity acquisition and the joint venture contract if the resulting entity will be a joint venture. The definitive agreements are not legally binding until approved by the authorities. After receiving MOFCOM approval, the target must within 30 days apply to SAIC for issuance of a new business license. The business license will reflect the revised equity holding of the target entity.

As with formation of new entities, the level of government review required of a proposed acquisition varies with the size of the investment and its classification under the Catalogue, and certain restricted industries have special approval processes as described in Part II, Section F(3).

G. State-Owned Assets

Special rules apply when a foreign investor proposes to acquire state-owned assets. For the purposes of these rules, equity in a state-owned enterprise (SOE) is considered a state-owned asset.

The two basic requirements of the state-owned assets rules are that state-owned assets be appraised prior to transfer and that the transfer occur after a public bidding process on a designated equity exchange.

The appraisal process must be conducted by an asset appraisal firm licensed by the State-owned Assets Supervision and Administration Commission (SASAC). All licensed firms are domestic Chinese firms. During the appraisal process, in order to gain leverage and reliability, it may be useful for the foreign investor to retain an international accounting firm to assist with the appraisal, with the understanding that the Chinese firm's name only would appear on the report. The international accounting firms can generally help in selecting a Chinese counterpart willing to be engaged on this basis.

Under the existing SOE Rules, to avoid interference from SASAC, the negotiated purchase price for state-owned assets must be equal to or above the appraised value, unless there are compelling reasons that support a discount. Compelling reasons generally involve other terms favorable to the seller. Any discount over 10% is not likely to be approved.

After the assets are appraised, the actual transaction must occur through a public notice and bidding process on a designated "equity exchange," government sponsored entities which administer the bidding and tendering of state-owned assets. Listing on an equity exchange involves publication requirements, which has the effect of inviting other bidders. In theory, anyone can bid on assets listed on an equity exchange, and only the highest qualifying bidder is to be selected.

In some cases, it is possible to apply to SASAC for a waiver of the public bidding requirement and allow the transfer to be transacted as agreed to among the parties. Even if SASAC waives the bidding requirement, however, the foreign investor would still need to make a filing with an equity exchange and pay the prescribed processing fees.

After completing the transfer process on the equity exchange, the exchange will issue an equity transfer verification certificate, at which point the foreign investor can commence the standard approval process, including approval from MOFCOM.

H. The New Antimonopoly Law

China's new Antimonopoly Law went into effect on August 1, 2008. The law is the result of 13 years of drafting and consideration by the PRC government. Prior to the Antimonopoly Law, there were some merger control provisions set forth in the M&A Rules, but the Antimonopoly Law is the first comprehensive antitrust legislation in the PRC. It stands to make China a third center for antitrust review (along with the US and the EU) for large-scale global mergers and acquisitions.

The Antimonopoly Law principally regulates the following four antitrust areas: (1) monopoly agreements, (2) abuses of dominant position, (3) concentrations, and (4) administrative monopolies.

The Antimonopoly Law prohibits both horizontal and vertical monopoly agreements. With regard to horizontal agreements, competing business operators are prohibited from entering into any agreement to (a) fix or change prices of goods or services, (b) limit the output or sales of goods or services, (c) allocate sales markets or raw materials supply markets, or (d) limit the purchase of new technologies or new equipment, or restrict the development of new technologies or new products.

Under the Antimonopoly Law, monopoly agreements include any agreements, decisions, or other concerted practices that restrict or eliminate competition. The list appears to include many cartel arrangements (such as price fixing and market allocation). Although the law does not expressly prohibit bid rigging, a general provision prohibiting bid rigging is set out in the Bid and Tender Law.

The Antimonopoly Law also prohibits vertical agreements intended to fix prices or limit minimum prices, but does not ban imposing maximum prices or recommending prices. It remains to be seen how the Chinese authorities will respond to other potentially sensitive agreements, such as cooperation agreements and distribution agreements.

In terms of broad principles, the Antimonopoly Law is relatively clear and comprehensive with regard to abuses of a dominant position. Under the new law, a business operator with a dominant position may not

(1) sell products at unfairly high prices or buy supplies at unfairly low prices, (2) without proper justification, sell products at a price below cost, (3) without proper justification, refuse to trade with its trading partners, (4) without proper justification, restrict trading partners to only trade with itself or its designee, (5) without proper justification, tie products or impose other unreasonable trading conditions, (6) without proper justification, give different treatment to equally situated trading partners, or (7) conduct other practices that are deemed to be an abuse of a dominant position by the enforcement authorities.

A business operator with a market share of 50% or more in a relevant market is presumed to have a dominant position. A business operator presumed to have a dominant position may overcome the presumption by providing evidence demonstrating otherwise. Other factors are also relevant to a finding of a dominant position. These include (a) competition in the relevant market, (b) the ability of the business operator to control sales markets and supply markets for raw materials, (c) the business operator's financial strength and technical prowess, (d) the degree of reliance on the business operator, and (e) entry barriers.

Once a dominant position is established, the authorities must still establish market abuse. The Antimonopoly Law remains unclear on what elements are required to establish market abuse, and what factors may overcome an alleged market abuse.

Another question left unanswered is how the "relevant market" should be defined. Although the Antimonopoly Law is not clear on this point, MOFCOM has recently issued a draft Guidelines on Defining a Relevant Market seeking to use a complex economic analysis to define a relevant market.

The Antimonopoly Law defines a "concentration" of business operators as a merger with, or the acquisition of controlling rights in, another business operator through an equity or asset acquisition, or through contractual arrangements. If the concentration of business operators reaches certain thresholds triggering a merger control filing, a prior notification must be filed with MOFCOM and the transaction may proceed only with MOFCOM's approval. An important aspect of the law is that it applies to offshore, as well as onshore, mergers and acquisitions. As such, even if a transaction takes place entirely overseas, PRC government approval may be required if a merger control filing is triggered under the statute.

The relevant thresholds are not stipulated in the new law itself, but they are laid out in the State Council Regulation on Notification of Concentration of Business Operators (the "State Council Regulation"). The State Council Regulation requires a merger control filing if, during the previous fiscal year, (1) the total global revenue of all business operators participating in the concentration exceeded RMB 10 billion, and at least two of the business operators participating in the concentration each had revenue of more than RMB 400 million in China, or (2) the total revenue in China of all business operators participating in the concentration exceeded RMB 2 billion, and at least two of the business operators participating in the concentration each had revenue of more than RMB 400 million in China. Article 27 of the Antimonopoly Law specifies the factors that MOFCOM should consider in making its antitrust review, including, for example, the degree of concentration in the relevant markets, the market share of the participants to the proposed concentration, the effect on consumers, the effect on market access, the effect on technological development, and the effect on "national economic development."

MOFCOM may bar a concentration, permit a concentration, or permit a concentration subject to conditions. Recent practice indicates that MOFCOM may frequently exercise its authority to impose conditions to a transaction. MOFCOM has the power to impose structural conditions which compel business operators to divest certain assets prior to the concentration, behavioral conditions which prohibit the merged entity from practices that may have an anticompetitive effect, and hybrid conditions combining both structural and behavioral elements.

The Antimonopoly Law also contains provisions that prohibit a State monopoly with administrative power (such as in the power, petro-chemical, tobacco and alcohol, and telecommunication sectors) from abusing its administrative power to restrict or eliminate competition. This development was welcomed by the international business and legal community as it could potentially help create an even playing field for private companies (foreign or domestic) vis-à-vis State owned enterprises.

NDRC, MOFCOM, and SAIC will continue to be in charge of their respective substantive areas, but with a somewhat improved organizational structure. Reflecting prior divisions of responsibility, a pricing supervision and inspection bureau has been set up within NDRC to investigate and regulate monopolistic pricing, an antitrust bureau has been set up within MOFCOM to review merger control filings, and an antitrust and unfair competition bureau has been set up within SAIC to regulate monopoly agreements, abuses of dominant market position, State monopolies and other acts that restrict or eliminate competition. In addition, an independent ministry-level antitrust commission has also been set up under the State Council to (1) conduct research and draft policies relating to competition, (2) organize investigations and evaluations of overall market competition, (3) formulate and publish antitrust guidelines, and (4) coordinate the enforcement of the Antimonopoly Law. The State Council's antitrust commission is headed by Vice-Premier Wang Qishan, who would likely be in a strong position to coordinate the parallel enforcement of the Antimonopoly Law by each of NDRC, MOFCOM and SAIC in their respective substantive areas.

The Antimonopoly Law is a complex piece of legislation containing many key concepts and principles seen in well-established antitrust jurisdictions. Details in some areas, particularly in the area of enforcement, are still missing. Enforcement authorities, particularly MOFCOM, have recently released several drafts of implementation and enforcement rules and regulations, which will gradually fill in some of the specifics and address some of the questions that have already arisen as to the Antimonopoly Law.

In light of the sweeping changes in China's antitrust law landscape, multinationals and private equity firms doing business in or relating to China should develop a strategy with regard to the application of the Antimonopoly Law. At a minimum, an internal review of business and operations, particularly joint venture or other cooperative arrangements, supply and distribution agreements, and pricing policies should be carefully reviewed to ensure compliance with the Antimonopoly Law. Merger and acquisition activities and other business combinations must also take into account the merger control filing requirement under the Antimonopoly Law at an early stage.

I. Taxation of Equity and Asset Acquisitions

In an onshore equity deal, equity deal, the relevant tax rate depends on the identity of the seller. In most cases, the seller is a Chinese individual or Chinese enterprise. For a Chinese natural person, income from the sale of property (including equity) is taxed at the flat rate of 20%. For a Chinese enterprise seller, the tax rate is the generally applicable corporate income tax rate of 25%. Foreign sellers of equity in domestic enterprises are subject to a 10% withholding tax.

Taxation of asset deals is more complex because different rates and kinds of taxation are applicable to different categories of assets. The sale of assets may result in taxable profits for the selling enterprise at the generally applicable corporate income tax rate of 25%. Additional sales taxes apply to different categories of assets. For example, sales of land and buildings are subject to business tax of five percent, and may also be subject to land appreciation tax ranging from 30% to 60%. The purchaser of real property assets is subject to a deed tax ranging from three percent to five percent. Sales of inventory may be subject to value added tax of 17%, although it may be possible under some circumstances to pass this cost to the ultimate consumer. Consumption tax may apply for certain items. Used equipment sold above its purchase price is subject to value added tax of two percent. A stamp tax may also apply.

J. Domestic Fund Formation

As noted above, most FIEs are not permitted to make equity investments in other enterprises. Foreign invested holding companies (FIHCs) constitute one exception to this rule, as described in Part II, Section (G)(2). An additional exception exists for venture capital investors. Under the 2003 *Provisions Concerning the Administration of Foreign-Invested Venture Capital Enterprises*, foreign investors may now set up on-shore, RMB denominated venture capital funds. These onshore funds may invest only in non-publicly traded, high technology companies.

Foreign-invested venture capital funds may be set up as separate limited liability entities, or as contractual entities without limited liability. Each fund must have at least two, and no more than 50, investors. At

least one of these investors must be a business primarily engaged in venture capital, with total invested assets in the three years preceding the application of at least US$100 million. At least US$50 million of the invested capital must have been directed to investments in non-public, high technology enterprises. If the lead investor is Chinese, the capital requirements are reduced to RMB 100 million invested in the prior three years, with at least RMB 50 million invested in non-public, high technology enterprises.

It is also possible to use a form of PRC entity called a trust company as a vehicle for private equity investments in the PRC. A trust company, under Chinese law, is considered a "non-banking financial institution" under the supervision of the CBRC. Trust companies manage assets and funds entrusted to their care for the benefit of beneficiaries, in return for fees and performance awards. PRC law permits trust companies to engage in private equity and investment activities with entrusted funds (and in some cases, with the trust company's own funds). Foreign ownership of the trust company itself is restricted under PRC law, with only foreign-invested financial institutions meeting certain minimum asset and other requirements eligible to invest. No more than two foreign investors may own an interest in any one trust company, and each foreign investor is limited to no more than a 20% interest in the company. There may also be foreign exchange obstacles to repatriating profits gained by investing through a PRC trust company.

China's new Partnership Enterprise Law, which came into effect in 2007, provides for limited partnerships with pass-through tax treatment. Partnerships are popular structures internationally for investment funds. The Partnership Enterprise Law applies by its own terms only to partnerships among domestic enterprises or individuals, but stated that further regulations would be issued with respect to foreign-invested partnerships. In November 2009, the State Council issued such regulations, permitting the formation of foreign-invested partnership enterprises (FIPEs). Starting on the effective date of the regulations on March 1, 2010, it will be possible to form partnerships with foreign participation. When the regulations come into effect, the FIPE structure may become the preferred method for establishing an RMB-denominated investment fund.

FIPEs will remain subject to otherwise applicable industry and legal restrictions, including the restrictions in the Catalogue. The FIPE structure nevertheless possesses several attractive features, including a streamlined approval process that requires only registration with the local AIC, as opposed to examination and approval by MOFCOM. FIPEs also receive pass-through tax treatment under PRC law. They do not have express restrictions on the minimum total investment or registered capital. Investment in other FIEs must be paid up on a stated schedule; a FIPE partnership agreement may provide for any schedule for capital payments. FIPEs also offer flexibility in profit distribution. The profits in most forms of FIE must be distributed in strict proportion to each party's equity investment. This restriction does not apply to FIPEs—the partnership structure allows the flexibility to structure different terms and conditions on which profits will be distributed.

Because of the flexibility, tax treatment, and general business scope of FIPEs, the FIPE structure could prove especially suitable for private equity and other investment funds. The Chinese authorities recognize that the FIPE structure is likely to be used for these types of funds, and have indicated that the development practices applicable to funds set up as FIPEs will be an evolving process. A publication of the Legal Affairs Office of the State Council relating to the FIPE regulations emphasized China's lack of experience in regulating private equity and venture capital investment. It further emphasized a "flexible" approach, which implies that for the time being discretionary authority will be exercised on a case-by-case basis by the relevant authorities. Although a comprehensive body of regulation and practice has not yet developed, partnerships offer advantages in tax and capital structure that should make them an attractive choice for certain foreign investors in the PRC. As is always the case in China, however, much will depend on how the Chinese authorities actually implement the rules.

K. Public Company M&A and Takeovers

China has two major stock exchanges, the Shanghai and Shenzhen exchanges, for publicly traded companies. Chinese companies issue two forms of stock. A-shares are shares subscribed for and traded in RMB, which may be freely purchased only by Chinese persons. Foreign investors may purchase equity in listed companies generally only through one of four special avenues, including the Qualified Foreign Institutional

Investor (QFII) program, by strategic investment, by purchasing non-listed shares, or by asset purchase. B-shares are shares traded in foreign currency. Originally, Chinese persons could not trade in B-shares, but now both Chinese and foreign persons can freely trade in this type of equity.

Most listed companies have not issued B-shares, and the number of B-shares (when issued) is typically small when compared to the number of A-shares. As such, it is generally not possible to acquire a controlling interest in a Chinese company by acquiring B-shares.

1. Qualified Foreign Institutional Investor (QFII)

   The QFII program allows qualified and approved foreign investors to trade in A-shares. The application for QFII status must be made through a custodian bank to the CSRC and SAFE. The types of entities that may qualify for QFII status are fund management firms, insurance companies, securities firms, commercial banks, and other institutional investors (such as pension funds and sovereign wealth funds). The basic minimum requirements for each type of institutional investor are shown below:

Type of Institutional Investor	Minimum Securities Assets Under Management in Fiscal Year Prior to Application	Minimum Operational History
Fund management institution	US$5 billion	5 years
Insurance company	US$5 billion	5 years
Securities house	US$10 billion	30 years
Commercial bank	US$10 billion in securities assets, and total assets in the top 100 commercial banks globally	None
Other institutional investors, including pension funds and sovereign wealth funds	US$5 billion	5 years

   Each QFII institution must apply for an investment quota from SAFE of at least US$50 million and not more than US$800 million. QFIIs may invest on their own accounts or as nominees for other investors. No QFII may own more than 10% in any listed company, and investments from all QFIIs combined may not exceed 20% in any listed company. As of November 2009, CSRC had approved and licensed 88 institutions as QFIIs.

2. Strategic Investors

   Many publicly listed companies in China have non-listed shares, typically shares issued in return for the contribution of state assets or state funds. These non-listed shares are not tradable on the stock exchanges.

   In 2005, the Chinese government began a share reform initiative to convert many of these non-tradable shares into tradable ones. As part of this effort, MOFCOM and other relevant government agencies issued a regulation in late 2005 permitting qualifying foreign investors, called "strategic investors," to invest in companies which have completed the share reform process. A strategic investor must purchase at least 10% of the company, and may not transfer its shares for three years.

   The relevant regulations make it easier to qualify as a strategic investor than as a QFII. Strategic investors must have assets of at least US$100 million, or manage assets of at least US$500 million. They may not have been subjected to a material penalty by regulatory authorities in China or anywhere abroad for at least three years. The regulation also sets forth subjective criteria as to the

investor's financial soundness, governance systems, and compliance processes. A strategic investor application should be directed to MOFCOM, rather than CSRC and SAFE (which review QFII applications).

3. Non-listed Shares

As noted above, many Chinese companies have non-listed shares. Unlike A-shares, unlisted shares may currently be purchased by foreign investors. Non-listed shares purchased by foreign investors are subject to a one-year lock up period. Under Chinese law, if an investor intends to acquire 30% or more of the issued shares of a listed company, it must make a tender offer. Because most foreign investors cannot legally purchase A-shares, it will not be possible to satisfy the tender offer requirement. As such, the investor will need to apply to CSRC to waive the requirement. CSRC has discretion to waive the tender offer requirement under certain specified scenarios.

4. Asset Deals

Within the restrictions of the general rules governing foreign investment in China, foreign investors may acquire assets from listed companies. All sales of "substantial assets" to take place within a one-year period must be approved by two-thirds of the shareholders. CSRC verification of the transaction is also required if (a) the assets are valued at more than 50% of the total asset value of the listed company, (b) the net asset value of the assets exceeds 50% of the net asset value of the target, or (c) the assets accounted for more than 50% of the operating revenue for the target in the prior fiscal year. This type of transaction is rare.

5. Takeover Rules

In those cases where foreign investors can legally acquire interests in publicly traded companies, they must comply with China's generally applicable takeover rules, as set forth in the *Measures for the Administration of the Takeover of Listed Companies* (the "Takeover Rules"). The Takeover Rules contain two main types of requirements: disclosure obligations and tender offer obligations.

If the holding of an investor, together with parties acting in concert with the investor, is expected to reach five percent or more of the target, a report must be prepared for CSRC and the stock exchange. The investor group must also notify the local CSRC branch where the company is located, notify the target itself, and make an announcement to the general public. The report must be filed within three days, and no additional trading may take place within this three-day period. Once an investor group reaches five percent, any subsequent stock market purchases or sales of five percent or more of the target re-trigger the reporting requirement.

If the investor and parties acting in concert will reach 20% to 30% of the listed company, a more detailed report must be prepared including the reasons for the purchases; information regarding the acquiring investors; a 12-month plan for adjusting the business, assets, and employees of the target; and other facts about the transaction as set forth in the Takeover Rules. If the investor will become the controlling shareholder of the listed company, the detailed report and supporting documents must be verified by an independent financial advisor, unless the investor agrees not to trade the shares for three years.

Once the investor group reaches 30% shareholding in the listed company, an obligation to make a partial or general tender offer arises. A disclosure requirement in the form of a tender offer report also applies. The Takeover Rules contain detailed provisions governing the form and content of such mandatory tender offers.

In most cases, the purchaser of a publicly traded company is required by law to hire a financial advisor to assist in the transaction. The financial advisor plays a semi-regulatory role. It should be independent from its client, certify the accuracy of the documents it prepares, and refuse to sign off on transactions that damage the legitimate rights and interests of the target company.

IV. OPERATING IN CHINA

A. Overview

This part provides an overview of the principal business and commercial regulations governing the operations of FIEs in China. Whereas the previous two parts of the Guide addressed entry into the China market, this part covers a foreign investor's ongoing legal obligations once established in China. Topics include home country compliance, taxation, dispute resolution, employment and labor law, environmental regulation, intellectual property, real property and product safety.

B. Home Country Compliance

Regulatory compliance often begins at home. Some countries have laws that reach beyond their borders and apply extraterritorially to the activities of corporations operating abroad. In terms of practical impact, one of the most important of these extraterritorial laws is the US Foreign Corrupt Practices Act of 1977, as amended (the "FCPA"). The FCPA prohibits covered persons from bribing foreign officials to obtain or retain business or to influence official decisions. In 2008, there were at least four major FCPA cases concerning China. Lucent Technologies was assessed a US$2 million fine as a result of paying for trips for Chinese officials to visit the United States. AGA Medical Corporation and Faro Technologies were assessed US$2.5 million and US$3 million fines respectively for paying bribes to employees at state-owned companies in return for product purchases. The largest case in 2008 concerned the German conglomerate Siemens, which was assessed a US$800 million fine under United States law, as part of a US$1.6 billion global settlement. In China, Siemens was alleged to have paid suspicious business consultants to bribe Chinese officials in connection with train and signaling projects.

The FCPA applies to US issuers, meaning any US or foreign corporation with securities registered under the Securities and Exchange Act of 1934 (the "Exchange Act") in the United States, or which is required to file reports under the Exchange Act. This definition includes any company, including any foreign company, listed on a US stock exchange. The FCPA also applies to "domestic concerns," which are US corporations, US natural persons, and any corporation with a principal place of business in the United States.

The FCPA prohibits covered persons from paying bribes to foreign government officials, including bribes to influence an act or decision of the official in his official capacity and bribes to obtain or retain business. The term "government official" has a broad scope under the Act, including, for example, low-level government officials such as police officers and, in China, employees of SOEs. The FCPA also applies to bribes paid to foreign political parties, party officials, and candidates for public office. As such, bribes paid to Communist Party officials fall within the purview of the statute.

The FCPA contains some exceptions. One exception applies to payments permitted under the written law of the official's country. Another exception applies to "facilitating payments" paid in respect of routine, non-discretionary acts such as the issuance of visas, work permits, and business licenses. The scope of each exception is narrowly interpreted and so, as a practical matter, FCPA risk is better managed with a robust compliance program rather than reliance upon either exception.

In addition to the FCPA's anti-bribery provisions, the FCPA also contains a provision requiring US issuers to keep accurate books and records, and to maintain an adequate internal control and compliance system.

Many other jurisdictions have anti-bribery statutes with extraterritorial reach, and China has its own laws governing official bribery and corruption. In some cases, China's anti-corruption laws may be more strict than the FCPA and other foreign laws with extraterritorial application. Chinese law provides for criminal sanctions, up to and including life imprisonment in very serious cases, for bribing government officials (including, in some cases, employees of SOEs). Purely commercial bribery among private parties can also constitute a criminal offense in China if the monetary value of the bribe exceeds certain thresholds or the circumstances are otherwise severe. Commercial bribery among private persons in less severe cases, although not criminal, may still result in fines and forfeiture of income.

Besides the FCPA, several other US laws and regulations have extraterritorial reach. US export control laws apply to the sales of some sensitive advanced technologies. Trade sanctions, administered by the US Office of Foreign Asset Control (OFAC), prohibit or restrict trade of covered persons with certain countries, persons, and groups. For example, Cuba, Iran, and Sudan are all subject to OFAC-administered embargoes. The US and several other jurisdictions also have extraterritorial money laundering regulations, which require financial institutions and other covered entities to establish anti-money laundering programs, identify suspicious activity, and perform diligence on certain accounts involving foreign persons.

C. Taxation

1. Corporate Income Tax

Under China's new Enterprise Income Tax Law, effective January 1, 2008, both FIEs and domestic companies are subject to a corporate income tax on profits at the rate of 25%. In the past, FIEs were nominally subject to a 30% national tax and a three percent local tax. In practice, many FIEs received tax benefits reducing their tax burden below the rate paid by domestic enterprises. One of the main purposes of the new tax law was to phase out tax preferences for FIEs. New FIEs are subject to the 25% rate from the outset. Certain FIEs previously enjoying preferential tax rates will now have those preferential rates phased out over time. FIEs must pay tax on their worldwide income, but tax credits may be available under dual tax treaties for income tax paid in other countries.

2. Sales Taxes

In addition to the corporate income tax, China also imposes several forms of sales tax. Sales of services, intangible property, and real estate are subject to business tax on gross revenue. The business tax rate typically ranges from three percent to five percent, depending on the type of activity, although some entertainment business are subject to a 20% tax on gross receipts. For real property transactions, additional taxes, including a land appreciation tax, land use fees, and deed tax may apply.

For sales of goods, China imposes a value added tax (VAT), generally at the rate of 17%. Some goods receive a preferential rate of 13%. Certain luxury products are subject to an additional consumption tax on top of the VAT.

3. Withholding Tax

Dividends from investments, royalties, and rents paid to foreign entities from their China activities are subject to a 10% withholding tax. The tax applies, for example, to dividends paid by FIEs to their overseas investors. Generally, the Chinese person making payments abroad must act as a "withholding agent" for the foreign recipient, and withhold the applicable taxes on the foreign entity's behalf prior to remitting the net proceeds to a bank account outside of China.

4. Individual Income Tax

China has a progressive individual income tax ranging up to 45%. An FIE must generally serve as a withholding agent for its employees, and withhold and pay income tax on their behalf each month. China relies principally on withholding to collect individual income tax, and only high income individuals are generally required to file separate annual tax returns.

Special tax planning options are available to expatriate employees. Certain categories of reimbursements paid to expatriate employees for their meal, home return, dependent education, language education, and housing expenses can be paid on a tax free basis when supported by adequate receipts. Special tax treatment is also available for an annual bonus. As such, careful tax planning can help alleviate the tax burden on expatriate employees.

5. Stamp Tax

Legal documents used in China, such as contracts and licenses, may be subject to a stamp tax at varying rates.

D. Dispute Resolution

China has made significant progress in increasing the integrity and reliability of its courts. Nevertheless, there continue to be significant obstacles to litigating in Chinese courts. Foreign investors continue almost universally to prefer alternative dispute resolution in China. As explained in detail below, PRC law permits the parties to elect for binding arbitration to resolve their disputes and the courts will generally enforce arbitration judgments without inquiring into the merits.

1. Litigation

The PRC judiciary consists of four layers: the People's Courts (at the district or county level), Intermediate People's Courts (at the municipal level), High People's Courts (at the provincial level), and the Supreme People's Court (at the national level). The nature and size of the dispute generally determines in which level of the hierarchy to file suit in the first instance. In most cases, disputes with a foreign connection may be brought initially in the Intermediate People's Courts.

With some exceptions, PRC litigation is open to the public. When the dispute involves confidential commercial information, it may sometimes be possible to arrange for closed hearings at the discretion of the presiding judges. All court proceedings must be conducted in Chinese, although foreign parties may request that an interpreter be provided, at their own expense.

For contracts with a foreign connection, PRC contract law under some circumstances permits the parties to select a foreign law to apply to the contract and to provide for exclusive jurisdiction in foreign courts. However, it is generally very difficult to enforce foreign court judgments in the PRC. Hong Kong judgments may be the exception to this rule. In 2008, China and Hong Kong implemented a special reciprocal arrangement for enforcing money judgments in commercial disputes. Hong Kong maintains a common law legal system and relatively sophisticated courts. If jurisdiction can be obtained, litigation in Hong Kong may now be a viable dispute resolution option for foreign parties doing business in China.

2. Arbitration

The vast majority of foreign investors operating in China include exclusive arbitration clauses in their contracts. Chinese law generally requires the courts to enforce the decisions of arbitral panels without further inquiry on the merits. Arbitration is generally considered quicker, more efficient, and more reliable than litigation in China's courts.

Under Chinese law, an express clause clearly indicating the parties' selection of binding arbitration is enforceable. The clause must be in writing and must contain a clear statement of the parties' intention to submit the dispute to arbitration, the scope of disputes subject to arbitration, and the specific arbitral commission to resolve the dispute. It is possible for the parties to reach an arbitration agreement after a dispute arises, but in most cases an arbitration clause is included from the outset in the operative contracts.

The China International Economic and Trade Arbitration Commission (CIETAC) is one of the most frequently selected arbitration forums when the arbitration will be held within mainland China. CIETAC was established expressly to handle commercial disputes involving foreign parties. CIETAC's own arbitration rules will apply by default, but it is possible to agree to another set of arbitration rules as long as such rules do not conflict with any mandatory provision of PRC law. CIETAC is based in Beijing, and has branches in Shanghai and Shenzhen.

Foreign parties sometimes object to onshore arbitration, including arbitration at CIETAC, because they believe that the Chinese party will have a home court advantage. Chinese parties concomitantly often hesitate to agree to arbitration abroad. Hong Kong is often seen as a compromise acceptable to both parties. China and Hong Kong have a reciprocal agreement regarding the enforcement of arbitral awards. A popular forum for arbitration in Hong Kong is the Hong Kong International Arbitration Center.

It is also possible to select a foreign jurisdiction for arbitration, including, for example, the Singapore International Arbitration Center or the Arbitration Institute of Stockholm Chamber of Commerce, and have the arbitration award enforced in China by the Chinese courts. China is a party to the United Nations Convention on Recognition and Enforcement of Foreign Arbitral Awards, and it is generally possible to obtain enforcement of an arbitration award issued by a panel in any member country.

Note, however, a trap for the unwary: China's civil procedure law requires that the winner of a foreign arbitral award apply to enforce that award within six months of the judgment. It is essential to apply for enforcement within the designated period.

E. Employment and Labor Law

On January 1, 2008, China's new Employment Contract Law went into effect. Other principal regulations governing employment include the Regulations on the Implementation of the Employment Contract Law and the Labor Disputes Mediation and Arbitration Law. These regulations provide a variety of rules and requirements applicable to FIEs and domestic employers alike.

1. Forming an Employment Relationship

Representative offices lack legal person status in China and may not directly employ Chinese nationals. Instead, a representative office must contract with a labor service organization, such as Foreign Enterprises Service Co., Ltd. (FESCO), to provide PRC national employees for the office.

FIEs with legal person status may directly hire employees, including Chinese nationals.

Special rules apply to hiring expatriate employees. In general, FIEs may hire foreigners more freely than domestic enterprises. A variety of work visas and permits are required to employ an expatriate legally in the PRC.

2. Employment Contracts

Chinese law requires written employment contracts. The Employment Contract Law sets forth certain terms that must be included in all labor contracts, including its term; a job description; the place where the work is to be performed; working hours, breaks, and vacations; remuneration; social security; and provisions regarding working conditions and protection against and prevention of occupational injury.

Chinese law provides for three basic types of employment contracts: fixed-term contract, non-fixed term contracts, and contracts expiring upon completion of certain tasks. China has no at will employment. Termination within the employment term must be for cause, and the law specifically delineates only certain justifications that rise to the level of cause for termination. As such, the fixed term contract generally provides the greatest flexibility for the employer because it allows periodic review of the employment relationship.

3. Minimum Wage, Social Insurance, and Working Hours

In China, the minimum wage varies by locality. The law permits deductions from an employee's salary only to withhold income tax or as otherwise required by law. An employer must pay its employees at least once each month.

FIEs, like domestic employers, must participate in a required social insurance program. Such programs generally require both employer and employee contributions. Social insurance provides a retirement pension, medical insurance and unemployment insurance. Local authorities may require additional types of contributions and provide additional benefits. Foreign employees are not covered by the program.

China requires that employees governed by its "standard working hours" regime work no more than eight hours per day and no more than 44 hours per week. Employees (or a labor union) may agree to an extension of these hours by up to three hours per day, not to exceed 36 hours per month. When an employer requires work beyond the standard working hours, it must pay at least one and a half times

the standard wage. Work over the standard period during the weekend must receive at least double wages, and work during public holidays requires triple wages.

For senior, managerial, and professional employees, it is possible to select a "flexible working hours" system, which does not require overtime pay for work beyond standard hours or during holidays.

4. Non-compete Agreements

Non-compete agreements with senior managers, senior technicians, and other employees are permitted within certain limitations. Only employees also subject to non-disclosure agreements can be asked to sign a non-compete agreement. The term of the non-compete period may not exceed two years from the date the employment relationship terminates, and separate compensation must be specified and paid to the employee in respect of the non-compete period.

5. Labor Disputes

The first step in resolving a labor dispute generally involves informal negotiations between the parties. If informal negotiations fail, the dispute must be submitted to a labor arbitration commission in the district or county where the work was to be carried out. The application to arbitrate must be filed within one year from the date the cause of action arises, and the arbitration panel has 60 days from the date of filing to issue a decision. The decision of the arbitration commission is binding, but a party may bring the dispute to the courts if dissatisfied with the arbitrator's decision.

F. Environmental Regulation

China's Ministry of Environmental Protection (the "MEP") has the power to establish national standards for environmental quality, including as to air, water, and soil quality and pollutant discharge. To the extent that there are no applicable national standards, provincial authorities are free to set their own environmental standards.

The MEP issues two basic types of permits. Pollution permits govern the amount of pollutions an enterprise may discharge into the environment. Environmental damage permits govern activities that consume natural resources, such as mining, hunting, fishing, and logging. If a party fails to obtain the appropriate permits, or exceeds the limitations of permits once granted, the MEP may fine the offending enterprise, close its operations, or act personally against responsible individuals.

Pollution and environmental damage also may give rise to civil liability, even when an enterprise is in compliance with its MEP permits.

China's recent "green policies" link benefits in other areas to environmental compliance. Green credit and green securities policies make bank loans and securities regulatory approval contingent on environmental compliance as certified by the MEP. Green insurance policies require enterprises in certain sectors to insure against environmental damage. Green trade policies may result in higher export taxes on products made in pollution-intensive industries. The new Enterprise Income Tax Law contemplates green taxation policies, providing tax incentives and sanctions related to the environment, but no implementing regulations have been issued to date.

G. Intellectual Property

Intellectual property protection in China has historically been a significant problem. Pirated movies and television shows continue to be widespread, as does trademark infringement. China is now a party to the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). Although IP protection is improving as China moves to implement its TRIPS obligations, widespread violations remain.

Chinese law provides for patent, trademark, and copyright protection. The term of a patent in China is 20 years. Patents may be assigned or licensed, but only upon registration with the State Intellectual Property Office (SIPO). China is a party to a number of international conventions on patents, including the Paris

Convention on the Protection of Industrial Property. A new draft patent law is currently under consideration, and may be passed in the near future.

Trademarks in China are under the supervision of SAIC's Trademark Office. Marks are registered for a renewable period of 10 years, and may be assigned or licensed provided such assignments or licenses are registered with and approved by the Trademark Office. Protection for well-known trademarks is available in China even if not registered, but the extent of the protection is greater for registered marks. China has a trademark dispute regime implemented by the Trademark Office.

PRC copyright law protects creative works, including software. The National Copyright Protection Center (NCPC) oversees the copyright system. The NCPC oversees a non-mandatory registration process covering both the registration of copyrights themselves and of assignments or licenses thereof.

H. Real Property

Under Chinese law, all land in urban areas is inalienably owned by the State. However, 1988 amendments to the Chinese constitution permit the State to grant the right to use land, for a limited time, to private persons. The term of such grants depends on the use of the land. Currently, land use rights are granted for 70 years for residential purposes, 50 years for industrial and mixed uses, and 40 years for commercial use.

Within the term of the land use grant, the holder of the rights has many of the same basic rights that are afforded to fee simple owners in common law jurisdictions. The holder of the rights can use and develop the land within the term and for the purposes specified in the grant. The holder of land use rights does not generally have the right to use or exploit underground resources in respect of the property; in general such rights remain with the State. Chinese law separately refers to "property ownership" or "building" rights, which are the rights to the structures built on the land. Although land use and building rights are separate conceptually, they must be conveyed together and in some locations they are reflected on the same ownership certificate.

The holder of the land use and building rights can sell, lease, mortgage or otherwise dispose of the property in accordance with law. The rights holder can also generally exclude other private persons from entering or using the property. Property transactions must be registered with the appropriate authorities to be effective.

The Chinese government has the power of eminent domain. The law requires the payment of fair compensation to land use rights owners if the property is reclaimed by the state, but in practice the amount of compensation is often below actual market standards. The government very seldom exercises its power of eminent domain to take high-end developments. Instead, the power is more often used to take the rights to older parcels of land to pave the way to modernization and new development.

The practice of granting land use rights to private persons in China is about 20 years old at this point, so there is some history and a track record with respect to private holding of land use rights. However, because the terms of the grants last for 40, 50, and 70 years, they have not yet started to expire and it is still too early to say with certainty what happens to land use rights upon expiration of the term of the grant. With respect to residential property, the law says that the land use rights "automatically" renew. It does not state whether such "automatic" renewal will be free. For other types of land use rights, the holder of the rights must generally apply a year prior to their expiration for renewal and pay a fee. The law does not yet specify a fee.

FIEs are generally permitted to hold land use and building rights for use in their businesses. For example, a manufacturing FIE may generally acquire land on which to build a factory. However, foreign real estate investment for its own sake, in the form of new development or acquisitions for the purposes of leasing to other persons or future sales, is very highly regulated in the PRC.

Land use rights granted to private parties, as described above, are termed "granted" land use rights under Chinese law. Granted land use rights generally can be transferred or mortgaged. Chinese law also recognizes more restrictive classes of land use rights, including "collective" land use rights in rural areas

and "allocated" land use rights for use by government entities and the military. In some cases, private enterprises have been allowed to use allocated land use rights. Because this type of land use right is reserved by law for government entities and may be repossessed at any time, using land with only allocated land use rights subjects an enterprise to significant risk and may make it difficult to obtain mortgage or other financing.

I. Product Safety

China has a general product quality law, along with national quality and safety standards covering more than 7700 kinds of products. Certain designated products are subject to the China Compulsory Certification (CCC) program, which requires government testing and certification before the product may be sold on the open market. Other products must be registered with the NDRC prior to sale. Special licensing requirements apply to food, medicine, and other sensitive products.

Despite these regulations, China experienced a number of significant product safety issues in 2007 and 2008. Products made in China, including toys, pet food, and the blood thinning drug heparin all caused safety issues in Europe and the United States. China experienced its own domestic product safety scare in 2008. At least six infants died, and over 300,000 infants fell ill, after drinking milk tainted with the chemical melamine. The dairy at the center of the milk scandal has since declared bankruptcy, and its former chairwoman plead guilty to criminal charges. In January 2009, a total of 21 persons involved in the melamine scandal were found guilty of criminal offenses. In November 2009, two men described as being among the most culpable of this group were executed. The melamine illnesses and product safety issues abroad may lead to increased regulation and government supervision of product safety. That said, these apparently systemic problems need to be addressed by appropriate supply chain selection and monitoring procedures.

V. CONCLUSION

Foreign investors remain on the lookout for opportunities in the PRC. Recent regulatory changes may make it easier for private equity investors to invest in China through onshore RMB funds, and strategic investors, in particular, remain motivated to participate in what remains a growing and vibrant economy. China's unique regulatory and legal environment is an important factor in navigating the perils and opportunities of investing in the China market, and understanding that legal and regulatory environment therefore continues to be of importance for foreign investors who wish to do business successfully in the PRC.

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