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HALE AND DORR LLP

## CHINA PRACTICE UPDATE

December 23, 2004

### *Revision of the Foreign-Invested Holding Company Regulations (November 17, 2004)*

The establishment by foreign investors of China-domiciled holding companies ("HoldCos"), typically wholly foreign-owned but by joint venture in some instances, was first authorized in 1995. The USD 30 million registered capital contribution threshold and other conditions for establishment, as well as restrictions on their functions, have limited the attractiveness of such entities. Nevertheless, as of September 2004, more than 200 HoldCos had been established by foreign investors with relatively large investment programs in multiple projects. They have been attracted by the opportunities to centralize administrative operations, create better career opportunities for management personnel, and build a stronger brand.

The restrictions on establishing HoldCos and on their activities have been relaxed several times since 1995, and have now been further relaxed. The Regulations Concerning Foreign-Invested Holding Companies issued by the Ministry of Commerce ("[MOFCOM](#)"), last amended on February 13, 2004, were amended again on November 17, effective on December 17. This recent round of amendments (the "[November 17 Revision](#)") improves on the earlier version (the "[February 13 Revision](#)") by lowering qualification thresholds, requiring statutory compliance with respect to trading and distribution, eliminating some minor redundancies, and clarifying certain issues. Other positive

changes include reduced thresholds for qualification as a regional headquarters and expansion of permitted activities for HoldCos in general, including their function as regional headquarters. Set forth below is a summary of the changes.

### Qualifications and Application

The minimum USD 30 million registered capital requirement for the establishment of a HoldCo remains in place under the November 17 Revision.<sup>1</sup> In earlier versions of the Regulations, including the February 13 Revision, a foreign company also needed to have either (1) minimum total assets of USD 400 million in the year preceding the application, at least one existing foreign-invested enterprise ("FIE") in China with minimum registered capital of USD 10 million, and at least three proposed investment projects; or (2) at least ten FIEs in China with aggregate minimum registered capital of USD 30 million. The November 17 Revision has abolished the minimum proposed investment project requirement under (1).<sup>2</sup> This added flexibility will permit foreign companies with sufficient capital but no immediate investment plans in China to first establish a HoldCo to demonstrate their commitment to the China market while taking the time to understand the investment environment and investigate investment opportunities without being rushed into making specific commitments at the outset. It is particularly important

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1. Article 3(3) of the November 17 Revision.

2. Article 3(1) of the November 17 Revision.

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because only new investments, whether to new or existing FIEs, count toward the HoldCo's registered capital requirement.

Other changes relate to document submission requirements. Most HoldCos are held by a single foreign investor, but can be established as Chinese-foreign joint ventures. An application to establish a joint venture HoldCo need no longer include a feasibility study report, but instead require only an application report, and the requirement to submit project proposals has been eliminated for both joint venture and wholly foreign-owned HoldCos.<sup>3</sup>

## Clarification of Distribution Rights

The February 13 Revision provided additional privileges for HoldCos that qualify as regional hubs or headquarters, most notably, the right to import products from the parent company for distribution in the domestic market.<sup>4</sup> However, it was not made clear at the time whether a HoldCo would acquire distribution rights simply by qualifying as a regional headquarters, or if the HoldCo would require additional approvals to engage in distribution activities pursuant to relevant regulations. The November 17 Revision provides some clarification by stipulating that HoldCos that engage in commission agency, wholesale, retail and franchising activities must comply with the relevant provisions of the Administrative Measures on Foreign Investment in the Commercial Sector and amend their scope of business accordingly.<sup>5</sup> This is emphasized in each reference to import rights of HoldCos in the November 17 Revision, which specifically state that such rights do not include the right to conduct retail activities.<sup>6</sup> To engage in distribution activities, a HoldCo can either apply to establish a new foreign-invested distribution enterprise,<sup>7</sup> invest in an existing domestic distribution enterprise with the requisite distribution permit, or expand its business scope to include specific distribution activities.<sup>8</sup> However, the text does not make clear whether this right to engage in domestic distribution of the

parent company's products that is granted to qualified HoldCos or the longstanding right of HoldCos (subject to unanimous Board approval of the relevant investee) to sell products manufactured by its investee enterprises onshore or offshore<sup>9</sup> are automatically extended to a HoldCo once it fulfills the requisite requirements, or whether a HoldCo must apply for approval under the Administrative Measures on Foreign Investment in the Commercial Sector. Based on inquiries conducted on a no-names basis with MOFCOM officials, we understand that MOFCOM is electing to interpret the Regulations in the strictest sense, that is, it intends to require new or existing HoldCos whose scope of business do not presently permit them to conduct commission agency, wholesale, retail and franchising activities to apply for approval with respect to such commercial activities in accordance with the Administrative Measures on Foreign Investment in the Commercial Sector.

## Expansion of Permitted Activities

The November 17 Revision permits HoldCos to provide after-sale services not only for products manufactured by its parent company but for all imported products, and to import (but not sell through retail channels) products from its parent company into the domestic market.<sup>10</sup> The November 17 Revision also stipulates that HoldCos which engage in the import or export of goods or technologies must comply with MOFCOM's Foreign Trade Operators Recordation Registration Measures.<sup>11</sup> If the import activities described in this paragraph exceed the original scope of business of the HoldCo, it will have to file a registration for the record (not an application for approval) with the relevant registration authority.<sup>12</sup>

## Regional Headquarters

The February 13 Revision, which first addressed the issue of granting additional privileges to HoldCos that qualified as multinational company regional

3. Article 7 of the November 17 Revision.

4. Article 22 of the November 17 Revision (originally Article 21 of the February 13 Revision).

5. Article 11 of the November 17 Revision.

6. Article 15 and 22 of the November 17 Revision.

7. Article 12 of the Administrative Measures on Foreign Investment in the Commercial Sector.

8. Articles 23 and 24 of the Administrative Measures on Foreign Investment in the Commercial Sector.

9. Article 10 of the November 17 Revision.

10. Article 15 of the November 17 Revision.

11. Article 11 of the November 17 Revision.

12. Article 14 of the Foreign Trade Operators Recordation Registration Measures.

headquarters, set forth requirements to qualify as a regional headquarters under the Regulations. A HoldCo had to: (a) fulfill all requirements with respect to utilization of registered capital applicable to HoldCos; (b) establish at least two R&D organizations (one of which must be a legal person) in accordance with relevant regulations and (c) have (i) minimum paid-in registered capital of USD 100 million or (ii) minimum paid-in registered capital of USD 50 million, investments in companies with a total asset value of not less than RMB 3 billion and earned total profits of not less than RMB 100 million (based on consolidated financial statements) as of the year prior to the application date. The requirement with respect to the establishment of R&D organizations has now been relaxed. The November 17 Revision provides that only one R&D organization is required, and it need not be a legal person.<sup>13</sup>

The November 17 Revision also expands the privileges enjoyed by HoldCos that qualify as regional headquarters. They can now import and sell in the domestic market products not only of their respective foreign parents, but also products of affiliates in which the foreign parent has a controlling interest. Regional headquarters are now also permitted to entrust other onshore enterprises to manufacture/process their products or products of their parent company for sale in domestic and foreign markets.<sup>14</sup>

The February 13 Revision first introduced the concept of encouraging HoldCos which have met specific requirements to apply for recognition as regional headquarters by permitting such hybrid entities to expand their scope of business to include additional import, service and finance functions. These provisions remain unchanged in the November 17 Revision. Not long after the February 13 Revision was promulgated, we were given to understand from discussions with MOFCOM officials that HoldCos which also qualified as regional headquarters under less stringent local rules could also be eligible for the privileges

provided to such hybrid entities under these regulations. As of this date, there are no plans to require such HoldCos to fulfill the stipulated requirements retroactively in order to retain their status as regional headquarters, so it is likely that they may be grandfathered. Although we were given to understand that the existing local rules governing establishment of regional headquarters would be revised to conform to the national-level requirements as first provided in the February 13 Revision (we were told at the time that the Shanghai rules were to be revised by July 2004), we have confirmed that the Shanghai Municipal Interim Provisions on Encouraging Foreign Multinational Companies to Establish Regional Headquarters and its Implementing Rules (promulgated respectively on July 20, 2002 and March 1, 2003, collectively, the “Shanghai Rules”) are still in effect, and the Shanghai Commission on Foreign Economic Relations and Trade (“Shanghai COFERT”) is still accepting applications to convert to regional headquarters under such existing rules<sup>15</sup> at this time.

On the other hand, based on discussions with Beijing Commerce Bureau officials, we understand that HoldCos in Beijing seeking to qualify as regional headquarters can no longer look to the earlier local requirements, but must now comply with the more rigorous national-level requirements first set forth in the February 13 Revision and which remain in the November 17 Revision. As it is unclear how long MOFCOM will permit the coexistence of the inconsistent national and Shanghai regimes, HoldCos in Shanghai that fulfill all of the criteria set forth for qualifying as a regional headquarters under the Shanghai Rules should consider quickly positioning themselves to take advantage of benefits that are available to qualified regional headquarters HoldCos, as well as the preferential treatment in the form of tax exemptions and subsidies that are already available to regional headquarters established in Shanghai. Similar advantages may also be available in other localities.

13. Article 22(1) of the November 17 Revision.

14. Article 22(2) of the November 17 Revision.

15. Under the Shanghai Rules, the requirements to become a regional headquarters are: independent legal person status, total assets (of parent company) of not less than USD 400 million, China investments (of parent company) of not less than USD 30 million, and at least three subordinate entities (onshore or offshore) under its supervision. For a HoldCo to qualify as a regional headquarters in Shanghai, the following must be submitted to Shanghai COFERT:

1. Application form signed by the legal representative of the HoldCo;
2. Document signed by the legal representative of the HoldCo's parent company authorizing the HoldCo to perform all the basic functions of a regional headquarters;
3. Approval certificate, business license, and capital verification report of the HoldCo (photocopies); and
4. Approval certificates and business licenses of all PRC entities invested in by the HoldCo or its parent company (photocopies).

Shanghai COFERT is to complete its review and make its decision within thirty (30) working days after receipt of the complete application materials, and then issue the qualification certificate and make a report to MOFCOM for the record.

*16. Article 15(1) of the November 17 Revision.*

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## Conclusion

The HoldCo structure has proven to be an effective vehicle for multinational companies to hold their China investments under a single umbrella entity to permit consolidation in respect of corporate governance, strategic planning, and administrative functions. The changes in the November 17 Revision summarized above further streamline the application procedure and provide greater flexibility in terms of establishment and permitted activities for HoldCos. Taken together, they indicate greater receptivity toward establishment of HoldCos for such purposes and encouragement of this mode of foreign investment by the central government. Unfortunately, they do not yet provide the much-needed right to file consolidated tax returns which is commonplace in other jurisdictions, but presumably awaits action by the tax authorities, nor do they dispense with the requirement for unanimous approval by the boards of directors of its joint venture FIEs in order for the HoldCo to provide them with sales, logistics and warehousing services.<sup>16</sup>