

威 凯 平 和 而 德

How Changes in Law Are
Facilitating Foreign Investment and
Supply Chain Management in China

Lester Ross
Doing Business in China
Boston, MA
March 16, 2005

I Changes in Investment Vehicles

A. Chinese-Foreign Equity Joint Venture (EJV)

- Oldest foreign-invested enterprise (FIE) vehicle but diminishing in popularity
 - 25% minimum foreign investment

I Changes in Investment Vehicles

- Remains popular under the following circumstances:
 - Statutory: Industries where foreign investment is restricted, e.g., automobile manufacturing, life insurance and telecommunications
 - Capital: Foreign investor lacks sufficient capital
 - Politics: Chinese partner may be capable of influencing government decisions

I Changes in Investment Vehicles

- But drawbacks make the EJV less attractive:
 - Partnership: Chinese partner entitled to proportionate share of profits even if inactive in the EJV

I Changes in Investment Vehicles

- But drawbacks make the EJV less attractive:
 - Governance: Unanimity rule on key Board decisions (amendments to constitutional documents, capital changes, termination/dissolution, merger/division) and typical division of appointment/nomination powers (Chair/Vice Chair, General Manager/Deputy General Manager)

I Changes in Investment Vehicles

- Culture: Difficulty bridging organizational and national cultures
- IPR: Greater risk of infringement

I Changes in Investment Vehicles

B. Chinese-Foreign Cooperative Joint Venture (CJV)

- Less popular investment vehicle
- Similar to EJV but more flexible
 - Investors can contribute terms of cooperation instead of capital
 - No proportionality rule
 - No statutory requirement for shared appointment/nomination powers

I Changes in Investment Vehicles

- But not allowed in all industries
 - And grant of security interests also subject to unanimous Board approval

I Changes in Investment Vehicles

- C. Wholly Foreign-Owned Enterprise (WFOE)
 - Most popular investment vehicle

I Changes in Investment Vehicles

- Now allowed in most industries under Guiding Catalogue on Foreign Investment
 - Maximizes investor control
 - Fastest and least expensive to establish
 - Chinese parties can invest overseas (restrictions on foreign exchange transfers exist but gradually diminishing)
- But not allowed in all industries

I Changes in Investment Vehicles

D. Foreign-Invested Companies Limited by Shares (FICLS)

- First allowed 1995 but 2003 reforms have widened their utility
- Governance: limited liability company structure without the rigidities of EJV or CJV

I Changes in Investment Vehicles

- Must have at least 25% foreign investment and registered capital of at least RMB30 million to qualify for investment preferences
- Particularly attractive to financial investors, including VC arms of technology companies

I Changes in Investment Vehicles

E. R&D Centers

- Minimum registered capital is USD2 million to qualify for preference
- Can be stand-alone legal person or branch or department of FIEs
- At least 80% of personnel must be directly engaged in R&D if established as WFOE or JV; at least 10 employees or 80% of personnel if established as branch or department of an FIE

I Changes in Investment Vehicles

F. Holding (Investment) Companies

- Suitable for larger investors planning fresh investments of at least USD30 million
- Preconditions for establishment are diminishing
 - Over 300 already established

I Changes in Investment Vehicles

- Can provide various back office and financial services to investors
 - But provision of key sales and logistic services requires unanimous consent by joint venture investors
 - Cannot file unified tax returns
- Can serve as regional headquarters with additional investment preferences

FDI BY INVESTMENT VEHICLE (2003-2004)

YEAR 2003					Unit: USD100M	
VEHICLE	NO. OF PROJECTS		CONTRACTED FOREIGN INVESTMENT		ACTUAL UTILIZATION	
EQUITY JV	12521	30.50%	255.06	22.18%	153.92	29.07%
COOPERATIVE JV	1547	3.77%	74.79	6.50%	38.36	7.25%
WFOE	26943	65.64%	816.09	70.97%	333.84	63.06%
FICLS	37	0.09%	3.89	0.34%	3.28	0.62%
TOTAL	41048	100%	1149.83	100%	529.4	100%
UP TO YEAR 2003						
EQUITY JV	238367	51.26%	3518.37	37.50%	2060.27	41.77%
COOPERATIVE JV	54512	11.72%	1707.99	18.20%	866.19	17.56%
WFOE	172108	37.01%	4141.47	44.14%	1990	40.35%
FICLS	67	0.01%	14.55	0.16%	15.53	0.31%
TOTAL	465054	100%	9382.38	100%	4931.99	100%

FDI BY INVESTMENT VEHICLE (CUMULATIVE)

**THROUGH YEAR 2004
USD100M**

Unit:

EQUITY JV	249937	49.13%	3794.78	34.76%	2224.13	40.17%
COOPERATIVE JV	55855	10.98%	1785.87	16.36%	897.31	16.21%
WFOE	202816	39.87%	5314.22	48.68%	2392.22	43.20%
FICLS	110	0.02%	22.29	0.20%	23.3	0.42%
TOTAL	508718	100%	10917.16	100%	5536.96	100%

**Source: China Commercial Year Book 2004
China Info Bank, China Statistics Database
Ministry of Commerce website, Statistics Database**

II M&A

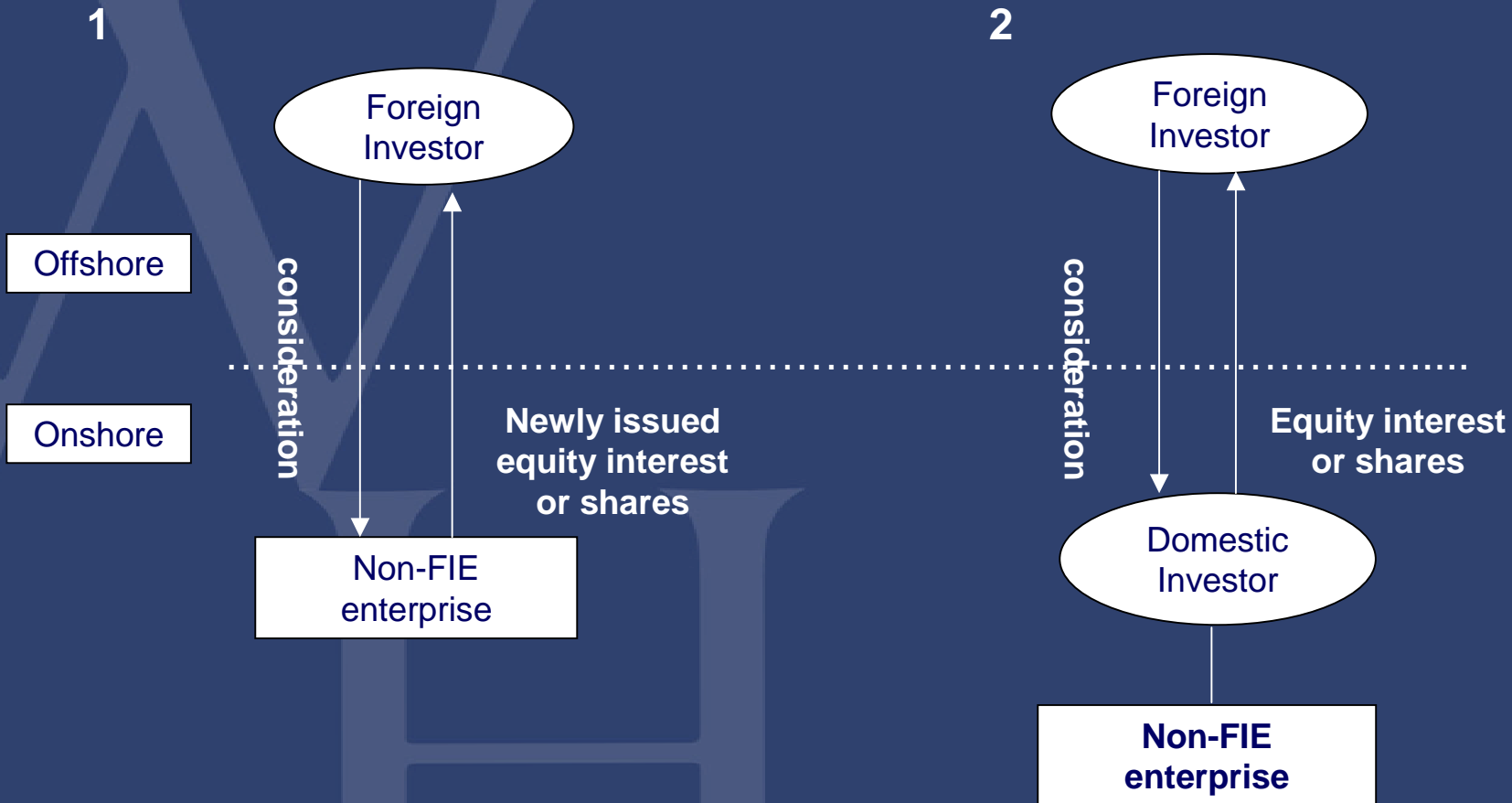
- Expansion by M&A has become widely accepted for foreign as well as domestic investors
- Different rules exist depending on nature of parties

II M&A

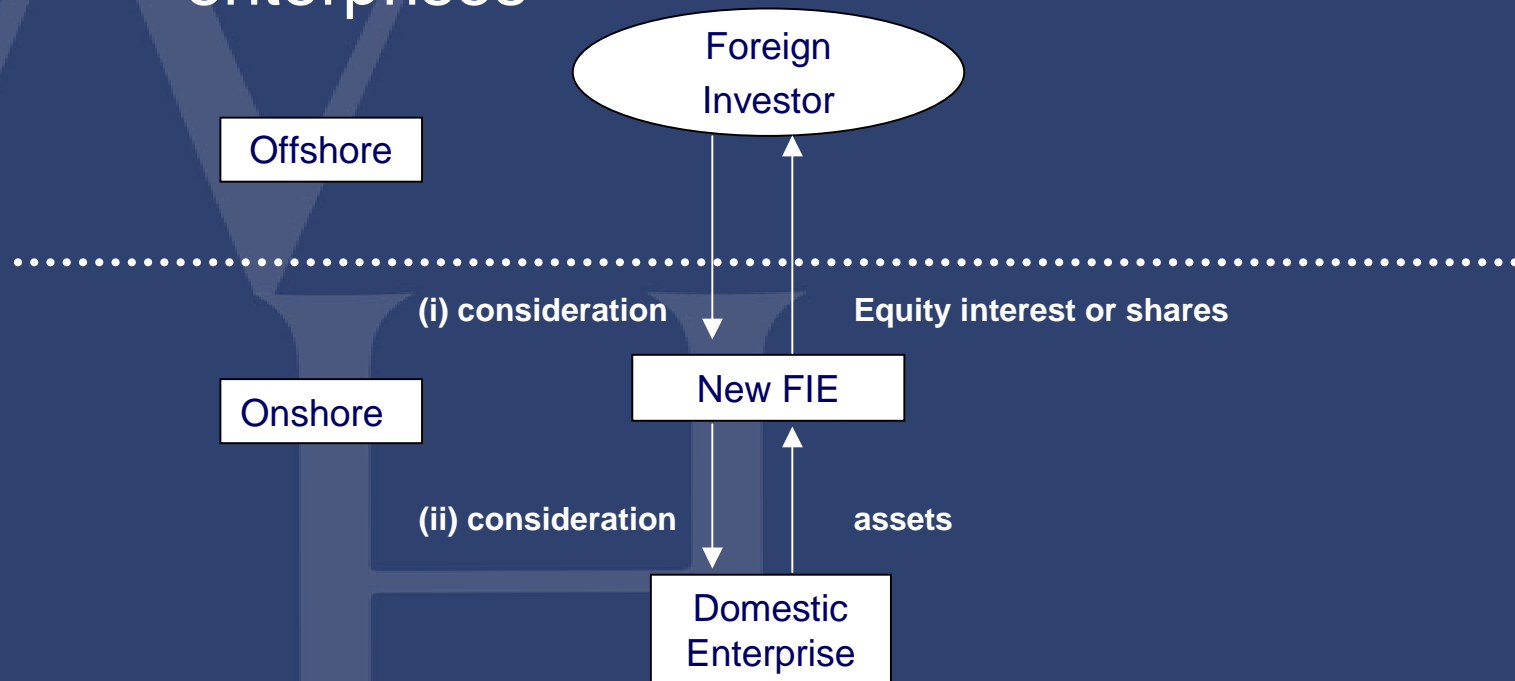
A. Interim Provisions on M&A of Domestic Enterprises by Foreign Investors

- Acquisition of non-FIE domestic enterprises from existing shareholders or by purchase of new shares

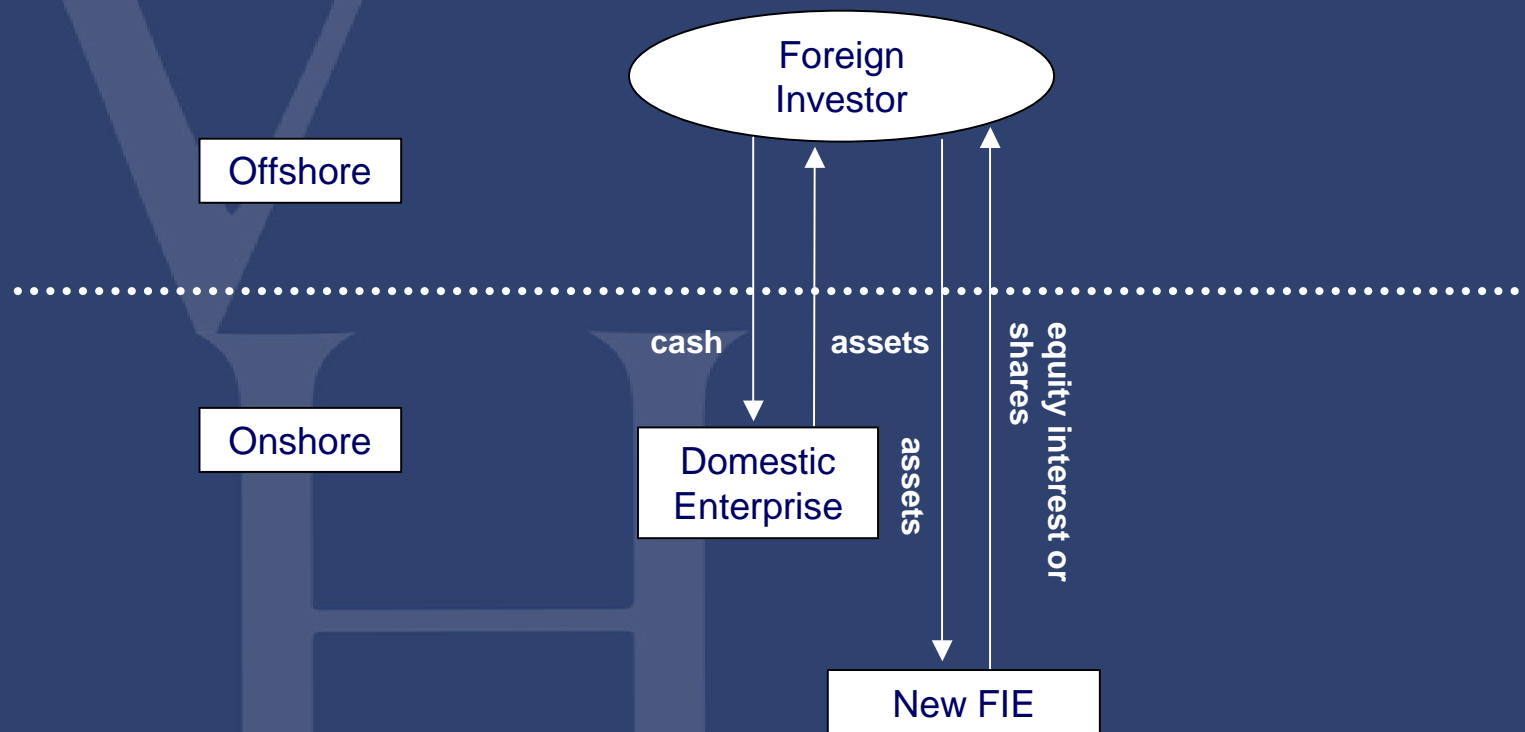
Covered Transactions



- Establishment of new FIEs which purchase and operate assets from domestic enterprises



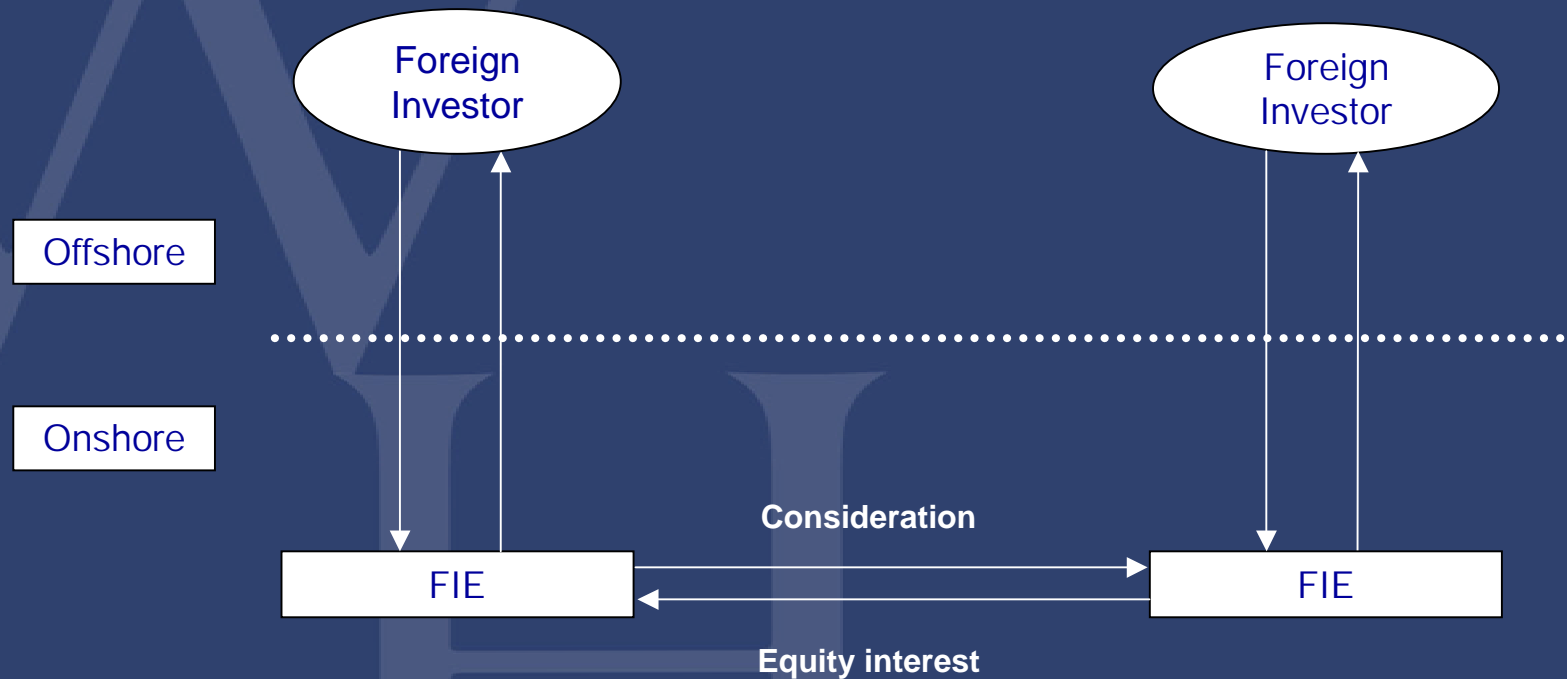
- Purchase of assets from domestic enterprises for investment as capital in newly established FIEs



- Basic distinction re: obligation between mergers and acquisitions is maintained, but creditors are given statutory notice right
- Pricing subject to appraisal by accredited appraisal firm and prices “clearly below” appraisal value are prohibited

B. Regulations on Merger and Division of FIEs and Several Provisions on Changes in Equity Interests of Investors in FIEs

- Merger and division of existing FIEs



C. Interim Provisions on Utilizing Foreign Investment to Reorganize State-owned Enterprises (SOEs)

- Applies to conversion to FIEs

■ Structures

- Acquisition of equity interests or property rights
- Acquisition of claims which are then converted into equity interests
- Acquisition of assets
- Purchase of new shares or registered capital interests

- Not applicable to investments in listed SOEs
- Subject to appraisal of state-owned interests (acquisitions at less than 90% of appraised value generally prohibited, but appraisal process may be shaped)
- Must be processed through property rights exchange

D. Purchase of Equity in FICLS

E. Purchase of Equity in Listed Companies

- Companies listed onshore
- Companies listed offshore

F. Anti-Monopoly Regulation

- Anti-monopoly law pending
 - Presumption of market dominance if:

one enterprise	50%
two enterprises	67%
three enterprises	75%

but can also be established on basis of evidence

- Review of FIE mergers if may result in monopoly or market domination impairing fair competition

- Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors
 - Filing requirement for domestic M&A transactions if:
 - A party has China operating revenues \geq RMB1.5 billion
 - The foreign acquirer has more than 10 domestic enterprises in the industry

- Filing requirement for domestic M&A transactions if:
 - Market share $\geq 20\%$
 - Market share will become $\geq 25\%$ as result of transaction

- Filing requirement for overseas M&A transactions if:
 - A party has China assets \geq of RMB3 billion
 - A party has China operating revenue \geq RMB1.5 billion
 - Direct and indirect market share \geq 20%
 - Direct and indirect market share will become \geq 25% as result of transaction
 - Acquirer will directly or indirectly have equity investments in more than 15 domestic enterprises in the industry

- Contents of filing to Ministry of Commerce and State Administration for Industry and Commerce (need not be notarized):
 - Basic facts about the parties
 - Nature and size of transaction, affected industries or products, economic rationale
 - M&A Agreement (Chinese version for key provisions)

- Sales volume and market share of parties in relevant markets during prior year (with rationale for market segmentation and formula for calculation of market shares)
- Nature of relevant markets with names of three leading competitors
- Reporting circumstances in other jurisdictions
- Other relevant circumstances

- Filing to be made at same time as made in home jurisdiction
- No response in 90 days means clearance (approval usually is faster)

III Managing the Supply Chain: Trading and Distribution Rights

- A. Trading Rights (Import/Export) Previously Restricted, Forcing Enterprises to Use Import/Export Agents
- B. Distribution Rights (Domestic Procurement and Sale) for Manufacturing FIEs Previously Limited to Self-Manufactured Goods

III Managing the Supply Chain: Trading and Distribution Rights

- C. China committed under WTO to lift restrictions on trading (import/export) and distribution (domestic procurement and sale) rights by December 11, 2004; subject to limited restrictions for certain commodities

III Managing the Supply Chain: Trading and Distribution Rights

D. Trading rights by July 2004 liberalized

- Simple 5-day on-line registration (not approval) process
- No minimum registered capital requirement except as provided in Company Law or by local regulation

III Managing the Supply Chain: Trading and Distribution Rights

E. Under Administrative Measures on Foreign Investment in the Commercial Sector, Distribution Rights to be Made Widely Available

- Minimum registered capital requirement (RMB500,000 for wholesale, RMB300,000 for retail)

III Managing the Supply Chain: Trading and Distribution Rights

- Some restrictions on larger FIE retail enterprise establishments and chains
- Subject to approval process
- Action on applications currently on hold pending promulgation of implementing regulations

IV Conclusion

- Increasing opportunities to grow a business and better manage a supply chain are now available
- Care must still be taken with respect to selection of business partners, management and the overall business and legal environment