



CHINA UPDATE 2006

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MOFCOM Revises Rules on Venture Capital Enterprises

Key Point:

- *Easier market entry for foreign-invested enterprises*

The PRC Ministry of Commerce (“MOFCOM”) posted a revised draft of the Administrative Regulations for Foreign-Invested Venture Capital (“VC”) Enterprises on July 14, 2006 for public comments. When finalized, the regulations will replace the existing rules that have been in effect since March 2003.

The revised regulations will provide much easier market entry for foreign-invested VC enterprises. Under the draft, Chinese individuals are, for the first time, permitted to act as partners to these enterprises. In addition, the required minimum capital managed by an investor in a foreign-invested VC enterprise will be reduced from US\$100 million (US\$50 million of which must be in the form of VC investments) to US\$60 million (US\$30 million of which must be in the form of VC investments). A VC enterprise, if not a qualified “legal person,” will be able to use a name containing the words “venture capital fund.”

The draft also expands the business scope of a VC enterprise. Under the draft, a VC enterprise can invest via shares (preferred shares, convertible

notes, etc.) and can as a strategic investor invest in, for example, public companies. Foreign-invested VC enterprises established according to the regulations could enjoy preferential tax treatment awarded by the state to VC enterprises. The revisions specify that domestic investments in RMB by foreign-invested VC enterprises would be exempted from approvals of foreign exchange administrations. If adopted, the revisions would also speed up the application and approval process. The current regulations require provincial-level commerce authorities to complete the pre-examination process within 15 days, while the revisions reduce the process to 10 days. The revisions also cut the period for the examination and approval process by MOFCOM from 45 to 30 days. – *Wei Zhong*

CIRC Updates Rules on Foreign Insurance Representative Offices

Key Points:

- *Stricter requirements established*
- *New termination mechanism added*

The PRC China Insurance Regulatory Commission (“CIRC”) recently published new rules on the operation of foreign insurance representative offices in China. These new rules, which replace the rules issued in 2004, provide the following stricter requirements on establishing a representative office in China:

i) New qualification requirements for applicants: foreign insurance companies must have at least 20 years' experience in insurance; representative office applicants without insurance operations are required to have been in business for at least 20 years.

ii) New documentation requirements: The applicant is required to submit a representative office feasibility study and other research reports and declare that the chief representative has no record of major violations of laws or regulations in the three years prior to the date of application. The chief representative must also keep a mobile telephone number and email address on file with the CIRC.

In addition, the new rules state that a general manager or chief representative must spend a total of at least 240 days at a representative office and he or she must not be away from the representative office for more than 30 days at a time. If a general manager or chief representative plans to be away from the office for more than 14 continuous days, he or she must appoint a temporary replacement and notify local CIRC officials.

In addition to these stricter requirements, the new rules include a termination mechanism for representative offices that fail to abide by regulations. If an office has been punished by the

CIRC or its local authorities three times, or found to have derived considerable benefit from engaging in business activities that violate Chinese law, the CIRC will take this into consideration when determining whether its parent company is eligible to establish a foreign investment insurance company in China.

China has opened its insurance industry to foreign investors to meet its WTO commitments. Its new, stricter rules, although issued mainly for governance purposes, are good news for those outside China awaiting investment opportunities. – *Li Zijie (Lesley)*

New Policies to Boost Insurance Sector

Key Points:

- *State Council policies for industry reform issued*
- *Insurance companies encouraged to invest in capital market and commercial banks*
- *Implementing rules yet to come*

In June 2006, the PRC State Council issued Several Opinions Concerning the Reform and Development of the Insurance Industry ("Opinions"). This is the first guiding document issued by the State Council since the formation of the CIRC, its goal being support of the insurance sector. The Opinions deal with all the important aspects of the insurance sector and lift some restrictions that previously limited the development of the industry.

Issuance of the Opinions reflects the importance of the insurance industry in China's economy today.

The Opinions encourage insurance companies to invest in the capital market, acquire interests in commercial banks and invest overseas with insurance capital. In addition, insurance capital investments in real property and venture capital entities will be permitted on a trial basis. These provisions are intended to stimulate domestic insurance companies to improve their comprehensive financial capabilities so as to be better able to compete internationally. According to China's commitment upon its entry to the WTO, the insurance industry was the first finance sector to be opened to foreign investment, and China will fully open its financial market to the world by the end of this year. The Opinions also encourage development of agricultural insurance suitable for China and more investment in commercial endowment insurance, health insurance and liability insurance.

The Opinions provide general guidelines for reform and development of the insurance industry; however, to implement these policies, detailed rules are still needed. The CIRC is expected to issue some implementing rules within this year. – *Liu JingNan (Jennifer)*

China Tightens Regulation Over Acquisitions by Foreign Investors

Key Points:

- *Acquisition by share swap allowed under certain conditions*
- *Approval from Ministry of Commerce required for establishment of overseas special vehicle companies by PRC companies or individuals for listing purposes*
- *Overseas special vehicle company listings to be done with one year*

On August 9, 2006, six authorities jointly issued the Provisions on Acquisition of Domestic Enterprises by Foreign Investors ("new M&A rules"). Most of the clauses of the Interim Provisions on Acquisition of Domestic Enterprises by Foreign Investors issued in 2003 ("old M&A rules") have been incorporated into the new M&A rules. The major changes are in the provisions regarding share swaps and special vehicle companies.

The Ministry of Commerce is the approval authority for share swaps. The target company, or its shareholder, is required to engage a consultant able to conduct investigations and analyze the legal system in which the foreign listing company is registered and listed and the company's financial status as well. The consultant's report is one of the documents required for approval. Upon the approval of MOFCOM, a Certificate of Approval, valid for only six months after the issuance date of

the business license, will be issued. The share swap must then be completed within six months; otherwise, the share structure of the target company will be restored to what it was before acquisition.

The new rules devote a whole subsection to overseas special vehicle companies established by PRC companies or individuals for the purpose of listing. The new M&A rules provide that if an overseas company established by a PRC company, enterprise or individual acquires its affiliate company in China, approval from MOFCOM is required, and no one is permitted to circumvent this requirement in any way. When a special vehicle company acquires its affiliate company in China by purchasing its stock, pre-approval from MOFCOM and final approval from the China Securities Regulatory Commission are required. The temporary Certificate of Approval is valid for only one year. If the special vehicle company cannot be successfully listed within the year, the share structure of the target company is to be restored to what it was before acquisition.

These rules also tighten supervision of acquisitions by foreign investors. Without knowing the approval criteria of MOFCOM and the China Securities Regulatory Commission, many privately owned Chinese companies who want to go public through a special vehicle company may become bogged down in the process. Because of the six-

month/one-year limitation and restoration requirement, foreign investors' exposure is significantly increased and venture capital funds may be more reluctant to invest in China. It has become more difficult for privately owned Chinese companies to obtain financing from overseas markets since the new M&A rules became effective; also, the time and expense of an initial public offering in overseas markets has decidedly increased. – *Wang Huimin (Laura)*

Policy Changes Target Foreign Investors Into China's Property Market

Key Points:

- *Measures designed to cool property prices*
- *Property investment off limits to foreigners*
- *Enhanced government monitoring of market*

Earlier this year, in response to soaring property prices, particularly in the residential sector of China's booming east coast cities, the government introduced measures that, *inter alia*, served to limit the size of residential properties, require larger down payments and penalize developers who fail to undertake construction projects on time. These earlier measures were recently complemented by a series of "policy changes" jointly issued by six government entities including MOFCOM, the National Development and Reform, Commission ("NDRC") and the State Administration of Foreign Exchange ("SAFE"). While the earlier changes were

aimed at developers and borrowers, the latest changes are targeted at foreign investors and foreign individuals, with a view to eliminating property speculation by foreigners.

One of the main changes is that foreign-invested property enterprises with a total investment exceeding US\$10 million are now required to inject a registered capital of at least 50% of the total investment. While foreign invested property enterprises are still permitted – and continue to be heavily regulated – the policies impose a prohibition on the purchase of property by foreign individuals and representative offices unless they can prove registration in China for at least one year. In such cases, the purchase of the property must be for personal use only – not for investment purposes.

Foreign-invested property enterprises also face more onerous procedures in the undertaking forex settlement. SAFE may not undertake forex settlement transactions for foreign-invested property enterprises if the enterprise has not contributed its entire registered capital, has not obtained the required government land permit, and if the development capital is less than 35% of the overall project investment. In yet another policy change, local governments are directed to cancel and cease offering property-related investment incentives and preferential treatment.

The changes will not merely eliminate foreign investment by individuals; they also seriously affect

China's market attractiveness to foreign companies eager to participate in the PRC property market.

Enforcement of these policies will take place through enhanced government monitoring of foreign investment in the property sector and the sharing of property-related information by MOFCOM and other government agencies, which should result in a more accurate assessment of the market and its development. Given that the changes have been issued by six prominent government agencies, they will most likely be implemented fully.

It is unclear whether these “policy changes” were envisaged earlier this year or whether they constitute a reaction to the continuing rise in property prices. However, if property prices continue their exorbitant rise, further changes could be in the offering before too long. – *Diarmuid O'Brien*

China Implements New Corporate Insolvency Law

Key Points:

- *Uniform code for corporate insolvency established*
- *Requires payment of creditors before laid-off employees*

On August 1, China promulgated a new bankruptcy law, to become effective June 1, 2007. Drafted over many years, the new law has its roots in a plethora of laws, provisions and circulars issued in

piecemeal fashion since 1986, when China introduced its first law addressing bankruptcy.

Known as the Enterprise Bankruptcy Law of China (“EBL”), China’s first bankruptcy law was initially introduced on a provisional basis and was confined to addressing state-owned enterprise (“SOE”)-sector insolvency. Given its limitations, the EBL was supplemented by the Opinions of the Supreme People’s Court on Several Questions Concerning the Implementation of the Enterprise Bankruptcy Law, which addressed many unresolved EBL issues, but again failed to venture outside the province of SOE insolvency.

The first legislative foray into private sector insolvency did not surface until 1991, with the Civil Procedure Law (“CPL”). While the CPL contains only broadly drafted framework provisions treating private sector insolvency, its lack of specificity was partially addressed through the subsequent issuing of the CPL Opinions, which confirmed the applicability of the CPL’s insolvency provisions solely to the non-SOE sector. Other important relevant legislative instruments have included MOFCOM’s 1996 Measures on the Liquidation of Foreign Investment Enterprises (“FIEs”), dedicated to FIE liquidations, and the PRC Company Law, which contains a section treating corporate insolvency, dissolution and liquidation.

Because of the relative lack of private sector insolvency legislation, in practice, the EBL was

effectively used to govern private sector insolvency, a practice that was formally accepted in 2002 through the issuing of the Supreme People’s Court Provisions on Several Questions Concerning the Treatment of Enterprise Bankruptcy Cases. Given that this unsatisfactory situation has existed for a number of years, there has been considerable commercial and governmental consensus on the need to introduce a comprehensive and uniform law covering all PRC corporations, both domestic and FIEs.

The new law outlines the legal test for determining insolvency and details insolvency procedures, all of which are designed to enhance the protection of both the creditors and the employees of the insolvent enterprise. In particular, the new law compels solvent enterprises to make credit guarantees available to allow for the settlement of debts to creditors and, thereafter, to pay the enterprise’s employees. This system will replace the existing system, which requires that employees be paid before settlement of debts with creditors.

One exception to the law concerns some 2,000 government identified SOEs. If any SOE on this government identified list declares bankruptcy before June 2007, the government will assist in its liquidation, including the payment of compensation to laid-off employees.

When the new bankruptcy law becomes effective, it will supersede the outdated EBL. Overall, while the

new law is welcome, observers expect that yet more insolvency regulations will be required to

address any outstanding issues remaining. –
Diarmuid O'Brien

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>.

Aaron R. Wininger, national partner in Squire Sanders' Shanghai office, was quoted in Sheila Wong's article "IPR: Progress or Impasse?" in the August 2006 issue of *Shanghai Business Review*.

Upcoming Events

Charles R. McElwee, counsel in Squire Sanders' Shanghai office, will speak at *Chemical Week* and *Chemical Engineering* magazines' 12th Annual China Chemical Industry Conference September 12-14, 2006 at the Sofitel Jin Jiang Oriental Pudong, Shanghai. Squire Sanders is a supporting sponsor of the conference. Mr. McElwee will speak at noon on Thursday, September 14 on "Corporate Environmental Strategies for China." For more information and to register, visit:

<http://www.chemconference.com/events/ChinaIndustry2006/index.php?eventsfolder=ChinaIndustry2006&menuTitle=12th%20Annual%20China%20Chemical%20Industry%20Conference>. Mr. McElwee will also speak at the Environmental Outlook 2007 event sponsored by Squire Sanders at Firestone Country Club in Akron, Ohio, USA, September 19-21. His September 20 presentation will be "China and Asia Perspectives on Environmental Management."

James M. Zimmerman, partner in Squire Sanders' Beijing office, will give a presentation, "Developments Concerning the Anti-Monopoly Law in China," at a Capital Club roundtable sponsored by Hughes-Castell Ltd. on September 14, 2006.

Presentations and Recent Events

Nicholas Chan, national partner in Squire Sanders' Hong Kong office, spoke at the invitation of the Hong Kong Law Society on "Understanding E-Commerce Law" at a public seminar hosted by the Digital Trade and Transportation Network and co-hosted by professional groups including the Hong Kong Productivity Council, the Hong Kong Logistics Association and the Hong Kong Trade Development Council on July 27, 2006. As the spokesperson of the Law Society of Hong Kong, he also delivered a public lecture, "Understanding the Employment Ordinance," on August 26, 2006 for the Salvation Army.

James M. Zimmerman, partner in Squire Sanders' Beijing office, gave a presentation and moderated at a luncheon with United States Trade Representative Ambassador Susan Schwab, hosted by the US-China Business Council and AmCham, on August 29, 2006. On September 6, he gave a presentation, "Labor and Employment Law Trends in China," sponsored by the US Embassy, at the American Club to a delegation of 25 corporate labor lawyers from the United States.

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This newsletter provides free information on the influence of certain aspects of the Chinese legal environment and does not constitute legal advice.

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Squire Sanders Contacts

BEIJING

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

HONG KONG

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

SHANGHAI

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

TOKYO

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

NORTH AMERICA

Cincinnati
Cleveland
Columbus
Houston
Los Angeles
Miami
New York
Palo Alto
Phoenix
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