



China Regulatory Updates

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- ▶ *Unique player in the PRC legal service market*
- ▶ *Simplicity, but always with a focus on key points and attention to details*

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FOREIGN INVESTMENT / DISPUTE RESOLUTION

Supreme People's Court Standardizes Judicial Practice on Disputes Involving FIEs

On August 5, 2010, the PRC Supreme People's Court ("SPC") promulgated the *Provisions on Several Issues Concerning the Hearing of Cases Involving Foreign Invested Enterprises (Part I)* (the "Provisions"), which Provisions have become effective as of August 16, 2010. The Provisions focus on how the relevant laws should apply to various disputes during the establishment and change process of foreign invested enterprises or FIEs, especially how to deal with the practical problems related to FIEs' contracts, equity transfers, entrusted investments, among others.

(a) Enforceability of FIE Contracts without Governmental Approval

According to the Provisions, (i) contracts executed during an FIE's establishment or change process, even if absent any governmental approval, should not be deemed as void or invalid, and the relevant provisions thereunder governing the obligation of submitting such contracts for governmental approval should still be enforceable; (ii) contracts properly executed by the parties thereto and approved by competent government authority could still be declared by court of competent jurisdiction as invalid or revocable according to applicable PRC laws and regulations; and (iii) minor and immaterial changes made to an approved FIE contract (*other than changes to such important items as capital increase, corporate merger or division, equity transfer, and etc.*) should not be determined as invalid or unenforceable due to absence of government approval.

Han Yi Observations: The Provisions have explicitly differentiated the formation and validity of an FIE contract. A duly executed FIE contract will not come into effect without competent government approval, but will still be partly enforceable at least with respect to such provisions that require the relevant parties to submit such contract for approval in order to effectuate the contract. This will help prevent parties, who may otherwise take advantage of the mandatory PRC law requirement that a governmental approval will

be needed in order to effectuate almost all FIE establishment and change contracts, from terminating an FIE contract maliciously.

(b) Equity Transfers without Governmental Approval

When an FIE's equity interest is transferred, if the transferor and the FIE, as the parties obliged to initiate the approval application, fail to submit the underlying equity transfer agreement for PRC governmental approval after it has been properly executed, then (i) the transferee will be entitled to apply to the court of competent jurisdiction to order the transferor and the FIE to jointly carry out their submission obligations within a time period prescribed by the court, and (ii) if the transferor and FIE refuse to do so, the transferee will be entitled to, upon permission by the court, submit the agreement for approval on its own or initiate other proceedings demanding termination of the agreement, return of the paid-up equity transfer price, and compensation of its losses.

Han Yi Observations: The Provisions have spelt out specific remedies for the transferee party in the case of an equity transfer when the other parties fail to submit a properly signed equity transfer for PRC governmental approval. In particular, the Provisions have expressly provided that the transferee can also submit such application itself if the transferor and the FIE refuse to perform their obligations. This will greatly help reduce possible disputes associated with market uncertainties during an FIE's equity transfer process and facilitate the orderly completion of such equity transfers in a more predictable and timely way.

(c) Effectiveness of Entrusted/Nominee Shareholding

Based on the Provisions, (i) entrusted investment agreements should be valid and enforceable unless otherwise provided under applicable PRC laws and regulations; (ii) the

beneficial owner's identity as a shareholder of the FIE can be confirmed by a court of competent jurisdiction upon its satisfaction with certain conditions (e.g., the fact that the beneficial owner has indeed made investment into the FIE, recognition by the FIE's other shareholders of the beneficial owner's identity as a co-shareholder, and existence of any approval by competent government authority); (iii) the beneficial owner may request the nominee shareholder to perform its obligations according to the entrusted investment agreement (if no such provisions is provided therein, the beneficial owner may claim for payment of the investment gains while the nominee shareholder would be entitled to necessary remunerations); and (iv) the beneficial owner has no right to directly claim against the FIE for any profit distribution or exercise other rights as a shareholder of the FIE.

Han Yi Observations: The legal relationship between parties to an entrusted shareholding structure under PRC law and practice has for the first time been explicitly specified by these Provisions, under which the beneficial owner (or "actual investor" as it is literally used in Chinese) will generally be entitled to the rights provided under the entrusted investment agreement but not the rights directly enjoyed by the FIE's shareholders.

(d) Exercise of Right of First Refusal

If any shareholder transfers its equity interest in an FIE to a third party in violation of other shareholders' right of first refusal, each such other shareholder may claim for revocation of such equity transfer, provided however that such claim should be raised within one year from the date it becomes (or should become) aware of the execution of such equity transfer agreement.

Han Yi Observations: The Provisions have specified remedies that a non-transferring

shareholder may rely upon when its right of first refusal has been infringed by a transferring shareholder in the event of an equity transfer involving an FIE, subject to certain exceptions provided under the Company Law. In addition, a reasonable time limit for claiming such remedies have also been imposed so that executed transactions will not be unduly re-examined for indefinite time period.

(e) Other Noteworthy Points

Capital Contribution: If a shareholder transfers certain property to an FIE as part of its capital contribution but has failed to duly register with competent government authority to effectuate the ownership transfer with respect to such property, the court of competent jurisdiction may hold that such shareholder party has made its capital contribution if it could complete the title transfer registration within a time limit prescribed by the court, provided however, that such shareholder party should compensate any loss incurred by the FIE as a result of the FIE's delay in obtaining the title.

Equity Pledge Agreement: According to the Provisions, unless otherwise provided under PRC laws and regulations or agreed by the parties, all equity pledge agreements with respect to an FIE's equity interest will become effective upon their due execution (*instead of receipt of necessary governmental approval as provided under existing FIE rules and regulations*). However, the equity pledge itself thereunder will only be effectively created upon approval of the equity pledge agreement and the registration of such pledge with competent SAIC office.

The Provisions do not apply to disputes related to FIE's dissolution, liquidation, and M&A activities. It is reported that additional rules will soon be separately formulated and issued by the SPC as well.

INSURANCE

Insurance Funds Permitted to Be Invested in Equity Interest and Real Property

On July 30, 2010, the China Insurance Regulatory

Commission (the "CIRC") released the *Interim*

Administrative Measures on the Operation of Insurance Funds (the “Measures”), generally regulating the investments of the insurers with the insurance funds. Following the issuance of the Measures, CIRC has just issued two additional rules on September 5, 2010 to regulate investments with insurance funds in equity interest and real property, respectively. Here are some of the highlights from these three pieces of new rules:

(a) Scope of Equity Investment. Direct equity investment with insurance funds into non-listed equity interests of certain financial service industries is now permitted, regardless of whether it is for controlling purpose or not. Further, equity investment by insurance funds can now also be made in private equity funds (excluding the fund managers) as an indirect investment in equity interests, although the fund recipients (including their management companies) should meet certain thresholds, including the size of the fund (i.e., at least RMB500 million of committed capital), the size of the fund manager (i.e., at least RMB100 million of registered capital), total asset under management by the fund manager (i.e., no less than RMB3 billion under management) and number of exited projects (i.e., the fund manager has successfully exited from at least 3 projects), among others. It is also clear now under these rules that insurance funds

may not be used for VC investments or other “high risk” equity investments.

- (b) Real Property Investment. Under these new rules, insurance funds can now be used for investments in infrastructure type of real estate projects, real estate projects related to other basic social facility projects, and real property based financial products. According to the rules, (i) insurance funds are not allowed to be directly involved in real property development and construction projects, (ii) no insurance funds can be used to establish any real estate development company, (iii) no insurance funds can be used to invest in the equity interest of any unlisted real estate companies (excluding real estate project companies), and (iv) no insurance companies may seek to control a real estate company through investment in its stocks, among others.
- (c) Investment in ChiNext Board. Investment in stocks of listed companies on China’s growth enterprise board by insurance funds, which is explicitly prohibited by the earlier draft of the Measures, is now generally permitted by the Measures. However, since according to the Measures CIRC is to separately regulate such investment activities, investments of insurance funds in ChiNext board stocks are effectively still restricted for the time being.

BANKING

Offshore Institutions Allowed to Tap Mainland Inter-Bank Bond Market

With immediate effect, the People’s Bank of China (the “PBOC”) made an announcement on August 16, 2010 to launch a pilot scheme to permit eligible offshore institutions to invest in mainland China’s inter-bank bond market with RMB.

Pursuant to the announcement, offshore financial institutions such as RMB clearance banks in Hong Kong SAR and Macao SAR, participating banks of cross-border RMB settlement, and offshore central banks or currency authorities are allowed to use their RMB funds to invest in mainland China’s inter-bank bond market, within a quota approved by the PBOC. The announcement has further

specified details with respect to the pilot scheme such as application documents, investing procedures, and market supervision, so as to mitigate the risks and promote a smooth investment environment.

The announcement has opened up a channel for RMB funds possessed by eligible offshore institutions to be invested in mainland China and will further promote the development of international settlement in RMB as well as the attractiveness of RMB business outside of mainland China.

For further information, please write us at inquiry@hanyilaw.com.