

# CHINA LEGAL FRAMEWORK

BEIJING, FEBRUARY 2010



## **Foreign Direct Investment in China**

Foreign investments in the People's Republic of China ("China", "PRC") may be divided into direct investment and other means of investment. The direct investment, which is widely adopted, mainly includes Sino-foreign Equity Joint Ventures ("EJV"), Sino-foreign Cooperative Joint Ventures ("CJV"), Wholly Foreign-Owned Enterprises ("WFOE") and some other vehicles for special purposes. The three are generally also referred to as Foreign Invested Enterprises ("FIE").

### **Equity Joint Venture**

The key distinguishing feature of an EJV is that profits are distributed and risks allocated in proportion to each party's contribution to the registered capital of the limited liability company. In other words, the risk and profit allocation between the JV partners may not deviate from the proportion set out in the original investment. EJVs are established in the legal form of a limited liability company. In general the capital contribution from the foreign party shall not be lower than 25%.

### **Cooperative Joint Venture**

A CJV may either be a "legal person" (PRC terminology) of limited liability, or a non-legal person with unlimited liability in accordance with PRC Civil Law.

The key differentiating features of a CJV compared to a EJV are: a) The parties may allocate profits and losses as they choose rather than in proportion to their respective contributions to the registered capital, b) the foreign party may apply to recover its investment capital during the term of the venture (in some cases before payment of income tax).

The flexibility inherent in the CJV makes it particularly suitable for certain types of investment. The foreign party may apply to recover its investment during the term of the venture with the funds derived from depreciation of fixed assets, amortization of intangible assets, and so on.

## **Wholly Foreign Owned Enterprises**

The advantages of the WFOE limited liability company (i.e. a 100% subsidiary) are obviously the 100% management and financial control over the enterprise. In addition, from a practical point of view, a WFOE may be established faster.

Opting for WFOE finally helps avoid potential disputes with PRC partners.

## **Comparison between JV and WFOE**

The major reason for opting for a JV structure rather than a WFOE is the desire of the foreign party to be active in a restricted industry or business area where a WFOE is not yet (see further below) permitted.

In addition, a JV may have the side advantages that the foreign investor may need to invest less capital and seeks to diversify risks or costs to its PRC JV partner. In addition, certain assets of the PRC partner may be valuable to the foreign investor (land-use rights, equipment, infrastructure, trained staff, marketing or distribution channels, etc.) Further, connections from the PRC partner in securing the approval of misc. licenses, get-ting preferential government treatment, fending off government and administrative interventions might constitute other reasons.

Based on the WTO commitments, more and more industries will be open for 100% foreign investment (WFOE) in the coming future.

In addition to the above-mentioned three major types of foreign direct investment, foreign investors may, de-pending on their business objectives or operation scale, and subject to restrictions and more detailed regulations expected in the future, upgrade the EJV to a foreign invested company limited by shares, to be listed in a PRC stock market.

## **Representative Office**

Opening a representative office is sometimes reckoned to be the easiest way to establish a commercial presence. However, such rep offices may only be engaged in

liaison, marketing or other non-profit-generating activities. This principle is not observed in case of rep offices of foreign service providers such as foreign law firms, accounting and tax firms, whose rep offices in China are allowed to conduct profit-generating activities and are therefore subject to corporate income tax.

### **Foreign Investment Company**

To create a comprehensive vehicle for various types of investment and centralize service functions in the PRC, foreign investors may also establish foreign investment companies in the PRC. A foreign party seeking to establish a foreign investment company must have good credit standing and either: a minimum asset value of \$400 million (calculated for its corporate group as a whole), total registered capital in existing FIEs of at least \$10 million or at least \$30 million of registered capital in 10 or more existing FIEs. Foreign investment companies may invest up to four times their registered capital (not less than \$30 million), keep a higher leverage ratio than is permitted FIEs, and possess a wide-ranging business license, allowing them to act more liberally in many respects compared to ordinary companies. The relevant regulations modified in 2006 expand the scope of services that a foreign invested holding company may provide its affiliates in the PRC with, which may help rationalize the organizational structure and improve the efficiency of its investments in the PRC. The modification has also alleviated the restrictions about the investment methods available to the foreign invested holding companies in that it allows such companies to make strategic investment in domestic listed companies.

### **Reinvestment of FIEs**

The PRC Company Law effective as of January 1, 2006 relaxes the limitation on reinvestment to 50 percentages of a company's net assets. PRC limited liability companies and joint stock companies (including FIEs) are permitted to invest in other enterprises without reference to their net assets level. This amendment should simplify and accelerate the M&A market in China, and making it easier to conduct M&A involving smaller, especially private, companies that need to inject the major part or all of their assets into a proposed joint venture.

### **Foreign Invested Partnerships**

New Option Available for FDI in China: The Administrative Measures for Establishment of Partnership Enterprises in China by Foreign Enterprises or Individuals (the "Measures") was issued by State Council on 2 December 2009. The Measures, effective from 1 March 2010, will allow foreign investors to directly act as partners of partnerships in China.

Without the Measures, the existing Partnership Enterprise Law itself does not allow foreign investors to directly invest in partnerships due to a provision which says such circumstances will be subject to administrative measures to be issued by State Council. Though with such restrictions, international PE/VC firms were forced to using limited partnerships as the form of RMB funds, and try the approach of setting up a foreign invested company acting as the general partner and raising fund from domestic investors, which proves practicable in some areas of China. Nonetheless, due to the foreign exchange control in China, a limited partnership cannot receive substantial funding from foreign investors even in such an indirect way.

The Measures generally allow a foreign investor to act as a general partner or limited partner of a limited partnership, but it is still too early for PE/VC firms to celebrate this new rule. The Measures indicate that for foreign enterprises or individuals setting up partnerships in China with the main business of investment, special laws or regulations in this regard could apply. The implementation of the Measures will thus require detailed rules to further address this issue.

The Ministry of Commerce and its local bureaus ("MOFCOM") have been the main approval authority for foreign invested enterprises for decades, but the Measures take a different approach for foreign invested partnerships ("FIP"). An Application for the establishment of an FIP shall be submitted to the local administration of industry and commerce as authorized by the State Administration of Industry and Commerce ("AIC"). MOFCOM will only be notified of the registration information upon the establishment of an FIP. An FIP is still subject to foreign investment industrial policies, including the Foreign Investment Industry Catalogue, and the AIC will review an explanation on compliance with foreign investment industrial policies as part of the application process. We would like to put a question mark on the consistency between AIC and MOFCOM in applying industrial policies to FIPs and other foreign invested enterprises respectively, and speculate that this could trigger the involvement of MOFCOM in approving FIPs.

## **Developments since China's WTO Accession**

Upon China's entry into WTO and in accordance with its WTO commitments, China made significant amendments in laws and regulations and promulgated new regulations related to direct foreign investment, and it continues to open up related restrictions.

The latest "Catalogue for the Guidance of Foreign Investment Industries" encourages foreign investment to flow into target industries, for example high-tech industry, resource development, infrastructure construction, as well as certain fields in the agricultural sector. However, the government continues to restrict foreign investment in many industries and industry sectors which are considered strategic.

Within the strategy of development of the West of the PRC, the government has enacted the "Advantageous Industries Catalogue for Foreign Investment in Middle and Western Regions" to implement preferential policies for foreign investment in the Western regions.

### **Future Tendencies**

China declares that it will continue to improve the political and legal environment for foreign investment, and to enhance quality and transparency of all administrative levels. China is further expected to continue to improve its legal system, subject to ongoing reforms.

Industry-wise, more and more emphasis have been laid on the factors about resource efficiency, environment protection and safety production, with a series of relevant laws & regulations and national standards being promulgated to ensure the national industry policy is adhered to.

The newly released Administrative Measures for the Registration of Capital Contributions with Equities of Companies introduces a new significant way of capital contribution in China. Faced with the financial crisis and an increasingly stagnant market, more and more investor will seek and try equity capitalization rather than other cumbersome fund raising method. It appears that the new Measures may not be applicable to cross-border share transactions; however, there are good reasons to believe that it will facilitate investments under the current economic crisis and provide more opportunities for investors to participate in the domestic M&A market.

### **Responsible Authorities**

Generally, the Ministry of Commerce (MOFCOM) is the central government authority that examines and approves the establishment of FIEs with foreign contributions exceeding certain amounts, or engaged in certain restricted business areas, or in businesses subject to quotas and specific licenses. The responsible division within MOFCOM is the Department of Foreign Investment Administration.

MOFCOM

No. 2 Dong Chang An Avenue

Beijing China (100731)

Tel: +86 10 6512 1919

Fax: +86 10 6567 7512

Email: [service@fdi.gov.cn](mailto:service@fdi.gov.cn)

Web: [www.mofcom.gov.cn](http://www.mofcom.gov.cn)

## **CUSTOMS AND FOREIGN TRADE SYSTEM**

### **PRC Customs System**

#### **Customs Clearance**

The current customs system is based on PRC Custom Law and regulations on the related Import and Export Tariffs, the latter of which is amended annually to provide a detailed and updated list of tariffs.

The PRC customs duty includes Most-Favored-Nation (MFN) duties, duties subject to territorial trade treaties, special preferential duties, common duties and quota duties, which will apply depending on the status of the country in which the imported goods are produced.

Customs clearance must be applied for to the customs within a certain period of time (generally, within 14 days after the declaration of arrival of imported goods in China for import customs clearance and within 24 hours before the arrival of goods to be exported in customs supervision area for export customs clearance). While applying for customs clearance, the applicant shall submit a series of documents including import license (if applicable), commercial invoices, bill of lading, packing list or purchase contracts, certificate of origin and commodity inspection certificate etc.

## **Processing Trade**

Goods imported for processing trade (that after being finished in the PRC will be re-exported) are not subject to custom duties. However, FIEs, which intend to be engaged in processing trade shall handle the procedures of record keeping at the customs and obtain a registration manual for processing trade.

However, the Government has recently expanded the list of items included in the Prohibition and Restriction Lists of Commodities for Processing Trade. As goods listed on the prohibition list can only be imported under the general trade customs category, companies active in processing trade are not allowed to import them, even if they are willing to pay customs duty and import VAT. The extension of the list of items is one of many steps taken by the Chinese Government to curb the part of the processing industry that engages in labor intensive, low value added processing trade and shift the industry towards the processing of higher technology goods.

## **Bonded Zones**

In principle, goods shipped into bonded zones are not subject to import customs duty and import VAT, as they are not deemed imported. These import customs duty and VAT will become payable only when they are trans-ported into areas that are within the PRC but outside of the bonded zones. Furthermore, products that are manufactured in the bonded zones are exempt from export duty while being exported. Consequently, bonded zones are used mainly for foreign trade, logistics, warehousing and processing trade.

## **VAT Refund**

FIEs that export its goods manufactured in China can apply for VAT refund on a monthly basis at the respective customs. However, to qualify as a VAT tax payer and VAT refund, local approval authorities in charge of foreign direct investment may set certain requirements for the registered capital of the FIEs. Note that VAT refunds in the PRC can be subject to considerable time-lags.

China further implemented the Agreement on Customs Valuation under the WTO by enacting the Measures of the Customs of the People's Republic of China for the Assessment and Determination of Dutiable Value of Import and Export Goods in 2006.

## **IPR Protection**

China's system for customs protection was established with the promulgation of the Regulations on Customs' Protection of Intellectual Property Rights (1995), and was further strengthened with a 2004 amendment. The implementing rules were published in 2005 and further amended in 2009.

At present, the IP rights subject to customs protection include the following:

- Registered trademarks as verified and approved by the China Trademark Office (except service trademarks);
- Trademarks registered internationally with the World Intellectual Property Organization (WIPO) and extended to China (except service trademarks);
- Patents for invention, for utility model and for design as granted by China's State Intellectual Property Office (SIPO);
- Copyright and related rights as held by citizens or organizations of the member states under the Berne Convention for the Protection of Literary and Artistic Works

The first consideration that IPR owners should make is whether or not to record their IPR with the General Administration of Customs (GAC). The recording of trademarks, patents and copyrights serves as a notification on the conditions of an IPR, with details on who to contact in case of suspected infringement, and a picture or sample of the products and its packaging. While recording is not a precondition for Customs protection, it provides owners with some distinct advantages. Recording is inexpensive, will last for an extendable ten years, and will ensure that an owner can use Customs protection should the occasion arise. For invention and utility model patent rights, recording is less relevant; since Customs will unlikely detect infringements during their daily supervision of imported and exported goods. However, for active protection, such recording may still be useful

Customs protection falls into two distinct categories: passive protection, which relates to Customs taking measures in response to an IPR owner's request; and active protection, in which Customs investigates and disposes of infringing goods on their

own initiative. Most cases until now still fall into the first category, but Customs is now becoming inclined to actively investigate infringements. At any rate, IPR owners have fewer challenges to overcome when Customs takes the lead.

### **Future Tendencies**

China is to impose temporarily low import tariffs on more than 600 commodities in 2010 in line with its WTO commitments. The targeted commodities comprised resource commodities, including coal, granite, and phosphate ore; key components for optic communications; medical products, including plasma and vaccines; and some advanced production machines. The general tariff level would be left unchanged at 9.8 percent, the same as the previous three years

### **Responsible Authorities**

The General Administration of Quality Supervision, Inspection and Quarantine of the People's Republic of China is responsible for the inspection of imported goods whereas the Customs General Administration is the competent authority for supervision and control over import and export and collection of customs duties and import VAT.

#### **General Administration of Quality Supervision, Inspection and Quarantine No. 9**

Madiandonglu, Haidian District  
Beijing China 100088  
Tel: +86 10 82262114  
Fax: +86 10 82260011  
Email: [webmaster@aqsiq.gov.cn](mailto:webmaster@aqsiq.gov.cn)  
Web: <http://www.aqsiq.gov.cn>

#### **General Administration of Customs**

No.6 Jianguomennei Avenue 6  
Beijing China (100730)  
Tel: +86 10 65194114  
Web: <http://www.customs.gov.cn>

## **PRC FOREIGN TRADE REGIME**

### **Overview and Recent Developments**

The PRC foreign trade regime rests primarily in the PRC Foreign Trade Law, which has been amended in light of the WTO accession. The new Foreign Trade Law has come into effect as of July 1, 2004. In comparison with the former, highly restrictive PRC Foreign Trade Law, the new law contains the following major amendments:

1. The scope of foreign trade operators has been broadened to individuals.
2. No more administrative approval is required for foreign trade operators engaged in goods or technology import and export. Foreign trade dealers are merely required to register for record keeping.
3. Import and export automatic licensing systems are brought into conformity with WTO procedures.
4. Trade investigations and trade remedies are provided to achieve a fair foreign trade order.

While FIEs in China seeking to acquire export and import rights used to be subject to considerably high requirements with regard to capital contributions and previous business records by the foreign investors, the newly promulgated Regulations on Foreign Investment in Commercial Areas has substantially lowered the threshold for foreign invested enterprises to obtain import and export rights, as registered capital of such foreign invested commercial enterprises now only needs to meet the minimum requirements set forth in the PRC Company Law.

### **Future Tendencies**

The new Foreign Trade Law provides a legal framework that will entail future amendments. The State Council and the administrative agencies will promulgate implementing rules and regulations and amend the existing ones. Understanding those implementing rules and regulations will be necessary to take advantage of the de-regulated trade regime and the related business opportunities in the near future.

### **Responsible Authority**

The Ministry of Commerce (MOFCOM) is the state organ in charge of administration of foreign trade. The responsible division at MOFCOM is Department of Foreign Trade. (MOFCOM contact information see above)

## **TAXATION**

### **Major PRC taxes affecting foreign investors**

#### **Value Added Tax ("VAT")**

VAT currently applies to all individuals and enterprises engaged in supplying goods or rendering specified services or in importing goods (not services). Provision of services that are not covered by VAT may be subject to Business Tax (see below).

The standard VAT rate is 17%, except for food grains, edible vegetable oils; tap water, heating, air conditioning, hot water, coal gas, liquefied petroleum gas, natural gas, methane gas, coal/ charcoal products for house-hold use; books, newspapers, magazines; fees, chemical fertilizer, agricultural chemicals, agricultural machinery and covering plastic film for farming; and other goods as regulated by the State Council. For agricultural products, water, gas and central heating, a reduced rate of 13% applies.

#### **Business Tax**

Business Tax is a local tax on business activities, including services not covered by VAT, the transfer of im-movable property as well as intangible property within China. The rates of tax vary from 3% to 5%, except for the entertainment business where rates may be as high as 20%. No credit is allowed of VAT against Business Tax. A Business Tax of 5% will also be imposed on rep offices of foreign enterprises in certain industries such as law firms, accounting firms and tax consulting firms and cost-plus basis rep offices etc.

## **Foreign Enterprise Income Tax**

Prior to 1 January 2008, Foreign Invested Enterprises (FIE) and domestic enterprises are taxed under two different regimes. FIEs and foreign enterprises were subject to the foreign enterprise income tax, the rate of which was lower than the respective rates for domestic enterprises. However, the new Chinese Enterprise In-come Law unifies the two different regimes, and the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises was abolished as of 1 January 2008.

The newly unified tax rate of enterprise income is generally 25%. Small enterprises with less profit enjoy a rate of 20%, and high-tech enterprises encouraged by the State enjoy a preferential rate of 15%.

Enterprise income tax adopts the classical system whereby profits distributed by a company in the form of dividends will then also be subject to individual income tax in the hands of individual shareholders.

Income derived in the PRC (e.g. dividend, interests or royalties) by a foreign company with domicile outside the PRC may be subject to Enterprise Income Tax. Reductions may apply in case of bilateral treaties (from usually 10% withholding tax to as low as 5%).

## **Individual Income Tax**

There is no system of personal deductions, though a standard monthly deduction is allowed for some income (such as employment income) and specified deductions may be made for some types of income. Each individual is considered to be a separate taxable person, and there is no aggregation of the income of, or joint taxation of, spouses.

Income is taxed at different rates depending on the nature of the income. Whereas wage income, business income, and management fees are subject to progressive taxation, some other types of income such as remuneration for professional services and rent, royalties, interest and dividends are taxed at a flat rate.

With regard to the employment income, residents of the countries or regions having concluded bilateral treaties with China will generally only be taxed in China for China-related income, as long as they stay in China for less than 183 days and the income is not paid by a PE of a foreign enterprise in China.

### **Main Other Taxes**

Consumption tax, agriculture tax, stamp duty, deed tax, land appreciation tax, urban property tax, vehicle and vessel use tax, slaughter tax, tax on tonnages of ships, vehicle purchase tax and resource tax.

### **Tax Incentives for Foreign Direct Investment**

Tax incentives are mainly available for enterprise income tax, import duty and VAT (imported equipments of qualified FIEs within the range of their total investment may be exempted) and business tax (might be ex-empted for high-technology-related services).

The new Chinese Enterprises Income Law erased the previous tax incentives which were particular to FDIs and changed the landscape of tax incentives in China remarkably. The system of tax incentives embodied by the Income Tax Law of the PRC on Enterprises with Foreign Investment and Foreign Enterprises was based on facts as who invests and where they invest in, while the new system of tax incentives mainly focus on in which industries the investors invest, regardless of the origins of capitals. In other words, preferential in enterprise income tax treatments are granted to the important industries and projects whose development is supported and encouraged by the state.

Major tax incentives provided by the new Chinese Enterprises Income Law are as follows:

1. The enterprise income tax on enterprises with small profits, that meet certain conditions, shall be levied at reduced tax rate of 20%.
2. The enterprise income tax on important high- and new-tech enterprises that are supported by the state shall be levied at the reduced tax rate of 15%.
3. The incomes incurred from projects of agriculture, forestry, husbandry and fishery, from business operations of the important public infrastructure investment projects supported by the state, from the

projects of environmental protection, energy and water saving, from the transfer of technologies, may be exempted or reduced.

For enterprises established prior to 1 January 2008, which enjoyed tax incentives according to the previous policies and rules, the new Enterprise Income Law allows a transition period of five years so that the tax rate for such enterprises will gradually be in line with the new law. In addition, the high- and new-tech enterprises newly established in Shenzhen, Zhuhai, Shantou, Xiamen and Hainan Special Economic Zones as well as Pudong New District of Shanghai may continue to enjoy transitional preferential tax treatments. The State Council still holds the right to offer additional beneficial policies in some specific cases.

In addition, FIEs also enjoy VAT refunds if they purchase domestic equipment. I.e. an FIE can apply for the refunding of the VAT contained in the selling price of the domestic equipment it buys, subject to the purchased equipment are used for investment categorized as "encouraged projects" according to "Catalogue for the Guidance of Foreign Investment Industries" and "Advantageous Industries Catalogue for Foreign Investment in Middle and Western Regions".

## **Tax Authorities**

The State Administration of Taxation (SAT) is the Ministry of Finance's department which implements the tax law. It is situated in Beijing and has many branch offices throughout the country. In addition to local SATs, there are local tax authorities responsible for collecting and managing local taxes.

With regard to the major tax categories, SAT is primarily responsible for the levy of corporate income tax, VAT and consumption tax whereas local tax administrations are mainly responsible for the levy of business tax and individual income tax. However, for the sake of efficiency, they may also collect each other's taxes upon mutual request.

### **State Administration of Taxation**

Yang Fang Xi Lu No. 5, Haidian District  
Beijing, 100038  
Tel: +86 10 6341 7114  
Email: [webmaster@chinatax.gov.cn](mailto:webmaster@chinatax.gov.cn)  
Web: <http://www.chinatax.gov.cn>

## **CAPITAL MARKETS**

### **Overview**

Since their opening around 20 years ago, China's capital markets are now best described as emerging. The WTO also opened the door to foreign participation in China's capital markets. A number of new regulations issued since 2002 have made it possible for foreign firms to establish joint-venture fund management companies as well as securities companies. In addition, a Qualified Foreign Institutional Investor (QFII) scheme was introduced to permit major foreign financial institutions to invest directly in the domestic bond and equities markets. There is a general assumption in the market that China will continue to liberalize its capital markets.

### **Fund Management Companies**

According to Article 10 of the Measures for the Administration of Securities Investment Fund Management Companies, the cumulative proportion of capital contribution of or cumulative proportion of rights and interests owned (directly and indirectly) by the foreign party of a Sino-foreign joint venture fund management company may not exceed those in the commitment made by the state on securities industry for opening to the outside world .According to Article 10 of the Measures for the Administration of Securities Investment Fund Management Companies, the proportion of capital contribution of or proportion of rights and interests owned by the foreign party of a Sino-foreign joint venture fund management company may not exceed those in the commitment made by the state on securities industry for opening to the outside world accumulatively (including those owned directly and indirectly). Under the Catalogue of Industries for Guiding Foreign Investment (Revised 2007), the current limit to foreign participation in fund management companies is a maximum investment of 49%. By August of 2007, 25 joint-venture fund management companies have already been established in china.

### **Securities Companies**

Regulations limit foreign participation in the domestic securities industry to joint ventures, with a maximum foreign shareholding of one third of the total access. Although foreign joint venture securities companies are permitted to underwrite RMB-denominated so-called "A shares", there is no provision for when brokerage licenses will be made available.

### **Qualified Foreign Institutional Investors (QFII)**

In December 2002, QFII regulations were enacted, allowing foreign institutions to invest in the domestic stock and bond markets. As of August, 2008, the applications of 65 QFII have been approved.

The Measures on the Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors (QFII) came into force as of September 2006. The Measures provide a better legal environment for QFII investing in the Chinese market, and they are therefore considered to be propitious to QFII to actively participate in the reform and development process of the Chinese capital market. The Measures are also in favor of dispersing financial risks.

### **Tradable Shares and Non-tradable Shares**

There used to be a partition on China's securities market between tradable shares and non-tradable shares. State-owned shares – which usually account for the majority shares in a listed company, were not tradable unless approved by the authorities. Such partition was largely eliminated during the reform starting from September 2005, and as a result of this reform all shares became tradable (subject to a certain locking period) and are quoted with the same price. This change obviously makes a foreign acquisition of a Chinese company much easier.

### **Launch of the Second Board**

After 10 years of preparation, China launched ChiNext on Oct 30th, 2009, otherwise known as "Growth Enterprise Market" or "Second Board" in Shenzhen, The Nasdaq-style board aims to nurture small and medium-sized growth companies in the country and provide them new financing channels amid the global economic recession.

Applicants for the second board listings are required to have at least RMB 30 million worth of stock capital, which is much lower than the minimum RMB 50 million needed

to list on Shenzhen's SME board or Shanghai Stock Exchange. Likewise, second board applicants shall have been profitable for two years prior to listing, with net profits of at least RMB 10 million, or alternatively have the net profits of at least RMB 5 million in the latest year together with an operating income of at least RMB 50 million, and the operating income would have to achieve the growth rate of not less than 30% over the previous two years. On the SME board, the requirements are three years and profits of at least RMB 30 million. The qualifications

The opening of ChiNext has clearly positive effect on the development of China's small and medium-sized enterprises (SMEs), which are often overlooked when it comes to domestic funding routes. And the proposed international board on Shanghai Stock Exchange will allow overseas companies to list in the A-share market. This is seen as a move to trigger a return of 'red chips' - companies registered and listed overseas - to Shanghai.

### **Foreign Strategic Investments to Listed Companies**

As per the Administrative Measures for Foreign Strategic Investment to Listed Companies of December 31st, 2005, a foreign investor may, by way of subscribing to a private placement of A shares or entering in a share transfer agreement with shareholders, make a "strategic investment" in a listed company. This is new in the way that foreigners in general had no access to A shares

### **Acquisition of domestic enterprises and FIEs**

The Provisions on Acquisition of Domestic Enterprises by Foreign Investors which came into effect on September 8th, 2006 defined the approaches and procedures to acquire the equity or assets of domestic enterprises. All equity acquisitions are subject to the review by Ministry of Commerce (MOFCOM). The Provisions for the first time explicitly allow payments in the way of stock swaps. The Circular issued by MOFCOM on June 22nd, 2009 has further clarified different acquisition options.

The acquisition of an existing FIE is also subject to review by MOFCOM or its authorized branches.

### **Future Tendencies**

The state authorities constantly follow a policy of opening the capital market, though they maintain many restrictions considered to be crucial for a sound development in this area. A recently published circular of the CSRC calls on domestic listed companies to reveal information actively which could be interesting for FIEs direct investment in these companies. Listed companies are asked to create an account of their business activities that can attract attention of FIEs and promote a better mutual understanding. In doing so listed companies are supposed to regard especially the needs of small and middle sized investors.

China is currently realizing a share structure reform of state owned enterprises for the purpose of allowing shares to float on the market. But the state will hold a controlling position as a shareholder in enterprises considered to be of crucial interest for the national economic development.

Furthermore there was a law released in 2005 regulating management buy outs of small and middle sized current state owned enterprises for the first time. This law stipulates that in the future managers of these enterprises shall stand a fair competition with private bidders. However, big state owned enterprises remain excluded from management buy outs.

## **Governing authorities**

China Securities Regulatory Commission (CSRC) is the dominating regulatory body over China's capital market. A recently published draft for the 2nd revision of the securities law envisions to give more rights to the CSRC in order to supervise the capital market but also limits its power to guarantee a fair and lawful use of its rights.

## **CSRC**

Fukai Building A, Finance Avenue 19, Xicheng District,  
Beijing, 100140  
Tel: +86 10 6620 0182  
Web: <http://www.csrc.gov.cn>

## **Foreign Invested Banks**

### **Overview**

China published its updated Administrative Regulations for Foreign Invested Banks in November, 2006 in order to fulfill all its commitments made upon its WTO accession. Starting from December 11th, 2006, foreign in-vested banks began to enjoy national treatment in offering their services in China.

### **Legal Forms of Foreign Invested Banks**

The following choices are available for a foreign bank in establishing business presence in China: 1) representative offices; 2) bank branch; 3) wholly foreign owned subsidiary banks; and 4) joint ventures with Chinese banks.

A representative office, though limited mainly to liaison purpose, is important for any foreign banks that newly enter the Chinese market, because 2 years' presence of such a representative office is the prerequisite for any foreign bank to apply for the opening of any operational branch/subsidiary in China.

Subsidiary banks may provide the full range of banking services like local banks. However, a foreign banks branch (unincorporated) is not allowed to offer RMB services to Chinese natural person customers - except receiving deposits each with a value of no less than RMB 1 million (roughly USD 130 k). Capital requirements for a subsidiary bank are RMB 1 billion.

The fourth alternative is a joint venture with local banks, which now are usually implemented by acquiring shares in some Chinese bank and one of the advantages of such a strategy is that the existing networks of the Chinese bank can be utilized. However, such acquisition by a foreign bank is subject to the ceiling of 20% shares in one single Chinese bank.

### **Approval Procedures**

The establishment of any of the aforesaid business presences has to be first approved by CBRC, the supervisory authority over the banking sector in China.

A two-stage process is imposed by CBRC on any application for opening a bank branch and subsidiary banks in China. The Establishment Application shall be first filed and CBRC will decide whether it approves or not within 6 months. Upon physical establishment, the bank should file its Operation Application and CBRC will decide whether to give operation license or not within 2 months.

## **Governing Authorities**

China Banking Regulatory Commission (CBRC) is the dominating regulatory body over China's banking sector.

## **CBRC**

N0.15 Financial Street Jia, Xicheng District, Beijing, 100800  
Tel: +86 10 6627 9113  
Website: <http://www.cbrc.gov.cn>

## **FOREIGN EXCHANGE**

### **Overview**

PRC authorities removed most restrictions on foreign exchanges under current account in the year 1997 so that PRC individuals and enterprises can easily purchase and make payment in foreign currencies whenever necessary. However, restrictions under capital account remain to a large extent as they were. Borrowing money from overseas is subject to a strict official examination and approval process.

Foreign investors, however, are treated somehow differently. The profits derived from their investments in China (i.e. FIEs), after due taxation, can be freely changed into foreign currencies and remitted abroad. Foreign currencies brought in by foreigners can either be kept by them or be sold to or deposited with designated banks.

Since July 21st, 2005 the RMB is no longer pegged to the US Dollar but is free to float according to market supply and demand. From that time the People's Bank of China announces the closing price for each foreign currency traded against the RMB at the end of each working day. This price will be the central parity for trading on the following working day. The RMB is allowed to float to the US Dollar within a band of 0.3 % around the central parity published by the People's Bank of China and shall be adjusted in relation to a basket of major foreign currencies.

## **Anti-money Laundering**

The promulgation of the Law of the People's Republic of China on Anti-money Laundering indicates the government's stand to attack money laundering and safeguard its foreign exchange order. The definition of the "money-laundering" mentioned hereto shall mainly include money obtained by means of illegal drug trafficking, organized crime, terrorist crimes, smuggling, corruption, bribe taking, violating financial management regulations and financial fraud. With the new Law, this definition of money-laundering has been widened considerably.

According to the Law, all financial and non-financial institutions incorporated within the territory of China shall be responsible for establishing procedures and systems to attack money laundering. The Law also stipulates that information, such as commercial secrets gained from attacking money-laundering, shall only be used for legal investigation and litigation.

An anti-money-laundering information center shall be established as per the requirements of the Law, and the responsibilities of such center shall be receiving information and analyzing suspicious trading and trades involving big amounts.

Where new financial institutions or new branches of existing financial institutions are established, an internal system of anti-money-laundering procedures and systems shall be established. Actual and effective identity information about the clients has to be recorded.

## **Individual foreign exchange**

As for individual foreign exchange, according to the Detailed Rules for Implementing the Measures for the Administration on Individual Foreign Exchange, each person may convert the total annual amount of USD 50,000 every year, and SAFE may make adjustments on the total annual amount in light of the national payment balance.

Foreign exchange purchased by an individual may be remitted abroad, deposited into his or her foreign exchange savings accounts or carried out of the territory of China in line with the related provisions. Personal foreign exchange income and expenditure

under the current account may be divided into business foreign ex-change income and expenditure and non-business foreign exchange income and expenditure.

## **Foreign Exchange Administration Regulations**

The revised Foreign Exchange Administration Regulations of the People's Republic of China (New FX Regulations) were promulgated on August 8 2008 and became effective the same day.

The new Regulations have removed the mandatory requirements for transfer and settlement of foreign ex-change. Under the new Regulations, the foreign exchange income of a domestic institution or individual may be transferred back into China (either to be reserved in a foreign exchange account or sold to qualified financial institutions), or deposited overseas.

A distinct shift of supervision focus can be seen in the clauses on the new penalty imposed on illegal collection and settlement of foreign exchange. Unauthorized collection and settlement of foreign exchange (such as so called "hot money", which is i.e. money transferred into China without due approval or filing) is subject to the same penalty as unauthorized purchase of foreign exchange and remittance offshore: The penalty is 30% of the amount of violation. To verify the legality of such cross-border foreign exchange transactions, the supervision authority applies a test about the authenticity and lawfulness of underlying transaction. The new law also strengthens the control over the use of settled foreign exchange, which should be strictly in line with the purpose as approved by the foreign exchange administration authority or by a qualified financial institution.

The new Regulations specify that in certain emergencies, such as a serious unbalance of international payments or an economic crisis, the government may take the necessary protection or control measures. In addition, the new Regulations opens a door for domestic financial institutions to provide commercial loans to off-shore entities, though implementing rules and rules about registration requirements are still pending.

## **Responsible Authority**

State Administration of Foreign Exchanges (SAFE) is responsible for the supervision and regulation of foreign exchange related affairs.

## **SAFE**

Huarong Building, Fucheng Road 18, Haidian District,  
Beijing, 100048  
Email: [safe-info@mail.safe.gov.cn](mailto:safe-info@mail.safe.gov.cn)  
Web: <http://www.safe.gov.cn>

## **INTELLECTUAL PROPERTY RIGHTS**

### **Overview**

Foreign investors are often concerned about the protection of their intellectual property rights (IP rights) in China. The IP protection regime of China consists mainly of the Trademark Law, the Patent Law, the Copyright Law and the Unfair Competition Law. A set of implementation rules and legal interpretations have also been promulgated to strengthen the protection in this area.

### **Trademarks**

By virtue of a series of international conventions, of which China is a signing party, trademarks from the other signing parties of these conventions may be registered in China and by virtue of such registration enjoy the same protection as a trademark registered by a Chinese applicant. In addition, a foreign trade-mark applicant from a signing country of the Paris Convention has the priority right to file for trademark protection in the PRC within six months after its filing proper application in its home jurisdiction. A foreign trademark from a signing country of the Madrid Agreement or Protocol can extend the protection of its IP rights to China by means of an international registration in Geneva and a separate request of extension.

Except for the applications through Madrid channel, applications for trademark registration by foreign entities must be made to the Trade-mark Office of the State Administration for Industry and Commerce (SAIC) through one of the officially designated trademark agents authorized to deal with PRC trade-mark application. A registration is valid for 10 years and may be renewed.

Trademark applications can be lodged for both goods and services. Trademark license agreements shall be registered at the Trademark Office of the respective SAIC upon its signing.

## **Patents**

The third revision of the Patent Law of China became effective on October 1, 2009. The new law brings many aspects of Chinese patent law further into line with current practice in major countries, and also reflects the need to build up an “innovative society”, by, for example, strengthening the standards of granting patents.

Patents in the PRC include invention patents, utility models and design patents. The new law now allows foreign applicants wanting to file a Chinese patent application to do so through any legally established patent agent firm, rather than having to file through a designated patent agent firm as is required under current law..

Patent applications are governed by the first-to-file principle. Since China is a member of the Paris Convention, for an application for an invention or utility model patent filed in another country that is a member of the Convention within 12 months prior to the filing of an application in China, the priority date will be deemed to be the prior filing date in the other country. For design patents the prior application must be made within 6 months of the application in China.

For the inventions completed in China, a confidentiality examination procedure shall be gone through first before any patent filing for the same is submitted to a foreign country for patent (the requirement that the patent shall be filed in China first is abolished in the 3rd revision). Failure to go through the secrecy examination will cause the Chinese patent not to be granted.

After the 3rd revision of the Patent Law, the substantive standards for granting a patent in China are not significantly different from those in most western countries, being “novelty”, “inventive step”, and “practical applicability” (one of the most important changes made in the 3rd revision of the Patent Law is the raise of the standard for novelty from “relative novelty” to “absolute novelty”, including the prior publications in a foreign country into the scope of “prior art”, against which the novelty of the technology or design is judged).

The procedures for examining the applications for invention patents on the one hand, and those for utility model patents and designs on the other hand are different. For the applications for invention patents, a substantive examination as to the qualification of the invention will be carried out, and for the applications for utility model patents and design patents, only a formal procedure as to the completeness of the application documents is to be gone through.

The term of protection of patents for invention is twenty years, subject to an annual fee, whereas the terms of protection for utility models and designs is ten years. As patent law systems of other countries, the patents granted in China are also subject to certain limitations, including mainly fair use and compulsory license.

Patent-related contracts (e.g. license agreements) shall be registered at the respective Patent Offices within three months after its entering into force.

## **Copyrights and Software**

Work produced by foreign persons and which is published first in China is protected by copyright. If the work is first published outside China, copyright protection is granted only under bilateral or multilateral agreements.

Furthermore, and unlike Switzerland, copyrights can be registered in China and a corresponding certificate of copyrights can be obtained. The same applies to computer software. The advantage of such registration is that once a dispute arises or escalates into litigation, the registered copyrights and computer software are strong evidences for IP rights that could be effectively applied during the litigations.

For something to qualify as a work it must be a physical reproduction of an intellectual creation in tangible form and it must have originality. Foreign computer softwares enjoy protection as literary works and do not need to be registered.

The term of protection for copyrights is usually the author's life plus fifty years. The term of protection for computer software is fifty years, starting from the end of the year in which the program was first published.

Since May 2005 a liability of internet content providers for violation of copyrights by users is stipulated by law. Owners of copyrights can claim providers to remove such content violating lawful rights of the owner. Providers who refuse to do so or know about unlawful content will be charged with fines.

The responsible authority for copyrights related issues is the State Copyright Administration.

## **Competent Authorities**

### **SAIC (Trademarks)**

**No. 8** Sanlihedonglu, Xicheng District,  
Beijing, 100820  
Tel: +86 10 88650000 Fax: +86 10 68052266X3129  
Web: [www.saic.gov.cn](http://www.saic.gov.cn)

### **State Intellectual Property Office (Patent)**

**No. 6** Jimengqiao Xituchenglu Haidian District,  
Beijing, 100088  
Tel: +86 10 62083114  
Web: [www.sipo.gov.cn](http://www.sipo.gov.cn)

### **National Copyright Administration**

**No. 40 Xuanwumenwaidajie**, Xuanwu District  
Beijing, 100052  
Web: [www.nac.gov.cn](http://www.nac.gov.cn)

## **LAND USE RIGHTS**

### **Overview**

In China, the ownership of land belongs to either the state or collectives (of farmers). The law prohibits the transfer of the ownership of land between individuals or entities, with the exception that the state may, in accordance with certain rules and procedures, expropriate collective-owned land (which again is subject to adequate compensation for the farmers).

However, the right to use land (LUR) is transferable. Investors may acquire LURs either by applying for such right directly from the government (LUR Assignment) upon payment of assignment price, or purchase the right from a non-governmental entity (LUR Transfer). Both Assignment and Transfer are on a paid basis, which are the main and most usual way to acquire LURs. Free LURs are granted (LUR Allocation) in some

exceptional cases, such as building of government offices, hospitals, military facilities and other infrastructure and public welfare facilities.

The term of Assignment LUR lasts from 30-70 years. Most terms of Assignment LUR for industrial land have a validity of 50 years.

The State Policy to Tighten the Control over Land

In August 2006, the State Council promulgated the Policy to Tighten the Control over Land. According to this policy, the assignment of all industrial purpose land must be subject to public sales such as bidding, auction or listing on LUR market. And the assignment price must not be below the "Bottom Price" of that in the specific area. This "Bottom Price" is fixed according to certain calculation formula.

The reiteration by the State Council of strengthening the administration of LUR assignment procedures and the implementation of local "Bottom Prices" indicates the central government's determination to ensure that the LURs are assigned in an adequately paid way instead of in a *de facto* for free as quite a lot of local governments have been practicing.

## **Land Use Tax**

The Provisional Regulations of the People's Republic of China on Land Use Tax in Cities and Towns (the "Regulations") have been revised by December 31st, 2006. These Regulations are formulated to rationalize the use of land in cities and towns, to regulate the income differential on land, to improve efficiency of the land use and to strengthen management of land. Units ("danwei") and individuals which use land within the boundaries of cities, counties, towns and industrial and mining districts shall be the obligatory tax payers for the land used within cities and towns and shall pay land use tax in accordance with provisions of these Regulations. The term of "Units ("danwei")" herein shall also refer to foreign invested enterprises and foreign enterprises. The calculation of the land use tax shall be based on the actual area of land used by the taxpayer and shall be levied in accordance with the stipulated tax rate.

## **The Classification of Land**

According to the Circular of the Ministry of Land and Resources Regarding the Promulgation and Implementation of the State Criterion on Minimum Assignment Price of Industry Use Land, the land of the whole country has been classified into 15 categories, from Class I to Class XV, and the minimum assignment price of Class I land is RMB 840 per square meter, and the minimum assignment price of Class XV land is RMB 60 per square meter.

### **Governing authority**

The related governing authority is the Ministry of Land and Resources

Ministry of Land and Resources

No. 64, Funeidajie, Xicheng District,

Beijing, 100812

Tel: +86 10 6655 8682

Web: <http://www.mlr.gov.cn>

## **LABOR & SOCIAL SECURITY**

### **Labor Contract**

The Chinese Labor Contract Law became effective on January 1st, 2008. According to this new law three types of labor contracts exist: labor contracts with a fixed period, labor contracts with an open period, and labor contracts for completing certain works. Any employer must conclude a written labor contract with the employee within one month after the commencement of employment. Non-compliance with this requirement will lead to substantial punishment on employer. If a labor contract is concluded with a period of more than three months but less than one year, the probation period thereof shall not be more than one month. Where the term of a labor contract is above one year but less than three years, the probation period thereof shall not exceed two months. With respect to a labor contract with a fixed period of above three years or with an open period, the probation term thereof shall not exceed six months.

If a worker violates the Labor Contract Law to dissolve the labor contract, or if he is in violation of relevant stipulations of the labor contract concerning the confidentiality obligation or limitation of competition, he shall bear liability, if the employer suffers losses through these actions.

Employees with whom an employer may agree on a non-competition obligation are limited to employees in a position of a senior manager, senior technician and a position which is otherwise reasonable to be subject to confidentiality obligation. The non-competition clause shall stipulate the geographical range, business fields involved, scope and time limit of the non-competition obligation. However, the maximum time a non-competition obligation can be agreed on, is two years.

### **Representative Offices**

The employment of PRC nationals by a representative office of foreign company must be arranged through a government-designated labor service companies (such as FESCO). The rep office will enter into a service contract with the service company and the service company will provide PRC employees to work for the office. Thus, the representative office only has a contractual relationship with the service company and not with the PRC staff. A supplementary contract may, however, be entered into by and between the foreign company and the PRC employee in order to regulate certain specific items such as salary amount, vacation, confidentiality, non-competition clauses and so on.

### **FIE recruitment**

In principle, FIEs may recruit any PRC individual directly without going through a service company. FIE must conclude an individual labor contract with each employee.

### **Employment of Expatriate Staff**

Every foreigner who plans to work in China is required to first obtain a Foreigner Work Permit Certificate, Work Visa, Work Certificate, and Residence Permit.

### **Welfare and social insurances**

The mandatory social security to be subscribed for PRC employees are (1) pension; (2) unemployment insurance; (3) medical insurance; (4) occupational insurance (5) birth

insurance and (6) housing fund, which should be borne by both employer and employee respectively at certain percentage.

### **Labor dispute resolution**

Labor disputes may be settled by mediation, arbitration, or by court proceedings. According to the "Labor Law of The People's Republic of China," which was implemented on Jan 1, 1995, the statutory period to file an arbitration application in labor disputes was 60 days commencing from the date the parties actually became aware of the dispute or should have become aware. The New Law extended the period to all circumstances, but gives an even longer time to apply in certain circumstances.

In addition, the new law further provides that when salary payments are in arrears and the aggrieved laborer fails to apply for arbitration for fear of retaliation, this statutory period can be further extended. This is not applicable in the case where an employment is terminated; in such cases the one year limitation shall be strictly construed.

It is also worth noting that this further extension for filing arbitration applications is only applicable to cases where "salary payments are in arrears." In other cases, such as the employer violating social security and welfare rights, the required period for filing shall be one year, which is calculated from the date the parties were aware or should have been aware of the disputes.

An arbitration award must be made within 45 days (could be extended to 60 days in certain circumstances) from the date of receipt of the application. Parties unsatisfied with the award may bring a lawsuit to a people's court within 15 days from the date of receipt of the written award.

### **Governing authority**

The related governing authority is the Ministry of Labor and Social Security.

Ministry of Human Resources and Social Security

No. 12 Hepinglizhongjie, Dongcheng District,

Beijing, 100716

Tel: +86 10 8420 1114

Web: <http://www.mohrss.gov.cn>

## **PROPERTY RIGHTS**

In general, the alteration, transfer and extinguishment of the property rights of movables are subject to and take effect upon the delivery of the property; the change of property rights of immovable is subject to registration with relevant authorities to be effective. Natural resources owned by the state are not subject to registration. Property rights determined by court judgments etc. and the acquisition of property rights out of succession and factual conducts take effects from the time of the judgment, succession or conduct.

### **1. Ownership**

Three different types of ownership, namely: state ownership, collective ownership and private ownership exist. For specific properties, only the state can enjoy their ownership. Those properties include: urban land, minerals, rivers, maritime areas, etc. Except for the object of ownership, the Property Law has not differentiated protections to state ownership, collective ownership and private ownership. The Distinguishable Ownership of Building (also named as "Ownership of Apartment House"), neighborhood relation, joint ownership and special regulations about the acquisition of ownership are also provided for in the Property Law of the People's Republic of China.

### **2. Usufructuary Rights**

Usufructuary Rights govern the relation in the utilization of properties. The major types of usufructuary rights are: land use rights, waterintaking right, exploration rights, mining rights, fishery rights, contracted land management right, easement. Although the Law admits both movables and immovable as the object of usufructuary rights, all the explicitly established usufructuary rights are related to immovable property.

### **3. Property Rights for Security**

Three types of Real Rights for Security exist under Chinese Law, namely: mortgage, pledge and lien. The object of mortgage can be either movables or the immovable and the institution of a mortgage does not require the delivery of the property; the object of a pledge can be either a movable or certain types of rights (such as bills, bonds,

equity interests, intellectual properties, receivables), and the institution of a pledge is subject to the delivery of the object or the corresponding pledge registration; the object of lien can only be movables, and the possession of the property by the lienor is indispensable for the right.

#### **4. Possession**

The fact of possession, whether authorized or unauthorized, is offered protection by the Property Law. The possessor is entitled to remedies such as the right to claim the restitution of the property or the elimination of obstacle or danger to the property when his possession of the property is prevented in some way, and the right to claim for damages incurred by such prevention.

Date: February 2010

Author: WENFEI Attorneys-at-Law Ltd.

Author's Address: Room 706, OFFICE TOWER A

BEIJING FORTUNE PLAZA, NO.7

DONG SAN HUAN ZHONG LU

Chaoyang District, Beijing 100020 PRC

Phone: +86 10 64687331/32,

Fax: +86 10 64603132

E-Mail: [info@wenfei.com](mailto:info@wenfei.com)