INDIA, CHINA AND AMERICA INSTITUTE
1549 CLAIRMONT ROAD, SUITE 202 ● DECATUR, GA 30033 USA
WWW.ICAINSTITUTE.ORG

2004 Year in Review: Legal Developments in the People's Republic of China and the Hong Kong Special Administrative Region

Michael E. Burke

Ver. 111605

2004 Year in Review:
Legal Developments in the People's Republic of China and the Hong Kong Special Administrative Region

2004 Year in Review: Legal Developments in the People's Republic of China and the Hong Kong Special Administrative Region

Michael Burke*

* J.D., 1998, Georgetown University Law Center; B.S.F.S., *cum laude*, 1993, Georgetown University School of Foreign Service. Mr. Burke is an Associate with the Washington, DC office of Williams Mullen and, since 2002, has been a Fellow with the Asian Institute of International Financial Law at Hong Kong University. This article is informational only, and should not be construed as legal advice.

Published in 2005

Introduction

In 2004, the People's Republic of China ("China" or "PRC") continued to implement its World Trade Organization ("WTO") commitments by overhauling its foreign trade law; implementing its commitments in the retail, wholesale, and franchising sectors; improving market access for foreign banks and insurance companies; and implemented WTO-compliant rules of origin for goods. The Chinese government also amended its *Constitution* for the fourth time since the PRC's founding, and seemed to liberalize foreign investors' access to the construction, media, and advertising sectors. 2004 was significant year for legal developments in Hong Kong, as well. China's National People's Congress clarified aspects of Hong Kong's *Basic Law*. In addition, the Hong Kong government amended its land title ordinance, landlord and tenant regulations, and its copyright protections. This article will review selected legal development that occurred in 2004 in China and Hong Kong. Space being at a premium, some legal developments, even important ones, may not be included in this article. Nonetheless, this article highlights an active year for legal development in China and Hong Kong.

I. People's Republic of China

1. Constitutional Amendments

In March 2004, China's National People's Congress (NPC) amended the *Constitution of the People's Republic* for the fourth time since the PRC's founding.[1] Major amendments include, *inter alia*:

- Adding the "Three Represents" as one of the government's guiding principles;
- Obligating (at least on paper) the government to pay compensation when it expropriates property;
- Solidifying the state's role in furthering private enterprise;
- Providing that the government will respect the right of citizens to own and inherit private property;
- Specifying that the government (at least on paper) respects and protects human rights; and
- Extending the term of office in local people's congresses to five (5) years.

2. Foreign Trade Law

The NPC amended the PRC Foreign Trade Law (the "FTL") on April 6, 2004, which amendments were effective as of July 1, 2004. The revised FTL (i) covers all cross-border transactions involving goods, technology or services; (ii) deregulates access to foreign trading rights; and (iii) addresses the roles of governmental authorities, foreign and domestic companies, state-operated trading entities, and trade associations. Most significantly, the revised FTL expands trading rights to all enterprises in China by ending the "foreign trading authority" regime, pursuant to which only licensed entities could import or export goods or technology. As such, a licensed third-party import/export entity is no longer a mandatory

[1] *See*, Major Amendments to Constitution, *available at* http://www.10thnpc.org.cn/english/features/90056.htm.

prerequisite to import or export transactions. Any entity may engage in foreign trade in the PRC through a "filing for the record" made with the Ministry of Commerce ("MOFCOM").

A foreign invested enterprise ("FIE") may import directly items for use in its operations and export directly items that it has produced, without making any filing for the record. FIEs only need to satisfy the general capital requirements in the Company Law in order to obtain approval for a business scope that includes foreign trade.

The revised FTL also states that it will provide a services sector-focused market access catalogue. Further, the revised FTL empowers MOFCOM to prohibit for a defined period of time production and sales in China by those who import goods that infringe intellectual property rights. Related thereto, the revised FTL protects licensees of imported technology in China against tying, exclusive grant back licenses, and certain other practices of licensors and allows the Chinese government to adopt retaliatory trade measures against other countries that fail to adequately protect the intellectual property rights of PRC entities and individuals.

3. Examination and Approval System

In July 2004, the State Council issued the *Reform of the Investment System Decision* that altered significantly the examination and approval system required of projects not using government funds.[2] Related thereto, in October 2004, the National Development and Reform Commission ("NDRC") issued *Administration of the Verification of Foreign-invested Projects Tentative Procedures*, specifying how it would regulate the new registration system. Under the new registration system, foreign investors only need to file one "project application report" to the NDRC for approval before commencing any investment project. However, these new regulations seem to introduce the NDRC as a quasi-regulator for matters, such as a FIE increasing its capital, also subject to MOFCOM approval and oversight.

Under this new approval regime, provincial government authorities may approve foreign investment projects of US$100 million in the "encouraged" or "permitted" foreign investment categories and US$50 million for projects in the "restricted" foreign investment category. The State Development Planning Commission must approve categories with a larger investment amount, and the State Council must approve projects with an investment of more than US$500 million in the "encouraged" or "permitted" categories and projects with more than US$100 million in the "restricted" category.

In addition, the NDRC must approve foreign investment projects (i) with investment of more than US$30 million by a Chinese party; and (ii) in the non-resource category involving use of foreign exchange exceeding US$10 million by a Chinese party. MOFCOM retains

[2] State Council, *Reform of the Investment System Decision*, China Law and Practice 2100/04.07.16, issued and effective as of July 16, 2004.

oversight over the international business activities of domestic Chinese enterprises. The NDRC must issue a decision as to a project within twenty (20) days of application receipt, but may extend its decision deadline another ten (10) days upon notice to the applicant. The NDRC can outsource project review to a consultant, which postpones the start of the twenty (20) day clock, but the decision as to retain a consultant must be made within five (5) days of application receipt.

Related to the above actions, the State Administration of Industry and Commerce ("SAIC") clarified that applicants and their appointed agents may file relevant registration applications by applying (i) in-person at the relevant SAIC office; or (ii) by post, facsimile or electronic data exchange. Except for in-person registration, the SAIC turn-around for registrations is set at fifteen (15) days.[3]

4. Administrative Licensing Law

The new *Administrative Licensing Law* ("ALL") narrows the scope of activities for which a license or approval is required. Further, in some cases where a license or approval is required, the ALL shifts a bias toward self-regulation. The ALL applies to the creation as well as the implementation of administrative licensing, defined as the grant of permission for the undertaking of specified activities in accordance with an application to do so as approved by an administrative authority. Administrative licensing, and the ALL's reach includes (i) permits, licenses or other certificates; (ii) professional qualifications; (iii) approval documents or other certificates; (iv) administrative licenses in other forms; and (v) labels or seals affixed to equipment, facilities, products and goods that have passed inspection.

Under the ALL, administrative licenses may be required in: (i) state security, public safety, macroeconomic regulation, ecological environmental protection, and matters that directly impact human health or the safety of people or property; (ii) the development and exploitation of natural resources, the allocation of public resources, and market entry in industries that directly impact the public interest; (iii) determination of the qualifications for professions and industries that provide services to the public and directly impact the public interest; (iv) important equipment, facilities, products and goods that directly impact public safety, human health, or the safety of people and property, which must be examined in accordance with technical standards and norms; (v) the establishment of enterprises or other organizations for which the qualifications of the principals must be determined; and (vi) other matters for which administrative licenses may be required by law or administrative regulation. Provincial governments may create administrative licensing requirements for matters not subject to national laws or administrative regulations, but may not do so for matters that should (but are not currently) the subject of national regulation. The ALL does not enable sub-provincial governments to impose administrative licensing requirements.

[3] State Administration for Industry and Commerce, *Procedure for Enterprise Registration Provisions*, China Law and Practice 2330/04.06.10, issued June 10, 2004 and effective as of July 1, 2004.

In creating an administrative license, the drafting authority must convene hearings or solicit comments, although persons have no right under the ALL to challenge improperly created administrative licensing laws and regulations. An administrative authority may not unilaterally alter a valid administrative license. A licensee is entitled to compensation if the license is altered or revoked because of a change of law or a material change in the conditions on which the license was based. Administrative licenses are not transferable except as provided by laws or regulations.

Application forms for an administrative license may not require applicants to provide irrelevant information. Requirements must be displayed, and the administrative authority is required to provide explanations and reliable information at the applicant's request. Two or more officers must conduct any verification of a license application, persons whose interests are materially affected by an application are to be informed by the administrative authority, and they along with the applicant have the right to comment on the application. Decisions on applications are to be made in writing on a timely basis and with an explanation in the event of rejection, decisions to grant administrative licenses are to be published, and administrative licenses generally are to be of nationwide scope unless a regional scope is specified. A decision is to be made within twenty (20) days subject to a ten (10) day extension in general, or forty-five (45) days subject to a fifteen (15) day extension when the application is processed in a unified or a joint and collective manner. An additional twenty (20) days is allowed for preliminary examination by a subordinate administrative authority when required, unless law or regulation provides otherwise.

Public hearings are convened as required by the ALL or when decided by the applicable administrative authority. Applicants and affected parties are entitled to seven days notice of any hearing, and hearings are to be open and publicly announced.

Administrative licenses may be revoked at the request of affected parties or by the administrative authority on its own initiative if the license was improperly granted or is the product of corruption. The licensee may be eligible for compensation if the license is revoked because it was improperly granted, but not if the licensee engaged in corruption.

5. Commercial Operations

MOFCOM issued the *Administration of Foreign Investment in the Commercial Sector Procedures* ("Commercial Sector Procedures"), on April 16, 2004, effective June 1, 2004. Major changes resulting from the Commercial Sector Procedures include: (i) wholly-foreign owned enterprises (WFOEs) will be permitted in the commercial sector as of December 11 2004, subject to certain restrictions; (ii) the high threshold registration requirements have been eliminated; (iii) a wider scope of permissible retail and wholesale activities; (iv) wholesalers are no longer subject to geographical limitations, and retailers will no longer be subject to geographical limitations as of December 11, 2004; and (v) a simplified approval process.

Pursuant to the Commercial Sector Procedures, parties only need to meet the minimum amount to establish a company under the *PRC Company Law*, RMB¥300,000 for retailers and RMB¥500,000 for wholesalers. Foreign investors are still limited to 49% where the foreign investor has opened more than 30 outlets, and in other specified circumstances. Wholesalers may not distribute chemical fertilizers, processed oil and crude oil before December 11, 2006. Retailers may not distribute chemical fertilizers before December 11, 2006. Neither wholesale nor retail FIEs may distribute tobacco, and wholesalers may not distribute salt.

Retail companies under the Commercial Sector Procedures may sell of products, import products for its own business, purchase and export domestic products, and related services, including after-sales services. Wholesale companies may sell products on a wholesale basis, act as a commissioned agent (excluding auctions), import and export products, and provide related services. Upon approval, a company may combine retail and wholesale activities. Commercial FIEs may also authorize third parties to operate franchises, which was not possible previously.

Related to the Commercial Sector Procedures, on November 23, 2004, MOFCOM circulated a draft of the *Interim Measures on Foreign Invested Enterprises That Engage in Commercial Franchising* ("FIE Franchising Measures"), effective in December 2004. The FIE Franchising Measures define "franchising" as a contractual relationship wherein a franchisor, in exchange for a fee, provides a franchisee the right to use its trademark, trade name, patents, know-how, copyright, business model and resources, and the franchisee engages in business activities in accordance with the unified franchise system set out in the contract. Potential franchisors must disclose, twenty (20) days before the franchise agreement is signed, information including the number and disbursement of current franchisees, the management methods and intellectual property used in operating the franchise, and the franchisor's equipment, materials and training requirements. A franchisee may not use the franchisor's registered trademarks, trade name or other commercial information after the franchise agreement ends.

6. State-Owned Asset Transfers

On February 1, 2004, the State-Owned Assets Supervision and Administration Commission (SASAC) and the Ministry of Finance's *Administration of the Assignment of Enterprise State-owned Assets and Equity Tentative Procedures* ("SOA Procedures") came into effect, creating a compulsory regime by which any transfer to any domestic or foreign entity of state-owned assets in enterprises should be conducted through qualified equity exchanges. The SOA Procedures do not cover transfers of state-owned assets by financial enterprises and listed companies or the transfer of state-owned assets from Chinese enterprises located abroad.

The SOA Procedures provide that transfers must be conducted either through auction, competitive bidding or agreement, and specify the circumstances pursuant to which a specific method should be used. Transfer by agreement is only allowed upon SASAC's approval and when only one (1) potential Assignee is identified following a public offer or when transferring state-owned assets to specially qualified Assignees in key designated industries.

Transactions involving state owned assets must be conducted at an authorized equity exchange in order to be legal. Subject the criteria in the SOA Procedures, SASAC has the power to select and authorize equity exchanges to engage in state-owned asset transfers.

Transfers should follow the steps specified in the SOA Procedures: (i) potential seller must complete and file a feasibility study report (FSR) that has been approved by the entity's highest decision-making body; (ii) the employees' representative congress must express its views and an employees' resettlement plan must be discussed and approved by the employees' representative congress to extent the transaction would impact such employees; (iii) the seller must verify its assets, compile a balance sheet and an assets list, and engage a qualified accounting firm to conduct a comprehensive audit; (iv) the potential seller must have a qualified state assets appraiser to appraise the assets, which report is to be filed with the relevant government authority; (v) detailed information of the proposed transaction must be published in selected newspapers and posted on the selected equity exchange's website, both for the purpose of soliciting potential purchasers; (vi) depending on the results of the public offer, the potential seller (having consulted with the equity exchange) must proceed by way of auction, competitive bidding or private agreement; (vii) the parties may then enter into negotiations to draft a purchase and sale contract, specifics of which must comply with those requirements stated in the SOA Procedures. Upon consummation of the transaction, the equity exchange is to issue an assets transfer certificate that both parties to the transfer must submit to the relevant government departments for registration. Importantly, the SOA Procedures do not define the timing or procedural steps for obtaining needed government approvals. Creditors must be notified before any transfer, and their consent is required in advance of any transaction.

The SOA Procedures state that if the value of the subject assets falls below 90% of the appraisal value, the transaction should be suspended and may be re-started only after obtaining relevant government consent. Also, the SOA Procedures seem to require that the transaction be settled with one payment, although installment payments are allowed where the transaction price is "relatively high." Installment plans require a first payment of 30% of the transaction amount, to be paid within five (5) days of transfer contract's effective date; further, the purchaser must provide a guarantee. The SASAC or other relevant approval authorities may stop the transaction or apply to the court to render the transfer null and void in certain circumstance specified in the SOA Procedures.

7. Financial Services Regulation

A. Insurance

Representative Offices of Foreign Insurance Institutions

The China Insurance Regulatory Commission ("CIRC") issued regulations governing representative offices of foreign insurance institutions. Under this new regulation, the phrase "foreign insurance institution" replaces the formerly ambiguous term "foreign-invested insurance company" used in former relevant regulations. A foreign insurance institution establishing a representative office must have an excellent record in the insurance business without any record of illegal conduct in the three (3) years prior to the application date, and must comply with other CIRC-stipulated prudential requirements. The applicant must include an opinion letter issued by applicant's home jurisdiction regulator or a letter of recommendation issued by an appropriate industry association. Application materials are to be submitted with the official application form to the applicable CIRC regional office, which must inform the applicant within five (5) days of receipt of the application if the application is incomplete. The CIRC regional office must make a decision on the application within twenty (20) days of receipt, although the CIRC chairman may extend such deadline by ten (10) days. Also, the CIRC regional office must make a decision, within twenty (20) days of receipt of the relevant application materials, as to a change in the general representative, chief representative, name of a representative office or cancellation of a representative office. Fewer issues are subject to administrative examination and approval (extensions of the representative office's term, change of address, and change of representatives only need to be reported afterwards), but specified events must be reported to the applicable CIRC regional office. The representative office must submit its parents' annual report of the previous accounting year to the CIRC and within six months of the end of the accounting year.[4]

Insurance Companies' Investment in Stock Market

The CIRC and the China Securities Regulatory Commission ("CSRC") issued tentative procedures pursuant to which specified insurance institutions (including insurance companies and insurance asset management companies) may directly purchase A-Shares in the primary market or trade such in the secondary market, and directly purchase convertible corporate bonds and other investment product types stipulated by the CIRC. Insurance entities may not hold more than 30% of the listed company's A-Shares. Insurance companies must obtain CIRC approval before engaging in any such transaction, while insurance asset management companies do not need such prior approval. The CIRC may stipulate a maximum level of an insurance institution's investments, expected to be 5% of an insurance institutional investor's total assets (calculated according to the cost price) as of the end of the previous year. The CIRC and the CSRC have joint responsibility and oversight for these procedures, according to their respective jurisdictions. Insurance funds are to maintain adequate risk controls for its stock investments including, *inter alia* risk control systems, transaction rules and adequate facilities and personnel.

Foreign-Invested Insurance Companies

[4] China Insurance Regulatory Commission, *Administration of Representative Offices in China of Foreign Insurance Institutions Procedures*, China Law and Practice 3910/04.01.15, issued and effective March 1, 2004.

On May 13, 2004, the CIRC issued the *PRC Administration of Foreign-invested Insurance Companies Implementing Rules* ("Implementing Rules"), effective as of June 15, 2004. Under the Implementing Rules, foreign-invested insurance companies are free to set up branch offices to conduct insurance businesses anywhere as long as they meet the relevant requirements and satisfy CIRC examination. Foreign-invested and Chinese insurance companies must have registered capital of at least RMB¥200 million, which must be increased by RMB¥20 million for each new branch prior to application to open such new branch. If the insurance company's capital reaches RMB¥500 million and if it complies with its solvency margin requirements, it is not required increase its capital to establish new branches. Further, subject to verification by the CIRC, property insurance companies may also engage in short-term health and accident insurance.

A single shareholder (aggregated with any affiliates) may hold no more than 20% of an insurance company's capital. Foreign investors may invest in domestic Chinese insurance companies, and if the aggregate foreign interest is less than 25% of the entity's capital, such insurance company will be regarded as a domestic Chinese enterprise.

The policy terms and premium rates on mandatory insurance products, new types of life products and other insurance products that concern the public interest are subject to prior approval by the CIRC. Insurance companies are required to give priority to domestic Chinese insurance companies when ceding reinsurance business. Insurance funds may be invested in bank deposits, government bonds, financial bonds, corporate bonds, and securities investment funds. If an insurance company's solvency margin ratio (being its actual solvency margin divided by the minimum solvency margin required by law) is lower than 100%, the insurance company will be subject to specific supervision by the CIRC.

<u>Insurance AMCs</u>

The CIRC promulgated the *Administration of Insurance Asset Management Companies Tentative Provisions* ("Insurance AMC Provisions") on April 21, 2004, effective June 1, 2004. Shortly thereafter, the CIRC issued the *Risk Control Guidelines for Use of Insurance Funds (Trial Implementation)* ("Risk Guidelines") effective on June 1, 2004. An Insurance AMC may be either a limited liability company or a company limited by shares. One of its shareholders must be an insurance company or an insurance holding company that satisfies the following requirements: (i) eight (8) years experience in the insurance business; (ii) no administrative penalties within the previous three (3) years as a result of misuse of funds; (iii) net assets in excess of RMB¥1 billion, total assets in excess of RMB¥5 billion, and, for an insurance holding company or an insurance company undertaking life insurance business, total assets in excess of RMB¥10 billion; (iv) compliance with the CIRC's solvency requirements; (v) sound corporate governance structure and internal control system; (vi) have established a department responsible for matching assets and liabilities and a risk control department (vii) assets centrally managed by its fund management department must exceed 50% of the entity's total assets, except for an insurance company carrying on life insurance business, whose assets centrally managed must exceed 80% of its total assets; and (viii) any other requirements stipulated by the CIRC.

Insurance AMCs must have a minimum capital of RMB¥30 million. The registered capital of an Insurance AMC, which must be paid up in cash, must exceed 0.1% of the insurance funds under its management unless its registered capital exceeds Rmb¥500 million. Domestic Chinese insurance companies and, possibly, foreign-invested insurance companies that have been established in China with CIRC approval must hold 75% of the equity in an Insurance AMC. Establishing an Insurance AMC is a two-stage process, involving a prepatory stage and the business commencement stage.

An Insurance AMC may manage (i) its own *renminbi* and foreign currency funds; (ii) the *renminbi* and foreign currency insurance funds entrusted by its shareholders or by insurance companies controlled by its shareholders; and (iii) other types of business as approved by the CIRC. The Insurance AMC Provisions provide that Insurance AMCs may only invest such funds in bank deposits, government bonds, financial bonds and other forms of investments approved by the State Council. Insurance AMCs with a minimum capital of RMB¥100 million and minimum net assets of RMB¥1000 million may, subject to obtaining approval from the CIRC and the Ministry of Labor and Social Security, manage enterprise annuity funds a type of supplementary pension,

Insurance AMCs may not: (i) provide any security; (ii) represent a specific rate of return for those funds under its management; (iii) entrust another party to manage its insurance funds; (iv) misdirect the use of funds to benefit someone other than the entrusting entity; (v) engage in other activities prohibited by Chinese laws and regulations or by regulatory authorities.

B. Banking

Liberalized Foreign Access to China's Banking Sector

The China Banking Regulatory Commission ("CBRC") issued various regulations to (i) establish the CBRC's regulatory authority over foreign financial institutions; and (ii) liberalize foreign access to certain banking subsectors.[5] For example, the one-year waiting period for a foreign bank to establish a branch, as provided in previous regulations, was abolished. Branches must meet requirements such as: (i) the per-branch non-callable operating capital requirement equal to RMB¥100 million; (ii) maintaining an 8% capital adequacy ratio; (iii) having operated in China for three years and reporting profits in each of the two years preceding application. The CBRC stated that it would give priority to applications for establishing foreign invested banks and branches in western and northeast China.

Starting from December 1, 2004, a foreign-invested financial institution applying for the establishment of a representative office in China may submit the application materials directly to the CBRC itself and the appropriate CBRC local office. Starting from January 1,

[5] China Banking Regulatory Commission, *PRC Administration of Foreign-invested Financial Institutions Regulations Implementing Rules*, issued July 26, 2004 and effective as of September 1, 2004.

2005, foreign-invested banks are permitted, after record filing with the local CBRC office, to engage in insurance agency services as provided in the entity's approved business scope.[6]

The CBRC issued the *Administration of Investment and Equity Participation in Chinese-invested Financial Institutions by Offshore Financial Institutions Procedures* ("Bank Procedures") to create a legal framework for equity investment by foreign investors in domestic financial institutions. Domestic financial institutions (the targets) include Chinese commercial banks, urban and rural credit cooperatives, trust and investment companies, enterprise group finance companies, financial leasing companies, and other Chinese-funded financial institutions established upon the approval of the CBRC. A single foreign investor may now hold up to 20% of the equity in a covered financial institution.

The Bank Procedures do not apply to foreign investment in auto-financing companies and the purchase by qualified foreign institutional investors of tradable shares in listed domestic financial institutions. The Procedures do not specify a maximum limit on the aggregate investment made by multiple foreign financial institutions. It is provided that if foreign investment in an unlisted domestic financial institution amounts to 25% or more, the latter will be treated as a foreign-funded financial institution. However, foreign investment of 25% or more in a listed domestic financial institution will not, for regulatory purposes, alter its domestic status.

To qualify to invest in a covered financial institution, the foreign investor must: (i) have total assets of at least US$10 billion (if investing in a domestic commercial bank) or US$1 billion (if investing in domestic urban and rural credit cooperatives or non-banking financial institutions) as of the end of the immediately preceding year; (ii) have long term credit ratings appraised as "good" by an international rating organization recognized by the CBRC in the immediately preceding two (2) years; (iii) have been profitable in the immediately preceding two (2) years; (iv) have a capital adequacy ratio not lower than 8% (for an acquirer that is a commercial bank) or total capital must not be lower than 10% of its total weighted risk assets (for an acquirer that is a non-banking financial institution); (v) have sound internal control rules; and (vi) be registered in a jurisdiction that has comprehensive rules for supervising and administering financial institutions and a sound economic environment. Foreign investment or equity participation in domestic financial institutions must be approved by the CBRC. Additional approvals from other regulatory or administrative entities may be needed, as based on the type of equity to be purchased by the foreign investor. Further, prior approval from the foreign exchange administration authority may be required if capital account transactions are involved.

Applications may be made to the CBRC or an appropriate branch that have three (3) months from the receipt of a complete set of application documents to make a decision. Once approved, the foreign investor must pay the acquisition price in "currency" to the domestic financial institution within sixty (60) days.

---

[6] China Banking Regulatory Commission, *Matters Relevant to Further Opening up the Banking Industry Notice*, China Law and Practice 3610/04.11.24, issued and effective as of November 24, 2004.

Foreign Exchange-Related Business

The CBRC expanded the areas where foreign-invested financial institutions are permitted to engage in *renminbi* business to include the cities of Kunming, Beijing, Xiamen, Xi'an and Shenyang. Related thereto, and applicable only operations in western and northeast China, the CBRC announced that it would examine, as part of the review of an application to engage in *renminbi* business, the consolidated profit of all the applicant's China branches instead of the current practice of examining each branch's profit.[7] New products must be approved by the CBRC, with the CBRC required to make a decision as to such products within sixty (60) days of application receipt. Foreign banks are required to maintain a 25% liquidity ratio for both foreign currency and RMB business. The new rules provide for the registered capital requirements for foreign exchange-related business as indicated in the following table:

[7] China Banking Regulatory Commission, *Matters Relevant to Further Opening up the Banking Industry Notice*, China Law and Practice 3610/04.11.24, issued and effective as of November 24, 2004.

Type of License and Business Scope	**Type of Vehicle**	**Registered Capital Requirement**
Restricted Foreign Currency (foreign currency business with foreign companies (FIEs) only)		
	Foreign Bank Branch	RMB¥100 million
	WFOE & J/V Bank	RMB¥300 million
	WFOE & J/V Finance Company	RMB¥200 million
	Domestic Branch of WFOE & J/V Banks	RMB¥100 million
Unrestricted Foreign Currency (foreign currency business with FIEs and Chinese companies and individuals)		
	Foreign Bank Branch	RMB¥200 million
	WFOE & J/V Bank	RMB¥400 million
	WFOE & J/V Finance Company	RMB¥300 million
	Domestic Branch of WFOE & J/V Banks	RMB¥100 million
Restricted RMB Business (foreign currency business with FIEs and RMB business with FIEs and foreign individuals only)		
	Foreign Bank Branch	RMB¥200 million
	WFOE & J/V Bank	RMB¥400 million
	WFOE & J/V Finance Company	RMB¥300 million
	Domestic Branch of WFOE & J/V Banks	RMB¥200 million (RMB¥100 million in RMB and equivalent RMB¥100 million in foreign currency)
Restricted RMB Business (foreign currency business with FIEs and Chinese companies and individuals, and renminbi business with FIEs)		
	Foreign Bank Branch	RMB¥300 million
	WFOE & J/V Bank	RMB¥500 million
	WFOE & J/V Finance Company	RMB¥400 million
	Domestic Branch of WFOE & J/V Banks	RMB¥200 million (RMB¥100 million in RMB

		and equivalent RMB¥100 million in foreign currency)
Foreign currency business with FIEs and Chinese companies and individuals, and renminbi business with FIEs and Chinese companies		
	Foreign Bank Branch	RMB¥300 million
	WFOE & J/V Bank	RMB¥600 million
	WFOE & J/V Finance Company	RMB¥300 million
	Domestic Branch of WFOE & J/V Banks	RMB¥200 million (RMB¥100 million in RMB and equivalent RMB¥100 million in foreign currency)
Unrestricted RMB license (for providing foreign currency business with FIEs and Chinese companies and individuals, and renminbi business with Chinese companies and individuals) available after December 1, 2006		
	Foreign Bank Branch	RMB¥500 million
	WFOE & J/V Bank	RMB¥1 billion
	WFOE & J/V Finance Company	RMB¥700 million
	Domestic Branch of WFOE & J/V Banks	RMB¥300 million (RMB¥200 million in RMB and equivalent RMB¥100 million in foreign currency)

Enterprise Group Finance Companies

In 2004, the CBRC regulated enterprise group finance companies, "in-house banks" for enterprise groups, for the first time.[8] The enterprise group finance company's parent must (i) have registered capital of RMB¥800 million; (ii) have total assets in excess of RMB¥5 billion; (iii) have an equity ratio of at least 30%; (iv) must have operating revenues in excess of RMB¥4 billion for each of the two years prior to application, with pre-tax income exceeding RMB¥200 million; and (v) must have a core business. Foreign invested group finance companies must satisfy the same criteria, except that (i) net assets in the year prior to application must not be less than RMB¥2 billion; and (ii) pre-tax income for the two consecutive years prior to application must exceed RMB¥200 million.

[8] *Administration of Enterprise Group Finance Companies Procedures*, issued July 27, 2004 and effective as of September 1, 2004.

The enterprise group finance company's registered capital must exceed RMB¥100 million, provided that companies engaging in foreign currency business must contribute more than US$5 million or other foreign currency equivalent in convertible currency. Such capital funds are to be raised from group affiliates and certain qualified long-term investors (the minimal holding period is five years). With the approval of the CBRC, group finance companies can set up branch offices and representative offices.

Enterprise group finance companies may provide, to group members: (i) asset management, financing advisory, and agency services; (ii) payment services; (iii) insurance agency; (iv) guarantees; (v) intermediary services for entrustment loans and investment; (vi) bills payment and discounting; (vii) handling internal settlements and designing inter-company settlement programs; (viii) taking deposits; (ix) making loans and finance leases; (x) interbank borrowing and lending; and (xi) other CBRC-approved business. If group finance companies meet certain criteria, they may apply to the CBRC to (i) issue bonds; (ii) underwrite bonds issued by group members; (iii) invest in financial institutions; and (iv) invest in marketable securities.

Capital Adequacy Requirements

The CBRC set the capital adequacy ratio of commercial banks, including Chinese and foreign invested banks, at 8%, with the core capital adequacy ratio set at 4%. Commercial banks are to report their ratios to the CBRC on a pre- and post- consolidation basis, and must report to the CBRC any "major event" that impacts their ratios. The CBRC is to classify commercial banks as (i) capital adequate, (ii) capital inadequate or (iii) capital severely inadequate, based on the banks' ratios. Commercial banks are to adopt measures to prevent or correct low capital adequacy ratios.[9]

Derivatives Regulation

For the first time, the CBRC issued tentative provisions regulating "derivatives," defined as financial contracts that derive their value from the prices of one or more underlying assets or indices, and structured financial instruments with the characteristics of forwards, futures, swaps and options, and various combinations thereof.[10] Banks, trust and investment companies, finance companies, financial leasing companies, automobile finance companies, and foreign bank branches are the types of financial institutions eligible to engage in financial derivatives trading. A financial institution may qualify as a dealer or end user (or both) according to the nature of its derivative business and market position. The Procedures for the first time establish the CBRC as the supervisory authority responsible for regulation of derivatives transactions.

---

[9] China Banking Regulatory Commission, *Administration of Capital Adequacy Ratios of Commercial Banks Procedures*, China Law and Practice 3600/04.02.23, issued and effective as of March 1, 2004.

[10] China Banking Regulatory Commission, *Administration of Trading of Derivatives by Financial Institutions Tentative Procedures*, issued on February 4, 2004 and effective as of March 1 2004.

Financial institutions seeking to trade in derivatives must, *inter alia*:(i) possess sound derivatives trade risk management and internal control systems; (ii) possess a complete derivatives transactions processing system; (iii) employ a chief manager responsible for derivatives business; (iv) employ at least two persons who have not less than two (2) years' experience in derivatives trading and at least six (6) months of specialized technical training in conducting derivatives trading; and (v) employ at least one person responsible for risk management and one person responsible for research and development of risk models or risk assessment.

Foreign bank branches qualify to trade derivatives if (i) its home jurisdiction has a legal framework for the regulation and supervision of derivative activities and its home country supervisor has relevant supervisory competence; (ii) it has provided a letter of authorization from its head office; and (iii) except as otherwise prescribed by its head office, its derivatives transactions shall be uniformly executed in a real time manner through the system run by its head office.

Financial institutions seeking to engage in derivatives activity are to submit the required application and supporting documents to the CBRC. The CBRC has sixty (60) days from the date of submission of the complete application package to issue a decision.

Foreign Exchange Reserve Requirements

The CBRC altered the ratio of foreign exchange deposits held by a financial institution that require offsetting foreign exchange reserve deposits. Covered foreign exchange deposits include (i) personal foreign exchange savings deposits, institutional foreign exchange deposits, and other foreign exchange deposits and liabilities as certified by the People's Bank of China; and (ii) the difference between the foreign exchange liability items and asset items generated by the bank's business. Under the revised regulations, a bank must transfer to an account designated by the People's Bank of China no later than the 15th of each month a foreign exchange reserve deposit equal to 3% of the bank's covered deposits.[11]

Issuance of Subordinated Bonds

Banks may issue subordinated bonds, through a public or private offering, subject to CBRC approval. Commercial banks issuing subordinate bonds through a public offering must (i) classify loans into five categories; (ii) have a core capital adequacy ratio better than 5%; (iii) have a full loan loss provision reserves; (iv) have sound corporate governance; and (v) not have committed a "major violation" of laws or regulations in the most recent three years. Banks seeking to issue subordinated bonds through a private offering must meet the same criteria, except that their core capital adequacy ratio must exceed 4%. Commercial banks may hold subordinated bonds in an amount not greater than 20% of that bank's core capital.

[11] People's Bank of China, *Administration of Foreign Exchange Reserve Deposits of Financial Institutions Provisions*, China Law and Practice 3610/04.10.29, issued October 29, 2004 and effective as of January 1, 2005.

Auto Loans

Chinese and foreign banks may issue an auto loan to (i) a PRC national; (ii) citizen of Hong Kong, Macao or Taiwan; or (iii) a foreigner who has resided in China for more than one year. Such loan may not exceed 80% of a new car's cost, defined as the lower of the manufacturer's suggested retail price or the actual sales price, exclusive of taxes, fees, and insurance. A new car loan's term may not exceed five (5) years. A loan for a used car may not exceed 50% of the used car's cost, defined as the lower of the actual transaction cost, exclusive of additional taxes, fees and insurance premiums or the price as evaluated by the lender. The maximum term for a used car loan is two (2) years. Interestingly, the maximum term of a dealer-financed loan is one (1) year.[12]

C. Securities

Disclosures by Securities Investment Funds

Certain information about securities investment funds are subject to public disclosure including, *inter alia*, the fund's (i) prospectus; (ii) custodianship agreement; (iii) sale of fund shares; (iv) listing of fund shares; (v) net asset value and the net value of the fund shares; (vi) the prices for purchase and redemption of the fund shares; (v) periodic and interim reports; and (vi) significant personnel changes of the fund manager. The parties required to make such disclosure include the fund's (i) manager; (ii) custodian; (iii) shareholders that convene the fund shareholders' general meeting; and (iv) related persons specified by relevant regulation. Disclosure is to be made through those publications designated by the CSRC and on the fund's and custodian's Internet sites.[13]

The fund's listing announcement, to be disclosed by the fund's managers three days before listing, is to include information such as verification information, trading code, and number of shares floated. In addition, the fund's listing announcement must include the number of fund shareholders, average holdings, the ratio of shares held by institutional investors and individual investors, and the names, shareholdings and proportions in the total number of fund shares of the top ten shareholders as of two (2) days before the listing announcement. The fund is also to release information on the fund's holdings as of two days before the listing announcement is released. [14]

[12] People's Bank of China and China Banking Regulatory Commission, *Administration of Auto Loans Procedures,* China Law and Practice 3510/04.08.16, issued August 16, 2004 and effective as of October 1, 2004.

[13] China Securities Regulatory Commission, *Administration of Information Disclosure of Securities Investment Funds Procedures*, China Law and Practice 3700/04.06.08, issued June 8, 2004 and effective as of July 1, 2004.

[14] China Securities Regulatory Commission, *Contents and Formats for Information Disclosure of Securities Investment Funds Guidelines (No.1) - Contents and Format of Listing Announcements*, China Law and Practice 3700/04.06.15(1), issued June 15, 2004 and effective as of July 1, 2004.

The fund's annual and interim reports are to include information on the fund's accounting results for longer of the previous three (3) years or from the fund's inception date. Other information to be disclosed includes the fund's (i) net earnings; (ii) net earnings per share; (iii) distributable earnings; (iv) distributable earnings per share; (v) net asset value; (vi) net value per share; (vii) weighted average return on net value; (viii) growth rate of the net value per share; (ix) growth rate of the cumulative net value per share; and (x) distributable earnings over the previous three (3) years.[15] An interim report shall be signed by at least two-thirds of the find manager's independent directors.[16] A fund's quarterly report is to include the same data and must be released within fifteen (15) working days after the end of each quarter.[17]

Securities Investment Fund Governance

A fund manager mist amend an open-ended fund's formation documents if (i) it was established prior to the implementation of the *Administration of the Sale of Securities Investment Funds Procedures*; (ii) has not completed its offering; and (iii) the percentage of redemption fee included in fund property accounts for less than 25% of the total amount of redemption fee.[18] In addition, the fund manager must amend their formation documents so that such documents comply with the fund shareholders' meeting and earning distribution methods specified in the *PRC Securities Investment Funds Law* and the *Administration of Securities Investment Fund Operations Procedures*.[19]

[15] China Securities Regulatory Commission, *Contents and Formats for Information Disclosure of Securities Investment Funds Guidelines (No.2) - Contents and Format of Annual Reports*, China Law and Practice 3700/04.06.15(2), issued June 15, 2004 and effective as of July 1, 2004.

[16] China Securities Regulatory Commission, *Contents and Formats for Information Disclosure of Securities Investment Funds Guidelines (No.3) - Contents and Format of Interim Reports*, China Law and Practice 3700/04.06.15(3), issued June 15, 2004 and effective as of July 1, 2004.

[17] China Securities Regulatory Commission, *Contents and Formats for Information Disclosure of Securities Investment Funds Guidelines (No.4) - Contents and Format of Quarterly Reports*, China Law and Practice 3700/04.06.15(4), issued June 15, 2004 and effective as of July 1, 2004.

[18] China Securities Regulatory Commission, *Issues Relevant to the Implementation of the (Administration of the Sale of Securities Investment Funds Procedures) Circular*, China Law and Practice 3700/04.07.15(1), issued and effective as of July 15, 2004.

[19] China Securities Regulatory Commission, *Issues Relevant to the Implementation of the (Administration of Securities Investment Fund Operations Procedures) Circular*, China Law and Practice 3700/04.07.15(2), issued and effective as of July 15, 2004.

Senior Management Requirements

The CSRC specified the qualitative requirements for senior management of a securities company and a securities investment fund, respectively:

- Senior managers in a securities company must have at least (i) three (3) years' experience in securities business; (ii) five (5) years' experience in financial, legal or accounting business; or (iii) ten (10) years' experience in general business. A securities company's general manager, deputy general manager, finance officer or compliance supervisor must have at least (i) three (3) years' experience in a securities company; or (ii) five (5) years' experience in finance business. Such senior managers may not engage in any business activity outside of the scope of their employment.[20]
- Senior managers in the securities fund management industry must have (i) obtained necessary qualifications; (ii) passed the senior management personnel examination; and (iii) at least three (3) years of work experience in finance related fields and relevant management experience. An investment fund management company's independent directors must have more than five (5) years' experience in the financial, legal or financing work field. The fund's manager must have more than three (3) years' experience in securities investment management.[21]

The following will satisfy requisite fund practice qualifications: (i) a fund practice qualification certificate issued by the Securities Association of China; (ii) passing a relevant qualification examination; (iii) passing the CSRC's personnel examination; or (iv) having relevant foreign qualifications.[22]

Short-Term Bond Issuance

The CSRC enabled securities companies to issue short-term bonds if they have (i) been a member of the national interbank loans market for at least one (1) year; (ii) made the required informational disclosures; (iii) appropriately segregated clients' transaction settlement; (iv) maintained sound internal controls; and (v) values assets and liabilities using a

---

[20] China Securities Regulatory Commission, *Administration of Senior Management Personnel of Securities Companies Procedures*, China Law and Practice 3700/04.10.09, issued October 9, 2004 and effective as of November 15, 2004.

[21] China Securities Regulatory Commission, *Administration of Appointment of Senior Management Personnel of the Securities Investment Fund Industry Procedures*, China Law and Practice 3700/04.09.22, issued September 22, 2004 and effective as of October 1, 2004.

[22] China Securities Regulatory Commission, *Issues Relevant to the Implementation of the (Administration of Appointment of Senior Management Personnel of the Securities Investment Fund Industry Procedures) Circular*, China Law and Practice 3700/04.09.23, issued September 23, 2004 and effective as of October 1, 2004.

market capitalization approach. Short-term bonds may not exceed 60% of the issuer's net capital and must be issued through an auction lasting not longer than three (3) working days. Capital raised from short-term bonds may not be used to (i) invest in fixed assets; (ii) invest in the secondary stock market; (iii) finance a firm client's securities transactions; or (iv) make long-term equity investments.[23]

Money Market Funds

The CSRC issued the *Money Market Fund Management Interim Regulations* on August 16, 2004, pursuant to which fund managers may invest in short-term deposit certificates, bonds with a balance term of 397 days or less, bond repurchases with a term of one year or less, central bank bills, and other permitted monetary market tools that have high liquidity. A fund may not hold more than 10% of its funds in a single issuer's short-term bonds. Further, a money market fund may not place more than 30% of its funds in one (1) qualified commercial bank. The balance of redeemed funds from bonds in the interbank bond market must not exceed 40% of the fund's net asset value.

8. Foreign Exchange

Personal Foreign Exchange

Non-resident individuals may (i) hold foreign exchange remitted from overseas or foreign currency cash brought by them; and (ii) deposit, withdraw or carry out foreign exchange settlement. Such individuals must provide proof of identification and, if the cumulative settlement amount per month exceeds US$50,000, must make an application with the local State Administration of Foreign Exchange ("SAFE") office.[24]

Foreign Trade Operators' Foreign Exchange

Foreign trade operators may open an individual foreign trade settlement account for its payables and receivables from import/export transactions. Foreign currency notes may not be withdrawn from such account. Foreign exchange transfers may be made between the same entity's foreign trade settlement account and foreign currency savings exchange account.[25]

---

[23] People's Bank of China, Administration *of Short-term Bonds of Securities Companies Procedures*, China Law and Practice 3510/04.10.18, issued October 18, 2004 and effective as of November 1, 2004.

[24] State Administration of Foreign Exchange, *Issues Relevant to Regulation of Foreign Exchange Control on Non-resident Individuals Circular*, China Law and Practice 3800/04.02.16, issued February 16, 2004 and effective as of March 1, 2004.

[25] State Administration of Foreign Exchange, *Foreign Exchange Administrative Issues Relevant to Individual Foreign Trade Business Circular*, China Law and Practice 3800/04.08.10, issued August 10, 2004 and effective September 10, 2004.

FIEs' Foreign Exchange Debt

SAFE issued the *Improving the Verification of Foreign Exchange Settlement for Capital Account Items and Administration of Foreign Debt Registration of Foreign-invested Enterprises Circular* ("2004 Debt Circular") on May 17, 2004 and effective from July 1, 2004. Under the 2004 Debt Circular, a FIE's excess foreign debt funds must be returned by the bank holding the funds acting at the direction of the local SAFE Bureau. A FIE may apply to the local SAFE office for approval to increase its total investment to cover its excess foreign debts. The local SAFE bureau can extend a three month grace period to an FIE that is applying for this increase. Approvals of increased total investment may be difficult to obtain. No special arrangements have been made for the handling of such applications by local or central foreign investment authorities or the local registration authorities.

Where more than US$200,000 in foreign currency is covered by a single application for conversion into *renminbi*, the converting bank is not permitted to deposit the *renminbi* funds into the FIE's account, but must instead remit the *renminbi* funds directly to the party to whom the FIE is obligated to make payment. Where foreign currency is converted into *renminbi* for an enterprise's small payments for wages, fund reserves, or foreign exchange settlements with an amount less than US$200,000, the converting bank may deposit the *renminbi* funds into the FIE's account, but the FIE must document its usage of these funds and attach the documentation to its subsequent application for conversion of additional funds. Foreign currency must not be converted for the purpose of paying off *renminbi* loans.

9. Foreign Investment

Revised Foreign Investment Catalogue

The revised foreign investment catalogue adds more items to the encouraged category, including manufacture of key components for large screen color rear projection monitors, production of ethylene glycol, manufacture of automobile electronic devices, manufacture of large circulating fluidized bed (CFB) boilers of 30 MW, and production of read-only optical disks. Construction and operation of large theme parks, market surveys, production and distribution of radio and television programs and film production have been added to the restricted category. Social surveys have been added to the prohibited category. Production of heavy plate, production of galvanized plate, processing of scrap steel, and manufacture of motorcycles and motorcycle engines have been taken out of the encouraged category.[26]

Advertising FIEs

[26] National Development and Reform Commission and Ministry of Commerce, *Foreign Investment Industrial Guidance Catalogue (Revised in 2004)*, China Law and Practice 2110/04.11.30, issued November 30, 2004 and effective as of January 1, 2005.

Revised regulations allow for advertising FIEs, with foreign interest of up to 70% allowed. Advertising WFOEs to be permitted from December 10, 2005. An advertising FIE should have capital in excess of RMB¥500,000; investors seeking to establish an advertising WFOE must have been in operations for more than three (3) years, while the experience requirement is shortened to two (2) years for other forms of advertising FIEs. Foreign investors' main business must be advertising.[27]

FIE Exhibition and Convention Entity

An FIE may be formed to engage in exhibition and convention activities, such as organize economic and technological exhibitions in China and elsewhere[28]

FIE Educational Facilities

An FIE educational facility may be formed wherein the intellectual property rights invested are to be valued by both parties. Further, such educational facility may not set up any branches or sub-branches, launch other Sino-foreign cooperative schools or engage in for-profit activities.[29]

Foreign Trade Operators

A foreign trade must register with MOFCOM unless it is exempted from such registration requirement. Customs may refuse to handle a customs declaration and release goods for an unregistered foreign trade operator. Re-registration is not needed for foreign trade operators operating within the original scope of their license. Foreign trade operators operating outside the scope of their original license must re-register.[30] FIEs engaged in import and export trading for their own use do not have to register as a foreign trade operator.[31]

[27] State Administration for Industry and Commerce and Ministry of Commerce, *Administration of Foreign-invested Advertising Enterprises Provisions*, China Law and Practice 5500/04.03.02, issued and effective as of March 2, 2004.

[28] Ministry of Commerce, Establishment of Foreign-invested Exhibition and Convention Companies Tentative Provisions, China Law and Practice 5000/04.01.13, issued January 13, 2004 and effective as of February 12, 2004.

[29] Ministry of Education, PRC *Sino-foreign Cooperation in Running Schools Regulations Implementing Procedures*, China Law and Practice 1720/04.06.02, issued June 2, 2004 and effective as of July 1, 2004.

[30] Ministry of Commerce, *Registration for the Record of Foreign Trade Operators Procedures*, China Law and Practice 5800/04.06.25, issued June 25, 2004 and effective as of July 1, 2004.

[31] Ministry of Commerce, *Issues Relevant to Registration for the Record of the Foreign Trade Right of Foreign-invested Enterprises Circular*, China Law and Practice 5800/04.08.17, issued and effective as of August 17, 2004.

Business Qualifications for Film Enterprises

Foreign investors (but not existing foreign-invested enterprises) may team with a domestic Chinese entity, through a cooperative or equity joint venture, to establish a:

- *Sino-foreign film production joint venture* where the Chinese partner has registered capital in excess of RMB¥1 million and the foreign partner has registered capital in excess of RMB¥5 million, with foreign registered capital capped at 49%.
- *Sino-foreign film technology joint venture* for the transformation of infrastructure and technical equipment for film production and exhibition. Both parties to this entity must have registered capital in excess of RMB¥5 million, with foreign registered capital capped at 49%.

At the same time, domestic Chinese enterprises are encouraged to:

- establish film distribution companies specializing in domestically produced films, provided that such distribution company has registered capital more than RMB¥500,000 (foreign investment in cinemas remains subject to the *Foreign Investment in Cinemas Tentative Provisions*);
- invest in, or form new, cinema chains; and
- invest in construction and transformation of cinemas.

Importation and distribution of imported films may only be undertaken by those entities approved by the State Administration of Radio, Film, and Television ("SARFT").[32]

Sino-foreign Cooperation in Production of Television Dramas

SARFT clarified that Sino-foreign production (between a Chinese radio and television production company and a foreign investor) of television dramas (including animated television programs) may only be carried out through (i) joint investment, joint appointment of major crew, and joint profit sharing and risk-bearing; (ii) the foreign party making a capital contribution and providing major crew, labor services, equipment, apparatus and premises; or (iii) commissioned production, where the foreign party contributes capital and commissions the Chinese party to produce the television drama. Joint production of television dramas and animated programs requires (i) the Chinese Party to be the holder of the Television Drama Production Permit (Type A) for television dramas or the Radio and Television Program Production and Distribution Permit for animated television program; (ii)

[32] State Administration of Radio, Film and Television and Ministry of Commerce, *Business Access Qualifications for Film Enterprises Tentative Provisions*, China Law and Practice 5600/04.10.10, issued October 10, 2004 and effective as of November 10, 2004.

joint investment by both parties; and (iii) joint ownership of domestic and foreign copyrights of jointly produced television dramas and animated television programs.[33]

Import and Broadcast of Foreign Television Programs Provisions

SARFT clarified that no current affair news programs may be imported, and foreign television programs that have not been examined or approved by SARFT may not be imported or broadcast in China. Applications to import foreign films and television programs through satellite broadcast must include specified contracts and copyright documents. Foreign television programs (other than films, television dramas and animated television programs) are to be repackaged, reedited, but are not to be broadcast directly as programs during fixed time slots. Logos or other wording referring to a foreign channel or production company may not appear on screen within the program.[34]

Cooperative Joint Ventures that Produce and Operate Radio and Television Programs

SARFT and MOFCOM specified that a foreign investor in such a joint venture must specialize in radio and television business. The principal Chinese investor must have either have a radio and television program production and operation permit or a television drama production permit and may contribute cash or in-kind to registered capital, although the in-kind contributions are limited to buildings, factories, machinery and equipment or other materials, industrial property rights, proprietary technology and land use rights. The Chinese party must appoint the venture's legal representative, and must consent to program selection and content. The foreign investor must contribute in cash and may only take up to a 49% ownership stake. Two-thirds or more of the content produced by such venture must be on Chinese topics, and the venture is prohibited from producing programs containing banned content.

Cinemas

In 2004, the maximum percentage of foreign ownership of companies engaged in the establishment, renovation or operation of cinemas was raised from 49% to 75% in seven pilot cities (Beijing, Shanghai, Guangzhou, Chengdu, Xian, Wuhan, and Nanjing). A foreign investor may own a controlling interest in a joint venture engaged in the upgrading of film production and projection infrastructure, technologies and equipment.

---

[33] State Administration of Radio, Film and Television, *Administration of Sino-Foreign Cooperation in Production of Television Dramas Provisions*, China Law and Practice 5600/04.09.21, issued September 21, 2004 and effective as of October 21, 2004.

[34] State Administration of Radio, Film and Television, *Administration of the Import and Broadcast of Foreign Television Programs Provisions*, China Law and Practice 5600/04.09.23, issued September 23, 2004 and effective as of October 23, 2004.

Foreign Satellite Television

Foreign satellite TV channels may be broadcast to hotels ranked three stars and above, subject to certain restrictions on landing platform, conditions, applicant qualifications and procedures. To qualify, an applicant must be a licensed TV broadcaster in its home region, must designate an agent in China, must not transmit to China in any non-approved manner and must meet a variety of subjective criteria.

Freight Forwarding

Shareholders of an international freight forwarding agency may be enterprise legal persons, natural persons or other economic organizations, although shareholders other than enterprise legal persons are not allowed to hold controlling shares.[35]

International Shipping

Subject to the approval of the Ministry of Communications ("MOC") and MOFCOM, foreign investors may establish a FIE to engage in (i) international shipping services; (ii) international shipping agency services; (iii) international ship management services; (iv) loading and uploading of international shipments; (v) international maritime container station and depot services; (vi) storage and warehousing for international maritime freight; and (vii) general services for vessels that they own or operate. Foreign interest in an FIE formed in the sectors stated in (i) and (ii), above, may not exceed 49%. However, as of January 1, 2004, Hong Kong and Macao service suppliers may establish wholly owned entities to engage in the services stated in (iii), (vi), and (v), above, as well as non-vessel operating common carrying services. Further, Hong Kong and Macao service providers may establish a wholly owned entity to canvas cargoes, issue bills of lading, settle freight and sign service contracts for vessels that they own or operate.[36]

Wholly foreign-owned enterprises may be formed to engage in storage and warehousing for international maritime freight, and general services for vessels that they own or operate. Foreign shipping companies may establish an FIE to canvas cargoes, issue bills of lading, settle freight and sign service contracts for vessels that they own or operate.

Construction Project Price Stipulation

A contractor and principal may stipulate project cost through: (i) fixed total amount; (ii) fixed per unit price; or (iii) adjustable price. If a change to a project's design necessitates a

[35] Ministry of Commerce, *PRC Administration of International Freight Forwarding Agency Business Provisions Implementing Rules (Revised)*, China Law and Practice 4000/04.01.01, issued and effective as of January 1, 2004.

[36] Ministry of Communications and Ministry of Commerce, *Administration of Foreign Investment in the International Maritime Transport Industry Provisions*, China Law and Practice 4500/04.02.25, issued February 25, 2004 and effective as of June 1, 2004.

price adjustment, the contractor must, within fourteen (14) days inform the principal of such change. If a contractor fails to so report the price adjustment, the principal may adjust the contract price at its own discretion. Construction contract prepayment may be stipulated by contract, except that prepayment may only be between 10% and 30% of the contract's amount. Prepayments are to be made within one (1) month of contract conclusion or no less than seven (7) days before project commencement date as provided in the contract. A contractor may seek an interim payment from the principal of between 60% and 90% of the project price, subject to certain conditions. A principal shall pay the contractor the contract balance upon on the basis of the completion settlement report, except that the principal may retain 5% of the project price as a quality assurance deposit. Such deposit is to be paid to the contractor one (1) year after project delivery; costs associated with repairs undertaken within the one-year quality assurance period are to be deducted from the quality assurance deposit.[37]

Construction Project Management

A construction project management enterprise must have (i) one or more existing construction-related skill qualification certificates in project surveying, design, construction, supervision, cost consulting and bidding agency; and (ii) a professional technician who has one or multiple practice qualifications as an urban planner, architect, engineer, construction engineer, supervision engineer and cost engineer. The enterprise can undertake project management services for projects within the same scope as its skill qualification certificate referred to in (i), including:

- making preliminary planning, economic analysis, special item appraisal and investment decisions;
- handling land requisition and planning approval;
- developing project design requirements, organizing the appraisal of the project design proposal, organizing the invitation for bids for project surveying and design, and executing relevant contracts;
- organizing invitation for bids for project supervision, construction, and equipment and materials procurement;
- execute supply contracts related for construction materials, equipment, and fittings;
- carrying out project cost settlement and final accounting, handling project claims, organizing acceptance check upon completion of the project, and handing over to the owner the project completion files and information; and
- managing the project during the maintenance guarantee periods, and organizing post-project appraisal.

[37] Ministry of Finance and Ministry of Construction, Settlement *of Construction Project Monies Tentative Procedures*, China Law and Practice 4200/04.10.20, issued and effective as of October 20, 2004.

A project owner may select a project manager through an invitation for bids or entrustment. A construction company may not engage in both project management and project contracting for the same project.[38]

Draft Construction Law

The Chinese government issued a draft Construction Law on August 27, 2004, that, among other things, enables EPC and turnkey contracting in China, so that an enterprise holding a relevant skill qualification certificate for one part of the project could contract for the whole of the project provided that it subcontracted those aspects of the project for which it is not qualified to qualified subcontractors. Under the draft law, the prime contractor is solely responsible to the owner for delivery of the project, and the subcontractors are responsible to the prime contractor for their respective portions of the project. However, both the prime and subcontractor are jointly liable to the owner for such subcontracted work. It is common in China for employers and contractors to enter into two contracts for the same work. The first is the official contract that is registered and used to apply for permits, to report tax and other such procedures. Alongside that is a second contract that sets out the real commercial deal agreed between the parties, but which is not declared to the authorities. The draft law clearly provides that the official, registered contract controls in the event of a disputes over terms as between the official and unofficial contracts.

Subcontractors

On February 3, 2004, the Ministry of Construction issued the Measures for the Administration of Subcontractors for the Construction of Buildings and Municipal Infrastructure Projects, effective April 1, 2004. The new measures define "subcontractor" for professional and hired labor construction projects and require subcontractors and general contractors to enter into signed agreements that stipulate specific payment schedules and settlement procedures, as well as performance and payment guarantees. The contracts must be filed for the record with the relevant departments-in-charge of construction within seven business days after execution of the contract and after any major contract modifications.

Concession Requirements

Entities bidding for a concession must have the necessary level of registered capital, facilities and equipment, and good credit, sound finances and an appropriate debt service capacity. A concession agreement should include (i) the particulars, district, scope and term of operation of the concession; (ii) security management; (iii) information about a performance bond; (iv)

[38] Ministry of Construction, *Construction Project Management Trial Procedures*, China Law and Practice 4200/04.11.16, issued November 16, 2004 and effective as of December 1, 2004.

termination and modification of the concession; (v) liability for breach of contract; and (vi) a dispute resolution mechanism. A concession's term should not exceed thirty (30) years.[39]

Representative Offices

China's foreign representative office establishment, change and termination procedures have recently been simplified for foreign companies in most industries. The previous two-step application (for approval and registration) has been consolidated into a one-step application (for registration only). Only registration procedures by the local Administration of Industry and Commerce (AIC) will be required, without the approval procedures previously handled by local government foreign trade departments authorized by MOFCOM. No change has been announced for most specially regulated industries, where representative offices have been subject to approval by a ministry or a bureau other than MOFCOM.

Holding Companies

MOFCOM amended the administrative rules governing holding companies on February 12, 2004 (*Establishment of Companies with an Investment Nature by Foreign Investors Provisions (Revised)*. Subject to the satisfaction of certain criteria, holding companies can be granted the status of "regional headquarters" ("RHQs"). Such a RHQ may import items from its group parent entity and sell the imported products in the PRC. A RHQ can also now import materials and components necessary for servicing products manufactured both by the offshore group and by the companies in which the holding company has invested in China. RHQs may establish finance companies to provide central treasury functions to the group in China, subject to CBRC approval. Similarly, RHQs may set up financial leasing companies, subject to CBRC approval. RHQs may also (i) provide outsourcing services for foreign and domestic companies; (ii) provide logistics services; (iii) provide foreign project contracting; and (iv) invest offshore.

Export Processing Zones

On April 8, 2004, the General Administration of Customs, NDRC, the Ministry of Finance, the Ministry of Land and Natural Resources, MOFCOM, the State Administration of Taxation, the State Administration for Industry and Commerce (SAIC), AQSIQ, and the State Administration of Foreign Exchange jointly promulgated the Approval Standards and Procedures for Establishing Export Processing Zones, effective on the date of issue. The standards provide that only one (1) export processing zone may exist per State Council-established national level development zone. The construction of an export processing zone must be completed within two (2) years of approval. Export processing zones that receive no investment within the first three years or that have an annual turnover of less than US$1 million may be closed.

[39] Ministry of Construction, *Administration of Concessions for Urban Utilities Procedures*, China Law and Practice 4300/04.03.19, issued March 19, 2004 and effective as of May 1, 2004.

Drug Wholesaling and Retailing

On February 4, 2004, the State Food and Drug Administration ("SFDA") issued the *Administrative Measures for Drug Operating License* ("SFDA Measures"), effective as of April 1, 2004. The SFDA Measures specify the licensing requirements for wholesale and retail distribution of almost any type of drugs. All drug wholesalers and retailers to obtain an operating license, valid for five (5) years; provincial-level SFDA offices will license wholesalers while local-level SFDA offices will license retailers. Potential drug distribution companies must complete a two-step approval process, prepatory going on to operational. Such license is not transferable.

Nonprofit Foundations

Pursuant to the *Regulations on the Administration of Foundations* issued by the Ministry of Civil Affairs and effective as of June 1, 2004, foreigners may establish foundations or representative offices in China.

Public Utility Franchising

The Ministry of Construction ("MOC") issued the *Administrative Measures on Franchise Operation of Municipal Public Utilities* on March 19, 2004 that are effective as of May 1, 2004. Under these measures, government entities may start to grant franchise rights, through a tendering process, to provide public utility services. Note, however, that these measures will be implemented through provincial-level legislation. Potential providers must meet certain requirements as provided in the administrative regulations. Local governments may impose additional local requirements as part of the tender process. The franchise contract must include the information as required by the administrative measures, including the business scope, geographic areas, and the term of the franchise operation. Local MOC offices are to oversee such franchise operations.

10. International Trade Regulation

Changes to Antidumping, Countervailing Duty, and Safeguards Regulations

Antidumping and countervailing duty regulations were amended to include "public interest" as a criteria for any decision to (i) suspend or terminate an anti-dumping investigation; (ii) not adopt a provisional anti-dumping measure; or (iii) not impose a provisional anti-dumping duty or countervailing duty. An exporter may now have MOFCOM re-open an antidumping investigation and a foreign country may now have MOFCOM re-open a countervailing duty. [40] Safeguards regulations have been amended to (i) state that an increase

[40] State Council, *PRC Anti-dumping Regulations (Revised)*, China Law and Practice 5800/04.03.31(1), issued March 31, 2004 and effective as of June 1, 2004; State Council, *PRC Countervailing Regulations (Revised)*, China Law and Practice 5800/04.03.31(2), issued March 31, 2004 and effective as of June 1, 2004.

in an imported product's quantity is calculated as the absolute increase or the increase relative to the domestic production. "Public interest" is included as criteria for imposing a safeguards measure, which may now not exceed, either in its original or extension term, ten (10) years.[41]

Place of Origin Regulations

In early September 2004, the State Council promulgated the *PRC Place of Origin of Imports and Exports Regulations*, effective as of January 1, 2005 ("Rule of Origin Regulations"). The Rule of Origin Regulations implement China's World Trade Organization ("WTO") commitment to adopt and implement internationally harmonized, non-preferential rules of origin. The Rule of Origin Regulations provide that several administrative entities have some form of involvement as to implementation of the new regulations --including the General Administration of Customs ("Customs"), MOFCOM and the State Administration of Quality Inspection and Quarantine (AQSIQ)—but do not specify which entity is to be the ultimate arbiter of such regulation. The Rule of Origin Regulations incorporate several definitions from the WTO Agreement on Rules of Origin so that, under the Rule of Origin Regulations, a good:

- is *wholly obtained* within a country if it is captured, caught, collected, harvested, mined, processed or produced within a certain country or region (including items obtained from the seabed or seabed bottom soil outside such country's territorial waters and to which such country enjoys the exclusive exploitation rights);
- is *substantially transformed* if, following manufacturing or processing, a change in tariff classification occurs, as determined by Customs, MOFCOM and AQSIQ (but assumed to be a value added threshold of 30%); and
- originates in the jurisdiction where the primary manufacturing or processing that give rise to a good's basic features occurs.

Actions and items such as packaging, accessories, explanatory documents, energy used to produce goods, the physical buildings, equipment, machinery and tools used to produce a product do not affect a good's place of origin.

Consignors must apply for a certificate of origin from AQSIQ or the China Council for the Promotion and International Trade (CCPIT) prior to export, although the Rule of Origin Regulations do not specify the procedures for registering with the AQSIQ and CCPIT. Consignees may apply for preliminary determinations on the origins of imports, with Customs limited to 150 days to make such determination.

The regulations require importers to truthfully report the origins of their imports; if Customs determines that the origins of a particular product are determined to differ from that which

[41] State Council, *PRC Safeguard Measures Regulations (Revised)*, China Law and Practice 5800/04.03.31(3), issued March 31, 2004 and effective as of June 1, 2004.

is marked on the goods, Customs may order the importer to remedy the classification. Attempts to falsify certificates of origin or the supporting documents necessary to obtain a certificate of origin are subject to fines of between RMB¥5,000 to RMB¥100,000. If an importer or exporter receives illegal income from falsified documents, Customs may confiscate such income and significant violations may result in criminal penalties.

11. Taxation

Cancelled or Lowered Export Tax Rebates

Manufacturing enterprises (including FIEs) are responsible for that portion of a cancelled or lowered export tax rebate that is not refunded. Exports on which tax is not refunded are to be deemed as domestically sold and subject to value-added tax and consumption tax. Exports on which tax rebate rates are lowered should have the amount of tax that is not exempted or offset transferred to cost from value-added tax on purchases. Value-added tax is to be paid if the amount of value-added tax on purchases is less than the amount of tax not exempted or offset.[42]

Deposit or Guarantees for Import Taxes

Value-added and consumption taxes are not payable on the import of (i) goods to be displayed or used at exhibitions; (ii) items used in performances and contests; (iii) instruments, equipment and items used in news reporting or shooting film or television programs; (iv) instruments, equipment and items used for scientific research, education, and medical activities; (v) transportation vehicles used in connection with the foregoing; (vi) samples; (vii) instruments and tools used for installation, tuning and testing of equipment; (viii) containers for holding goods; and (ix) other goods used for non-commercial purposes. Such items should be re-exported within six (6) months of import. Value-added and consumption tax are also not levied on (i) goods compensated or replaced free of charge; (ii) advertising and sample goods with no commercial value; (iii) materials donated by foreign governments and international organizations; and (iv) fuel, material, food and beverages required in the course of loading and uploading of means of transportation within China.[43]

Application for Tax Rebates

---

42 Ministry of Finance and State Administration of Taxation, *Relevant Tax Issues Concerning Exports of Production Enterprises whose Tax is not Refunded or whose Tax Rebate Rates are Lowered Circular*, China Law and Practice 3220/04.03.03, issued and effective as of March 3, 2004.

43 Ministry of Finance, General Administration of Customs and State Administration of Taxation, *Tax Collection Policy Issues Relevant to Tax Levy by Customs as an Agent on Imported Goods for the Import Section Provisions*, China Law and Practice 3220/04.03.16, issued March 16, 2004 and effective as of January 1, 2004.

Applicants for tax rebates or exemptions on exports must file paper certificates, such as export invoices, a customs declaration sheet and the sheet for verification of foreign exchange receipts from exports (Verification Sheet) with its rebate/exemption application. Note, however, that if the foreign exchange settlement is not yet due, however, the Verification Sheet is not required.[44]

Tax Audits

The State Administration of Taxation ("SAT") specified that there are two types of joint tax audit: (i) an audit conducted simultaneously by all competent tax authorities on FIEs engaging in cross-regional operations; and (ii) an audit conducted by the relevant tax authorities on FIEs operating in a single region. A joint tax audit, in either form, may not be conducted more than once per tax year.[45]

Transfer Pricing and Advance Pricing Arrangements

In 2004, the SAT issued Circular 70, which requires local tax authorities to strengthen transfer pricing investigations of transactions between affiliated enterprises. Circular 70 identifies the major issues that should be the target of investigations: (i) transactions with entities in tax havens; (ii) thin capitalization arrangements; and (iii) tax evasion through certain types of processing and re-export enterprises.

On September 3, 2004, the SAT issued the *Trial Implementing Rules on Advance Pricing Arrangements Involving Transfers Between Affiliates*, effective immediately. Under the these rules, an applicant may sign an advance pricing arrangement ("APA") with the SAT stipulating the transfer pricing methods and tax consequences to be applied to transactions that occur between affiliates over the course of a predetermined period of between two (2) and four (4) years. An APA covers transactions involving purchases and sales of tangible assets, transfers of intangible assets, the provision of services, and the collection and circulation of funds between a taxpayer and an affiliated enterprise. An APA is mandatory if (i) the transactions involve affiliates in three or more provinces; (ii) the total value of affiliate transactions exceeds RMB¥10 million; or (ii) the transactions are "complicated."

Loss-Making FIEs

SAT issued the Official Reply of the State Administration of Taxation on Handling Issues Concerning False Declarations of Enterprise Income Tax Regarding Losses by Foreign Invested Enterprises and Foreign Enterprises on February 24, 2004. This reply states that if an enterprise treats losses improperly and misstates its tax liability, it will be subject to

[44] State Administration of Taxation, *Issues Relevant to Administration of Tax Rebates (Exemptions) on Exports Circular*, China Law and Practice 3220/04.05.31, issued May 31, 2004 and effective as of June 1, 2004.

[45] State Administration of Taxation, *Joint Tax Audit of Foreign-related Enterprises Tentative Procedures*, China Law and Practice 3210/04.04.06, issued and effective as of April 6, 2004.

sanctions for non-compliance. If a FIE fails to pay tax or underpays the taxes due, the penalty ranges from 0.5 to 5 times the amount of the unpaid tax.

12. Intellectual Property

ISP Liability for Copyright Infringement

The Supreme People's Court's *Several Issues Concerning the Laws Applicable to the Trial of Copyright Disputes Involving Computer Networks Interpretation* (the ISP Interpretation), was amended in 2004 to cover circumvention technologies. If a network service provider uploads, broadcasts or provides methods, equipment or materials that it knows are used specially to deliberately avoid or destroy the technical protection measures for others' copyright, civil liability for infringement shall be pursued pursuant to Article 47(6) of the *Copyright Law*.[46]

Trademark Infringement Cases

Even if a trademark owner or other, similar, party in interest to a trademark infringement investigation applies for revocation of the case, the investigating authority may still pursue administrative liability against the infringer. The infringer may mitigate its potential liability if it takes action to mitigate the harm caused by their infringement.[47]

Electronic Filing for Patent Applications

Starting March 12, 2004, the State Intellectual Property Office ("SIPO") began accepting electronically filed patent applications, pursuant to the *Rules Regarding Electronic Filing of Patent Applications*. Potential applicants must enter into a standard agreement with SIPO, specifying the terms and conditions of electronic filing. If an applicant starts the application process on paper, it may not switch the process to an electronic format, and vice versa.

13. Company Law

Purchasing Control

[46] Supreme People's Court, *Several Issues Concerning the Laws Applicable to the Trial of Copyright Disputes Involving Computer Networks Interpretation (Revised)*, China Law and Practice 5100/04.01.02, issued January 2, 2004 and effective as of January 7, 2004.

[47] Trademark Office of the State Administration for Industry and Commerce, *How Administrative Legal Liability of an Infringer shall be Pursued after Consultation and Resolution between the Parties Official Reply*, China Law and Practice 5100/04.04.15, issued and effective as of April 15, 2004.

A purchaser may not hold the voting rights to any shares in any target company before the actual shares containing such voting rights are transferred to the purchaser. Further, a purchaser may not require a seller to enter into any voting arrangements. Prior to the transaction's closing, the purchaser may not pledge the target company's equity nor may it appropriate funds or assets of the target company for their own use.[48]

Limits on IPO Valuation

The amount of funds raised through an initial public offering may not exceed two (2) times the issuer's unaudited net asset value as of a date one (1) year prior to the issuer's application to publicly list, less any amount of undistributed profits rolled over by existing shareholders. Companies intending to distribute dividends prior to listing must complete relevant procedures before listing. A prospectus should include a special notice as to the amount of undistributed profits rolled over and any plans for a dividend distribution.[49]

Amendments to the Securities Law

Issuers may issue shares above par without the CSRC's approval.[50] Responsibility for verification procedures related to the issuance of corporate bonds has been shifted from the CSRC to the stock exchange on which such bonds would be issued.[51]

Voting Systems

Chinese public companies are to provide to their shareholder a safe, economic and convenient voting network system for off-site exercise of voting rights to compliment in-person voting processes at shareholders' meetings. The network voting service provider, the listed company and its principal shareholders must keep the voting information confidential prior to any public announcement.[52]

---

48 China Securities Regulatory Commission, *Issues Relevant to Regulating the Acts of Transferring the Actual Controlling Power of Listed Companies Circular*, China Law and Practice 3710/04.01.07, issued and effective January 7, 2004.

49 Department of Public Offering Supervision of the China Securities Regulatory Commission, *Standards for Examination and Verification of Share Issues Memorandum No.17: Examination and Verification Requirements for Fund Raising of Companies Initially Offering Shares to the Public*, China Law and Practice 3710/04.05.11, issued and effective as of May 11, 2004.

50 *PRC Company Law (2nd Revision)*, China Law and Practice 2330/04.08.28, issued and effective as of August 28, 2004.

51 *PRC Securities Law (Revised)*, China Law and Practice 3700/04.08.28, issued and effective as of August 28, 2004.

52 China Securities Regulatory Commission, *Network Voting for Shareholders' General Meeting of Listed Companies Working Guide (Trial Implementation)*, China Law and Practice 2300/04.11.29, issued and effective as of November 29, 2004.

Offshore Subsidiaries' Listing

On August 10, 2004, the CSRC issued the *Certain Issues Regarding the Regulation of Offshore Listing of Subsidiaries of Domestic Listed Companies Circular* (the Circular). The Circular provides that a listed parent company must meet specified criteria before it may list, offshore, shares in a subsidiary: (i) profitability for the three (3) years prior to application; (ii) any contributions made by the parent to the subsidiary in the previous three (3) years shall not have come from the proceeds generated by the parent's own listing; (iii) the subsidiary should not account for 50% or more of the parent's total net profit; (iv) the subsidiary should not account for 30% or more of the parent's total assets; (v) the parent and subsidiary may not compete in the same line of business, and each must have separate assets and financial accounts, with no management personnel in one entity allowed to serve concurrently in the other; (vi) cross-shareholding by the directors, officers and other related persons of the parent and subsidiary may not account for more than 10% of the subsidiary's total share capital; (vii) there must be no appropriation of parent company assets by a person controlling the parent; and (viii) the parent should not have committed any substantial irregularities in the past three (3) years. After the spin-off, the subsidiary's officers, directors, employees, and operations are to be totally independent of the parent company.

Sponsorship System for Offering and Listing of Securities

The CSRC requires that the entity sponsoring an issuer's initial public offering and listing be a comprehensive securities company, while a sponsorship agent, who is qualified to operate the sponsorship work, should be an individual with statutory investment bank experience who has passed the relevant competence examination. The sponsor is now required to supervise their client's conduct for the rest of the year of listing and the subsequent two full fiscal years in the case of an IPO, or the rest of the year of listing and the subsequent one full fiscal year in case of a new issue or issue of convertible bonds.

Sponsors are required to independently investigate and verify the information stated in their client's prospectus and (i) must have "sufficient reasons" to believe their clients have fulfilled all the statutory requirements for stock issue or listing; (ii) believe their clients' application documents and prospectus contain no false records, misleading representations or material omissions; and (iii) believe the opinions in the prospectus are based on sufficient and reasonable grounds. After the submission of initial reference documents to the CSRC, sponsors must ensure that their clients respond to the CSRC's comments, proceed with due diligence investigations or verifications on certain relevant matters as requested by the CSRC, and designate sponsorship representatives to communicate with the CSRC.

Sponsors may not recommending companies that have special relations with them or their main affiliates. Further, a sponsor may not recommend any company where any of the sponsor's representative, director, supervisor or any other senior official has an affiliation with the potential issuer.

Derivative Lawsuits

In 2004, the Supreme People's Court released draft regulations addressing corporate disputes, and introducing the possibility of shareholder derivative suits. A shareholder may initiate an action against a company's controlling shareholders, directors, managers or officers who breach of their duty of loyalty (but not a duty of care) to the company. A potential plaintiff shareholder must have been a shareholder at the time of the alleged breach and continued to hold such shares. If the company in question is a limited liability company, potential plaintiffs must hold at least 10% of the company's equity; potential plaintiffs against a company limited by shares must hold more than 1% of the entity's shares. Notice of the alleged breach must have been furnished to the company more than two (2) months prior to the initiation of the action and potential plaintiffs must show that the company did not take any corrective action.

14. Electronic Signatures

On August 28, 2004, the National People's Congress passed the *PRC Electronic Signatures Law* ("E-Signatures Law"), effective on April 1 2005. As China's first national e-commerce regulation, the E-Signatures Law largely implements the provisions contained in the United Nations Commission on International Trade Law's Model Law on Electronic Signatures. The E-Signatures Law covers "data messages," defined as information generated, sent, received or stored by electronic, optical, magnetic or similar means. As such, and subject to some exceptions, parties may data messages in contracts or other documents used in civil activities. If the parties agree to use data messages, such document shall not be denied validity or enforceability on the sole ground that data messages were used for that purpose. Further, a data message that is capable of tangibly representing its content and is accessible for use and investigation shall be deemed to be in writing.

A data message may be deemed to be in its original form if (i) the information therein is capable of being effectively displayed and is accessible for use and investigation; and (ii) a reliable method is used with the data message to prevent tampering with such message. Subject to some exceptions, a data message is deemed signed when it is affixed with a reliable electronic signature, as a reliable electronic signature will have the same legal effect as a handwritten signature or a seal. An electronic signature is considered to be reliable and retained, dispatched and received as provided in the law. The E-Signatures Law also provides for forming and operating a certification authority.

II. Hong Kong SAR

1. Constitutional Development

In April 2004, the Standing Committee of China's National People's Congress weighed in on a controversy surrounding Article 45 and Annex I of Hong Kong's *Basic Law*. These provisions state that Hong Kong's Chief Executive would be directly elected "for the terms subsequent to 2007." This language is unclear as to whether a direct election could take place *in* 2007 for an elective term starting after 2007 or whether the first direct election would be held *after* 2007. The *Basic Law's* legislative history indicates that its drafters intended that direct elections for Hong Kong's Chief Executive should first occur *in* 2007.

This controversy also involved Article 68 and Annex II of the *Basic Law*, which provide for direct election of members of Hong Kong's Legislative Council "for the terms subsequent to 2007." The effect of this unclear language is the same as the effect of the unclear language in Article 45 and Annex I of the *Basic Law*, described above.

An ambiguity between Article 158 and Clause 7 of Annexes I and II of the *Basic Law* complicated matters. Article 158 vests in the National People's Congress ("NPC") the power to interpret the Basic Law. Clause 7 of Annex I to the *Basic Law* states that any change in the method of selecting a Chief Executive is to be "reported" to the NPC for approval, something less than the power provided in Article 158. Similarly, Clause 3 to Annex II requires amendments to the method of selecting Hong Kong's Legislative Council ("LegCo") to be reported to the NPC "for the record."

In any event, on April 27, 2004, the NPC's Standing Committee, pursuant to Article 158 of the *Basic Law*, ruled out direct elections for the Chief Executive in 2007 and the Legislative Council in 2008 because of "immature conditions." As such, the NPC interpreted Articles

45 and 68 of the *Basic Law* and seems to indicate that Article 158 of the *Basic Law* trumps any contrary language elsewhere in the *Basic Law*.

Elections for the third Legislative Council term were held on September 12, 2004, for four (4) year terms beginning on October 1, 2004. The third-session Legislative Council now has sixty members, thirty each returned by direct election and functional constituencies, respectively.

2. CEPA II

In August 2004, the PRC and HK governments signed a new *Closer Economic Partnership Arrangement* ("CEPA II"), effective. Pursuant to CEPA II, the PRC will apply zero tariffs to products classified under 713 PRC Y2004 tariff codes (529 for existing products and 184 for planned products), in addition to the products under 374 PRC codes under the original *Closer Economic Partnership Arrangement* ("CEPA I"). For the 184 planned products, the PRC will apply zero tariff from January 1 of the year following the in which the PRC and Hong Kong governments confirm that such goods have come into production in Hong Kong.

For trade in services under CEPA II, the PRC agreed to grant preferential treatment in eight new areas: (i) airport services; (ii) information technology services; (iii) patent agency services; (iv) trademark agency services; (v) job referral agencies; (vi) cultural and entertainment services; (vii) job intermediaries; and (viii) professional and technical qualification examinations. The PRC also will broaden liberalization in the eleven (11) service sectors covered originally in CEPA I: (i) legal services; (ii) construction services; (iii) distribution services; (iv) transport services (including road passengers transportation and maritime transport); (v) freight forwarding agency services; (vi) medical services; (vii) audio-visual services; (viii) accounting services; (ix) banking services; (x) securities and futures services; and (xi) individually owned stores. For example, the PRC has lifted the geographical restriction and expand the business scope for the individually owned stores set up by Hong Kong permanent residents with Chinese nationality.

3. Deposit Protection Scheme Ordinance

The *Deposit Protection Scheme Ordinance* creates a depositor compensation scheme mandatory for all Hong Kong banks, *except* for foreign banks subject to a similar scheme in their home jurisdiction. The scheme would provide compensation to holders of any deposit *except* (i) term deposits with a term longer than five years; (ii) secured deposits; (iii) deposits taken outside of Hong Kong; (iv) deposits held for account of the Exchange Fund; (v) any bearer instruments; and (vi) any deposits made by a bank or a related entity.

Three levies will fund the scheme:

- A build-up levy payable annually until the scheme reaches its targeted fund size, set at 0.3% of the value of all covered deposits held by covered banks. This levy is calculated as the product of the covered deposits held by a bank the previous October 20 times a percentage based on that bank's Monetary Authority ("MA") rating.
- An expected loss levy, payable annually once the scheme's target fund size has been reached. A covered bank's payment into the expected loss levy is calculated in the same manner as the build-up levy.
- A surcharge is payable after the target fund size is reached and balance of the fund as of October 20th of the preceding year is less than 70% of the target fund size. The surcharge is calculated as the difference between build up levy and expected loss levy, subject to a cap of 30% of the amount the target fund size exceeds the actual DPS fund size as of October 20th of the immediately preceding year.

Compensation payable on the first to occur of a winding up order from the Court of First Instance or an order from the MA. Maximum amount of compensation is HK$100,000 per depositor.

4. Broadcasting (Amendment) Ordinance

In amending the *Broadcasting Ordinance* (Cap. 562), this legislation (i) introduces civil remedies and criminal sanction against the possession or use of unauthorized decoders for commercial purposes; and (ii) provides civil remedies against the use or possession of unauthorized decoders to view subscription television programs. A licensee who provides programs for a fee and who sustains a loss due to another's possession or use of unauthorized decoder can sue such person damages, injunction, or other relief.

5. Copyright (Amendment) Ordinance

This amending ordinance specifies that a person will be criminally liable if he possesses, in the course of business, a pirated infringing copy (but not a parallel imported infringing copy) of a computer program, movie, television drama, and musical recording. In doing so, this amending ordinance removes civil and criminal liability in relation to parallel importing and possession of copyrighted works (original literary works, dramatic works, musical works, artistic works, sound recordings, films, broadcasts, cable programs, and published editions) unless the importation or possession is for selling, letting for hire, or distributing for profit or to any extent that could prejudice the copyright holder.

This amending ordinance creates new offense for copy-shops: a person who provides reprographic copying services to the public will commit an offense if he possesses two or more substantially identical infringing copies of a copyright work as published in a book, magazine or periodical (the principal work) unless he can show (a) he did not know and had no reason to believe that the copies in question are infringing copies; (b) the principal work is available free of charge; or (c) his possession of the principal work and extracts from the principal work constitute no more than 20% of the principal work concerned.

6. Electronic Transactions (Amendment) Ordinance

The *Electronic Transactions (Amendment) Ordinance* amends the *Electronic Transactions Ordinance* ("ETO") to recognize forms of electronic signatures other than those generated through Public Key Infrastructure ("PKI") technology. Such recognition, for transactions not involving the government, is subject to conditions as to reliability, appropriateness and consent of those involved. This amending ordinance makes the ETO technology-neutral as to electronic signatures and is consistent with UNCITRAL model law on Electronic Commerce.

This amending ordinance amends voluntary registration scheme for electronic signature certification authorities ("CAs") by requiring the CA to engage a qualified and independent assessor to assess the trustworthiness of the certification system, such as system security, procedural safeguards, and financial viability of the CA prior to registration. Further, the Director of Information Technology Services may require a recognized CA to furnish an assessment report/statutory declaration as to any major changes to the CA that may occur between two annual assessments. This ordinance also transfers power to the Permanent Secretary for Commerce, Industry, and Technology (Communications and Technology) for making orders excluding the application of the ETO to electronic records and digital signatures.

7. Clearing and Settlement Systems Ordinance

Hong Kong's Monetary Authority is empowered to designate any clearing and settlement system to be subject to its oversight if such system meets certain specified criteria. System operators must conduct the system in a safe and efficient manner, establish appropriate operating rules providing for safety and efficiency related matters, and provide sufficient financial resources to the system.

Intended to apply only to those important clearing and settlement systems that have implications for the stability of Hong Kong's monetary or financial system, this ordinance covers those payment systems currently subject to the MA's *de facto* oversight. The power to designate under this ordinance does not apply to a clearing and settlement system that is, or is operated by, a company recognized as a clearinghouse under the *Securities and Futures Ordinance*. Pursuant to this ordinance, the MA has the power to: (i) request information from a designated system and to give directions to a designated system for the purpose of bringing the system into compliance with the requirements under the act; (ii) amend a designated system's operating rules so to bring such rules into compliance with the act; (iii) issue regulations as to the oversight of a designated systems' safety, efficiency and financial soundness; and (d) revoke a designated system's designation if such designated system no longer meets the criteria specified under the act.

The MA may issue a certificate of finality to a designated system, the effect of which is to apply those provisions in the act relating to the finality of transactions and proceedings within such designated systems to such system. The act also provides that a relevant insolvency office holder such as the Official Receiver, a liquidator of a company or a trustee in bankruptcy, and the powers of a court acting under insolvency laws, are not to be exercised in such a way as to prevent or interfere with the transactions and proceedings within a designated system.

8. Landlord and Tenant (Consolidation) (Amendment) Ordinance

The *Landlord and Tenant (Consolidation) (Amendment) Ordinance* amends the *Landlord and Tenant (Consolidation) Ordinance* (Cap. 7) by (i) removing provisions relating to the security of tenure of domestic premises; and (ii) abolishing the notice of termination requirement. By ending the security of tenure for tenants, a landlord would be able to regain possession of the let premises upon the expiration of the contractual term without the need to justify so doing before any court or tribunal. Note, though, that these provisions do not apply to any notices served by landlords or requests made by tenants prior to its commencement. When in force, these provisions apply to all domestic tenancies in Hong Kong. By abolishing the notice of termination requirement, tenants of monthly tenancies and tenancies for fixed terms less than 3 years lose the right to be served a notice of termination of not less than 6 months before their tenancies could be terminated.

9. United Nations (Anti-Terrorism Measures) (Amendment) Ordinance

The *United Nations (Anti-Terrorism Measures) (Amendment) Ordinance* empowers the Secretary for Security to freeze funds to any property suspected to be terrorist property. As such, this ordinance is consistent with the obligations imposed by United Nations Security Council Resolution 1373 and the Special Recommendations of the Financial Action Task Force. The Ordinance also implements the International Convention for the Suppression of Terrorist Bombings by prohibiting the bombing of an infrastructure facility, a place of public use, a public transportation system or a state or government facility in the HKSAR by means of explosive or other lethal device. To implement the Convention for the Suppression of Unlawful Acts Against the Safety of Maritime Navigation and the Protocol for the Suppression of Unlawful Acts Against the Safety of Fixed Platforms Located on the Continental Shelf, the Bill prohibits various acts of violence relating to ships and fixed platforms. These offenses apply to actions within the HKSAR and to any person outside the HKSAR who is a Hong Kong permanent resident or a body incorporated or constituted under the law of the HKSAR.

10. Land Titles Ordinance

The *Land Titles Ordinance* overrides the *Land Registration Ordinance* (Cap. 128) to provide for a registration system—for interests in land—based on where such title is held. Under this ordinance, a first registration of land (i) must be made upon the first assignment or the issue of the Government lease on or after the date of commencement; or (ii) may be made by owners named in the register kept and maintained under the Land Registration Ordinance. The registration of a person as an owner would vest in that person the legal estate or equitable estate in the land or the undivided share in the land subject to certain unregistered interests (under particular circumstances) and overriding interests.

11. Professional Accountants (Amendment) Ordinance

Pursuant to the *Professional Accountants (Amendment) Ordinance*, the number of members of the Professional Accountant's Council ("Council") will be increased to 23. Four of them would be laypersons appointed by Hong Kong's Chief Executive in addition to the two ex-officio members. They would be appointed for a term not exceeding two years and eligible for reappointment for further terms not exceeding two years each.

The Investigation Panel and the Disciplinary Panel would both be restructured. There would be two Investigation Panels (clause 45(a)) and two Disciplinary Panels (clause 35(a)). Panel A would in each case comprise of not less than 18 lay persons appointed by CE and one of them would be appointed the relevant Committee Convener. Panel B would in each case be constituted by not less than 12 certified public accountants appointed by the

Council, of whom not less than six must be holders of practicing certificates. Lay persons would have a majority on any Investigation Committee and Disciplinary Committee as the chairman and two members of each Committee would be appointed from Panel A.

The Council would, in connection with the discharge of any of its functions or duties or the exercise of any of its powers, be empowered to give directions to certified public accountants ("CPAs") either generally or individually requiring the production of any document or information to the Institute relating to the registration of CPAs or the issuing of practicing certificates, the delivering up of cancelled or invalid practicing certificates, an explanation of any unbecoming or disreputable act or omission of a CPA in relation to his practice and conduct as a CPA Penalties could be imposed by the Council against a CPA for any failure to comply with its direction.

The Council would have the power not to issue a practicing certificate if the applicant has not complied with the Institute's requirements for continuing professional development or, alternatively, to issue a practicing certificate subject to the continuing professional development requirements being complied with within a specified period. It would also have power to cancel the practicing certificate of a CPA who is or has become bankrupt or has entered into voluntary arrangement with his creditors or not to issue a practicing certificate to such CPA.

The Council would have the power to delegate any of its powers or duties under the Ordinance to any person or to a committee of the Council except the power to make rules. Each of the Investigation Committee and the Disciplinary Committee would have its Chairman and two members appointed from the respective Panel A of lay persons and two members appointed from the respective Panel B of CPAs. The appointments for each Committee would be made by the relevant Convener, who would be a lay person appointed from the respective Panel A and could not appoint himself to be a member of a Committee. A Convener would be appointed for a term not exceeding one year and would be eligible for reappointment for further terms not exceeding one year each.

The Investigation Committee would be empowered to require production of records and documents not only from the CPA, firm of CPAs or corporate practice under investigation and his, their or its employees and former employees, but also from any CPA, firm of CPAs or corporate practice and any of his, their or its employees and former employees who is a CPA or a student registered with the Institute. Unless the Council is of the opinion that no prima facie case has been shown for a complaint, or that a complaint is frivolous or vexatious, it must refer a complaint to the Disciplinary Panels at the request of the complainant. Every hearing of the Disciplinary Committee must be held in public unless it determines that in the interest of justice a hearing or any part thereof should not be held in public.

12. Bankruptcy (Amendment) Bill 2004

The *Bankruptcy (Amendment) Bill* was gazetted by the Legislative Council on October 8, 2004. This Bill would empower the official received ("OR") as the provisional trustee to appoint "any person" as provisional trustee in his place at any time when he considers that the value of the property of the bankrupt is unlikely to exceed HK$200,000. In exercising such power, OR could appoint two or more persons to act jointly as such trustee. The remuneration of the provisional trustee and the first trustee would be fixed by OR in accordance with a scale of fees or on such other basis as OR may from time to time approve in writing.

13. Companies (Amendment) Bill 2004

LegCo gazetted the *Companies (Amendment) Bill 2004* on October 8, 2004. The bill would amend the Companies Ordinance to provide that (i) the right to give directions with respect to the operating and financial policies of that other undertaking would be introduced as a test of the parent/subsidiary undertaking relationship; (ii) would define "undertaking" to include body corporates or corporations, partnerships and other unincorporated bodies; and (iii) under specified circumstances, a subsidiary may be excluded from the group accounts. The bill proposes to introduce the "true and fair override" provisions to enable the directors to depart from requirements under the Ordinance if compliance of which does not give a true and fair view of the state of affairs of the company or the group.

14. Trade Descriptions (Amendment) Bill 2004

LegCo gazetted the *Trade Descriptions (Amendment) Bill 2004* on October 29, 2004. Pursuant to this bill, goods would be deemed to have been manufactured in the "country" in which they last underwent substantial transformation. The Commissioner for Customs and Excise and the Director-General for Trade and Industry would be empowered to specify special manufacture-marking requirements by orders and notices respectively. In part, this bill seeks to clarify that Hong Kong could be deemed as a "country" of manufacture for the concerned goods under CEPA I and hence whether the goods could be marked as "Made in Hong Kong."

III. Conclusion

As can be seen by the breadth of this article, 2004 was a busy year for legal developments in the PRC and Hong Kong. China implemented many of its WTO commitments, at least on paper, and overhauled its foreign trade law, implemented its commitments in the retail, wholesale, and franchising sectors, and improved market access for foreign banks and insurance companies. 2005 likely will be as busy, since many of China's WTO commitments are due to be implemented in 2005, and the NPC has indicated that intends further revisions to China's *Company Law* and its *Securities Law*. In 2004, Hong Kong amended its land title ordinance, landlord and tenant regulations, and its copyright protections. 2005 legal developments in Hong Kong will be important, as important issues related to the *Basic Law* and Hong Kong citizens' relationship with the Hong Kong and PRC governments remain unanswered. Stay tuned.