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MOFCOM UPDATES REGULATIONS ON EXPORT-PROCESSING ZONES

Key Points:

- *Encourage high-tech projects*
- *Different policies toward coastal and western EPZs*
- *Post-sale services allowed in EPZs*

The PRC Ministry of Commerce (MOFCOM) recently issued regulations that update the government's policy toward export-processing zones (EPZs) and reflect China's desire to move up the manufacturing value chain. The new Provisional Management Measures for Trade in Export-Processing Zones took effect January 1, 2006 and replace the previous measures issued in 2001.

The measures explicitly require EPZs in coastal areas to approve only projects that involve a

significant value-added component and to avoid labour-intensive, low-value-added industries. The measures also encourage high-tech projects and larger-scale operations that use significant components from domestic companies. EPZs in central and western provinces are encouraged to facilitate the transfer of lower-value-added enterprises from coastal zones to the interior. The new measures also set a deadline of 10 working days for EPZs to approve or reject applications to set up processing operations in an EPZ.

Of note, enterprises that produce electrical goods and machinery in China may offer repair and after-sales services for those products originally manufactured in China in EPZs. From this point of view, this provision may be important for manufacturers of consumer electronics and other goods that want to take advantage of China's low-cost labor for both production and repair work. Goods imported and exported between EPZs and overseas, except as provided by the state, will not be

subject to import-export quotas and permit requirements. Nevertheless, enterprises are explicitly prohibited from conducting disposal or refurbishing activities in EPZs (query where the dividing line lies between 'repair' and 'refurbishing'). The measures also outline procedures for transferring goods from an EPZ to other EPZs or non-EPZs for further processing, provided that such goods have been materially processed in an EPZ. – *Wei Zhong*

MOFCOM DELEGATES MORE APPROVAL AUTHORITY FOR FICES TO LOCAL AUTHORITIES

Key Points:

- *Authority delegated to provinces*
- *Approval time will shorten substantially*

On December 9, 2005, MOFCOM issued the "Circular on Delegation of Approval Authority for Foreign-Invested Commercial Enterprises (FICES) to Local Authorities (the Circular). According to the Circular, effective March 1, 2006, generally, approval of formation of FICES will be delegated from MOFCOM to provincial-level authorities.

The local MOFCOM will now be responsible for approvals of the following: (1) establishment of new FICES, (2) expansion of business scope allowing FICES to conduct distribution operations, (3) amendments to existing FICE articles of association and (4) opening of retail shops within the territory of the local authority if any of the following conditions are present: (a) the physical area of a single store does not exceed **5,000** square meters, the total number of stores does not exceed three, and the

total number of similar stores opened by the foreign investor in China via an established FICE does not exceed 30; (b) the physical area of a single store does not exceed **3,000** square meters, the number of stores does not exceed five, and the total number of similar stores opened by the foreign investor in China via an established FICE does not exceed 50; or (c) the physical area of a single store does not exceed **300** square meters.

However, MOFCOM approval will still be required to form a FICE if the following conditions are met: (1) sales activities are conducted via television, telephone, mail order, Internet, vending machine and the like; (2) there is trading and distribution of significant raw materials for industrial use, including steel, precious metals, iron ores, fuels, rubber, etc.; (3) there is trading and distribution of specified products such as books, newspapers, periodicals, refined oil, automobiles, edible sugar, cotton, pharmaceutical products, etc., as specified in the FICE regulations; (4) the opening of retail shops within the area of the same local authority exceeds the aforesaid amounts as to total area, number of stores and total number of similar stores opened by the foreign investor in China via FICE.

Presumably approval times for establishing FICE will be shortened substantially when the delegation of authority takes effect on March 1. – *Zhang Wei*

ANTIMONOPOLY LAW AND ITS ANTICIPATED EFFECT ON MERGERS

Key Points:

- *Long-awaited promulgation may soon take effect*
- *Definition of merger is partly “soft”*

China's Antimonopoly Law (AML) has been said to be one step away from promulgation for about 10 years. It became news again in December 2005 when the bill is expected to be presented to the National People's Congress (NPC) in early 2006 for possible passage, with an anticipated effective date sometime in 2006. It is still uncertain whether this anticipated event will take place this year.

With respect to addressing mergers, the draft AML defines mergers, imposes premerger reporting obligations on certain large-scale mergers, provides a timeframe and standards for approval, and suggests possible penalties for violations.

Definition of merger

Mergers and acquisitions under AML include situations in which (1) one company merges into another company and becomes a part of the accepting company, (2) two companies combine management teams and become one new entity, (3) one company gains control of another through the purchase of shares or (4) two companies agree or contract to form a relationship in which one may control the other.

Regarding (item 3) above, more than one proposal has been presented for gaining control of another company through share purchases. One suggests that when a company acquires 20 percent of the voting rights or a majority of the assets of another, it shall be considered a merger under AML. This standard is less likely to be adopted because with

small and midsized companies there may be only one or two shareholders, and 20 percent of the voting rights may only make the holder a minority shareholder. By way of reference, the New York Business and Corporation Law provides that a minor shareholder who holds more than 20 percent of the issued share may bring an action against a majority shareholder for dissolution of the company under certain circumstances. It is also unreasonable to consider such a combination a merger for AML purposes when one company purchases another company's key assets. It is common for companies to sell certain lines of their business to other companies for various purpose, and sometimes, such a sale does constitute a major disposition of assets. They are not necessarily all mergers, however.

Obligations of merging companies

The AML contains two proposals on reporting obligations of merging companies. One is to leave the task of creating criteria for required reporting obligation to the State Council, and another one is proposed in the AML itself. Below are the criteria set forth in the draft:

1. The transaction amount is more than RMB 200 million, and worldwide revenues for the previous year exceeded RMB 3 billion. In addition, at least one of the participants had in excess of RMB 3 billion in sales in China in the previous year;
2. The merger transaction in China will involve more than RMB 500 million;
3. One of the participants has more than 20 percent of the relevant market share in China; or

4. The merger may result in a participant's market share exceeding 25 percent in China.

Approvals

When a company with an obligation to report a proposed merger submits an application for approval to the appropriate authority (and it is not clear whether a new independent bureau will be established or the authority will be entrusted to an existing bureau), the authority must reply within 45 days. The authority's failure to respond to an application within the specified period will give the applicant the green light to proceed.

If the authority decides to investigate the merger further, it has 90 working days from the date it issues a notice of such investigation to the applicant either to grant an approval or deny it. In certain very limited circumstances, this period may be extended up to 180 days.

The authority may prohibit a large-scale mergers if the merger will (1) intensify market domination, (2) restrict or exclude market competition, (3) hinder the healthy development of the national economy or (4) damage social or public interests.

The AML does not take market domination into consideration in defining a market. For example, a company may have a strong presence in a local market but pose no threat to national competition. Approval of a merger of such a company with another local company may have the effect of restricting local competition but not competition at the national level. In addition, the criteria for prohibition in Items (3) and (4) above are soft standards, giving the authority the power easily to deny any large

combination, because "healthy development of the national economy" and "the social and public interests" can not clearly be defined and may alter from time to time.

Penalties

The penalties for an unapproved merger are an order to restore the status before the merger and a fine ranging from RMB 100,000 to RMB 10 million. Although the AML does give an injured private party the right to claim damages against an entity for violating the AML, the language of the text is unclear whether any such party may claim damages resulting from violations of the merger regulations. – *Weiheng Jia*

NEW REGULATIONS ON BONDED LOGISTICS PARKS AND EXPORT-SUPERVISED WAREHOUSES

Key Points:

- *Goods transferred among bonded logistics centers, ESWs, BLPs and export-processing zones not subject to duty or value-added tax*
- *Requirements vary by entity type*

The PRC General Administration of Customs (GAC) issued two new regulations in November 2005 that govern export-supervised warehouses (ESWs) and bonded logistics parks (BLPs). Both regulations took effect on January 1, 2006.

Management rules for ESWs and goods stored therein

An ESW is a warehouse specifically used for customs purposes for the (a) storage of goods for export that have cleared all customs-export formalities and (b) provision of bonded logistics distribution and value-added services for such goods.¹

To operate an ESW, one must be a corporate legal person duly registered with the Administration of Industry and Commerce, have the right to handle imports and exports, and provide warehousing services. Registered capital must be more than RMB 3 million, and the warehouse area must not be smaller than 1,000 square meters (for domestic carry-over type warehouses) or 5,000 square meters (for export-distribution type warehouses).² An ESW may be operated only by the entity that has been granted the right to run it. No subletting is allowed.³

Management rules for BLPs

A BLP is a zone approved by the State Council to be established within a bonded zone or bonded port zone⁴ and be designated to develop modern international logistics business. Commercial retail, production and processing, refurbishment, disassembly or other business unrelated to a BLP cannot be conducted within a BLP.⁵

A BLP enterprise must be a corporate legal person and must have registered with Customs pursuant to the *Regulations of the General Administration of PRC Customs on Registration of Customs*

Declaration Entities (the Regulations) and other regulations. This means that the registered capital of a BLP must not be less than RMB 1.5 million⁶, and it must have not fewer than five customs declarators.⁷ The responsible person for the customs declaration business must have more than five years of experience in foreign trade or customs declaration.⁸

Bonded logistics centers v. ESWs v. BLPs

No processing of goods stored in bonded logistics centers, ESWs or BLPs is allowed, but simple value-added services such as quality inspection, classification, sorting, loading, labeling and repackaging may be performed.

In general, goods transferred among bonded logistics centers, ESWs, BLPs and export-processing zones are not subject to duty or value-added tax.

While bonded logistics centers are run and managed by enterprises that operate them, ESWs and BLPs are monitored closely by Customs. ESW and BLP enterprises are subject to monthly and annual requirements for Customs reporting.⁹

In addition to similar bonded benefits granted to goods that may be stored in bonded logistics centers under their relevant governing regulations, the BLP management rules specifically provide that exhibits and samples imported into a BLP can enjoy bonded

¹ Article 2 of the ESW Management Rules.

² Article 9 of the ESW Management Rules.

³ Article 14 of the ESW Management Rules.

⁴ Article 2 of the BLP Management Rules.

⁵ Article 8 of the BLP Management Rules.

⁶ Article 9(2) of the Regulations.

⁷ Article 9(4) of the Regulations.

⁸ Article 9(6) of the Regulations.

⁹ Article 19 in the ESW Management Rules and Articles 16 and 40 of the BLP Management Rules.

status.¹⁰ A BLP enterprise may also conduct repair business with a BLP.¹¹

While goods stored in bonded logistics centers and BLPs are deemed to be imported or exported, goods are not deemed to be exported when they enter an ESW. For goods entering an ESW approved to enjoy the benefits of the “goods entry and duty drawback” policy, Customs will issue an export-goods customs declaration upon the entry of such goods into such ESW. For goods entering an ESW not subject to the “goods entry and duty drawback” policy, Customs will issue an export-goods customs declaration only after such goods are exported.¹²

The time limits for storage of goods in bonded logistics centers are one year (type A) and two years (type B). Extension of such a time limit cannot be more than one year. The period for storage in an ESW is six months. Such time limit could be extended if approved by Customs, but the extension must not be longer than six months.¹³ There is no time limit as to the period of storage of goods in a BLP.¹⁴

Minimum registered capital required for a bonded logistic center is RMB 30 million (type A) or RMB 50 million (type B). However, only RMB 3 million is required for an ESW, and RMB 1.5 million for a BLP enterprise. – *Jaime Kwok*

CHINA APPROVES RULES FOR MANUFACTURE OF GENERIC DRUGS UNDER COMPULSORY LICENSING

Key Points:

- *New measures for responding to public health crises to now in effect*
- *Generic drugs in question are for infectious diseases only*

China recently released measures that allow the PRC State Intellectual Property Office (SIPO) to issue compulsory licenses to drug manufacturers in China so that certain drugs can be produced more quickly in the event of a public health crisis. The *Measures for Compulsory Licensing Related to Questions of Public Health* took effect January 1, 2006.

Under the measures, the relevant ministries or committees under the State Council (e.g., the Ministry of Agriculture for an animal drug, the Ministry of Health for a human drug) may request that SIPO issue a compulsory license for drug producers in China (usually such a request should be made together with the appointment of a specific manufacturer) to manufacture and sell a drug that is patented in China. A compulsory license may also be issued to import a drug that is patented in China but for which China's manufacturing capacity is non-existent or inadequate. Finally, a compulsory license may be issued for a domestic manufacturer to produce and export a drug, following the request of a WTO member country or a non-WTO, least-developed country. In all of these cases, the recipient

¹⁰ Articles 7(7) and 22(8) of the BLP Management Rules.

¹¹ Articles 7(6) and 39 of the BLP Management Rules.

¹² Article 24 of the ESW Management Rules.

¹³ Article 22 of the ESW Management Rules.

¹⁴ Article 47 of the BLP Management Rules.

of the compulsory licensing must comply with the conditions set by SIPO in its grant of the compulsory license and provide reasonable compensation to the patent holder.

The measures state that the generic drugs in question are those used for infectious diseases only, explicitly naming AIDS, pulmonary tuberculosis and malaria as examples.

The legal basis for compulsory licensing lies in Article 5 of the Paris Convention and Article 31 of the WTO's Trade-Related Aspects of Intellectual Property Rights agreement (TRIPS). Article 31 of TRIPS stipulates that a WTO member may permit the use of a patent without the authorization of the patent holder if reasonable requests to the patent holder for its use are not granted within a reasonable period of time. The article also states that this condition may be waived in the case of a national emergency or matters of extreme urgency or for public, noncommercial use. In similar language, the

PRC Patent Law stipulates that compulsory licenses may be issued in the event of national emergency, for the public interest or if, after a reasonable period, a reasonable request to the patent holder is not met. SIPO's recent measures state that preventing and controlling the appearance and spread of infectious diseases, as well as curing such diseases, qualify as a public interest under the Patent Law.

According to SIPO the additional provision allowing for the export of drugs manufactured under compulsory licensing is meant to realize the August 2003 decision of the WTO General Council. The decision specifies the conditions under which WTO members may issue compulsory licenses to produce and export drugs to other countries for public health purposes, waiving the TRIPS provision that the R&D pharmaceutical industry in China has adopted a "wait-and-see" approach toward the measures, and their implementation will be followed closely. *–Jie Chen*

MOFCOM INTRODUCES NEW FREIGHT-FORWARDING REGULATIONS

Key Points:

- *Wholly foreign-owned investment permitted*

Nationwide branches permitted

Effective from December 11, 2005, China's amended *Measures for the Administration of Foreign-Funded International Freight-Forwarding Enterprises* have been warmly welcomed. In joining the WTO, China made certain commitments regarding market liberalization in the field of logistics. Many observers have commented that the staged market liberalization of individual sectors within the logistics arena has prevented the overall development of an integrated and seamless logistics sector. Given that China committed to permit wholly foreign-owned freight-forwarding subsidiaries starting in December 2005, many potential market players effectively postponed investment until the promulgation of the new measures. The new measures now permit the establishment of wholly-foreign owned enterprises ("WFOEs"); imposing a minimum registered capital requirement of US\$1 million, with each application subject to MOFCOM approval. The business scope of foreign-funded freight forwarders is broad and all-encompassing, entitling approved investors to engage in an array of services including leasing of vessels; air charters; the storage, packing and consignment of goods; goods supervision, distribution, multimodal transport, both loading and unloading; and container shipping and express delivery services. According to a 2005 survey by the US-China Business Council, liberalization of the express-delivery services sector alone would lead to the creation of more than 800,000 jobs in China over five years (see "2005 White Paper Report," AmCham). Critically, the WFOEs are now also entitled to provide agency services for the preparation of transport documentation and Customs clearance. Finally, and significantly, given the nature of the freight-forwarding business, the measures recognize the

need for the establishment of branch offices nationwide. Investors must increase their registered capital by RMB 500,000 for each new branch. However, where the initial investment for the establishment of the enterprise has exceeded the minimum registered capital required, the difference can be used to satisfy the foregoing branch capitalization requirement. Overall, the measures will add favorably to the swell of regulations and measures issued in recent years, which collectively ensure that China will achieve an integrated and ultimately seamless transportation and logistics system. --Diarmuid O'Brien

Articles and Publications

James Zimmerman, *China Law Deskbook, Second Edition (2005): A Legal Guide for Foreign-Invested Enterprises*. More information is available on ABA's Web site:

<http://www.abanet.org/abastore/index.cfm?section=main&fm=Product.AddToCart&pid=5210139>.

Amy L. Sommers, "Foreign Investment Verification: Reform, Status Quo, or Bafflement?," *China Business Review*, November-December 2005. Access to the article is available at:

http://www.ssd.com/publications/pub_detail.aspx?pubid=9426

"Cal Law 2005 Roundtable Series: Doing Business in China," GC California Magazine, November 2005. The article features **Jerome J. Joondeph Jr.**, partner in Squire Sanders' Palo Alto office, on a panel discussing US companies and law firms setting up operations in China. Access to the article is available at:

http://www.ssd.com/resources/news_detail.aspx?newsid=12381

Wei Zhong, "Legal Analysis for International Protection of Chinese Brands," *China Development Observation*, Issue 12, 2005. Wei Zhong is an associate in the Beijing office. *China Development Observation* is a journal published by the State Council Development Research Center, the most influential think-tank in China. Access to the article (in Chinese) is available at: <http://www.chinado.cn/ReadNews.asp?NewsID=466>.

Presentations and Recent Events

Amy Sommers, national partner in Squire Sanders' Shanghai office, participated on a panel at the International Real Estate Trade Organization (IRETO) International Commercial Investors Day December 17, 2005 at CIHAF 2005, the 7th Annual China International Real Estate & Architectural Fair, in Shanghai. The panel was titled "Step-by Step: Understanding Chinese Real Estate Development and Investment from Planning, Legal Accounting, Social and Due Diligence Standpoints." Squire Sanders was a Gold Level Sponsor of IRETO International Commercial Investors Day.

Amy Sommers; Dan Roules, partner in Squire Sanders' Beijing and Shanghai office; and **Charles McElwee** Counsel in the Shanghai office, participated in a roundtable discussion on China and government procurement issues at a December 6 event at Shanghai Jiao Tong University cosponsored with the US Council of International Business and the Shanghai WTO Affairs Consultation Center.

Mark Dosker, partner in Squire Sanders' San Francisco office, presented a seminar on "Litigation in the U.S. Courts and Arbitration with U.S. Companies and other challenges for Chinese Companies" on December 12 in Beijing and December 14 in Shanghai.

Charlie McElwee, presented a paper on Judicial Review in Administrative Litigation at an International Symposium on Judicial Review sponsored by the United Nations Development Programme and the Supreme People's Court in Shanghai on January 10-11.

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January 2006

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Squire Sanders Contacts

<p>BEIJING</p> <p>Daniel F. Roules Sungbo Shim James M. Zimmerman Squire, Sanders & Dempsey L.L.P. Suite 2501, 25th Floor, North Tower Beijing Kerry Centre 1 Guanghua Road, Chaoyang District Beijing 100020, China +86.10.8529.6998 Email: droules@ssd.com sshim@ssd.com jzimmerman@ssd.com</p>	<p>SHANGHAI</p> <p>Daniel F. Roules Amy L. Sommers Squire, Sanders & Dempsey L.L.P. Suite 1207, 12th Floor Shanghai Kerry Centre 1515 Nanjing Road West Shanghai 200040, China +86.21.6103.6300 Email: droules@ssd.com asommers@ssd.com</p>
<p>HONG KONG</p> <p>James Tsang John Lo Squire, Sanders & Dempsey Room 4008 Gloucester Tower The Landmark, 11 Pedder Street Central, Hong Kong +852.2509.9977 Email: jtsang@ssd.com jlo@ssd.com</p>	<p>TOKYO</p> <p>Ken Kurosu Steven S. Doi Squire Sanders Gaikokuho Kyodo Jigyo Horitsu Jimusho Ebisu Prime Square Tower, 16/F 1-1-39 Hiroo Shibuya-ku, Tokyo 150-0012 Japan +81.3.5774.1800 Email: kkurosu@ssd.com sdoi@ssd.com</p>



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