



CHINA UPDATE 2006

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Foreign Banks Now Qualified for QDII Program

Key Points:

- **Commercial banks, including foreign banks, now eligible**
- **Inclusion consistent with China's WTO commitments**

The Provisional Administrative Rules on the Overseas Assets Management Business of Commercial Banks on Behalf of Their Clients (the "Rules"), promulgated on April 17, 2006, officially launched the Qualified Domestic Institutional Investor ("QDII") program for commercial banks in China. Under China's QDII program, qualified financial institutions, including commercial banks, insurance companies and fund management companies, are able to pool renminbi (RMB) from domestic institutions and residents and convert it into foreign currency for investment in overseas capital markets.

Because the Rules only refer generally to "commercial banks" as being qualified for the program, there was, initially, some question in the industry as to whether foreign-funded banks (including foreign-invested joint venture banks, wholly foreign-invested banks, and branches of foreign banks in China) were qualified. Foreign banks were also concerned that the China Banking Regulatory Commission ("CBRC") might

discriminate between foreign-funded banks' applications and those of domestic entities, even if foreign-funded banks were eligible for the program. To respond to those concerns and confusions, the CBRC announced through its website that foreign-funded banks are also qualified for the QDII program and that the inclusion of foreign banks in the program is consistent with the PRC government's World Trade Organization commitments.

The program has since proven irresistible to foreign financial institutions, as it offers them access to more than RMB 1.8 trillion in personal savings in China. On June 30, six banks were granted the first QDII licenses by CBRC, including four domestic banks and two foreign-funded banks, HSBC and Bank of East Asia.

– Guojun Ye

New System to Restrict Car Exporters

Key Points:

- **Chinese auto manufacturers must now be licensed in order to export vehicles**
- **Goals: increase overall quality of Chinese auto exports, decrease vicious competition**

In order to curb industrial infighting, China plans to restrict the access of domestic companies to the automobile export business beginning in 2007. A new system, which will become effective in January 2007, is designed to bring the number of

automobile exporters in the country more into alignment with actual global demand for the nation's vehicles and raise the overall quality of the nation's auto exports.

In recent years, the output of Chinese automobile manufacturers has increased and domestic competition has been keen. Accordingly, the number of cars the country exports is increasing rapidly. Statistics from the Ministry of Commerce indicate that in the first quarter of 2006, China exported 62,628 automobiles, up 139 percent from the same period in 2005. The total value of these exports amounted to US\$647 million, a one-year increase of 204.5 percent.

Although China's automobile output amounts to 10 percent of the world's total, its export volume represents less than 1 percent. The sheer number of companies exporting automobiles is also disproportionate to each company's actual export volume. For example, in 2005, 1,025 Chinese companies exported vehicles, but more than 600 of those companies exported fewer than 10 vehicles, and 106 of the companies exported only one vehicle.

Some of these vehicles are exported by small companies lacking sophisticated technology and producing inexpensive, low-quality vehicles. These vehicles are blamed for having an adverse influence on China's overall vehicle export industry,

giving the entire country a reputation for producing shoddy automobiles and leading to questions about the safety and reliability of its exports.

An additional problem caused by a multitude of Chinese companies producing poor-quality automobiles is their main tool of competition: price cutting, which results in vicious domestic competition and also triggers antidumping protections in the countries to which the automobiles are exported.

Under the new system, China's government will limit the number of automobile manufacturers permitted to export vehicles through the issuance of export licenses. Only companies with a large enough export volume to warrant one will receive an export license. Smaller companies attempting to enter global markets with price-cutting strategies that may hurt the reputation of the nation's automotive industry will not be awarded export licenses. The state will set license qualification standards including export amount in the previous year, export amount of each deal and volume of domestic sales in the previous year. Observers expect that after the new system is established, as many as two-thirds of companies will be prohibited from exporting vehicles.

In June 2006, the Draft of the Provisional Rules of Investigation and Sanction on Export by Unfair Low Price ("Draft") was published for comments. Under

the terms of the Draft as currently written, a competent authority may sanction a company believed to be exporting vehicles with unfairly undercut prices with a fine of up to RMB 30,000, and by embargoing exports of the investigated product for the next 12 months.

– *Li Teng*

MOFCOM Revises Holding Company Rules

Key Points:

- *Several provisions in Regulation of 2004 clarified*
- *Some restrictions on foreign-invested holding companies relaxed*

On May 26, 2006, the Ministry of Commerce (“MOFCOM”) issued the Supplementary Regulation on Foreign Investment in Holding Companies (“Supplementary Regulation”). Regulations on foreign investment in China-based holding companies have been revised several times since foreign investors were first granted the right to establish such companies in 1995, the most recent revision being in November 2004 (the “Regulation of 2004”). This Supplementary Regulation clarifies several provisions stipulated in the Regulation of 2004 and also relaxes some restrictions on foreign-invested holding companies. The main changes are as follows:

- Holding companies may complete the contribution of registered capital within five years upon issuance of a business license, while a minimum of only US\$30 million must be contributed within two years upon issuance of the business license.
- Holding companies may contract the outsourced services of foreign companies.
- Holding companies may engage in strategic investment in listed companies.
- Before establishing subsidiaries or producing new products, holding companies may import relevant products for domestic trial sale and may designate domestic enterprises to produce their products or their parent company’s products and to sell the products domestically and abroad.
- Importation by holding companies is not restricted by amount of paid-in registered capital.
- Holding companies with regional headquarters status may engage in activities related to operational and financial leasing (this provision does not mention remittances or loans of foreign exchange to overseas companies).
- Holding companies with the status of regional headquarters and finance center or capital management center may, after approval from the State Administration of Foreign Exchange, engage in centralized management of the foreign exchange of domestic affiliated

companies (in the Regulation of 2004, only a holding company with regional headquarters status could set up a finance company to provide financial services to the companies in which it invested).

In addition to the above changes, this Supplementary Regulation clarifies and emphasizes that holding companies have the right to enjoy export rebates and conduct distribution through wholesale or commission agencies subject to relevant authorities' approvals.

Finally, in order to better regulate holding companies, this Supplementary Regulation requires holding companies to prepare and submit reports to MOFCOM on June 1 of each year covering the previous year's investment and operation activities. However, the specific investment and operation information these reports must include is not yet clear.

Generally, this Supplementary Regulation demonstrates the government's affirmative stance in encouraging holding companies to obtain regional headquarters status and in promoting foreign investors' mergers and acquisitions of listed companies.

– Zhang Wei

SAIC Clarifies Opinion on Registration of FIE Liaison Offices

Key Points:

- ***Need not obtain separate business license with local AICs***
- ***"Business activities" still prohibited, but still poorly defined***

The State Administration of Industry and Commerce ("SAIC") issued a notice on June 2, 2006, to clarify several issues regarding the Notice released recently on registration of foreign-invested enterprises ("FIEs"). The notice elaborates on several issues regarding liaison offices of FIEs.

First, the notice provides official confirmation that FIEs may set up liaison offices and that these offices do not need to register for a business license with the local administrations of industry and commerce ("AICs"). As reported in our last China Update, this confirmation previously appeared only in SAIC's press release, which was issued alongside the opinion. Liaison offices should be able to use the business licenses of the parent FIE to conduct their liaison activities where the office is located.

Second, the notice again emphasizes that these offices may engage only in liaison-related activities, such as market research, and may not conduct "business activities." No official definition of "business activities" has been provided, however. The notice also states that local AICs are responsible for overseeing all liaison offices and for

determining whether they are engaged in “business activities.” If liaison offices are found to be pursuing such activities, local AICs are to ensure that the office is brought into compliance, either by converting it into a formal branch of the FIE or by requiring it to cease and desist business activities. AICs may also impose penalties on liaison offices determined to have engaged in business activities.

The lack of an official definition of “business activities” gives local AICs much discretion in determining the scope of these activities. Companies should expect conflicting definitions, both formal and informal, to emerge as various local AICs begin to implement the opinion.

– Lindsay Zhu

New Rules to Crack Down on Illegal Activities on the Chinese Stock Market

Key Points:

- *Violators to be prohibited market access*
- *Prohibitions may range from short-term to life*

In order to crack down on illegal activities on the Chinese stock market, maintain order in the stocks and securities business, protect the legal rights and social interests of investors, and promote the healthy and stable development of the market, the China Securities Regulatory Commission (“CSRC”) issued the Provisions Regarding Prohibition Against Access to the Stock Market (“the Access Prohibition Provisions”).

Under the Access Prohibition Provisions, the CSRC may take measures to prohibit access to the Chinese stock market by the following persons who violate any Chinese laws, administrative regulations and relevant provisions of the CSRC:

1. any director, supervisor or senior manager of an issuer or listed company, any other information disclosure obligor or any of its directors, supervisors or senior managers;
2. any controlling shareholder, actual controlling person of an issuer or listed company or any director, supervisor or senior manager of an issuer or any controlling shareholder or actual controlling person of a listed company;
3. any director, supervisor, senior manager of a securities company or any of its internal business departments principals, branch principals or other securities business persons;
4. any controlling shareholder, actual controlling person of a securities company or any director, supervisor or senior manager of any controlling shareholder or actual controlling person of a securities company;
5. any person engaging in the securities service business such as the directors, supervisors or senior managers of a securities service institution or any actual controlling person of a securities service

institution or any director, supervisor or senior manager of any actual controlling person of a securities service institution;

6. any managing person of a securities investment fund or any director, supervisor, senior manager of a securities investment fund or any of its internal business department principals, branch principals or other securities investment fund business persons;
7. other relevant principals recognized by the CSRC to be in violation of laws, administrative regulations or the CSRC's provisions.
8. Any person against whom the CSRC takes measures to prohibit that person's access to the Chinese stock market shall neither continue to engage in the securities business in his or her original institution; serve in the position of director, supervisor or senior manager of his or her original listed company; nor engage in the

securities business in any other institution or serve the position of director, supervisor or senior manager of any other listed company.

Depending on the seriousness of the circumstances, persons prohibited access to the Chinese stock market by the CSRC may be prohibited access for anywhere from three to five years to life.

Prior to taking access prohibition measures, the CSRC is required to inform the affected party of the facts, causes and bases on which it is taking such measures and his or her right to make statements, to appeal the measures and to demand a hearing. In addition, the names of persons prohibited access to the Chinese stock market by the CSRC must be published on the CSRC's website or designated media and recorded in its fiduciary files.

– *Linferson Shu*

Articles and Publications

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

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

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