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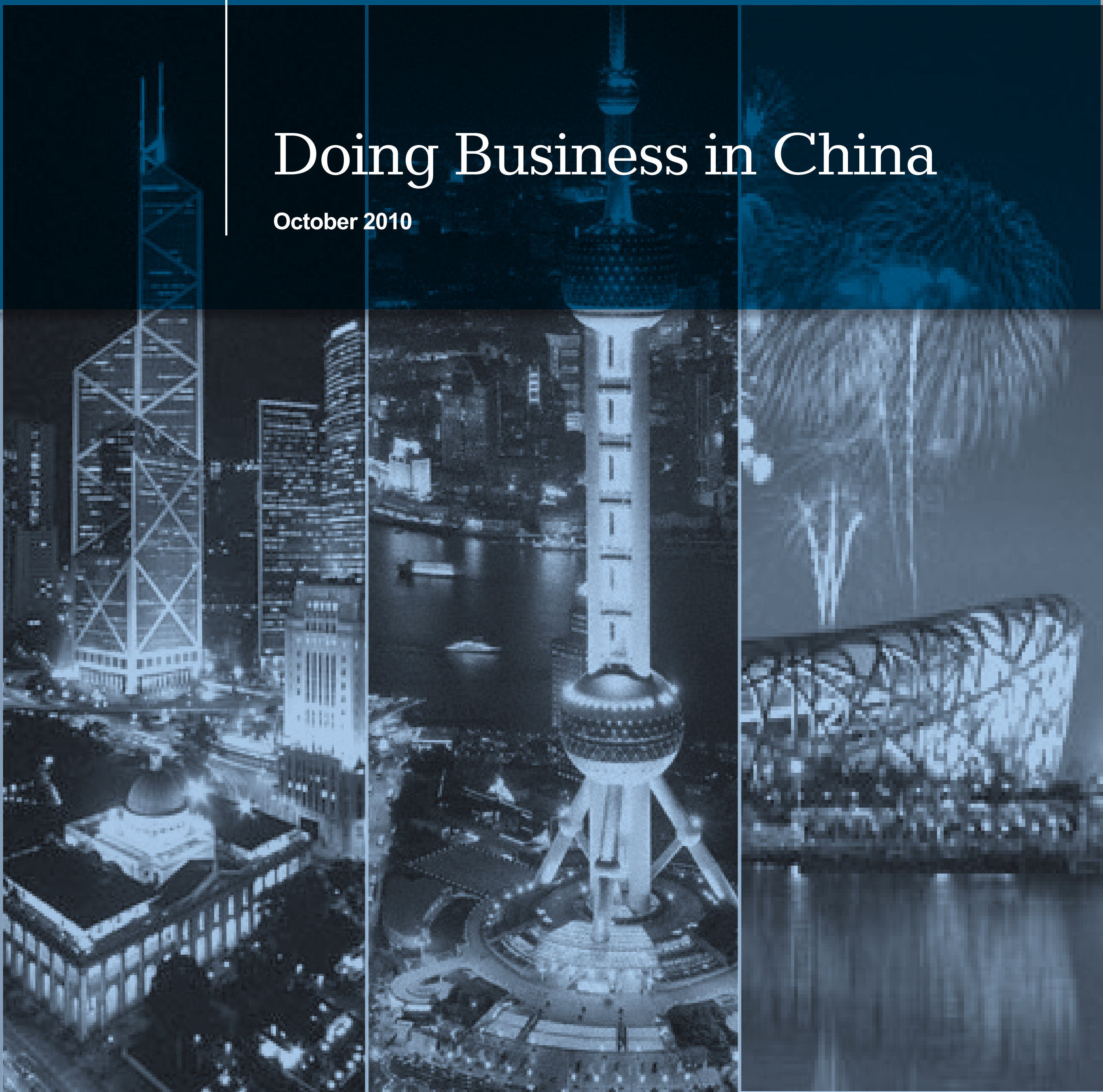
Doing Business in China

October 2010



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A. INTRODUCTION

China has consistently been the largest or second-largest recipient of foreign direct investment globally over the past decade, attracting over US $90 billion of foreign direct investment in 2009. Its economy has experienced double-digit growth for most part of the past three decades and is poised to overtake Japan as the world's second-largest economy this year. Through such growth, China has evolved into a manufacturing powerhouse and its consumer and industrial goods made up the bulk of its US $1,201 billion exports in 2009. The number of patent applications filed in China in 2009 was 976,686 — the fifth highest in the world. This shows that China also has the potential of becoming a technology powerhouse in due course. China overtook Germany as the world's largest trading nation last year. Its foreign exchange reserves stood at US $2,454 billion at the end of June 2010 and are the largest in the world. In April 2009, the Chinese government announced its objective of grooming Shanghai to be an international financial center by 2020.

On its accession to the WTO in 2001, China promised to remove or relax certain restrictions on foreign participation in a range of important industry sectors, and this deregulation program has largely been completed. The Chinese government is embarking on a major revision of its foreign investment guidance policy to meet its need for more sophisticated products, technologies and services, as well as for wider sources of capital in the next phase of its economic development. All these factors make for a very positive environment for attracting further foreign direct investment in China.

This guide provides a general outline of the legal and regulatory environment for the establishment or acquisition of businesses in China by foreign investors. It is not intended to be comprehensive or to provide a summary of all the legal or regulatory issues relevant to a particular topic. It also does not take into account possible local variations in practice.

A map of China showing its administrative regions and major political or economic centers is set forth in the table on page 3. Basic information on China's political systems and key economic indicators can be found in the tables on pages 4 and 5, respectively. A glossary of acronyms and terms used in this guide appears on page 15.


Russia
Kazakhstan
Mongolia
Desert Gobi
Kyrgyzstan
Urumqi
XINJIANG
Pakistan
TIBET
Lhasa
HIMALAYA
Nepal
Butan
India
Bangladesh
Mianmar
Laos
Thailand
Vietnam
QINGHAI
Xining
GANSU
Lanzhou
NINGXIA
Yinchuan
INNER MONGOLIA
Hohhot
HEILONGJIANG
Harbin
JILIN
ChangChun
LIAONING
Shenyang
BEIJING
TIANJIN
HEBEI
Shijiazhuang
SHANXI
Taiyuan
SHANDONG
Jinan
SHAANXI
Xian
HENAN
Zhengzhou
JIANGSU
Nanjing
ANHUI
Hefei
SHANGHAI
Hangzhou
ZHEJIANG
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Wuhan
SICHUAN
Chengdu
CHONGQING
Changsha
HUNAN
Nanchang
JIANGXI
Guiyang
GUIZHOU
Kunming
YUNNAN
FUJIAN
Fuzhou
Taipei
Taiwan
GUANGDONG
Guangzhou (Canton)
GUANGXI
Nanning
MACAU
HONGKONG
HAINAN
North Korea
South Korea
Nippon

Name:	The People's Republic of China (founded October 1, 1949)
Area:	9,600,000 sq. km.
Population:	1,334.74 million (as at the end of 2009)
Party in power:	Chinese Communist Party (Head : Chairman HU Jin Tao)
Head of State:	President HU Jin Tao
Highest legislative organization:	National People's Congress (NPC) (Head : Chairman WU Bang Guo)
Highest administrative organization:	State Council (Head : Premier WEN Jia Bao)
Highest consultative organization:	China Political Consultative Committee (Head : Chairman JIA Qing Lin)
Political system:	The PRC adopts a people's congress system. The highest organization of authority at the central, provincial and municipal levels are the NPC, provincial people's congress and municipal people's congress respectively. There is no universal suffrage in China. Members of the people's congress at each level are elected indirectly.
Government system:	Two-tier government: central government based in Beijing and 34 provincial level governments in four centrally governed municipalities (Beijing, Shanghai, Tianjin and Chongqing), 23 provinces, five autonomous regions and two special administrative regions (Hong Kong and Macau). The central government is headed by the State Council and is sub-divided into three commissions, 22 ministries, the State Audit Administration and the People's Bank of China.
Legislative system:	The Constitution and all laws are enacted by the NPC. The State Council and each provincial level People's Congress have powers to enact regulations and rules which have the force of law. Administrative authorities at the central, provincial, and municipal levels also enact a large body of rules and directives which do not have the force of law but which may, nonetheless, be recognized and enforced by a people's court if not inconsistent with any law or regulation or rule having the force of law. Each of Hong Kong and Macau has a legislative system which is independent and very different from that of China. Each has its own mini-constitution (called Basic Law) which was enacted by the NPC.
Judicial system:	The highest judicial organization is the Supreme People's Court. There are three levels of local courts: the High People's Court, the Intermediate People's Court and the Basic People's Court. The court of first instance for all foreign-related cases will either be the Intermediate People's Court or the High People's Court. All court judgments may only be appealed once. The courts in Hong Kong and Macau are each independent from those in China.

GDP:	US $ 5,060.8 billion (2009)
GDP per capita:	US $3,796 (2009)
Composition of the economy:	
Primary sector:	10.3%
Secondary sector:	46.3%
Tertiary sector:	43.4%
Industrial production (2009):	
Oil	189,000,000 tons
Gas	85,170,000,000 cu.m.
Coal	3,050,000,000 tons
Power	3,714,650,000,000 Kwh
Iron ore	568,030,000 tons
Cement	1,650,000,000 tons
Raw steel	568,033,000 tons
Fertilizers	65,997,000 tons
Automobile	13,795,000 vehicles
Integrated circuits	41,440,000,000 units
Mobile hand sets	619,245,000 units
Mini-computers	182,151,000 units
Textile	74,000,000,000 m.
Export :	**US $ 1,201.66 billion (2009)**
United States	US $ 220.82 billion
Hong Kong	US $ 166.23 billion
Japan	US $ 97.91 billion
South Korea	US $ 53.68 billion
Germany	US $ 49.92 billion
Import:	**US $ 1,055.55 billion (2009)**
Japan	US $ 130.94 billion
South Korea	US $ 102.55 billion
Taiwan	US $ 85.72 billion
United States	US $ 77.44 billion
Germany	US $ 55.76 billion

B. CHINA'S FOREIGN INVESTMENT POLICY

i) Foreign Investment Policy

China seeks to manage the inflow of foreign investment into the country by directing it to industry sectors the government wishes to further develop with the help of foreign capital, advanced technologies and management expertise. This is implemented by classifying different industry sectors into four categories : "encouraged", "permitted", "restricted" and "prohibited".

Investors from Hong Kong, Macau and Taiwan are treated as foreign investors for all practical purposes under China's foreign investment policy.

ii) Categorization of Foreign Invested Projects

Since 1995, the PRC government has issued a *Foreign Investment Industrial Guidance Catalogue* (Guidance Catalogue), which lists specific industry sectors under the "encouraged", "restricted" and "prohibited" categories. Examples of industry sectors falling within each such category are given in the table below:

"Encouraged" Industry Sectors	"Restricted" Industry Sectors	"Prohibited" Industry Sectors
• Risk exploration and development of petroleum and natural gas • Construction and operation of pipelines and depots for oil or gas • Construction and operation of power plants using new sources of energy • Comprehensive use, treatment and disposal of waste • Production of new lighter or environmentally friendly materials for automobiles • Development of infant and geriatric foodstuffs	• Production and supply of power, gas and water • Construction and operation of power grids • Exploration and mining of precious metals • Construction and operation of villas, high-end hotels and high-end office buildings • Production of containers • Wholesale of oil products; construction and operation of petrol stations • Banks • Market surveys	• Exploration and mining of rare earth • Construction and operation of golf courses • Film production and distribution • Development and production of genetically modified plant seeds, livestock, poultry and aquaculture • Postal services • Publication and distribution of books, newspapers and periodicals • Gaming

Industry sectors not listed in the Guidance Catalogue are generally presumed to fall within the "permitted" category unless otherwise restricted or prohibited by laws or administrative rules. The Guidance Catalogue has been updated every few years to reflect new priorities in China's foreign investment policy.

Certain provincial governments have been authorized by the central government to treat foreign investment in certain business sectors in that province as falling within the "encouraged" category, even though such sectors would normally fall outside the Guidance Catalogue or be categorized as "restricted". This provides room for the provincial government in question to pursue its own industrial policy by channeling foreign investment into industry sectors which it is well positioned to develop further.

iii) Effects of Categorization

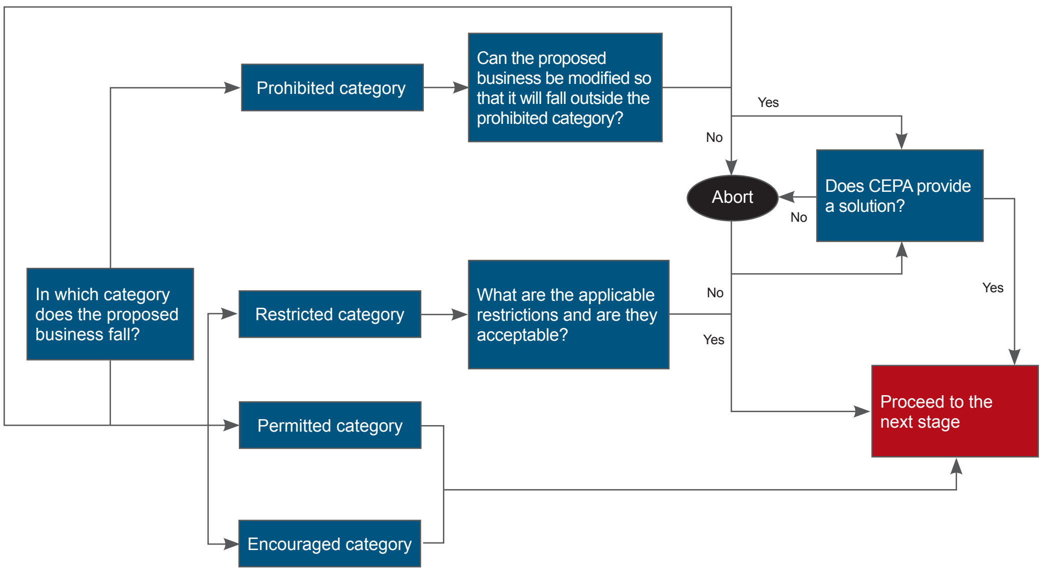
Foreign investment in an encouraged industry sector may be eligible for government support in the form of a lower enterprise income tax rate, a tax holiday or duty free importation of production equipment, among other things. Foreign investment in a restricted sector is usually subject to some form of foreign ownership restriction or is required to be approved at a higher level of government.

iv) CEPA

China and Hong Kong have entered into a series of Closer Economic Partnership Arrangements (CEPA), which give certain qualified Hong Kong companies some advantages (such as a higher foreign ownership percentage or earlier entry into a sector which is otherwise closed to foreign investment) over foreign companies in investing in certain industry sectors in China. These advantages make it attractive for foreign investors in those industry sectors to invest into China through Hong Kong. As only Hong Kong companies that meet certain qualification requirements may take advantage of the special arrangements under CEPA, some advance planning may be required.

v) How Does Your Proposed Business Fit in and What are the Next Steps ?

A foreign investor may have a great business plan for China. Before it moves too far forward with a plan, however, it will have to assess how its proposed business fits in with China's foreign investment policy. Such an assessment will assist in the identification of constraints which it may have to work around or live with. This assessment process is presented in the table below.



Having made the initial assessment that a proposed business is viable and can be implemented in China under foreign ownership and control in a manner which is generally acceptable, the next steps are to become familiar with the relevant approval processes, approval authorities and potential complications (discussed in sections C, D and E) and determine the preferred onshore investment vehicle to use (discussed in section F).

C. ESTABLISHMENT OF A BUSINESS IN CHINA

i) Overview

In general, a foreign investor wishing to establish a business in China, whether alone or in conjunction with other PRC or foreign investors, must obtain PRC government approvals for establishing a specific business vehicle to implement a specific project in China.

ii) Project Approval

If the business in question is a production-type or infrastructure business, the investors must first obtain approval for the proposed foreign investment project (Project Approval). The approval authority would normally be the National Development and Reform Commission (NDRC) or its local designee, although it could be or could include another ministry if certain types of projects are involved (collectively, Project Approval Authority).

Approval by the Project Approval Authority will not be required for foreign investments in the banking, securities and insurance sectors or in the case of the establishment of certain straightforward service-type businesses.

iii) Projects Involving State-owned Assets

Where the project involves the contribution of state-owned assets by a state-owned enterprise to a newly established joint venture, the approval of the state-owned Assets Supervision and Administration Commission (or its local designees) or the relevant state-owned assets holding company (“collectively”, SOA Approval Authority), may be required. Such issue is considered internal to the state-owned enterprise in question and will typically be resolved during the Project Approval stage.

iv) Reservation of Company Name

Investors are required to reserve a company name for the proposed business vehicle in China (each one is a foreign-invested enterprise or FIE) before an application may be made for the establishment of such FIE.

v) Approval for Establishment of Foreign-Invested Enterprises

After obtaining Project Approval (if applicable) and registering the desired company name, the investors may then apply to the Ministry of Commerce (MOFCOM) or its local designee (collectively, FIE Approval Authority) for approval (FIE Approval) to establish the proposed FIE on the basis of its constitutional document(s) as well as any applicable joint venture contract or other commercial documents (collectively, FIE Documents).

However, foreign investments in the banking, securities and insurance sectors, and the associated FIE Documents, will have to be approved by the China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC) and China Insurance Regulatory Commission (CIRC), respectively, although MOFCOM retains a nominal role in the process.

vi) Registration of the FIE

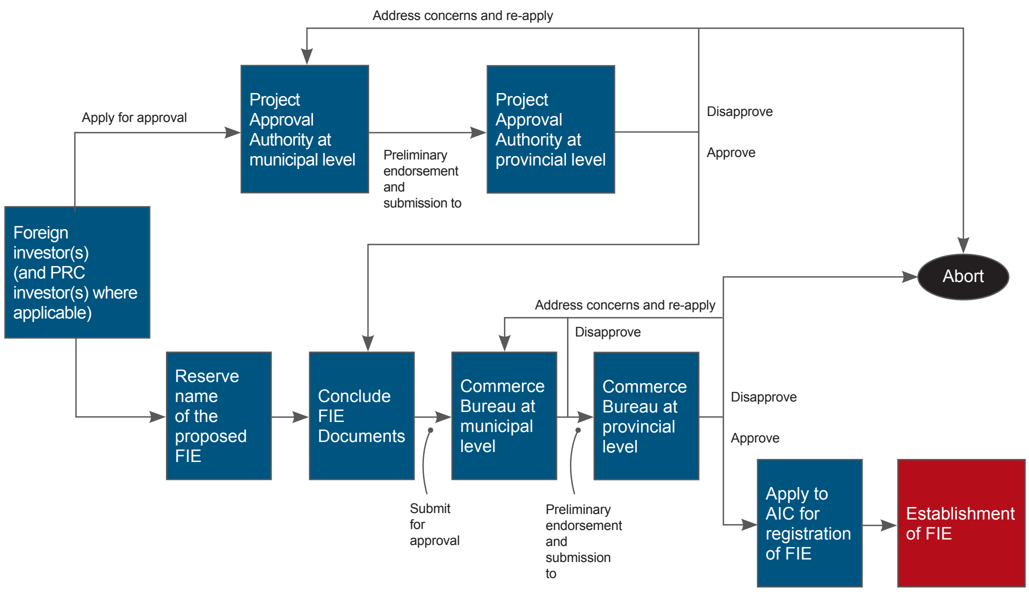
On obtaining the FIE Approval, the investors may apply to the local Administration for Industry and Commerce (AIC) to formally register and establish the FIE.

vii) Obtaining the Relevant Operating Permit

The conduct of certain highly regulated and specialized businesses (*e.g.*, telecommunications and banking), may require the obtaining of specific operating permits which can only be applied for and obtained after the FIEs in question have been established.

viii) Timing

The time required for the establishment of a FIE can vary considerably (from 1-2 months to well over a year) depending on the complications of the project or business structure involved, the existence of environmental issues, whether state-owned assets are involved and the level at which approval is required. The table below sets out the typical steps involved in the approval of an industrial project with no environmental issues and requiring approval at the provincial level.



D. ACQUISITION OF A BUSINESS IN CHINA

i) PRC Targets

Foreign investors are prohibited from acquiring any stake in a PRC entity which engages in a business falling within the "prohibited" category under the Guidance Catalogue. Other than this, with requisite approvals and subject to compliance with the Guidance Catalogue in terms of foreign ownership restrictions, a foreign investor may, by agreement with the seller, buy into almost any type of non-publicly listed business entity in China.

ii) Approval Requirement

Where the acquisition target is a PRC banking, securities or insurance institution, the respective approvals of the CBRC, CSRC and CIRC will be required. Where the acquisition target is a PRC entity in another industry sector, the approval of the FIE Approval Authority will typically be required, and the prior approval by the Project Approval Authority may also be required in appropriate cases.

iii) Ways of Effecting an Acquisition

A foreign investor may acquire a PRC business through :

- Acquisition of existing equity in the PRC target company
- Subscription for new equity in the PRC target company
- Acquisition of assets from the PRC target company
- Merger of the foreign investor's PRC subsidiary with the PRC target company
- Demerger of the PRC target company and acquisition of one of the de-merged entities

Acquisitions involving a merger or demerger will usually take longer to complete. Asset acquisitions, on the other hand, can be straightforward, depending on the type of assets to be transferred.

iv) Pre-emption Rights

Where a shareholder of a limited liability company proposes to transfer its shareholding, its co-shareholders enjoy a statutory pre-emption right to purchase such shareholding. In addition, the consent of each co-shareholder and the target company's board of directors may be required. As such pre-emption rights and consent requirements may be modified by the articles of association or joint venture contract of the target company, such documents will have to be examined in each case to determine the parameters within which any contractual arrangement for the acquisition must operate.

v) State-owned Interests

Where the acquisition involves the transfer of state-owned assets or a dilution of a state-owned shareholding, such transfer or dilution may have to be approved by the SOA Approval Authority. Once approved, the proposed transfer may have to be listed for competitive bidding in an appropriate local property rights exchange center to ensure that the best price can be obtained for the state-owned assets.

Most privatizations of municipal public utility services are implemented through a public tendering process administered by the relevant municipal industry regulator.

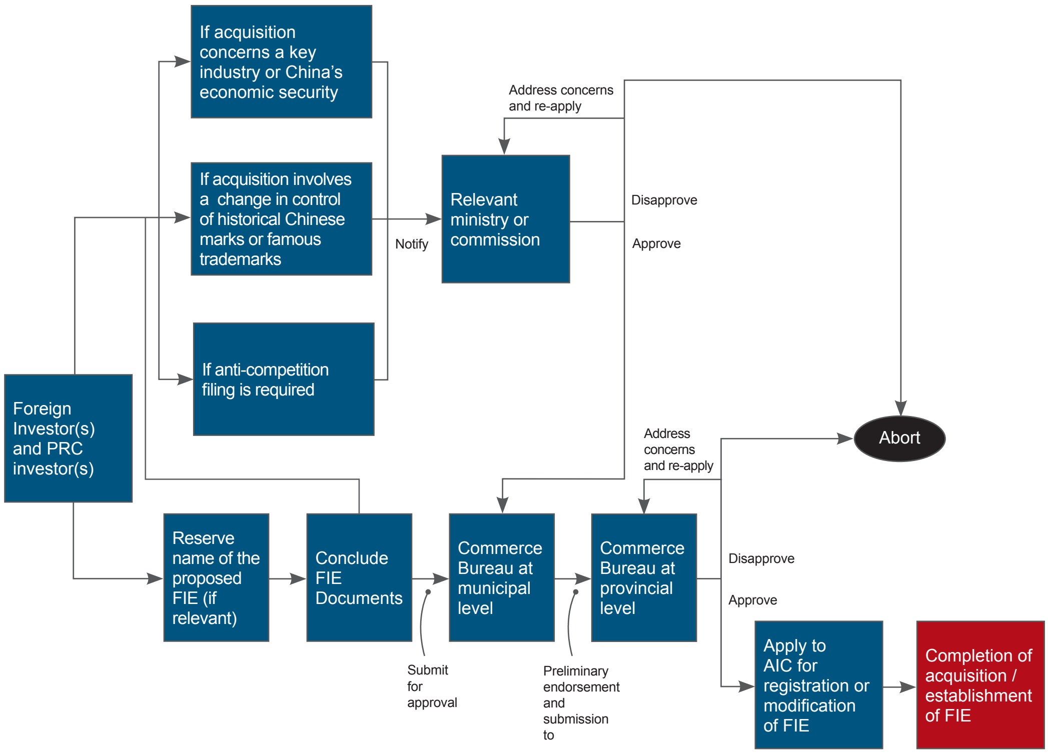
vi) Acquisitions Requiring Special Notifications

Before an acquisition may be submitted to the relevant FIE Approval Authority, MOFCOM must also be notified in the following types of transactions, regardless of the size of the transaction:

- If the foreign company acquires *de facto* control of a target which operates in a "key industry" (such as automotive or major equipment), or which may result in the "economic security of the State" being affected or potentially affected (*e.g.,* when the target owns a power grid)
- If the acquisition results in a change in *de facto* control of any PRC entity which owns one or more "Well-known Trademark(s)" or "Historical Chinese Mark(s)"
- If the acquisition amounts to a "concentration of business operators" under the *PRC Anti-Competition Law* and the threshold requirements for the filing of an anti-competition notification are met

vii) Procedures and Timing

The SOA approval and competitive bidding requirements and special notification processes can add significant time to the acquisition process. The table below sets out the typical steps involved in an acquisition scenario where the target is in a non-financial sector, Project Approval is not required, and FIE Approval is required to be given only at the provincial level.



E. APPROVAL AUTHORITY AND CAPITALIZATION REQUIREMENTS

i) Approval Limits

Foreign investment projects and the FIEs to be established to implement them may require approvals at different levels of government (*i.e.,* the central, provincial, municipal or district/county levels) depending on the total investment amount of the project in question and the nature of the project.

In general, projects in the “encouraged” or “permitted” category that have a total investment amount of US $300 million or more will be approved by the NDRC and the FIEs established to implement such projects will require approval from MOFCOM. Where the total investment amount is US $500 million or more, the project has to be approved by the State Council. For projects falling within the “encouraged” category which do not require the coordination of the central government, MOFCOM has further delegated its approval authority to its provincial counterparts. The provincial counterparts of the NDRC and MOFCOM have also delegated their approval authority to their respective municipal and district/county level counterparts. The extent of such delegated authority varies from province to province and has to be confirmed in each case.

Foreign investment in the banking, securities and insurance sectors and certain other restrictive industry sectors are required to be approved at the central government level irrespective of the size of the transaction.

ii) Total Investment Amount and Registered Capital

The total investment amount and registered capital of every FIE, and all subsequent changes thereto, are required to be approved by the government. “Registered capital” refers to the aggregate amount of equity capital subscribed by all investors in the FIE and registered with the relevant AIC. The “total investment amount” of an FIE refers to the sum of the FIE’s registered capital plus all debts which are intended to be borrowed by the FIE in order to complete the construction of the project in question, including the requisite working capital for operating the project.

FIEs are required to maintain a certain relationship between their registered capital and their approved total investment amount. The capitalization requirements applicable to most FIEs are summarized in the table below:

Total Investment Amount	Minimum Registered Capital
• Less than US $3 million	• 70% of the total investment amount
• US $3,000,001-10 million	• 50% of the total investment amount or US $2.1 million (whichever is higher)
• US $10,000,001-30 million	• 40% of the total investment amount or US $5 million (whichever is higher)
• More than US $30 million	• 1/3 of the total investment amount or US $12 million (whichever is higher)

Different capitalization rules apply to FIEs in the financial sector and certain other types of businesses.

F. CHOICE OF PRC BUSINESS VEHICLES

i) Forms of Foreign-Invested Enterprises

When a foreign investor wishes to establish a PRC entity to conduct business in China, it may choose from a number of business vehicles. The major forms of such business vehicles are equity joint ventures (EJV), cooperative joint ventures (CJV), wholly foreign-owned enterprises (WFOE) and foreign-invested companies limited by shares (FCIS). They are collectively referred to as foreign-invested enterprises or FIEs. Apart from a WFOE, which has to be 100 percent foreign owned, all other forms of FIEs have a minimum foreign ownership requirement of 25 percent.

The number of each type of FIEs approved in 2009 and the foreign direct investment amount involved are given in the table below.

	Number of FIEs	% of total	FDI involved (US $ billion)	% of total	FDI per FIE (US $ million)
EJV	4,283	18.28%	17.27	19.18%	4.03
CJV	390	1.66%	2.03	2.26%	5.20
WFOE	18,741	79.97%	68.68	76.29%	3.66
FICS	21	0.09%	2.04	2.27%	97.14
Total	23,435	100.00%	90.02	100.00%	3.84

ii) Equity Joint Ventures

An EJV is a limited liability company jointly established by one or more foreign investor(s) and one or more PRC investor(s). Investors in an EJV are required to contribute equity to the EJV in the form of cash or assets. Such investors are also required to share in the profits and risk of losses, as well as the final distribution on liquidation, of the EJV strictly in accordance with the ratio of their respective equity investments in the EJV.

iii) Cooperative Joint Ventures

There are two types of CJVs. The first type is often referred to as an “incorporated” CJV as it is very much like an EJV in that it is a separate legal person from its investors and the liability of each of its investors towards the CJV is limited to the portion of the CJV’s registered capital which it has subscribed to contribute. In the case of the second type of CJV, no legal person will be created and the investors will carry on activities and undertake liabilities all in accordance with the manner stipulated in the cooperative joint venture contract. This latter type of CJV is often called an “unincorporated” or “contractual” CJV.

A CJV offers more flexibility than an EJV in terms of the nature of the contributions the joint venture parties can make to the CJV. For example, instead of contributing cash or assets, the PRC party may contribute its existing labor force or the right to use certain real estate. Such contributions will not be considered a part of the CJV’s registered capital but will be recognized as a valuable contribution which entitles the PRC party to a share of the CJV’s profits. There is also more flexibility in terms of the ratios at which the joint venture parties may share in the profits, risk of loss and final distribution of the CJV. In the case of a contractual CJV, the parties may even agree to share in the products of the CJV, rather than its profits.

These flexibilities have their appeals to investors in certain situations. This form of FIE was particularly popular during the early days of China’s economic reform when many PRC parties were unable to contribute cash or other assets but has become much less common in recent years.

iv) Wholly Foreign-Owned Enterprises

A WFOE is a limited liability company in which all investors are either a foreign entity or a foreign individual. This makes it an inappropriate vehicle for investment in industry sectors where a maximum foreign ownership percentage is prescribed by law or the Guidance Catalogue.

Like those of an EJV, the investors in a WFOE are required to contribute equity to the WFOE in the form of cash or assets and to share in the profits, risk of loss and final distribution strictly in accordance with the ratio of their respective equity investments in the WFOE.

This form of FIE gives foreign investors full autonomy in determining the direction, management and operation of the company. As foreign investors increasingly gain experience in operating businesses in China without the help of local partners, the WFOE has become by far the most popular form of FIE in recent years.

v) Foreign-Invested Companies Limited by Shares

A FCIS is a company limited by shares (*i.e.*, a company which has a share capital divided into specific number of shares each having a specific nominal value) rather than a limited liability company (*i.e.*, a company with a registered capital which is not divided into shares). In general, PRC and foreign investors may only choose to establish a FCIS if the number of investors involved is large or if the company is expected to be listed on a securities exchange in the near future. A FCIS may not be wholly owned by foreign investors alone.

vi) Domestic Companies with Foreign Investment

Where the aggregate foreign ownership level in a PRC company falls below 25 percent, the company does not qualify as a FIE. However, the FIE approval procedures will still be applicable, although the company will be regulated operationally as a domestic company.

vii) Conversion of a Domestic Company into a FIE

When a foreign investor acquires an interest in a domestic PRC company and the resultant foreign stake in the target company equals or exceeds 25 percent, the target company will become a FIE. The incoming and remaining shareholders of the target company can decide the form of FIE to be adopted during the conversion process.

GLOSSARY

CEPA	Closer Economic Partnership Arrangements
CBRC	China Banking Regulatory Commission
China or the PRC	People's Republic of China
CIRC	China Insurance Regulatory Commission
CJV	Cooperative joint venture
CSRC	China Securities Regulatory Commission
EJV	Equity joint venture
FICS	Foreign-invested company limited by shares
FIE	Foreign-invested enterprise
FIE Approval	Approval for the establishment of the proposed FIE
FIE Approval Authority	MOFCOM or its local designees
FIE Documents	All legal documents relating to the establishment of a FIE
Guidance Catalogue	Foreign Investment Industrial Guidance Catalogue
MOFCOM	Ministry of Commerce
NDRC	National Development and Reform Commission
NPC	National People's Congress
Project Approval	Approval of the project to be undertaken by the proposed FIE
Project Approval Authority	NDRC or its local designees and (in some cases) another ministry
AIC	Local Administration of Industry and Commerce
SOA Approval Authority	State-owned Assets Supervision and Administration Commission (or its local designees) or the relevant state-owned assets holding company
WFOE	Wholly foreign-owned enterprise

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