



China Regulatory Updates

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- › Standardization
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■ PRIVATE EQUITY

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■ REAL ESTATE

State Council Issues New Measures to Regulate Real Estate Investments

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PRIVATE EQUITY

NDRC Restarts PE Filing; Funds Larger than RMB500 Million Subject to Mandatory Filing Requirement

In order to regulate the development of China's equity investment market, NDRC has recently issued the *Circular on Further Regulating the Development and Filing Administration Work for Equity Investment Enterprises in Pilot Places (the "Circular")*, to restart, after a suspension for over one year, filing of equity investment funds ("PE") registered in certain pilot places such as Tianjin, Beijing, Hubei, Shanghai, Zhejiang and Jiangsu and to impose mandatory filing obligations on RMB funds at a size of RMB500 million or larger. Previously, PE funds may file with NDRC at their own discretion, provided that only those filed with NDRC may obtain investments of National Social Security Fund ("NSSF").

The Circular addressed such issues as establishment and filing, fundraising, investment direction, information disclosure, industry self-discipline and proper supervisions. Some of the highlights under the Circular include:

- (a) **Regular Filings Formulated.** For all PE funds registered with SAIC offices at the pilot places with a size of RMB500 million or larger, they should, together with their managers (if any), complete a mandatory filing with NDRC within a certain time after establishment. PEs failing to comply with this filing requirement will be negatively publicized on NDRC's website. However, no filing is required for any PE fund that is wholly owned or controlled by a single investor or for a venture capital investment enterprise that has completed filing according to the *Interim Measures on Administration of Venture Capital Investment Enterprises*.
- (b) **Means of Fundraising and Direction of Investment Regulated.** It is provided in the Circular that PE funds should be placed to

specific investors with certain risk recognition and assumption capabilities. Disguised/semi-public placements such as those through text messaging, seminars and lectures are not permitted. No fixed returns may be promised by any PE fund. In addition, all PE investments should be directed towards private equity interests that are not publicly traded and idle funds may only be deposited in banks or used to purchase national debts or other fixed-return investment products.

Han Yi Observations: In practice, some PE funds are not acting properly in fundraising and investments, such as raising funds through holding forums or other disguised public means, and making investments in securities or real estate or extending loans, which are all subject to express regulation of the Circular.

(c) **Filing Procedures Simplified.** Filing applications should first be submitted by PE funds to provincial authorities which in turn will forward to the national NDRC within 20 working days together with their preliminary review comments. National NDRC will publicize any qualified PE fund upon its final review on its website within 20 working days from receipt of the preliminary review comments and the filing application. In addition, the Circular also sets out in detail materials and documents to be submitted by PE funds and their managers for filing application purposes.

Han Yi Observations: The clarification of the above issues indicates that PEs may file with NDRC according to the procedures and requirements of the Circular, which will greatly increase the efficiency of PE filing, as under the old filing system, the approval time is very long and unpredictable.

- (d) **Asset Custody of Foreign-Invested PE Funds.** Where the manager of any PE fund is a WFOE or a Sino-foreign JV, the assets of the underlying PE fund should be entrusted to a legal-person custodian registered in China for

administration and supervision.

Han Yi Observations: The 22 PEs filed with NDRC under the old filing system are mainly domestically funded. Despite NDRC's statement that there is in principle no legal obstacle for foreign-invested PEs to obtain NDRC filing, it is still pending the promulgation of relevant guidelines. The stipulations of the Circular seem to indicate that foreign-invested PEs may file with NDRC

and receive investments from NSSF.

In addition, the Circular also provides in details the duties and responsibilities of PE managers, information disclosure system of PE funds (e.g., submission of annual financial reports to NDRC and reporting of major investment issues), and etc. In additions to NDRC mandatory requirements, PEs filed with NDRC are qualified for NSSF investments. Therefore, the restart of PE filing will be likely to lead to a new wave of PE filings.

FOREIGN INVESTMENT

China Establishes National Security Review Mechanism for Foreign Related M&A Transactions

On February 3, 2011, the General Office of the PRC State Council issued the *Circular on Establishment of National Security Review Mechanism for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (the "Circular"), with an aim to establish a mechanism for national security review of mergers and acquisitions ("M&A") of domestic enterprises by foreign investors. The Circular specifies the scope, content, working mechanism and procedure of the M&A security review and will take effect 30 days after its promulgation.

(a) Scope of Review. M&A security review mainly covers two categories of industries which have significant impact on national security: mergers and acquisitions by foreign investors of any domestic defense industry enterprise or any defense industry supporting enterprise, any enterprise adjacent to key or sensitive military facilities, or any other enterprise related to national defense or security; mergers and acquisitions by foreign investors of any domestic enterprise engaging in important agriculture products, important energy and resource products, critical infrastructure, critical transportation systems, key technology or equipment, in each case involving national security and the actual control of the domestic enterprise may be acquired by foreign investors after the transaction.

The Circular also clarifies the concept of "foreign M&A of domestic enterprises" and "acquiring actual control by the foreign investor". As defined in the Circular, the transactions classified as "foreign M&A of

domestic enterprises", which includes purchasing equity interest from Chinese shareholders of a foreign invested enterprise or subscribing to its capital increase or establishing a foreign-invested enterprise to purchase the equity interest of a domestic company, is much broader than that of the M&A Rules (as defined hereunder).

(b) Content of Review. The national security review is based on the following four aspects: (i) influence on national defense security, including influence on domestic manufacturing capabilities, services and related facilities and equipment required by national defense; (ii) influence on national economic stability; (iii) influence on basic social order; and (iv) influence on China's ability to research and develop key technologies for national security.

(c) Review Procedures. If the transaction falls under the above scope of review, MOFCOM shall submit the application to an interagency committee co-chaired by NDRC and MOFCOM (the "Committee") for national security review. The review process entails general review and special review. General reviews will be conducted through soliciting opinions from relevant agencies in writing within 20 working days; if any agency finds that the transaction may potentially have any impact on national security, the special review process shall be launched. Generally, the special review shall be completed within 60 working days unless there is any major disagreement among the members of the

Committee, under which circumstance the Committee shall submit the case to the State Council for further review.

- (d) **Consequences.** Where the acquisition of domestic companies by foreign investors has had or may have a material impact on national security, the committee shall request MOFCOM, together with the relevant agencies, to terminate the transaction or transfer relevant equity or assets or take other effective measures to eliminate the impact of the transaction on national security.

The Chinese government has been long concerned about national security with respect to foreign investments. It has been mentioned in the *Provisions on M&A of Domestic Enterprise by Foreign Investors* (the “M&A Rules”, effective on August 8, 2006) and the *Antimonopoly Law* (the “AML”, effective on August 1, 2008) that foreign acquisitions of domestic companies which concern national security are subject to national security review. Following the M&A Rules and the AML, the *Several Opinions on Further Improving the Work of Utilizing Foreign Capital* which is promulgated in early 2010 restated that the government shall accelerate the establishment of a national security review mechanism on M&A of

domestic companies by foreign investors. Recently, the promulgation and enforcement of the Circular has finally carried out the national security review mechanism.

China’s establishment of national security review mechanism complies with the principle of the WTO, and has also drawn experience from other developed countries such as the United States, Germany and Canada. The promulgation of the Circular will not change the increasingly open and convenient investment environment created by PRC government. However, China’s national security review may add additional burden and costs on M&A transactions in China to certain extent.

According to the NDRC, the establishment of national security review mechanism is to improve the present review system for M&A transactions and not to set any administrative permission. However, the investors may be requested to provide materials and information necessary for the security review in the course of other regulatory reviews. Currently, the competent authority is further enacting implementing rules and regulations and the detailed scope for national security review will be further specified.

MOFCOM Clarifies Certain Issues Concerning Foreign Investment Administration

Recently, MOFCOM issued the *Circular of the Ministry of Commerce on Relevant Issues Concerning the Foreign Investment Administration* (the “Circular”), with a view to clarifying relevant issues concerning administration and examination of foreign investment items. The Circular stipulates that foreign-invested partnership enterprises with investments as their principal business are deemed as foreign investors when they make investments and should abide by relevant laws, administrative

regulations and rules of foreign investment. Accordingly, such enterprises should abide by the *Catalogue for the Guidance of Foreign Investment Industries* when making investments and should obtain necessary approval from the competent authority. Furthermore, the Circular has set out stipulations on issues concerning reduction of foreign shares of listed companies and domestic investment made by foreign investors with their RMB funds.

GENERAL CORPORATE

Supreme People’s Court Issues *Provisions on Several Issues Concerning Application of the PRC Company Law (III)*

On January 27, 2011, the Supreme People’s Court promulgated the *Provisions on Several Issues Concerning the Application of the PRC Company*

Law (III) (the “Interpretation (III)”), which becomes effective as of February 16, 2011. The Interpretation (III) focuses on how the relevant laws

should apply to various disputes arising from company establishment, capital contribution and equity interest confirmation. Highlights of the Interpretation (III) are as follows:

(a) Identify the Subject of Liability Before Incorporation.

Prior to the establishment of a company, in the event that any promoter enters into contracts with other persons in its own name for the establishment of a company, in principle, such promoter shall bear contractual liability unless the company recognizes such contract after its establishment, or has started to actually enjoy contractual rights or perform contractual obligations, in which case the company shall bear contractual liability; in the event that the promoter enters into contracts in the name of the company, in principle, the company shall bear contractual liability after its establishment unless there is evidence proving that the promoter has entered into contracts in the name of the company and for its own interests with a counterparty not acting in good faith. In accordance with such provisions, the subject of liability in connection with disputes arising from various contracts such as land use right agreements or housing rental contracts concluded prior to the establishment of company is identified.

(b) Specify Issues Concerning Non-Currency Contribution.

The Interpretation (III) has clarified the standards to judge whether any non-currency contribution is in place. In case one makes capital contribution with non-currency assets such as housing, land use right or intellectual property which requires ownership registration, the capital contributor will enjoy corresponding shareholders rights only after such ownership registration has been duly changed and the assets have been actually delivered to the company.

(c) Clarify the judicial remedy and civil liability for non-duly-performed obligation of capital contribution (including capital contribution obligation that is not performed or that is not completely performed) or contribution withdraw:

(i) Restrictions on shareholders' right and removal of shareholders' qualification: for any shareholder, who fails to

perform capital contribution obligation or withdraws capital contribution, a company may put reasonable restrictions on such shareholder's rights to request dividend distribution, preemptive rights to subscribe for new shares and rights to request residual assets distribution, etc.; for any shareholder who fails to perform capital contribution obligation or withdraws all capital contribution and fails to contribute its capital or return registered capital within a reasonable time after the company's notice, the company may remove such shareholder through shareholders resolutions.

(ii) Joint and several liabilities borne by directors, senior management and other shareholders: in respect of shareholder's failure to perform capital contribution obligation, incorporators (in the case of establishing a new company) or directors, senior management who contravene the obligation of fidelity and due diligence (in the case of increasing registered capital) shall assume joint and several liabilities for the portion of capital not contributed. In respect of shareholder who withdraws capital contribution, other shareholders, directors, senior management or persons of de facto control who assist in contribution withdraw shall assume joint and several liabilities for fled registered capital.

(iii) Impact of failure to perform capital contribution obligations on equity transfer: in case that a transferee is aware of or should be aware of transferor's failure to perform capital contribution obligation before the equity transfer, the transferee shall be jointly and severally liable for non-contributed capital, and unless otherwise agreed by relevant parties, the transferee may seek indemnification from the transferor after the transferee have born such liabilities.

(d) Regulate Dormant Investment.

In respect of dormant investment, the stipulation of the Interpretation (III) is consistent with that of the *Provisions of the*

Supreme People's Court on Several Issues Concerning the Hearing of Cases about Disputes Involving Foreign-funded Enterprises (I), which provides that such investment is valid so long as it does not contravene mandatory provisions of the *PRC Contract law*. It is noteworthy that the Interpretation (III) specifically provides that the principle of "bona fide acquisition" as stipulated in Article 106 of the *PRC Property Law* shall be applicable in case that the dummy shareholder transfers, pledges or otherwise disposes of his shares, i.e., and the disposal of shares will be held as valid in case that the transferee acts in good faith and has performed relevant contractual obligations and completed the relevant registration procedures, but the dormant shareholder may seek indemnifications from the dummy shareholder.

(e) Regulate Equity Transfer Activities

When the shareholder transfers, pledges or

otherwise disposes of the equity which has been transferred but not changed its registration with competent authority, the above-mentioned principle of "bona fide acquisition" shall also apply. The director, senior management or persons of de facto control who is at fault in not changing the registration in time shall bear corresponding responsibility (in the circumstance that the transferee who is at fault by himself, the corresponding responsibility of the director, the senior management or the actual controller may be appropriately eliminated).

Since the promulgation of the new *PRC Company Law*, more and more disputes arise from aspects regarding formation and maintenance of capital, balance of the interests among shareholders, protection of the right of creditors and undertaking of liability during the establishment of a company. The promulgation of Interpretation (III) shall further clarify relevant issues and standardize judicial practices on such disputes.

REAL ESTATE

State Council Issues New Measures to Regulate Real Estate Investments

Recently the General Office of the PRC State Council has issued *the Notice on Relevant Issues of Furthering Real-Estate Market Control* (the "Notice"), which put forward a set of new measures to regulate the real-estate market. These new measures include, among others, imposing turnover taxes on property transfer between individuals, differentiating credits for property loan, and strengthening land supply management.

According to the Notice, a full turnover tax based on sales income will be levied on any individual selling the property within 5 years after purchasing it. For any family buying a second property, the down payment shall not be less than 60% of the total price, and the interest rate shall not be less than 110% of the benchmark interest rate. In addition, the Notice strengthens review of qualifications of land supply market entry and source of fund, and requires that every city directly under the Central

Government, every city directly under State planning, every capital city of province and any other city in which property price is too high or rises too fast, formulate and implement strictly measures on property purchase restrictions (such as any domicile citizen owning two or more properties, any non-domicile citizen owning one or more properties, and any non-domicile citizen failing to provide a proof of duly paying taxes or duly contributing social welfare for a certain continuing period, are not allowed to purchase any local property temporarily).

To date, more than ten major cities including Beijing, Shanghai, Guangzhou, Tsingtao and Nanjing have issued implementing rules (including property purchase restrictions) to control the real-estate market. The Notice and the relevant implementing rules issued by various cities may affect real-estate developers, especially those in first-tier cities to certain extent.

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

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