



MAYER | BROWN

# Guide to Doing Business in China



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# Introduction

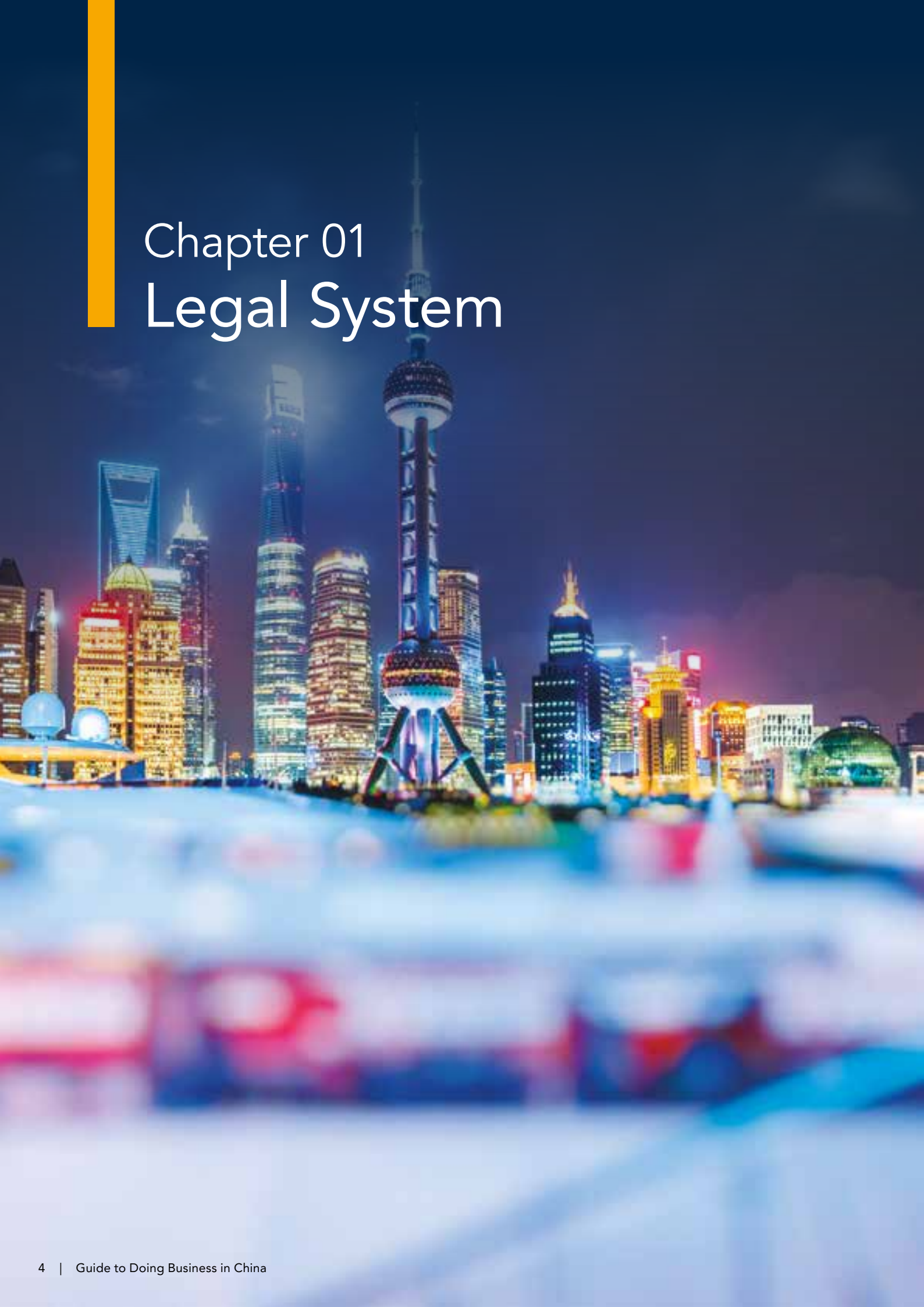
Since China opened its doors to foreign investors around forty years ago, it has been a top recipient for international direct investments. Despite the gradual slowdown of the country's overall economic growth, foreign interest in China continues to be strong. After a slight decline in 2016, foreign direct investment increased again by 3% to US\$134.97 billion in 2018.

The relatively steady increase in foreign investments has been accompanied by a structural shift in the projects financed and locations selected. Rising costs – particularly in the previously favoured coastal provinces – have led to a shift to the more technologically demanding production and services industries. Investment in the inland areas has also sharply increased in the past decade.

The changes in government subsidies are other drivers for the structural transformation in foreign investment. For example, since 2008 foreign invested manufacturing companies no longer receive tax exemptions. Now only hi-tech companies, or those that settle in less developed regions of China's inland, receive such tax incentives.

The Chinese legal regime for foreign investment is not completely straightforward – given its requirement for government approvals, filing and other China-specific requirements, such as foreign exchange control. Recent years have witnessed a series of substantial changes in China's foreign investment regime, including the promulgation of the *PRC Foreign Investment Law*, which may appear confusing or complicated to investors who are exploring and investigating investment opportunities in China. This Guide aims to provide existing and potential investors with a snapshot of the key legislation that may have an impact on foreign investment in China, as well as major issues that foreign investors should be aware of when making an investment in China. We hope you will find this Guide useful.



A nighttime photograph of the Shanghai skyline, featuring the Oriental Pearl Tower and other illuminated skyscrapers. The foreground is blurred, showing what appears to be a crowd of people or a large gathering.

# Chapter 01 Legal System

# The Legislative System

China is a civil law country. Statutes that are adopted by legislatures and court decisions do not have precedential authority. The Chinese legal system consists of various levels of law, including the Constitution, national laws, administrative regulations, departmental rules and local regulations.

## THE CONSTITUTION AND NATIONAL LAWS

The Constitution is adopted by a two-thirds majority vote from all deputies of the National People's Congress ("**NPC**"). Foreign investors are unlikely to encounter the Constitution in the course of commercial practice, although it sets the foundations for the principles to Chinese laws and the legal system.

Other national laws and amendments are adopted by a simple majority vote of all deputies of the NPC, or by its standing committee. National laws are utilised in a number of broad areas, such as crimes, fundamental civil institutions - such as property law, intellectual property law and other civil law – basic economic systems, and basic systems of finance, taxation, customs, banking, foreign trade, litigation and arbitration. Many national laws use general wording and only lay out broad principles.

The *PRC Foreign Investment Law*, coming into force on 1 January 2020, is the fundamental law promulgated by the PRC in the foreign investment area, which sets out general principles and basic administrative mechanism for foreign investments in China. More introduction on the *PRC Foreign Investment Law* will be provided in Chapter 2 – Foreign Investment Policy.

## ADMINISTRATIVE REGULATIONS AND DEPARTMENTAL RULES

The State Council enacts administrative regulations that implement national laws. The ministries and commissions of the State Council and the organs with administrative functions directly under the State Council - such as the Ministry of Commerce ("**MOFCOM**"), the State Administration for Market Regulation ("**SAMR**", previously known as the State Administration for Industry and Commerce, i.e. "**SAIC**"), and the China Securities Regulatory Commission ("**CSRC**") - may also enact departmental rules to provide detailed interpretation of

national laws and administrative regulations, relating to subject matters that are within their respective jurisdiction.

## LOCAL LEGISLATION

The people's congresses and the people's government of different provinces, autonomous regions and municipalities directly under the central government, also have the power to enact local regulations and administrative rules to implement national laws. These regulations and rules allow for the implementation of the laws in a way that takes into account the local political, economic and cultural conditions.

## PROPOSED BILLS

Bills are usually deliberated in closed sessions. The process is not published in government documents, nor are the bills announced to the public. However, in recent years, laws, regulations and rules that are controversial, or may have a significant social and economic impact on Chinese society, have been released on the internet to solicit public opinion, such as the *Individual Income Tax Law*, the *Drug Administration Law*, also among the latest and most significant ones, the *Foreign Investment Law* and six draft sections of the *PRC Civil Law in 2018 and 2019*. Public seminars and hearings have also been held – for example, revisions proposed for the *Individual Income Tax Law*. To comment on the draft bills, foreign investors and foreign-invested enterprises may submit comments on their own or, as is more commonly seen in practice, through trade associations or chambers of commerce.

## HOW DO THE DIFFERENT LEVELS OF LEGISLATION FIT TOGETHER?

National laws often provide a high-level framework which more detailed regulations can then be built from. National laws are usually supplemented by the State Council's administrative regulations – particularly when the issues involve multiple ministries. Administrative regulations are often worded broadly, with implementing details set out in departmental rules. In addition, local regulations may be promulgated to implement the national laws.

Legally, departmental rules should not conflict with the State Council's administrative regulations, while national laws take precedence over local regulations.

However, in practice it is not uncommon to find inconsistencies among rules promulgated by different ministries. In the case of inconsistencies, consultation with the relevant authorities may be needed.

## The Administration

The government hierarchy is headed by China's President down to the State Council, to China's ministries and administrative agencies, and to their respective counterparts at the provincial, municipal, county and township or village level.

The government organisations charged with approving investment projects are broadly divided into three levels: the central government level; provincial-level government or government of the municipalities directly controlled by the central government; and the local municipal or county government level. In each case, the higher the level of government, the greater the degree of authority and responsibility. Foreign investors need to understand which authorities are relevant to their particular activities – it is also important to recognise the government is playing a significant role in approving foreign-invested projects.

## The Judicial System

### COURTS

The People's Courts represent the judicial arm of the state and consist of the Supreme People's Court; the Special People's Courts, which includes maritime courts, military courts, forestry courts and so forth; and the Local People's Courts, consisting of District People's Courts, Intermediate People's Courts and Higher People's Courts. In recent years, two specific types of court have been established. The Standing Committee of NPC approved the establishment of the Intellectual Property Court in August 2014 in Beijing, Shanghai and Guangzhou, and the establishment of a Shanghai Financial Court in April 2018. The Intellectual Property Courts will have jurisdiction over specific types of intellectual property cases and the Shanghai Financial Court will have jurisdiction over specific types of financial cases in Shanghai. Also, since 2016, the Supreme People's Court has established six Circuit Courts as its standing judicial organs and branch offices to try major administrative, or civil and commercial cases across different Provinces

and Autonomous Regions. First-instance cases with significance impact nationwide or appeal cases filed against an administrative or civil and commercial judgment or ruling as rendered by a higher people's court as a court of first instance will be accepted by the Circuit Courts.

The Supreme People's Court supervises the Local People's Courts at each level, the Special People's Courts, and the Intellectual Property Courts. The higher-level People's Court supervises the work of the lower-level People's Courts. Shanghai Financial Court is subject to the supervision of both the Supreme People's Court and the Shanghai High People's Court.

In the Chinese trial system, judgment at second instance is final, meaning that a case is only heard twice, by courts at two levels, and the last court decision will be final and binding – under limited circumstances, a retrial procedure may be triggered. The People's Courts at various levels have jurisdiction to adjudicate criminal cases, civil and commercial cases, intellectual property cases, and administrative cases.

### JUDICIAL INTERPRETATION

The Supreme People's Court, in respect of all matters, and the Supreme People's Procuratorate, in respect of the matters within its authority (mainly criminal law), are authorised by the Standing Committee of the NPC to interpret laws and regulations in the context of specific legal issues, arising from cases they hear or as requested by lower People's Courts. In practice, the judicial interpretations made by the Supreme People's Court and the Supreme People's Procuratorate on particular legal issues are binding on, and followed by, lower-level courts.

### ARBITRATION INSTITUTIONS

Arbitration bodies are set up in China at national and local levels. The China International Economic and Trade Arbitration Commission ("**CIETAC**") is the best-known arbitration institute in China that handles international economic and trade disputes, including foreign investment-related cases. In 2012 and 2013, the former Shanghai Sub-Commission and Shenzhen Sub-Commission of CIETAC split from CIETAC and renamed themselves as Shanghai International Economic and Trade Arbitration Commission ("**SHIAC**", also known as Shanghai

International Arbitration Centre) and Shenzhen Court of International Arbitration ("**SCIA**", also known as Shenzhen Arbitration Commission or South China International Economic and Trade Arbitration Commission). Both are also capable of handling commercial cases that involve foreign investors.

In addition, local arbitration bodies, such as the Beijing Arbitration Commission and the Shanghai Arbitration Commission, arbitrate domestic and foreign-related cases. Arbitration rulings in China are final at first instance, which means that the ruling takes effect immediately when rendered. However, if the parties believe that the ruling has been wrongly decided, and that the conditions for an annulment of the ruling have been met, they may apply to court for a review of the case and an annulment of the arbitration award.



# Chapter 02 Foreign Investment Policy



## Foreign Investment Law

China introduced its *Foreign Investment Law* in March 2019, which will come into effect on 1 January 2020.

### PRINCIPLES RELATED TO INVESTMENT FACILITATION AND PROTECTION

The *Foreign Investment Law* sets out a number of general principles related to investment facilitation and protection. For example, governmental policies in support of enterprise development shall apply equally to FIEs; FIEs may equally participate in the standards formulation procedure, and may participate in government procurement activities through fair competition; and governmental officials shall keep confidential the trade secrets of FIEs.

The *Foreign Investment Law* also seeks to address some foreign investors' concerns about IP protection in China. It encourages the business parties to negotiate the terms and conditions of technology cooperation under the principle of fairness and prohibit governmental authorities from using administrative means to force foreign business to transfer their technology.

### NEGATIVE LIST

Foreign investments in China had long been subject to a "case-by-case" approval system. Such "case-by-case" approval system was replaced with a "Negative List" system since 2016.

The Negative List is the list(s) issued and updated by the State Council of the PRC (or ministries duly authorized by the State Council), which specify the industries in which foreign investments are prohibited or restricted. If an industry is not covered by the Negative List, then an investment would be considered permitted, or encouraged if it is classified as an encouraged industry in the Catalogue.

The Negative Lists will be updated from time-to-time. Any foreign investor intending to invest in China should consult the Negative Lists and the Catalogue to confirm which category the proposed investment falls within and whether any restrictive measure will apply. There are specific requirements on the corporate structure, e.g., equity joint venture, and shareholding, e.g., Chinese controlling interest, for some industries.

Normally the Free Trade Zones will have a separate Negative List, in which there will be less restrictive measures than the national Negative List.

### FOREIGN INVESTMENT INFORMATION REPORT SYSTEM

Along with the relaxation of entry restrictions, more emphasis will be placed on the post-establishment monitoring of FIEs. One major foreign investment administrative mechanism established under the *Foreign Investment Law* is information reporting system, i.e. foreign investors and foreign-invested enterprises are required to report investment information through online systems. Breach of such reporting obligation, if not corrected timely, may result in a fine ranging from RMB 100,000 to 500,000.

### NATIONAL SECURITY REVIEW SYSTEM

China started to establish its national security review system for foreign investments in 2011, but the system used to apply to

- i. projects where foreign investors acquire or merge Chinese companies; and
- ii. foreign investments within free trade zone.

The application of the national security review system will be expanded pursuant to the *Foreign Investment Law*.

## Catalogue of Encouraged Industries for Foreign Investment

In order to encourage foreign investment in specific industries, MOFCOM and National Development and Reform Commission ("**NDRC**") have jointly published a Catalogue of Encouraged Industries for Foreign Investment ("**Catalogue**"), which includes an industry catalogue for encouraging foreign investment nationwide and a catalogue of encourage industries for foreign investment in 22 specified provinces, most of which are located in the country's central and western regions. Pursuant to this Catalogue, a foreign investor may enjoy some tax or land related preferential policies.

## Local Investment Guidelines

Apart from the above Negative Lists and Catalogue at the central government level, many local governments have also promulgated their own investment guidelines covering certain industries – such as mining, automobile and integrated circuit sectors – which may contain more detailed requirements and restrictions on foreign investment, and which may not necessarily be consistent with the above catalogues.

## Industry Specific Policies and Requirements

### NATIONAL INDUSTRIAL DEVELOPMENT POLICIES

Although a specific business sector is open for foreign investment under the above catalogues, it may still be restricted by national industrial policies and access requirements issued by NDRC from time-to-time, for example development policy and plan for the steel industry, automobile industry and paper-making industry.

### REQUIREMENTS UNDER SPECIFIC INDUSTRY REGULATIONS

Certain industries are subject to sector specific regulations. For example:

- A foreign invested insurance company is required to have a minimum capital of RMB200 million.
- Foreign investors are not permitted to own a majority interest in car manufacturing or certain type of telecommunications companies except for certain pilot areas.
- FA foreign invested construction company is only allowed to contract for certain types of construction projects that are foreign invested or foreign related.

## Preferential Treatments In Special Zones

### SPECIAL ECONOMIC ZONES

Since the Chinese central government established four Special Economic Zones in Shenzhen, Zhuhai, Shantou and Xiamen in 1979, 14 coastal open cities

in 1984, and the Hainan Special Economic Zone in 1988, a variety of “economic and technological development zones” or “new zones” have been established throughout China to compete for attracting foreign investment. Local governments in these zones may provide various forms of preferential treatment to foreign investors, such as tax holidays and financial subsidies on a case-by-case basis.

### SHANGHAI FREE TRADE ZONE

On 29 September 2013, the China (Shanghai) Pilot Free Trade Zone (“**Shanghai FTZ**”) was officially launched. The Shanghai FTZ consists of four existing bonded zones, which will be expanded from 1 March 2015, to cover certain areas in Lujiazui financial district, Jinqiao development zone and Zhangjiang Hi-Tech Park. The Shanghai FTZ will cover an area of 121 square kilometres.

Compared to other areas in China, a more flexible foreign exchange regime, and a more efficient cross-border payment platform, have been established in the Shanghai FTZ to facilitate funding of foreign investment. The Shanghai FTZ has also introduced streamlined customs clearance procedures.

### SHENZHEN QIANHAI

In August 2010, the State Council approved the overall plan of the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone (“**Qianhai Zone**”), which is located along the west coast of the Shenzhen Special Economic Zone. Various policies have been issued by the State Council, NDRC, and other government authorities, in support of the Qianhai Zone development.

These policies provide foreign investors, especially Hong Kong business service professionals, with access to certain service sectors that are otherwise restricted to foreign investment. Focusing on finance, modern logistics, information and technology, and other service sectors such as education, medical, legal and accounting services, the Qianhai Zone offers investors preferential treatment – ranging from a more flexible foreign exchange regime and cross-border payment system, more options for fund raising, such as RMB-denominated bonds, to tax incentives.

Tax incentive is one of the highlights among the policies available in the Qianhai Zone. Eligible

investors may enjoy tax preferential treatment including:

- Enterprise income tax at a reduced rate of 15 percent (from the usual 25 percent generally applicable in China), for enterprises that engage in 21 designated sectors, including modern logistics, information service, technology service and cultural innovation.
- Individual income tax rate capped at 15 percent for eligible foreign professionals - this is substantially lower than the highest tax rate of 45 percent under the national tax law.

## OTHER FREE TRADE ZONES

In addition to the Shanghai FTZ, 12 new free trade zones have been established from 2015 to 2018 in Tianjin, Fujian, Guangdong, Liaoning, Zhejiang, Hubei, Henan, Chongqing, Sichuan, Shaanxi and Hainan. These new zones adopt the Shanghai FTZ model – including the Negative List approach regarding the establishment of foreign investment enterprises (FIEs) – with each focusing on different industry sectors. For example, the Guangdong zone focuses on co-operation with Hong Kong and Macau service providers; the Fujian zone focuses on co-operation with Taiwan investors; and the Tianjin zone focuses on finance and shipping sectors. The FTZ Negative List applies to all free trade zones, but the detailed preferential treatment and industrial policy adopted by each free trade zone may be different depending on its own industrial focus.

## CEPA

Since 2003, the government has entered into a series of agreements with Hong Kong and Macau under the framework of Closer Economic Partnership Arrangement ("**CEPA**") – these have granted greater access to the China market for Hong Kong and Macau investors. Goods that originate from Hong Kong and Macau can enjoy reduced tariffs. Hong Kong and Macau investors have also been given greater access to a number of service sectors across the country.

Since 2014, the CEPA framework has been further developed through the conclusion of a series of new agreements between the Mainland and Hong Kong/Macau, including the CEPA Agreement on Trade in Services, the CEPA Investment Agreement,

the CEPA Ecotech Agreement and the CEPA Agreement on Trade in Goods.

These agreements are aimed at expanding market liberalisation and facilitating trade and investment between the Mainland and Hong Kong/Macau.

The Mainland commits to providing national treatment to Hong Kong/Macau service providers and investors on par with Mainland service providers and investors save for the special restrictive measures listed in relevant agreements. The Most-Favoured Treatment provision in the Agreement on Trade in Services and the Investment Agreement specify that any preferential treatment the Mainland accords to service providers and investors from other countries or regions will be extended to Hong Kong/Macau service providers and investors. In specified sectors, investors from Hong Kong/Macau can enjoy more preferential investment access than other external investors.

An aerial photograph of a modern city skyline, likely Shanghai, featuring several prominent skyscrapers and a complex highway interchange. The image is overlaid with a semi-transparent blue gradient and a yellow vertical bar on the left side. The text is white and positioned in the upper left quadrant.

# Chapter 03 Approval, Filing and Registration

## Approval Authorities

Various government bodies are involved in overseeing different aspects of foreign investment, including: the State Council, NDRC, MOFCOM, industry regulators, such as the Civil Aviation Administration of China ("**CAAC**"), SAMR and their respective local branches. Among these authorities, NDRC and MOFCOM are the main approval authorities for establishment of FIEs depending on the industry and investment scale of an FIE.

## General Process

### PROJECT VERIFICATION OR RECORD-FILING WITH NDRC

NDRC formulates and implements macro-economic development strategies and plans, co-ordinates and supervises national economic development, and is responsible for examining and approving foreign-invested projects from a macro-economic

perspective. During the project approval stage, NDRC often seeks and co-ordinates opinions from other authorities – such as the Ministry of Environment, on environmental protection issues, and the Ministry of Land and Resources, on land grants for foreign-invested projects.

Prior to June 2014, project verification with NDRC was technically required for any foreign investment projects, however, in practice, such a procedure may only have been critical and implemented for certain projects, such as those in the infrastructure, energy, automobile sectors.

Since June 2014, NDRC has relaxed the project verification matrix for FIEs, the threshold of which was further lowered by the State Council during the subsequent years with the most recent one promulgated at the end of 2016. In most cases, establishment of an FIE now only requires a record filing with the local level NDRC. The table below sets out the NDRC approval thresholds:

Industry	Investment Amount	NDRC Approval
Restricted industry	US\$2 billion or above	Central NDRC Filing with the State Council
	US\$300 million – US\$2 billion	Central NDRC
	Less than US\$300 million	Provincial government
Certain projects which require government approval for fixed assets investment by either foreign or domestic investors  (such as certain infrastructure projects)	Regardless of the amount	Approval/Filing with central or local NDRC
Any foreign investment project other than the above: record-filing with local municipal or lower-level NDRC		

Note that the above NDRC approval or record-filing requirements apply to either greenfield FIE projects, capital increase of existing FIEs or foreign merger and acquisition ("**M&A**") transactions. The investment amount listed in the table above refers to total investment for a greenfield project, the increased amount for capital increase or acquisition price for an M&A deal.

### INCORPORATION APPROVAL BY/FILING WITH MOFCOM

Since October 2016, the three-decade-long MOFCOM approval regime for the establishment of FIE has been replaced with a simplified filing system for foreign investments in sectors that are not covered in the Negative List.

Due to such reform, MOFCOM is now responsible for reviewing and approving the incorporation of FIEs that fall within the Negative List, as well as the filing of the incorporation of other FIEs.

For FIEs that are subject to MOFCOM approval, its constitutional documents, such as the articles of association and joint venture contract, need to be

submitted to MOFCOM for review, and are only effective once approved.

Whether foreign investors should obtain approvals from the central or local level of MOFCOM

depends on the amount of investment they make. The following table shows the jurisdiction of MOFCOM and its local branches regarding approval of foreign investment projects:

Industry	Total Investment Amount	MOFCOM Approval
Restricted industry	US\$100 million or above	Central MOFCOM
	Less than US\$100 million	Provincial or lower-level MOFCOM

Once the project is approved, MOFCOM or its local branch will issue an approval reply and an approval certificate.

The MOFCOM filing process is much more straightforward, which can be done together with the registration with SAMR. For filing purpose, aside from the basic information of the company and its investor(s), the FIE is required to disclose its ultimate controller (either an individual, a listing company or a governmental organ) and submit the organization chart showing the shareholding information from the FIE up to its ultimate controller. A filing receipt will be issued after the filing process is completed.

### INDUSTRY REGULATORS

Apart from NDRC and MOFCOM, which are the main approving authorities, other government departments may be involved in the approval procedure, particularly where there are limits on entry by foreign investors into a specific industry. For example, pre-approval from the public security authority is needed for investment in security service industry. Pre-approval is also required from China Securities Regulatory Commission for investment in security companies.

In recent years, a number of pre-approvals (such as the drug production approval and the food operation approval) are no longer required to be obtained before the incorporation. Instead investor should obtain a business licence first and then apply for such approvals before the FIE actually commences relevant business.

### REGISTRATION WITH SAMR

After obtaining the required pre-approvals (if any), investors will need to register the FIE with SAMR or its local branch, for the issuance of a business licence. The issue date specified on the business

licence is the date of incorporation of the FIE.

All business entities should maintain records of corporate documents and basic information – including those regarding directors and shareholders – with SAMR or its local branches. Companies are required to complete an on-line filing with SAMR annually, providing its basic information and information related to its employees, and certain statistics on its financial statements. The basic information of the company filed is available for public inspection at a website maintained by SAMR.

SAMR and its local counterparts also oversee initial approvals for investment in special industries such as advertising.

## Post-Incorporation Approval and Registration

Once the FIE's business licence has been issued, the FIE is required to complete various post-incorporation approvals required by industry regulators (if any) and other registrations including tax landing, foreign exchange registration and customs registration.



Chapter 04  
Forms of Business  
Vehicle and Common  
Incorporation Issues

# Forms Of Business Vehicle

## GENERAL

After the *Foreign Investment Law* comes into force on 1 January 2020, the corporate structure of FIEs in China will generally follow the *PRC Company Law* and the *PRC Partnership Enterprise Law*, and take the form of a limited liability company, a company limited by share or a partnership enterprise.

This is one of the major changes introduced by the *Foreign Investment Law*. Previously foreign investment in China was typically formed as either a joint venture ("JV") or a wholly foreign-owned enterprise ("WFOE") before the effectiveness of the *Foreign Investment Law*. A JV may be either an equity joint venture ("EJV") or a co-operative joint venture ("CJV"). Therefore, FIEs established before 31 December 2019, especially JVs, are required to be re-structured according to the new law during a five year transitional period starting from 1 January 2020.

## FOREIGN-INVESTED LIMITED LIABILITY COMPANY

A limited liability company may be set up by up to fifty foreign investors. The investor's liability towards the company will be limited to the registered capital subscribed by such investor.

Where there is more than one foreign investor, it is more common to establish an offshore JV – which will then set up a limited liability company in China, as this allows more flexibility in structuring and exit.

Foreign investors should be aware that although a limited liability company wholly owned by foreign investors may be established in a wide variety of industry sectors, some sectors still remain unavailable for 100 % foreign ownership, e.g., telecommunications, car manufacturing, hospitals (except in certain pilot areas), and mining, in which case the FIE must be established together with Chinese partners.

## FOREIGN-INVESTED COMPANY LIMITED BY SHARES ("FICLS")

Foreign investors may also establish an FICLS with Chinese investors in China. An FICLS must have at least two promoters and at most 200 promoters.

An FICLS is mainly set up for the purpose of listing. Subject to the satisfaction of various listing

conditions and the government's approval, an FICLS may be listed on a recognised stock exchange in China to issue A shares or B shares, and may also be listed in overseas stock exchanges.

## FOREIGN-INVESTED PARTNERSHIP

Two or more foreign individuals or corporate investors may set up a foreign-invested partnership in China, with or without a Chinese individual or corporate investor.

A foreign-invested partnership may take the form of either a general partnership, or a limited liability partnership. In a general partnership, the partners are jointly and severally liable. In a limited liability partnership, there is at least one general partner with unlimited liability and other partners whose liabilities are limited to their capital contribution.

No pre-approval from MOFCOM or NDRC is required for establishing a foreign-invested partnership. Registration of the partnership with local branches of SAMR is needed.

There are a few other special investment vehicles for foreign investors:

### A. FOREIGN-INVESTED HOLDING COMPANY ("FIHC")

A foreign company with multiple investments in China may establish a foreign-invested holding company to serve as an onshore holding company.

An FIHC may take the form of either a limited liability company or an FICLS. Higher investment thresholds, and qualification requirements, are set by the laws and regulations for setting up an FIHC. The minimum registered capital of an FIHC is US\$30 million. The foreign investor must either:

- i. have total assets of no less than US\$400 million in the preceding year and have already invested in FIEs with total paid-up registered capital of US\$10 million or more; or
- ii. have already established more than 10 FIEs in China and contributed more than US\$30 million as registered capital of such FIEs.

An FIHC may serve as an investment platform in China for its group companies, and can use its registered capital for capital investment within China. It may also provide various services to the FIE it has invested in China, such as purchasing machinery and equipment, after-sales service,



training to employees, assisting in obtaining loans, establishing R&D centres.

An FIHC may be recognized as a regional headquarter if it satisfies relevant criteria in terms of the contributed capital, assets and annual revenue. A regional headquarter would normally be granted with certain incentives according to local policies and may have a wider business scope than a normal FIHC.

## B. VENTURE CAPITAL AND PRIVATE EQUITY FUND

Two forms of investment vehicles are available for foreign investors and they are aimed at setting up an Renminbi ("**RMB**") fund and making equity investments in China, these are: a foreign-invested venture capital enterprise ("**FIVCE**"), or a foreign-invested equity investment enterprise ("**FIEIE**").

### i. Foreign-invested Venture Capital Enterprise ("**FIVCE**")

Establishment of an FIVCE is allowed nationwide. Subject to approval of MOFCOM, foreign investors may set up an FIVCE, with or without Chinese partners. An FIVCE may be set up in a corporate form or a form of non-legal person (such as a partnership). The fund is a Chinese enterprise and its investments are denominated in RMB. As required by the law, an FIVCE should primarily invest in private portfolio companies in high technology industries.

If an FIVCE invests in portfolio companies in the "encouraged" or "permitted" industries, no prior governmental approval is required – a record-filing procedure is needed. However, if the portfolio company is in the "restricted" industry, relevant approval applicable to the usual foreign investments must be obtained.

### i. Foreign-invested Equity Investment Enterprise ("**FIEIE**")

Unlike FIVCE, that is available across the nation, an FIEIE is only permitted in a limited number of pilot cities, including: Beijing, Shanghai, Tianjin, Chongqing and Shenzhen. In 2017 and 2018, Guizhou Province, Pingtan and Zhuhai became new pilot areas for FIEIE. These cities/provinces have issued their respective local rules in regulating the establishment and operation of FIEIE. The establishment of an FIEIE would normally be reviewed on a case-by-case basis.

Shanghai probably has the most developed rules in respect of the FIEIE. Under Shanghai local rules, an FIEIE may be set up by foreign enterprises or individuals, as a partnership or other forms. However, the Shanghai rules expressly provide that an FIEIE cannot invest in real estate other than for its own use, nor can they trade listed stocks, corporate bonds (with some exceptions), trade futures or other financial derivative products. According to an official reply issued by NDRC regarding FIEIE's investment, an FIEIE's investment in portfolio companies is still subject to the sector restrictions set out in the Negative List.

## C. REPRESENTATIVE OFFICES

A representative office is not an independent legal person and thus cannot engage in direct business activities. It may only conduct liaison, information gathering and market research for its parent company. The number of representatives (including the chief representative) for each representative office is limited to four. Setting up representative offices in China was once a popular option for foreign companies, since the process was relatively quick, when compared to setting up a WFOE, and there is no capital requirement. However, with restrictions on foreign investment being relaxed, and the procedures for setting up a WFOE now streamlined, representative offices have become less attractive, given the limitations on the functions they can perform.

The establishment of a representative office does not require government pre-approval in the case of most industry sectors. It is only necessary to carry out registration with the local branches of SAMR. For certain special industries, such as aviation, securities, and insurance, pre-approvals must first be obtained from the government authorities in charge of the administration of the relevant industry, before registration with SAMR. Representative offices are not permitted to recruit Chinese employees directly and must do so through one of the government sponsored recruitment agencies.

## D. BRANCH OFFICES

Setting up branches by foreign companies is not usually permitted, except for certain industries such as banking and insurance; although, a FIE is generally allowed to set up branch offices in the place it would like to conduct business. Similar to a

representative office, a branch office does not have independent legal person status, and its parent company or head office will be held liable for all of its business activities in China.

### E. OTHER FORMS TO CONDUCT BUSINESS

In addition to setting up their own presence in China, another option for foreign investors is to conclude business contracts with Chinese parties, including domestic Chinese companies and FIEs, and to perform work under or provide services in accordance with the terms of such contracts.

Foreign investors may engage in exploration and exploitation of oil and gas in China by entering into co-operation contracts with designated Chinese companies. Foreign investors may also conduct other business activities: exploration of oil and mineral resources, engineering contracting – by entering into management or service contracts with their Chinese counterparts. After entering into the above contracts, the approval from relevant industry administration authorities (if applicable), must be obtained, and registration must be completed with SAMR, or its local branches, before commencing operations.

### REGISTERED CAPITAL AND TOTAL INVESTMENT

Registered capital is the amount of equity that investors hold in an FIE, and such equity plus debt amounts to the FIE’s total investment. The amount of both the registered capital and total investment is subject to government approval.

The Chinese laws prescribe mandatory ratios between registered capital and total investment:

Total Investment ("TI")	Minimum Registered Capital
US\$3 million or less	70%
Over US\$3 million and up to USD10 million	50%
Over US\$10 million and up to USD30 million	40%
Over US\$30 million	33.3%

The difference between the registered capital and total investment is the headroom of foreign debt that an FIE may borrow under the traditional foreign debt regime. Alternatively, an FIE may opt to a newly introduced foreign debt regime, in which case the maximum foreign debt that an FIE may borrow would be calculated based on its net assets value.

### CAPITAL CONTRIBUTION

Previously, under Chinese laws, a limited liability company was subject to a minimum registered capital of RMB 30,000, and such threshold for a single-investor company was RMB 100,000 and RMB 5 million for a company limited by shares. These thresholds were removed in March 2014

## Common Incorporation Issues

### BUSINESS SCOPE

FIEs in China are required to have a defined business scope, which is set out in their constitutional documents. FIEs are only permitted to engage in business activities within the approved scope. Operating beyond the business scope may result in penalties, such as administrative fines, confiscation of illegal income, and in the worst cases, revocation of the business licence.

While having too narrow a business scope may unnecessarily restrict the FIE’s business development, too broad a business scope may also not be practical, as it may be difficult to obtain the government’s approval. A FIE’s business scope is usually one industry sector or several related sectors. Investors may refer to the Industrial Classification for National Economic Activities for a description of activities in any specific industry that may be used in the business scope.

when the new *Company Law* went into effect. In theory, foreign investors may now set up a “one-dollar” company in China. However, as an FIE’s registered capital and total investment should correspond to its business scale, and since these figures are subject to government approval, it is always advisable to set the registered capital at a

reasonable and realistic amount which matches the FIE's business plan. It is also worth noting that shareholders will be liable for the FIE to the extent of the subscribed registered capital rather than the paid-in capital. Therefore shareholders should avoid setting an unreasonably high registered capital which will increase the liability exposure for the shareholders.

## CORPORATE GOVERNANCE

### *a. Legal Representative*

Each company in China, including FIEs, must have a legal representative, an individual who executes his/ her functions and powers on behalf of a company in accordance with Chinese laws and the company's articles of association. The chairman of the board of directors of the FIE is usually the legal representative. The executive director (under a sole executive directorship system for a small scale company) or the general manager of a company may also be appointed as the legal representative.

The legal representative has the statutory power to represent the company and his/her act binds the company with regard to third parties.

The legal representative as a senior executive owes a duty of loyalty and a duty of care to the company. Under certain circumstances, he/she can be held civilly liable to the company if his/her act as the legal representative have violated certain laws or the articles of association and caused damage to the company.

### *b. Shareholder, board of directors, supervisors and management*

The shareholders' general meeting, or the shareholder alone, in the case of a sole investor, is the highest management authority of the company. Shareholders exercise their voting rights in proportion to their respective shareholdings ratios.

The company must also set up a board of directors, or if the company has relatively few investors, it may instead set up a sole executive directorship where there is only one executive director.

For Chinese-foreign JVs established before 1 January 2020, the board of directors is the highest management authority, except in the case of an unincorporated CJV where the joint management committee is the highest authority. JV partners will need to re-consider and negotiate how their JV

should be restructured, and reach an agreement within the aforementioned five year transitional period.

An FIE is required to have one supervisor or a board of supervisors, consisting of at least three members. The supervisor plays a similar role to the independent director on the board of directors of a listed entity – the supervisor is responsible for supervising the directors and senior executives of the FIE in the exercise of their functions. A director or senior executive may not concurrently serve as a supervisor. The supervisor does not need to be a Chinese national or reside in China.

An FIE may also have senior management personnel such as a general manager, a deputy general manager, and a finance manager.

Directors, supervisors and senior management owe a fiduciary duty to the company, and are prohibited from using their position for personal gain. They should not misappropriate company funds, or engage in any businesses, which compete with those of the company.



# Chapter 05 Finance and Security

# Finance

## EQUITY FUNDING

As discussed in Chapter 3 "Approval, Filing and Registration" and Chapter 4 "Forms of Business Vehicle and Common Incorporation Issues", when a foreign company establishes an FIE, it must apply to the approval authority for approval of the FIE's total investment and registered capital. Registered capital is the amount of equity that investors hold in the FIE, and such equity plus debt amounts to the FIE's total investment. Both the amount of total investment and registered capital of an FIE may be changed subject to authority's prior approval, but the ratio that registered capital bears to the total investment must at all times satisfy relevant mandatory standards set by State Administration for Industry and Commerce (or known as State Administration for Market Regulation since 2018).

While registered capital is generally contributed by foreign investors from their own funds, however, it may also be arranged through borrowing from outside China. Profits, liquidation proceeds, and recouped investment from another existing FIE or company, in which a foreign investor has invested, may also be reinvested in the FIE itself or in another investee company, in the form of fresh or increased capital contribution.

In addition to private fund-raising for registered capital, FIEs are also eligible to be floated in Chinese capital market provided they are founded or re-organized as joint stock companies in accordance with Chinese company law and observe the procedures prescribed by security law and regulations promulgated by China Securities Regulatory Commission.

## INDEBTEDNESS

### a. Foreign exchange loans

An FIE is permitted to borrow foreign debt up to the approved debt portion of the total investment – i.e., the total investment less registered capital – often referred to as the "borrowing gap". If an FIE wishes to borrow more foreign loans than the approval amount, it must apply to the approval authority for approval, and the registered capital must be increased in proportion to the increased debt portion. An FIE may seek shareholders' loans in foreign currency – from its offshore

shareholder(s) or commercial loans in foreign currency from both domestic and overseas lenders. Such foreign exchange debts are required to be registered with the State Administration of Foreign Exchange ("**SAFE**"), or its local counterparts. Registration must also be updated as each installment of the foreign exchange loan is repaid.

### b. Domestic RMB and cross-border RMB loans

An FIE may borrow RMB loans or enter into an RMB facility agreement with domestic banks. With approval from the People's Bank of China ("**PBOC**") and MOFCOM, an FIE may also issue RMB-denominated bonds outside China, known as "dim-sum bonds" in Hong Kong, and then remit the funds raised from such issuance back to China to finance its operations.

The offshore shareholders loans borrowed by an FIE may also be denominated in RMB, provided that such offshore RMB funds satisfy the legitimacy test set by PBOC and MOFCOM, under the relevant rules.

### c. Interest rate regulation

Historically the interest rate was strictly regulated by PBOC and banks in China may only set interest rate for loans within the range calculated against the base interest rate published by PBOC. Such restriction, however, has been removed as China implements interest rate marketisation reform, which enables commercial banks to set interest rates for loans according to market conditions. For loans between individuals and companies, parties have general discretion in determining interest rates, provided that such rate does not exceed 24% per annum, which is not illegal but would be unenforceable in court, or exceed 36% per annum, which would be regarded as usury and be void.

# Security

## GENERAL

The principal legislation governing permitted types of security and their operation includes the PRC Security Law ("**Security Law**") and the PRC Property Law ("**Property Law**"). *The Judicial Interpretation of the Supreme People's Court on Certain Issues Relating to the PRC Security Law* also sheds useful light on points that often arise when implementing the Security Law.

The *Security Law* recognises the following forms of security:

### 1. Guarantees

A guarantee is a security arrangement between a guarantor and a creditor, under which the guarantor will "step into the shoes" of the debtor, if the latter fails to repay a debt to the creditor. Under the *Security Law* – a government authority; a public entity such as a school, hospital or similar entity; a branch of a company, except to the extent of written authorisation by the head office of such company – may not act as a guarantor.

The scope of a guarantee includes repayment of principal, interest, damages, compensation for losses and costs, and expenses relating to enforcement.

### 2. Mortgages

A mortgage is a security arrangement, under which the possession of the security does not transfer to the creditor, and the secured creditor has the right to have the security sold and receive the secured amount from such sale, if the debtor defaults on the loan repayment.

A mortgage may be created based on various forms of property including land use right, real estates, ships, vehicles and the equipment and machinery owned by a company. Registration is often one of the perfection requirements of mortgages, some of which must be registered with relevant authorities to become effective – for instance the mortgage of a land use right and real estate. Where registration is available although not compulsory, registered mortgage holder will enjoy priority against any competing unregistered mortgage on the same property.

### 3. Pledges

A pledge is a security arrangement, under which a debtor delivers the possession of a movable property to the creditor as security.

The *Security Law* also recognises a pledge created on transferable rights and interests, including: bills of exchange, cheques, bank drafts, bonds, deposit certificates, warehouse slips, bills of lading, shares, equity interests, intellectual property rights, insurance policies, and accounts receivable. All such pledges created on transferable rights, and

interests must be registered with relevant registration authorities to become effective.

### 4. Liens

A lien is a right of a creditor to retain an obligor's moveable property which has already been lawfully possessed by the creditor as a security in cases where the obligor fails to perform its obligation. Unlike mortgages and pledges, liens are created by law once the aforesaid criteria are satisfied even without any contractual agreement between the creditor and the obligor.

### 5. Deposits

A debtor may agree to deposit a sum of money with a creditor as security for another obligation that the debtor owes to the creditor. If the debtor performs such obligation, the money must be credited towards the obligation or refunded to the debtor by a debtor. The amount of the deposit should not exceed 20% of the total obligation owed to the creditor.

## Cross-Border Security

Over the past two decades, provision of cross-border security is generally subject to approval and registration with SAFE. Effective from 1 June 2014, a set of new regulations including, the Provisions on Foreign Exchange Administration of Cross-Border Security, and related implementation guidelines, have been introduced to overhaul the previous regime.

Under the new regime, only the following two types of specific cross-border security require registration with SAFE:

- *Neibaowaidai* ("NBWD"): security/guarantee provided by an onshore security provider for a debt owing by an offshore debtor to an offshore creditor. Where the onshore security provider/guarantor is a bank, relevant transaction is reported with SAFE through official data transfer program. Where the onshore security provider/guarantor is a non-bank entity, it must register with SAFE or its local counterparts within 15 business days upon execution of the security/guarantee.
- *Waibaoneidai* ("WBND"): security/guarantee provided by an offshore security provider for a debt owing by an onshore debtor to an onshore

financial institution, which will report the relevant transaction with SAFE through official data transfer program. Where the onshore debtor defaults and the offshore security provider/guarantor is required to perform its obligations under the security/guarantee, the onshore debtor must register with SAFE or its local counterparts the current foreign liability thus incurred.

For cross-border security which does not constitute NBWD or WBND, there is no longer any SAFE approval, registration or filing requirement, e.g., cross-border security provided by an onshore entity (e.g., an FIE) for its own debt obligations is not required to be registered with SAFE.

Previously, SAFE approval, registration, and/or filing, were mandatory in order to create a valid cross-border security. Under the new regime, cross-border security will not be rendered invalid by reason of non-compliance with SAFE regulatory requirements or failure to comply with SAFE approval, registration or filing requirements. However, failure to register NBWD or WBND will affect enforcement of the security or guarantee.



# Chapter 06 Foreign Exchange



China has a strict foreign exchange control policy. The *Regulations of the PRC on Foreign Exchange Administration* (“**Forex Regulations**”), were amended by the State Council on 5 August 2008. SAFE and its local counterparts are the government authorities in charge of regulating all aspects of foreign exchange in China.

## Foreign Exchange Registration

Pursuant to the Forex Regulations, and other relevant foreign exchange rules issued by SAFE: after a FIE is approved and established in China, it needs to complete foreign exchange registration with SAFE before it may conduct foreign exchange transactions. Since June 2015, an FIE may choose at its own discretion any bank at its place of incorporation to complete such foreign exchange registration.

Once an FIE completes its foreign exchange registration, relevant information is kept in a computerised foreign exchange monitoring system, which is mainly accessible by SAFE and banks handling foreign exchange transactions, for various regulatory and daily management purposes. At present, FIEs have very limited access to this system, save for annual filing and reporting purposes.

A FIE is permitted to open multiple foreign exchange bank accounts, to be used for the contribution and withdrawal of capital funds for operational purposes at multiple localities, where necessary.

## Current Account And Capital Account Transactions

### CURRENT ACCOUNT TRANSACTIONS

For the purpose of foreign direct investment, current account transactions include fund transfers or payments for imported goods and services, re-payments of foreign exchange loans made by domestic banks and related interest, and profit distributions. There is no restriction on current account transactions under the Forex Regulations. Generally, payments in foreign exchange, for a current account transaction, can be directly made through a FIE’s bank account after review by the

relevant bank, without prior approval of SAFE.

### CAPITAL ACCOUNT TRANSACTIONS

For the purpose of foreign direct investment, capital account transactions include, among others, payment of registered capital, cross-border fund borrowings and debt repayments, and transfers of ownership of fixed assets.

Various types of capital account transaction must be registered with SAFE. These include:

- Signing a loan agreement with any offshore entity or individual.
- Provision of security by a FIE for a debt owed by an offshore debtor to an offshore creditor, i.e., NBWD.
- Borrowing funds by a FIE from an onshore financial institution, where security is provided by an offshore entity, i.e., WBND, for which the onshore financial institution shall report relevant data to SAFE. The FIE will be required to complete relevant foreign debt registration if the offshore security provider has performed the repayment obligation.

### CONVERSION OF FOREIGN EXCHANGE IN THE CAPITAL ACCOUNT

The administrative regime for conversion and use of foreign exchange in an FIE’s capital account has also undergone reform in recent years.

Previously, conversion of foreign exchange capital fund can only be made when there is a real need for RMB payments, and in an amount that is actually required. Since 1 June 2015, theoretically an FIE is allowed to convert up to 100% of the foreign exchange in its capital accounts into RMB at any time. However, SAFE still retains the right to adjust the ratio of the capital fund that can be converted.

Most FIEs are prohibited from using RMB converted from the capital account balance for making an equity investment, security investment or purchasing real estate, unless its business scope allows it to do so.

## Foreign Direct Investment In Offshore RMB

Foreign investors are permitted to use “legitimately obtained” offshore RMB to make new or additional capital contributions to their FIEs, pay the

transaction price for acquiring equity or assets of onshore companies, or provide shareholder loans to their onshore subsidiaries. Legitimate sources of such offshore RMB funds include: RMB-denominated payments received by foreign companies from Chinese purchasers for imported goods; proceeds from offshore issuance of RMB-denominated bonds or shares; repatriated RMB that foreign investors have received from profits distributed by onshore subsidiaries, transfers of onshore equity/asset holdings, reduction in onshore capital or liquidation of assets; and investment recouped ahead of Chinese parties in the case of a CJV.



Chapter 07  
Acquisitions,  
Mergers and Division

A foreign investor may acquire an existing company in China if the target company is engaging in an industry open to foreign investment, and the percentage of foreign shareholding in the target company, after the transaction, complies with any applicable statutory restriction.

## Acquisition of Private Companies

Pursuant to the *Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors* ("**M&A Regulations**"), foreign investors may acquire equity in a domestic Chinese company by purchasing equity from any existing shareholder, or subscribing for the increased registered capital of the target company. The acquisition will result in the conversion of the target domestic company into an FIE. Foreign investors may also acquire the equity in an FIE. The M&A Regulations are equally applicable, unless otherwise specified in regulations applicable to FIEs.

### APPROVALS, FILING AND REGISTRATION

The acquisition of a company in China by a foreign investor is subject to, and will only become effective upon, approval by MOFCOM, or its local counterparts, if the target company engages in restricted business or if the acquisition is between two affiliated companies. Otherwise, the acquisition only needs to be filed with MOFCOM. An approval or record filing with NDRC, or its local counterpart, may also be required. Please refer to Chapter 3 "Approval, Filing and Registration", for details regarding approval thresholds.

If the acquisition results in change of control of the target company, and specific turnover thresholds are met, the acquisition may also be subject to the anti-monopoly review pursuant to the *Anti-Monopoly Law of PRC*. In addition, if the government authority considers the acquisition involves state security, a national security review process may be triggered. Please refer to Chapter 10 "Antitrust & Competition" for further information.

Once the acquisition is approved (if required) or filed, it needs to be registered with local AIC, and a new business licence for the target company will be issued. Other subsequent registrations will be required, such as registration with the tax authority,

and customs administration and foreign exchange authority, to effect necessary changes to the target company.

## Payment

### PAYMENT SCHEDULE

As a mandatory rule under the M&A Regulations, payment of the transaction price must be made in full within three months of the new business licence of the targeting company being issued. Subject to approval, this deadline may be extended to the effect that at least 60 percent of the transaction price is paid within six months, and the remainder is paid within one year after issuance of the new business licence.

### SHARE SWAP

As an alternative to cash payment, a foreign investor may use shares in an overseas listed company, to pay the purchase price – a share swap. However, certain conditions under Chinese law must be satisfied, including: stability of the trading price of the shares used as consideration during the year preceding the acquisition, and the production of a due diligence report by a registered Chinese financial adviser on the overseas listed company.

Acquisition of the equity in companies will be subject to the consent of more than half of the non-selling shareholders, and the non-selling shareholders have a pre-emptive right to acquire the sale equity.

## Acquisition of State-Owned Enterprise

If the foreign investor acquires equity of a state-owned enterprise ("**SOE**") or assets owned by an SOE, in addition to the approval, filing and registration specified in the section "Acquisition of Private Companies" above, there are extra requirements for the foreign investors to follow.

Under the *Measures for the Supervision and Administration of the Transactions of State-Owned Assets of Enterprises* issued in June 2016, the transferor must engage a qualified accounting firm to audit the target company, and if required by law, a qualified asset valuation company must be appointed to carry out valuation of the state-owned equity or assets. The valuation result must be

approved by, or filed with, the appropriate level of the state-owned assets supervision and administration authorities, it shall be used as a reference for the determination of the transfer price of the state-owned equity interest or assets. Moreover, the sale of state-owned equity interest or assets to foreign investors must be conducted through an open market process.

## Acquiring Shares of Chinese Public Companies

Shares in Chinese companies listed on the Shenzhen or Shanghai stock exchanges are classified into "A" shares and "B" shares. "A" shares may only be sold to Chinese persons, qualified foreign institutional investors ("**QFIIs**"), and qualified foreign strategic investors. "B" shares may be sold to Chinese or foreign persons.

QFIIs may trade "A" shares on Shenzhen or Shanghai stock exchanges. To qualify as a QFII, certain requirements must be satisfied, such as operation term in relevant industries, a minimum amount of assets under management – at least US\$5 billion for securities companies and commercial banks; US\$500 million for fund management companies, insurance companies and other institutional investors, a sound corporate governance structure and risk management system, and qualified personnel. CSRC approval is required to qualify as a QFII. A foreign exchange quota is allocated by SAFE to each QFII.

In addition to QFIIs, qualified foreign strategic investors are also permitted to invest in "A" shares. Various requirements must be satisfied to qualify as a strategic investor, such as a minimum amount of overseas assets – at least US\$100 million of overseas assets owned by the investor or its parent company, or US\$500 million of overseas assets under management by the investor or its parent company, a sound corporate governance structure and risk management system. Investment by the strategic foreign investors is subject to MOFCOM's approval or filing. The initial investment must generally be at least 10 percent of the shares. The shares held by strategic foreign investors are subject to a three-year lock-up period.

## Offshore Structure and Assets Deals

Where appropriate, foreign investors may also consider acquiring the offshore holding company of the target company (Offshore Transaction), or acquiring assets owned by the target company (Assets Deal).

The major advantage of an Offshore Transaction is that generally no Chinese government approval is required – except for merger control, national security review, and tax review. Other restrictions, such as the three-month payment deadline under the M&A Regulations, and the requirement to obtain consents from all the other non-selling shareholders of the target company, can be avoided. On the other hand, an Offshore Transaction may not be a practical option if an offshore structure does not already exist. If restructuring is needed for the Chinese seller to set up the offshore holding company, approvals from MOFCOM and SAFE may be required. Restructuring can be time-consuming, and extra due diligence is also required on the offshore structure set up by the Chinese shareholders.

In respect of an Assets Deal, the foreign purchaser needs to use an existing FIE, or establish a new FIE to buy and operate the assets. The main advantage of an Assets Deal is that the foreign purchaser will not assume the existing liabilities of the target company. However, certain assets, such as qualifications and licences held by the target company are generally not transferrable. The tax burden of an Assets Deal is usually heavier than that of an equity deal.

# Chapter 08

# Acquisition and Ownership of Land and Real Property



## Land Ownership

Land in China is either state-owned or rural collective entity-owned, depending on locations. Land in urban areas of a city is state-owned. Land in rural areas of a city and all rural land is, unless otherwise specified by the law, owned by the rural collective entity. No land may be owned by individuals, enterprises and other organisations; however land use rights can be granted to or acquired by these individuals, enterprises or organisations, and they are permitted to hold, lease and develop such land.

## Acquisition of Land Use Rights

Land use rights mean the rights to use a piece of land in China for a term of years, in accordance with a set of conditions of use. Land use rights are initially acquired either by compensatory grant from a land bureau at the level of municipality or county, or allocation by a land bureau at the level of county or above, without payment of land premium. After the initial acquisition of land use rights through compensatory grant, such compensatory land use rights may, subject to certain conditions stipulated by the law, be transferred to subsequent users. Allocated land use rights cannot be transferred, assigned or let.

### COMPENSATORY GRANTS

Except for land use rights that may be obtained through allocation, without payment of land premium pursuant to Chinese laws and regulations, land use rights must be obtained by compensatory grant initially from a land bureau. Upon payment in full of the land premium, the land use rights owners are entitled to register their land use rights, and obtain a land use rights certificate that will evidence ownership. There are two ways in which land use rights may be granted, namely by private agreement with the local land bureau or by competitive process – i.e., tender, auction or listing for sale at a land exchange, administered by the local land bureau.

Land to be used for industrial purpose, commerce, tourism, entertainment and commercial or residential housing, must be granted by way of tender, auction or listing for sale. If a land parcel is designated for purposes other than those set out above, and there exists only one prospective purchaser,

the land use rights may be granted by way of private agreement with the local land bureau.

Otherwise, the land use rights must still be granted by way of tender, auction or listing for sale.

The maximum term of land use rights for different purposes is as follows:

- 70 years for residential purposes
- 50 years for industrial purposes
- 50 years for the purposes of education, science and technology, culture, health and sports
- 40 years for commercial, tourism and recreational purposes
- 50 years for comprehensive utilisation, or other purposes

Land use rights owners are obliged to strictly observe the land use conditions prescribed in the land grant contract: including plot ratio, site coverage, height restriction, planning parameters, development restrictions, and time limits for commencement and completion of the construction work. A land parcel that remains idle after the prescribed commencement date of development may be subject to idle land fines, or even re-entry by the government without compensation.

Subject to compliance with the terms and conditions of the land grant contract, a land use rights owner may lawfully transfer, mortgage or lease its land use rights to a third party for the remainder of the term of the grant.

Land use rights will terminate upon expiry of the land use term granted. The state generally will not terminate land use rights before the expiration of the term granted, unless the land is required for public interest reasons – in which case the state shall offer proper compensation and refund the corresponding land premium to the land use rights owner, having regard to the specific circumstances and the length of the remainder of the term.

Land use rights for residential property shall be renewed automatically upon expiry of the term of the grant. The renewal of construction land use rights for non-residential property shall be subject to the approval of the government according to Chinese laws.

Upon expiration of the term of the grant, renewal may be granted, subject to the execution of a new contract for the grant of land use rights and the

payment of a premium. If the term of the grant is not renewed, the land use rights, and ownership of any buildings erected on the land, will revert to the state without compensation. However, if there is any agreement between the land user and the land bureau on the ownership of buildings, and other immovable on the land, such agreement shall prevail.

## LAND USE RIGHTS OBTAINED BY WAY OF ALLOCATION

Certain land use rights may be allocated without payment of land premium. This is where the land is used by or for:

- Government authorities and military purposes
- Urban infrastructure and public interests
- Energy, transportation, and water conveyance construction projects supported by the state
- Either purposes as provided for by laws and regulations

Allocated land use rights are non-transferable and may not be let or mortgaged by the land user, without approval from the government. In the event of any proposed transfer, allocated land use rights should first be converted into compensatory land use rights, by signing a land grant contract with the land authorities and paying the land premium.

## LEASE OF LAND

Other than land use rights acquired through compensatory grant or allocation, the land user may obtain land use rights for a fixed term through land lease according to applicable law and subject to the terms and conditions of land lease agreement between the land user and a land bureau at the level of county or above. As lessee, the land user shall pay land rent as required by land lease agreement. However, such leased state-owned land shall not be used for commercial real estate development.

State-owned land lease is categorized into two types, the short-term lease and the long-term lease. The term of land use rights obtained by short-term lease is capped at five years while the term of land use rights obtained by long-term lease is stipulated in the land lease agreement and capped at the longest term of compensatory-granted land use right for the same land. The land use rights obtained by land lease could be

sub-leased, transferred or mortgaged subject to the stipulations of the land lease agreement or the consent of the local land bureau. Provincial regulations may stipulate specific rules on sub-lease, transfer and mortgage of land use rights obtained by land lease. The land user of some specific sectors could use State-owned land through long-term lease, compensatory grant after lease or combination of lease and compensatory grant.

State-owned land may be leased by private agreement with the local land bureau or by tender and auction, and if possible, should be leased by tender and auction. However, other than national rules, provincial and local municipal rules are also applicable to State-owned land lease and may provide specific rules. For example, the relevant provincial rules in Zhejiang requires that all land use rights obtained by land lease must be obtained by competitive process, i.e. tender, auction and listing, except in some circumstances.

## TRANSFER OF COMPENSATORY LAND USE RIGHTS

Compensatory land use rights may be transferred, subject to the satisfaction of certain statutory requirements – as discussed in the paragraph below – from one owner to its transferee, by entering into a transfer contract. Upon a transfer of compensatory land use rights, all the rights and obligations of the transferor in relation to the land, shall be transferred to the transferee including those set out in the land use rights grant contract.

Compensatory land use rights may not be transferred unless the following statutory requirements are satisfied: at least 25% of the total investment for the relevant construction project, excluding the land premium, have been expended; the land premium has been paid in full; the transferor has already obtained a land use rights certificate for the land.

## Usage of the Land

Land use rights owners are required to use the land pursuant to the purpose specified under the land use rights grant contract. No land use rights owners may change the purpose without the prior consent of the authorities in charge of the land, urban and rural planning. Unauthorised change of the designated purposes may result in re-entry by the government without compensation.



## Property Ownership

Before 2015, property ownership was evidenced by property title certificates, while a land use rights certificate records the right of the property owner to use the underlying land use rights. In some cities, such as Shanghai, property owners were issued with a combined real estate certificate that records both the property title, and the ownership of the underlying land use rights. However, from 2015, a nationwide uniform combined real estate certificate records both property ownership and the underlying land use rights, although property title certificate and land use rights certificate issued before 2015 still remain valid and the property owners are not required to change to the new uniform real estate certificate.

## Pre-Sale and Sale of Real Property

When developers build property for sale, there are clear guidelines on how the sale should be conducted.

Prior to the completion of construction, a developer may be allowed to "pre-sell" its incomplete properties through a process called a "pre-sale", by obtaining a pre-sale permit and entering into pre-sale contracts with purchasers. The developer shall file the pre-sale contracts with relevant authorities in charge of administration of real estate development and land.

After the completion of construction, and with the issue of the land and property title certificate relating to the entire development, a developer can sell its development without further approval process by entering into sale and purchase contracts with purchasers.

In order to obtain a pre-sale permit, all of the following conditions must be met:

- The land premium has been paid in full and the relevant land use rights certificate has been obtained.
- The Construction Works Planning Permit and the Work Commencement Permit have been issued.
- In respect of the development to be put on pre-sale, no less than 25% of the total investment of the development project has already been expended, and the construction schedule and completion date have been confirmed.

These conditions may vary from place to place, as local government authorities may impose more stringent conditions for a pre-sale permit.

## Property Acquisition by Foreign Investors

A foreign investor intending to acquire a property in China may opt to acquire property or, where the target is a company, an equity interest in an existing property owner. When acquiring property, the foreign investor must incorporate a real estate FIE as the buyer, which is subject to the examination, approval and filing formalities with the relevant authorities, and compliance with the statutory total investment/registered capital ratio.

Due to austerity measures introduced by the government in recent years, aimed at curbing the overheated real estate market, foreign investors frequently find it troublesome and difficult to transfer either the assets or equity of an on-shore real estate company. One of the ways favoured by foreign investors has been the purchase of equity interest in an offshore holding company, which either holds an FIE, this in turn holds a property, or holds a property directly in China.

## Macro-Economic Control Measures in Recent Years

### MEASURES TO STABILISE MARKET

Since 2002, the government has imposed a series of measures to curb the runaway property prices, to discourage property speculation, and to promote healthy development of the real estate market. These measures include adjusting the minimum down payment for residential properties, increasing mortgage loan interest rates, tightening bank credit, imposing business tax on sale proceeds from the resale of residential properties within a certain period after purchase, and increasing land supply for ordinary and low-end residential properties to meet demand from owner-occupiers.

### MEASURES TO REGULATE FOREIGN INVESTMENT

In July 2006, six Chinese ministries and regulatory authorities jointly issued the Opinion on Regulating the Access and Management of Foreign Capital in the Real Estate Market ("**Opinion No.171**"). Opinion

No.171 aimed to regulate the access of foreign investment to the real estate market, and to restrict real property acquisition by foreign companies and foreign nationals. Opinion No.171 requires, among other things, that a foreign company or individual must establish an FIE in order to purchase real property in China, which is not intended for that company or individual's own use. Branches and representative offices of foreign entities in China and foreign nationals who work or study in China for more than one year, may purchase real property for their own use but not for any other purposes. Residents of Hong Kong, Macau and Taiwan, and other individuals of Chinese origin, are not subject to the one-year residency requirement and may purchase real property in China for their own use.

From 2006 to 2013, after the issuance of Opinion No.171, relevant Chinese ministries and regulatory authorities have issued a set of rules to repeat and explain the details of main points of Opinion No.171. However, in August 2015, the same six Chinese ministries and regulatory authorities issued Notice on Amending relevant policies on Regulating the Access and Management of Foreign Capital in the Real Estate Market ("**Notice No.122**"). This Notice sought to relax several rules of Opinion No.171, including making the real-estate FIEs to comply with the same ratio of total investment and registered capital as general FIEs, repeal the requirements for real-estate FIEs to pay their registered capital in full before borrowing domestic or foreign loans and repeal the "one year" requirement for foreign nationals who work or study in China to purchase self-use real property subject to local municipal property-purchase limitations. Except for the rules amended by Notice No.122, other rules of Opinion No.171 are still in force.

A large, illuminated, bird-shaped stadium at night, reflected in a body of water. The stadium's facade is a complex, glowing lattice of white and yellow lights, resembling a bird's nest. The structure is set against a dark blue night sky. In the foreground, a body of water reflects the stadium's lights, and a row of trees and a walkway with a railing are visible along the water's edge. A vertical yellow bar is on the left side of the page.

# Chapter 09 Employment

## Regulatory Environment

Employment matters within the territory of China, including those of FIEs, are all subject to the *Labour Law*, the *Labour Contract Law*, and other laws and regulations issued by the NPC or the central government. There are also local regulations and rules issued by provincial, municipal, and other lower-level government authorities that are only applicable to the relevant local regions.

## Contract of Employment

Employers are required to enter into a written labour contract with their full-time employees, within one month from the date of commencement of employment. The term of employment depends on the agreement between the employer and the employee – this could be a fixed-term contract, an indefinite term contract, and a contract with a term to expire upon completion of a certain job.

In the first of any series of contracts signed by an employer with an employee, a probationary period could be concluded. The maximum period for such probation depends on the term of the labour contract.

## Working Day and Overtime

There are three kinds of work hour systems – the standard work hour system, the comprehensive work hour system and the flexible work hour system.

Under the standard work hour system, work hours must be a maximum of eight hours per day and 40 hours per week. An employer must ensure that each employee enjoys at least one rest day per week.

Any extended work hours will be deemed as overtime and the number of extended work hours is capped by law – three hours per day and 36 hours per month. An employee is entitled to not less than 150% of his/her normal wages for working overtime on a working day, 200% for a rest day (generally Saturday and Sunday) and 300% for a public holiday respectively.

Prior approval from the local labour authority is required before an employer may implement the comprehensive work hour system, or the flexible work hour system.

## Public Holidays and Annual Leave

There are 11 days of fully paid public holidays each year in China – New Year's Day (one day), Chinese New Year (three days), Qing Ming Festival (one day), Labour Day (one day), Duan Wu Festival (one day), Mid-Autumn Festival (one day) and National Day (three days).

An employee who has worked for a continuous period of 12 months is entitled to take paid annual leave. An employee's minimum entitlement of annual leave is as set out below:

Employee's Cumulative Working Period	Entitlement to Annual Leave
Between 1 year and 10 years	5 days
More than 10 years but less than 20 years	10 days
More than 20 years	15 days

## Social Insurance

An employer is obliged to enrol its employees, including foreign employees, in applicable social insurance schemes managed by the local social insurance institution, and to withhold the required amount of social insurance premiums that each employee is responsible for from the employee's monthly salary. Each month, the employer must ensure the premiums each employee is responsible for are paid, together with the premiums that the employer is responsible for, to social insurance funds managed by the local social insurance institution. From 1 January 2019, the social insurance premiums are collected by the local administration of taxation instead of the local social insurance institution. The rates and bases on which such contributions are calculated, are specified in the relevant local regulations.

## Occupational Health and Safety

Employers are required to comply strictly with national rules and standards on occupational safety and health, train their employees on occupational health and safety matters, prevent accidents at work, and lessen occupational hazards at workplaces. Facilities of occupational health and safety must meet the national standards.

# Termination of Employment and Economic Compensation

An employer is generally not allowed to terminate a labour contract at will unilaterally, or without cause. The termination of employment initiated by an employer is not allowed unless one or more of the following statutory termination grounds has occurred:

## 1. Summary dismissal

An employer is entitled to dismiss an employee immediately without any economic compensation (i.e., severance pay), where the employee:

- fails to meet the job requirements within his/her probationary period;
- seriously violates work rules and regulations of the employer;
- is in serious breach of his/her duties, or engages in misconduct that has caused material loss to the employer;
- enters an employment relationship concurrently with another employer which materially affects the completion of his/her tasks for the first-mentioned employer or the employee refuses to rectify the matter after it was brought to his/her attention by the employer;
- concludes the labour contract by means of fraud, threat, force or exploitation of a disadvantageous position of the employer; or
- is prosecuted for criminal liability.

## 2. Termination by notice

An employer may terminate a labour contract unilaterally and must serve written notice on an employee in person 30 days in advance, or provide an additional one month salary to the employee as payment in lieu where:

- the employee suffers from a disease or from non-work-related injuries, and is unable to perform his/her original job after the medical treatment period, or any other job arranged for him or her by the employer;
- the employee is not competent to do the work assigned, even after receiving training or being assigned to other work; or
- material changes of the objective conditions have made the labour contract no longer

executable, and the parties cannot agree through consultation on a variation of the labour contract.

An employee is entitled to economic compensation for termination by notice. In case of the termination under the circumstances set out in limb (1) above, the employee is also entitled to an additional amount of medical subsidy, which may generally not be lower than an amount equivalent to six months salary.

## 3. Economic retrenchment

An employer may resort to a retrenchment procedure for early termination of a labour contract where:

- the employer undergoes reorganisation pursuant to the PRC *Enterprise Bankruptcy Law*;
- the employer encounters serious difficulties in production or business operations;
- there is a change of production, introduction of a major technological innovation, or a major adjustment to the employer's business operation; and after amendment of the labour contract, the employer still needs to lay off staff; or
- there are other material changes to the objective economic circumstances which were relied upon at the time that the labour contract was concluded, rendering it no longer performable.

An employer may only resort to retrenchment if it is necessary to lay off 20 or more employees, or, where the employer wishes to lay off less than 20 employees, where such employees account for 10% or more of the total number of employees.

## 4. Non-terminable employees

Even if a labour contract has expired, no employer may terminate an employee on the grounds of either "termination by notice" or "economic retrenchment", where the employee:

- is engaged in occupational disease-prone work and has not had a medical examination to determine that he/she is free from the disease, or is in any diagnostic or observation period pending such determination;
- has been confirmed as having lost or partially lost his/her capacity to work due to an occupational disease contracted, or a work-related injury sustained, during his/her employment with the employer;

- has contracted an illness, or sustained a non-work-related injury, and his/her applicable medical treatment period has not yet expired;
- is a female employee in pregnancy, on maternity leave, or in the nursing period which is one year commencing from the day when her baby was born; or
- has worked continuously for the employer for at least 15 years and is within five years of reaching his/her legal retirement age.

#### 5. Termination by mutual consent

Regardless of whether any of the above circumstances have occurred, if an employer proposes to terminate employment of an employee, and the employee so agrees after negotiation between the parties, the labour contract can be terminated. This is referred to as "termination by mutual consent" in the *Labour Contract Law*.

The Chinese laws do not require any prior notice or other termination procedures on termination by mutual consent. However, a sum of economic compensation is payable in such cases.

#### EXPIRY OR DEEMED EXPIRY

An employment relationship between the parties will expire, or be deemed to have expired, where:

- the date of expiry stated in the labour contract arrives (i.e., natural expiry);
- the employee reaches his/her retirement age or begins to receive payments under the basic pension plan in accordance with laws and regulations;
- the employee has died, or is lost, or has been so declared by the court;
- the employer is declared bankrupt;
- the employer has its business licence cancelled, is ordered to close down, or the employer decides on early liquidation, or where the term of the employer's business operation expires; or
- any other circumstance of expiry as stipulated by laws or regulations occurs.

In case of natural expiry, if the employer does not wish to renew the employment relationship upon similar or better terms and conditions, then the *Labour Contract Law* entitles employees to economic compensation. For cases meeting the circumstances described under limbs (4) or (5) above, then economic compensation is still payable to the employee.

#### ECONOMIC COMPENSATION

Economic compensation (i.e., severance pay) must be calculated based on the number of years of the employee's continuous service for the employer, and is equivalent to one month salary for each year worked for the employer. Any period of six months or more, but less than one year, is counted as one year. Half a month's salary is payable to the employee for a service period of less than six months.

The *Labour Contract Law* caps the monthly rate of severance payment at 300% of the average monthly salary, applicable in the relevant locality. In this situation, the *Labour Contract Law* further caps the total number of months at 12.

Unless otherwise agreed by the parties, a severance payment must be made upon completion of the work handover, and as a lump sum. Otherwise, the employer may be held responsible for underpayment of economic compensation, and may be exposed to additional compensation payable to the employee.

The *Labour Contract Law* came into effect on 1 January 2008. Therefore, an employer must provide severance pay in accordance with the computation rules applicable under previous legislation, for the part of the service period that commenced before that date, and in accordance with the Labour Contract Law computation rules, for the part of the service period which continued after that date.

#### WRONGFUL TERMINATION

If an employer terminates the employment of an employee in violation of the Chinese laws, the employee may request for specific performance, i.e., reinstatement to his/her job position. If the employee does make this request or the labour contract is no longer capable of being performed, the employer must pay twice the usual severance pay amount as damages to the employee.

## Labour Secondment/ Contract Worker

Representative offices set up by foreign companies in China are not allowed to employ staff directly in China, but must recruit local staff through certain designated labour agencies, including, but not limited, to Foreign Enterprise Services Corporation ("**FESCO**"), China International Intellectech

Corporation ("**CIIC**"), and China Star Corporation for International Economic and Technical Cooperation ("**STAR**"). This arrangement is generally referred to in China as a labour secondment arrangement. Local labour bureaus, and local branches of SAIC, are in charge of monitoring compliance. Under this arrangement, a representative office – i.e., the Seconded Company – signs a service contract with the labour agency for engagement of their labour secondment services, and an employee – i.e., the Seconded Employee – who may be appointed by a Seconded Company or a labour agency, signs a labour contract with the labour agency, and is seconded to work in the Seconded Company.

According to the *Labour Contract Law*, the Seconded Employees are used in temporary, supplementary or substitutable positions. "Temporary" means a position with duration of a maximum of six months, "supplementary" means a position that is not engaged in the principle business of the employer; and "substitutable" means a position that replaces another employee who cannot work for a certain period of time due to off-the-job study, leave, or another reason. A Seconded Company should follow the "democratic procedure" and thereafter "notify or publish to all employees" to determine the "supplementary" positions within the Seconded Company. A Seconded Company can use labour secondment employees in the above three positions, at a total number not exceeding 10% of its total workforce, meaning direct-hire employees and labour secondment employees.

## Employee Manual

The validity of an employee manual depends on whether it is prepared in accordance with laws and regulations, both in substantiality and procedure. In order to be valid on a procedure basis, the employee manual must be established and revised through the "democratic procedure" and thereafter "notified or published to all employees".

Any provision in an employee manual, handbook or other set of work rules and regulations, or any decision on major matters regarding employee's salary, working hours, rest and leave, occupational health and safety, insurances, training, labour discipline and work quota control or other issue directly involving the personal interest of

employees, may not be finalised until after the provision is discussed with, and proposals and suggestions are adopted by, the workers' council or all the workers, and is negotiated by the employer on equal basis with the union or employee representative.

## Restrictive Covenants

Confidentiality undertakings are legally recognised in China, and can be included in a labour contract or concluded separately.

An employer may enter into a non-compete covenant with an employee falling into one of the following categories:

- i. senior management staff member;
- ii. senior technical staff member; and
- iii. other staff member with an obligation of confidentiality.

The scope, area and period of non-competition can be agreed between the employer and the employee. However, the period of non-competition must not exceed two years after termination or expiry of a labour contract, provided that the employer shall provide compensation for such restrictions on a monthly basis within the agreed non-compete period.

Where there is no agreement on the non-compete compensation, the mandatory rate for monthly non-compete compensation is 30% of the employee's average salary for the 12 months preceding the termination or cessation of employment. The compensation should be paid at the rate of the local minimum wage, if the mandatory rate is less than the local minimum wage.

As to the definition of "non-competition", the *Labour Contract Law* expressly states that an employer may restrict an employee, after the termination or expiry of employment between the parties, from:

- i. being employed by any of its competitors who manufacture, operate or deal in products or business falling within the same category as those of the employer; or
- ii. engaging in, on his/her own account, manufacture or operation of products or business falling within the same category as those of the employer.

If an employer wishes to waive the agreed non-compete obligation of an employee, the employer must do so before the termination or cessation of the employee's employment. If the employer does so after the commencement of the non-compete period, then the employer may be ordered to pay an additional three months non-compete compensation.

## Employee Consultation/ Participation

Employees have the right to establish trade unions. A trade union may propose solutions if there is obvious potential for accidents or other occupational hazards present in production or operations. A trade union may also supervise working conditions and occupational health and safety facilities, with respect to any new construction, expanded construction, or technical restructuring projects undertaken by the employer. The employer must seriously deal with any suggestions and opinions expressed by the trade union and reply in a timely manner.

A trade union may sign a collective contract with the employer on behalf of all employees and deal with issues that infringe on the interests of employees.

## Employment of Foreigners

In most cases, employers must recruit Chinese nationals if at all possible. In order to bring in a foreign employee, an employer must first apply to the local labour bureau for an employment permit to bring in that employee. Once an employer has received the employment permit, then the foreign employee, with the exception of a Hong Kong, Macau and Taiwan resident, must apply for a work visa at his/her local Chinese consulate. After entering China, a foreign employee must obtain a work permit and work-type residence permit, prior to commencing employment. "Foreign experts", offshore petroleum workers, cultural and artistic performers, and representatives of representative offices enter China under different procedures. From 28 July 2018, Hong Kong, Macau and Taiwan residents do not need a work permit for working in Mainland China.





Chapter 10  
Antitrust & Competition

## Key Prohibitions

A broad range of Chinese laws contain one or more provisions prohibiting anti-competitive practices, such as price-fixing, market-sharing and below-cost sales. These include the *Anti-Unfair Competition Law* and the *Price Law*. Many of these provisions have not been widely enforced, and the fragmented structure of the competition legislation reflects the historical absence of a cohesive competition policy in China.

However, a comprehensive *Anti-Monopoly Law* ("**AML**") came into effect on 1 August 2008. While a number of provisions in the AML overlap with pre-existing competition provisions, the AML has become the primary law used to tackle anti-competitive conduct. Enforcement of the key prohibitions in the AML has been robust, and significant financial and other penalties can be applied where infringements are identified.

The AML regulates three main areas of business conduct: monopoly agreements, the abuse of a dominant market position, and concentrations, i.e., M&A deals and certain other transactions, with anti-competitive impacts. These prohibitions apply to nearly all businesses.

While the AML had previously been enforced by three different authorities within the PRC, these authorities have been consolidated into one agency in 2018 – the SAMR – which is now responsible for enforcing the AML. The Chinese courts also have the jurisdiction to hear private actions relating to the AML.

### MONOPOLY AGREEMENTS

Certain agreements between competing businesses, or between trading partners, are prohibited as "monopoly agreements" if they eliminate or restrict competition. The AML classifies monopoly agreements into horizontal and vertical agreements.

"Horizontal" monopoly agreements include agreements between competitors to fix prices, limit production or sales volumes, share markets or customers, restrict technology purchases or development, or to boycott competitors or customers.

"Vertical" monopoly agreements include agreements between a company and its trading partners to fix resale prices, or to restrict minimum resale prices to third parties. It could potentially also cover

other types of vertical agreements (e.g. certain types of territorial sales restrictions) and various draft guidelines have been issued to clarify how this prohibition would apply, both on a sector specific basis (e.g. automobile sector, intellectual property rights) and more generally.

The prohibition is subject to a range of exceptions. It does not apply to restrictions that improve technology, improve product quality or production efficiency, enhance the competitiveness of small or medium-sized companies, protect the parties from economic downturns, protect "legitimate interests" relating to foreign trade and economic cooperation, or are for the benefit of "social public interests" – such as energy conservation or environmental protection. The burden is on the parties to show that an exception applies.

The monopoly agreement prohibition has the potential to impact a broad range of trading arrangements and business activities in China, such as cooperation and information sharing between competitors, distribution arrangements, the activities of trade associations and technology standard-setting.

### ABUSE OF A DOMINANT MARKET POSITION

The AML also prohibits a business from abusing a dominant market position. Acts that may constitute "abuse" of that position include the sale of products at unfairly high prices, selling below cost, refusing to trade with partners, exclusive dealing, imposing unreasonable trading conditions or tie-in to sales, or discriminating partners under equal conditions.

The list of abuse is not exhaustive, and the AML allows the Chinese authorities to determine whether other types of conduct by dominant firms breach the prohibition.

A company has a "dominant market position" where it is able to control the price, the quantity of products, other trading conditions, or engage in conduct restricting or affecting entry of other companies into a relevant market. It provides for several factors to be taken into account when an assessment on "dominance" is made, including the current and potential future competitive situation in the relevant market, the company's power to control sales and supply markets, and the company's financial power and technical conditions.

Market share is also a relevant factor. A presumption of dominance can be raised based solely on market share. In particular, a business can be deemed (although this may be rebutted) to be dominant in a market if:

- It has a market share of 50% or more.
- The combined market share of two businesses account for two-thirds or more of the relevant market (although any business with less than 10% market share will not be considered dominant).
- The combined market share of three businesses account for three-quarters or more of the relevant market (although any business with less than 10% market share will not be considered dominant).

The prohibition is potentially of particular relevance to licensing and other activities in respect of Intellectual Property Rights ("IPRs").

The AML expressly states that it will not apply to the legitimate exercise of IPRs in accordance with intellectual property laws and administrative regulations. However, it will apply to any abuse of IPRs that eliminate or restrict competition. Accordingly, the prohibition regarding abuse of a dominant position may be applied to conduct by dominant IPR holders, where their dealings in IPRs fall within the various heads of "abuse" conduct detailed above. Guidelines have been issued by the regulator which explain that abusive conduct could include charging unfairly high royalty rates, refusal to license IPRs, and tying conduct involving IPRs, amongst others.

## MERGERS AND OTHER TRANSACTIONS THAT ELIMINATE OR RESTRICT COMPETITION

The AML prohibits participation in a "concentration" that has the effect, or likely effect, of eliminating or restricting competition. A "concentration" is defined as a transaction involving one of the following:

- Merger activity.
- The acquisition of "control" over other companies through the purchase of shares or assets.
- The acquisition of "control" or the capability to impose a "decisive influence" on other companies by virtue of contractual rights or other means, including the establishment of JVs.

Importantly, both greenfield JVs and JVs formed by way of change of control are notifiable. Unlike in the European Union, there is no requirement for the JV to be fully functional before it needs to be notified to the SAMR as a "concentration".

The concept of "control" – which captures "decisive influence" – is critical in determining whether a transaction is notifiable. Control includes sole control and joint control, and can be de jure control and de facto control. A change in the quality of control, for example, where there is an addition/reduction in the number of controlling shareholders or a change in the identity of controlling shareholders, will also be considered a change in control that falls within the definition of a "concentration".

The AML does not prescribe a bright line test for determining control (e.g. based on shareholding thresholds), but instead considers various factors when assessing control (e.g. shareholding structure, composition of board of directors and supervisors and their voting mechanisms, ability to appoint and remove senior management). Importantly, a party with minority shareholding can still be considered to have control, for example, if it has veto rights over significant business decisions of the target company by way of shareholder reserve matters or board representation.

## NOTIFICATION REQUIREMENTS

Concentrations that meet certain thresholds must be notified to SAMR, for approval before implementation. The thresholds are where:

- the worldwide turnover over the last accounting year of all parties to the concentration exceeds RMB 10 billion, and turnover within China of each of at least two of those parties exceeds RMB 400 million over the last accounting year; or
- the turnover within China over the last accounting year of all parties to the concentration exceeds RMB 2 billion, and turnover within China of each of at least two of those parties exceeds RMB 400 million over the last accounting year.

Regulatory guidance has been issued relating to the required method of turnover calculation, and special calculation rules apply to undertakings involved in industries like banking, insurance, securities and futures.

Even if a concentration does not meet these specified thresholds, SAMR has a right to examine the concentration, if it has evidence that the transaction may have the effect of eliminating or restricting competition.

Notified transactions need to be approved by SAMR before they can proceed. The formal review period may consist of up to three phases. All notified transactions go through an initial Phase I review period that may last up to 30 days. Within this period, the transaction may be cleared, or alternatively SAMR may deem that a further Phase II review is necessary. A Phase II review can last up to 90 days, and a further Phase III review of up to 60 days can also be added in certain circumstances – adding up to 180 calendar days for the maximum period of a formal review.

There is often a delay of a few weeks between the time when a notification is submitted to SAMR and the time when SAMR deems the notification to be complete. SAMR may request additional information in this 'pre-acceptance' period, as well as in the formal review period.

A quasi-simplified procedure for qualified simple cases exists to expedite the review process (although SAMR does not guarantee that the review of qualified simple cases will be completed within a certain timeframe). A transaction may be accepted as a simple case in any of the following circumstances, where:

- the aggregate market share of all parties involved in the concentration is less than 15% in all horizontal relevant markets;
- the market shares of the parties in all vertically related markets are less than 25%;
- the market shares of the parties in markets that are not horizontal or vertically related in closely related neighbouring markets, are less than 25%;
- a JV outside China is established, which is not engaged in any economic activity within China;
- there is the acquisition of the equity or assets of a foreign enterprise, which is not engaged in economic activity within China;
- a JV jointly is controlled by two or more parties prior to the transaction, and the JV will be controlled by one or more of these parties after the transaction.

Any concentration that SAMR believes will, or is likely to, eliminate or restrict competition, may be prohibited, or conditions may be placed upon it to remove or reduce its anti-competitive effect. The conditions SAMR can impose on a concentration may be classified as either "structural", such as mandated divestment of assets, or "behavioural", placing constraints on how a transaction party can conduct their business for a specified period.

## National Security Review

### AML & M&A REGULATIONS

The AML also provides for a government review to occur before foreign companies are permitted to engage in investments or acquisitions that could affect national security.

The M&A Regulations also contain a similar review requirement in relation to proposed acquisitions by foreign companies, which may affect "national economic security". The M&A Regulations require that reviews must occur before foreign investors are permitted to engage in acquisitions which result in a change of control of the target Chinese company, and where one of the following circumstances apply:

- the transaction relates to an "important industry" in the China economy;
- the transaction has or may have an impact on national economic security;
- the Chinese company holds a famous trademark or is a "time-honoured" Chinese brand.

However, neither the AML nor the M&A Regulations sets out an implementing mechanism for how such national security review would take place.

### STATE COUNCIL CIRCULAR NO.6

In 2011, the State Council issued the Circular on the Establishment of a Security Review System Regarding Mergers and Acquisition of Domestic Enterprises by Foreign Investors ("**Circular No.6**") which provides for the implementation of certain national security review processes that are detailed in the AML, and which operate in parallel to the AML's anti-monopoly merger review provisions. Circular No.6 establishes a multi-agency committee that assesses the extent to which a proposed foreign investment in, or acquisition of, a domestic Chinese enterprise raises certain national security

or related concerns. The committee effectively has the power to block the deal or impose conditions on it if, after completing a national security review in relation to a proposed transaction, it considers that such measures are appropriate to address the identified concerns.

For the purpose of the national security review, "merger and acquisition of domestic enterprises by foreign investors" includes any of the following types of transactions:

- Foreign investment in a domestic enterprise which is not an FIE, in the form of acquiring equity or subscribing to the capital increase, thereby transforming it into an FIE.
- The acquisition of equity in an FIE held by a Chinese shareholder, or the subscription to the capital increase of an FIE.
- The acquisition of assets or equity from a domestic enterprise, either a non-FIE or an FIE, through another FIE.
- The acquisition of assets of a domestic enterprise, either a non-FIE or an FIE, and the subsequent operation of such assets through a newly established FIE.

According to Circular No.6, the national security review process will apply to either of the following acquisitions by a foreign investor:

- National defence enterprises – such as military industrial enterprises and supporting enterprises for the military industry, enterprises in the vicinity of key or sensitive military installations, and other entities in relation to national defence security.
- Actual control of domestic enterprises that have a bearing on national security in areas such as important agricultural products, vital energy and resources, essential infrastructure, crucial transportation services, key technologies, and major equipment manufacturing.

The term "acquiring actual control" is defined in Circular No.6 as "becoming a controlling shareholder or an actual controller of a domestic enterprise through a merger or acquisition". In addition, Circular No.6 sets out certain examples of "acquiring actual control" following a transaction. These are:

- Where a foreign investor, together with its parent holding company and/or its subsidiary,

holds 50% or more of the total shares in a relevant domestic enterprise.

- Where several foreign investors hold an aggregate of 50% or more of the total shares in a relevant domestic enterprise.
- Where a foreign investor's voting rights attached to its shares in a relevant domestic enterprise, even if the foreign investor does not hold 50% or more of the total shares, are sufficient to have a major influence on the resolutions of any shareholder meeting, annual general meeting, or board meeting of that enterprise.
- Where other circumstances exist which may lead to the transfer of the actual control of matters, such as business decision-making, finance, personnel and technology of a relevant domestic enterprise to the foreign investor.

Circular No.6 confirms that investors located in Hong Kong, Macau and Taiwan will be considered to be foreign investors for the purposes of the national security review process.

More stringent national security review rules also apply to foreign investment in Free Trade Zones under the Notice of the General Office of the State Council on Issuing the Measures for the Pilot Program of National Security Review of Foreign Investment in Pilot Free Trade Zone, which came into effect in 2015.

## MOFCOM'S SECURITY REVIEW RULES

In 2011, MOFCOM published the Rules of Ministry of Commerce on Implementation of Security Review System for Merger and Acquisition of Domestic Enterprises by Foreign Investors ("**Security Review Rules**"), which outline the required content of notifications to the Security Review Committee, specify the timeframe and procedural steps of the review process, and reference the decision-making powers of the committee – which includes the power to block or impose conditions on deals.

The Security Review Rules make it clear that in considering whether an M&A transaction falls within the scope of security review, MOFCOM will look at both the substance and actual impact of the arrangements, rather than the form. Specifically, the Security Review Rules make it clear that foreign investors should not try to avoid the review process by utilising nominee holding structures, trust arrangements, multilayer investment and

reinvestment structures, leasing or lending arrangements, or other contractual control mechanisms, i.e., VIE mechanism; the Security Review Rules additionally confirm that the security review requirement will still apply where such cases are identified.

### 2015 NATIONAL SECURITY LAW

In 2015, the *National Security Law* ("**NSL**") was promulgated, which is currently the most comprehensive law governing national security reviews. Importantly, the NSL defines "national security" as a status in which the regime, sovereignty, unity, territorial integrity, welfare of the people, sustainable economic and social development, and other major interests of the state are relatively not faced with any danger and not threatened internally or externally and the capability to maintain a sustained security status. It further identifies various industrial sectors that are vital to the national economy, including the finance, food safety, culture, technology, cyber security, and environmental protection, amongst others.

While the NSL envisages that a set of rules and mechanisms will be established for national security review, such implementing rules have not yet been issued at the time of writing. Until these rules are issued, it remains to be seen how the national security review under the NSL will be applied on the ground, and how they will impact transactions.

## Legal Liabilities

Under the AML, businesses that implement prohibited monopoly agreements, or engage in unlawful abuse of a dominant market position, may be ordered to cease their unlawful activities, and income gained from those activities may be confiscated. Additionally, a fine may be imposed amounting to between 1 and 10% of business turnover from the preceding year – except for businesses that have entered into a monopoly agreement but have not yet implemented it, in which case the fine may not exceed RMB 500,000.

The AML provides for a leniency policy for businesses involved in monopoly agreements. If a business confesses the existence of a monopoly agreement, and provides the authorities with necessary evidence, the penalties that may be imposed may be reduced or waived altogether.

Businesses may also incur civil liabilities to compensate for losses suffered by third parties, as a result of the monopoly agreements or abuse of dominant market position in which they engage. Such civil claims can be brought on a stand-alone basis i.e. it does not need to follow-on from an infringement decision issued by the regulator.

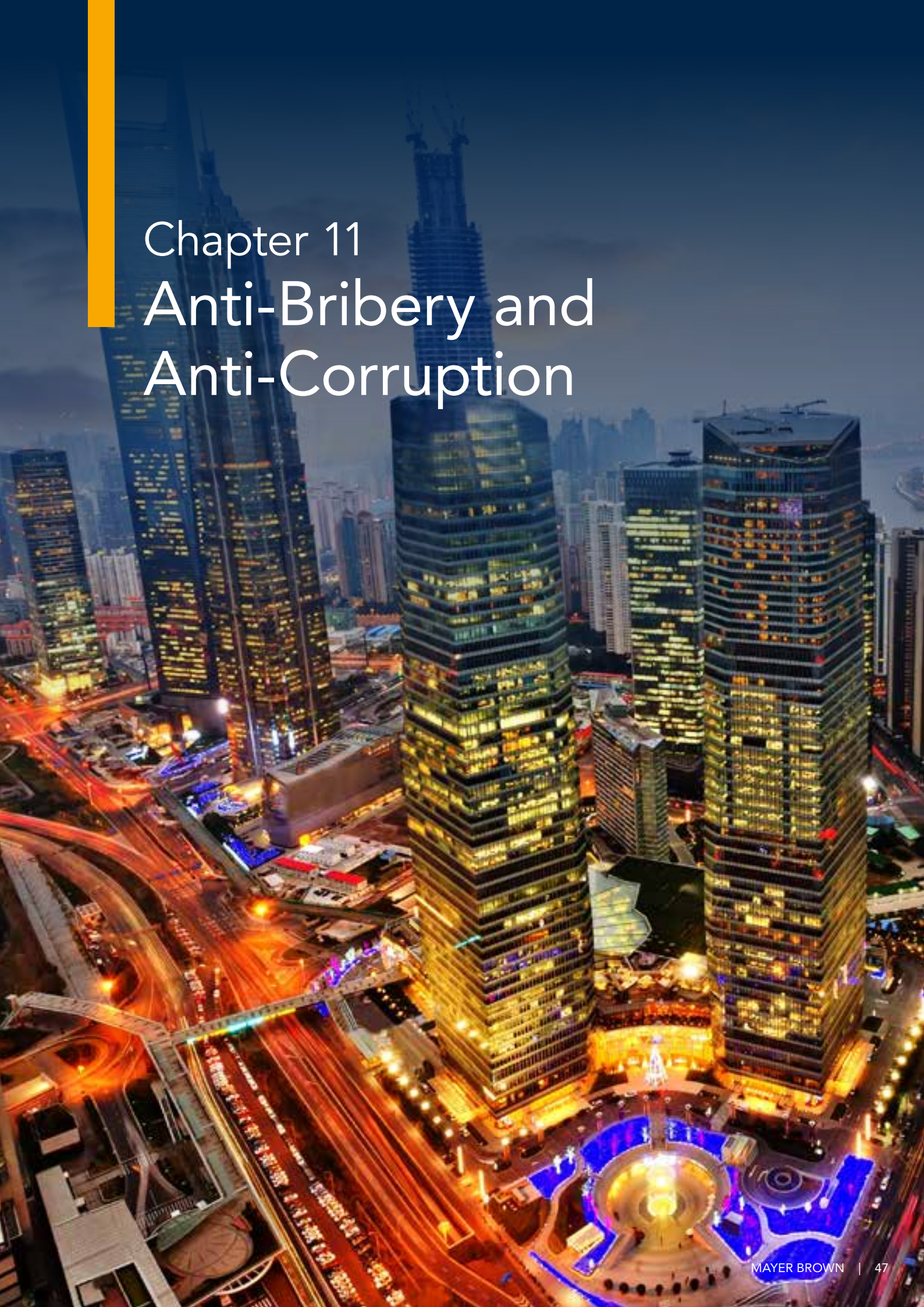
Businesses also face several legal consequences and sanctions if they attempt to implement a concentration without filing a notification, or prior to a clearance decision by SAMR in relation to a filed notification, or in breach of any SAMR clearance conditions.

In these cases, SAMR may impose a fine not exceeding RMB 500,000 on each of the parties involved in the relevant contravention. Additionally, where the contravention concerns an implemented concentration, that concentration may be required to be unwound or terminated. It may also be possible for third parties to institute civil proceedings, to recover loss suffered as a result of the implementation of an unlawful concentration.

## The Developing Nature of the Chinese Competition Regime

Prior to the commencement of the AML, most China competition-related provisions were rarely enforced. The main exception was the merger control regime under the old version of the M&A Regulations. However, the commencement of the AML, and the introduction of significant new legal liabilities relating to anti-competitive practices, reflects an increasing focus on competition issues in China.

It should also be noted that many of the pre-AML laws that incorporate competition-related provisions remain in force. While many of these provisions overlap with the AML, in some cases they may have a potentially broader application. Additionally, some competition provisions are sector-specific, relating to industries such as banking and telecommunications. It is possible these provisions may still be applied going forward, either in conjunction with the AML or on a stand-alone basis.

An aerial night view of a city skyline, likely Singapore, featuring several illuminated skyscrapers and a complex highway interchange with light trails from traffic. The scene is lit with warm yellow and orange lights from the buildings and roads, contrasting with the dark blue twilight sky. A prominent yellow vertical bar is on the left side of the page.

# Chapter 11 Anti-Bribery and Anti-Corruption

## Introduction

Any foreign investor intending to conduct business in China should be aware of the risks and challenges they face from corruption. The Corruption Perceptions Index 2017 from Transparency International, the global anti-corruption watchdog, ranked China 77 out of 180 countries and territories, where first represents the cleanest perceived country.

Corruption in China is a product of a number of factors, including:

- Heavy involvement of the government in commerce and finance.
- Government bureaucracy requiring enterprises to obtain numerous permits or licences, at the local, provincial and national levels.
- Reliance on third-party intermediaries when entering and operating within the Chinese market.
- Most large-scale Chinese corporations being wholly or partially state-owned.
- Long-held cultural expectations on gift giving and "guanxi" – the practice of fostering relationships using the exchange of favours and obligations to exert influence.
- The increasing wealth gap, which exacerbates corruption.

The government acknowledges that corruption is a threat to its economic development and social stability. China has now begun to address corruption head-on, including a recent tightening and increased enforcement of anti-corruption laws.

Historically, the general perception is that Chinese enforcement agencies pay more attention to official bribery (compared to commercial bribery), bribe takers/recipients (compared to bribe givers), individuals (compared to entities) and domestic entities/individuals (compared to foreign ones). PRC Anti-Bribery and Corruption ("**ABC**") Laws and enforcement have been undergoing a great deal of reform over the last few years and continue to evolve. Based on our observation, the general trend mentioned before no longer holds true.

International companies doing business in China should also be alive to the increasingly long arms of home law-enforcers, under anti-corruption legislation with extra-territorial reach – the Foreign Corrupt Practices Act ("**FCPA**") of the United

States of America ("**US**") and its equivalents in other countries. Penalties of hundreds of millions of US dollars and imprisonment of executives for the impropriety of their overseas subsidiaries and employees, are now common. China-related FCPA cases are, year-on-year, on the increase and include some very well-known global corporations. Further, the UK *Bribery Act 2010* ("**Bribery Act**") has more recently entered the fray as another aggressive long-reaching international anti-bribery statute.

Therefore, it is vital for companies operating in China to understand China from an anti-corruption perspective and the risk posed by domestic Chinese laws, the FCPA and the *Bribery Act* in terms of impact on their business activities in China. The comparison of the Chinese anti-corruption laws, the FCPA, and the *Bribery Act* at the end of this Chapter sets out a summary.

## Chinese Anti-Bribery and Anti-Corruption Legislation

### THE FRAMEWORK

China's principal anti-corruption laws are found in:

- the *Criminal Law of the PRC* ("**Criminal Law**"); and
- the *Anti-Unfair Competition Law*.

In addition, various administrative regulations, internal rules, and judicial interpretations further govern the anti-corruption approach in China.

The *Criminal Law* concerns crimes regarding official bribery, involving state functionaries, and commercial bribery, involving employees of private enterprises. It applies to WFOEs, JVs, and representative offices of non-Chinese companies, as well as Chinese companies.

The *Anti-Unfair Competition Law* regulates unfair competition practices by businesses – including the prohibition of offering and taking bribes in the process of selling and purchasing goods and services. It applies to all business operators in China, whether foreign or domestic.

### OFFICIAL BRIBERY UNDER THE CRIMINAL LAW

The *Criminal Law* prohibits giving or accepting a bribe to any state functionaries, state organs, State-owned Enterprises ("**SOEs**"), state



institutions, a close relative of, or any person close to, a current or former state functionary, or civil organisations' articles of property, tangible or intangible, in order to seek illegitimate benefits. The law applies to both individuals and entities, whether foreign or domestic.

The briber needs not actually gain any benefit, but there must be actual delivery of the bribe in order for it to be established as bribery. Increasingly, as well as improper payments, Chinese judicial courts also consider benefits such as meals, travel and accommodation as bribes.

### COMMERCIAL BRIBERY UNDER THE CRIMINAL LAW

The Criminal Law prohibits individuals and entities from paying money or giving property to non-state functionaries, including employees of private enterprises, for the purpose of seeking illegitimate benefits. The Criminal Law only applies to "relatively large" bribes.

The Criminal Law also includes provisions criminalising the bribery of officials of foreign governments or international public organisations. This is China's equivalent to long-arm legislation, such as the FCPA and the *Bribery Act*.

### COMMERCIAL BRIBERY UNDER THE ANTI-UNFAIR COMPETITION LAW

Commercial bribery in China is also regulated on a civil and administrative level. The *Anti-Unfair Competition Law* prohibits businesses from practicing bribery, tangible or intangible, to:

- employees of the transaction counterparty;
- entities or individuals entrusted by the transaction counterparty to handle relevant affairs; or
- entities or individuals with authority or influence to influence a transaction, in order to obtain business opportunities or competitive advantages.

Explicit discounts and commissions to the intermediary are permitted, if they are openly made and recorded accurately in accounts of both the company and the recipient.

## US Foreign Corruption Practices Act

### ANTI-BRIBERY PROVISIONS AND THE ACCOUNTING PROVISIONS

US companies doing business in China, and certain multi-national companies, are subject to the FCPA. In recent years, the number of FCPA enforcement actions pursued by the US authorities has dramatically increased, together with the penalties imposed on offending parties. This poses a significant commercial risk to businesses entering the Chinese market. Appropriate safeguards to manage corruption risks are critical in doing business in China.

The FCPA contains two main components: anti-bribery provisions and accounting provisions.

### ANTI-BRIBERY PROVISIONS

Under the FCPA, a bribe is the offer or promise of anything of value – including gifts, travel, meals and entertainment – made to a foreign official, with the intent to obtain or retain business or to secure an unfair business advantage. A foreign official is broadly defined to include any person acting in an official capacity regardless of rank or position.

Under the FCPA it is a crime to offer a payment, even if no payment is actually made. The FCPA also captures payments made to third parties if the payer is aware that a portion, or all of the payments, will be used by the third party, as bribes to foreign officials. Therefore, companies doing business in the Chinese market must be alert to this risk and conduct sufficient due diligence, and have sufficient controls in place to manage third parties, such as agents, consultants and distributors.

### ACCOUNTING PROVISIONS

In order to combat the concealment of bribes, the accounting provisions require companies to keep accurate books and records and maintain an adequate system of internal accounting controls. Consequently, companies must accurately record any permitted payments, bribes, or facilitation payments in their accounting books. This particularly applies to the recording of gifts, travel, meals, entertainment expenses and expenses relating to seminars and training events.

It is worth noting that many companies who find

themselves under the microscope of the US authorities, are in this position because of breaches of the books and records provisions, rather than because of bribery.

### TERRITORIAL (EXTRA-TERRITORIAL) APPLICATION AND RELEVANCE TO COMPANIES IN CHINA

Under the FCPA, liability can extend to any of the following:

- US incorporated entities and entities having their principal place of business in the US.
- US citizens, nationals or residents.
- Any entities that must either:
  - » issue securities registered in the US;
  - » file reports with the US Securities and Exchange Commission.
- Any foreign issuers whose American Depository Receipts are traded on US exchanges.

If conduct in the furtherance of an improper payment occurs "while in the territory of the United States", the FCPA may reach Asia-based companies, even if they do not qualify as "issuers" or are incorporated in the US. The key for this basis of jurisdiction is the existence of some connection to the territory of the US, which might be as little as an email from outside the US to someone in the US who participated in the conduct, or routing a wire transfer through a bank account in the US. The company can also be liable for acts of agents, distributors or other intermediaries. Employees cannot do indirectly, what they would be prohibited from doing directly.

Importantly, under the FCPA, mergers and acquisitions do not extinguish liability for any past unlawful conduct by the acquired target company. The FCPA may impose liability on the new company, or the newly acquired subsidiary, based on the target's historical conduct. Therefore, it is essential for companies contemplating mergers and acquisitions in China, to conduct a thorough FCPA-specific due diligence before the deal is agreed.

### EXCEPTION AND AFFIRMATIVE DEFENCES

The FCPA recognises a "facilitating payment" exception which applies to "routine governmental action" of typically non-discretionary functions such as: providing police protection, providing mail pickup and delivery, providing phone service,

power and water supply and loading and unloading cargo.

There are also two affirmative defences. These are:

- Where payments are lawful under a written law of the foreign official's country.
- When the payment was made as a reasonable and bona fide expenditure that is directly related to the promotion of products, or services, or in execution of a contract with a foreign government.

## UK Bribery Act 2010

The *Bribery Act* took effect on 11 July 2011 and is broader than the FCPA since it introduces a range of bribery offences that may be committed in both the public and private sectors. It also lacks the FCPA's exception for "facilitation payments" and the express affirmative defence for reasonable and bona fide business expenses. The Act introduces four categories of offence:

- A general offence of "active" bribery, i.e., bribing another person.
- A general offence of "passive" bribery, i.e., allowing oneself to be bribed.
- A discrete offence of bribing a foreign official, directly or indirectly through a third party.
- A new corporate offence of failing as a commercial organisation to prevent bribery.

Both general offences require intent for, and the improper performance of, a relevant function or activity. In respect of the bribery of foreign officials, acceptance is not necessary and with the requisite intent, any form of payment provided to a foreign official may trigger liability.

Under the corporate offence provision, a commercial organisation carrying on a business in the UK will be liable for bribery carried out by its "associated persons", regardless of whether the bribe in issue has any connection to the UK. The term "associated persons" is broadly defined and includes employees, agents, and subsidiaries. This offence does not require any knowledge of the underlying bribery activity. This creates an onus on a business to evaluate its existing policies and general compliance culture, and put in place effective procedures to prevent bribery. The only defence available is to prove that adequate procedures were in place to prevent bribery.

## TERRITORIAL (EXTRA-TERRITORIAL) APPLICATION AND RELEVANCE TO COMPANIES IN CHINA

In respect of the general offences and the offence of bribing a foreign public official, it is not necessary that the improper payment is performed in, or has any connection with, the UK. All that is necessary is that the offender has a "close connection" with the UK.

Thus any subsidiaries of a Chinese organisation that are incorporated in the UK, and any employees of a Chinese organisation holding a UK passport, will have this "close connection" and are therefore subject to jurisdiction of the Act for misconduct occurring anywhere in the world.

As to the corporate offence of failing to prevent bribery, it applies not only to organisations

incorporated under UK law, but also to any other company carrying on a business, or part of a business, in the UK. This offence potentially has a very significant extra-territorial impact and may expose commercial organisations, with only modest business operations in the UK, to the risk of prosecution in respect of bribery occurring in the course

of its business elsewhere in the world, even if that act had no connection to its UK business.

## Some Consideration

Acquirers of companies or businesses in China should conduct appropriate anti-bribery and corruption due diligence and risk assessments prior to acquisition, since all liabilities for past impropriety are inherited under the FCPA. Bribery violations by target companies may give rise to major liabilities, disruption to operations and reputational damage to the acquirer.

Third-party consultants and agents should also be thoroughly vetted before entering into any business relationship, corrupt practices cannot be masked by having them done by a third party.

Appropriate anti-corruption/bribery provisions should be incorporated into all relevant commercial agreements. Companies considering or already operating in China are strongly recommended to develop, strengthen and maintain corporate anti-corruption compliance systems, specifically designed to minimise the risk of anti-corruption liability.

## Comparison of China Anti-Corruption Laws, US FCPA and UK Bribery Act

	PRC Criminal Law	PRC Anti-Unfair Competition Law	FCPA	Bribery Act
Businesses	✓	✓	✓	✓
Individuals	✓	✓	✓	✓
Intent to bribe	✓	✓	✓	✓ (Except offence in respect of failure to prevent bribery)
Actual delivery of bribe	✗	✓	✗	✗
Extra-territorial scope	(Connection to China)	✓	(Connection to US)	(Connection to UK)
Other provisions	✗	✗	Accounting provisions	Failure to prevent
Exceptions/ Defences	✗	Explicit discount/commissions to intermediary (if made openly and accurately recorded in both the account of provider and recipient)	<ul style="list-style-type: none"> <li>Facilitation payments</li> <li>Affirmative defences</li> </ul>	Adequate procedure in place



Chapter 12  
Distribution and  
Franchising

## Distribution

Foreign investors can set up foreign-invested commercial enterprises ("**FICE**") to directly engage in wholesaling, retailing, commission agent's services, and franchising in China. In other words, foreign investors may, through a FICE incorporated by themselves, import goods into China and then distribute them in the domestic Chinese market, or purchase goods from the domestic Chinese market, and then export them to other countries.

A FICE can be set up in the form of an EJV, a CJV, or a WFOE. Most of the foreign investment restrictions that were implemented in the wholesaling and retailing sectors have been removed in recent years. The tobacco wholesaling and retailing industry remains as the only prohibited wholesaling and retailing sub-sector for foreign investors in the Negative Lists promulgated in 2018.

The above-mentioned changes in principle bring foreign investors to the same level playing field of domestic investors (except that a foreign investor needs to complete an additional filing formality when the FICE is established) in most of the wholesaling and retailing sub-sectors. It should be noted that foreign investors are still subject to applicable laws and regulations, including administrative approvals, import and export quota or restrictions, qualification requirements and so forth, that generally apply to companies engaging in relevant areas. For example, special pre-approvals issued by industrial regulators will be required if a FICE is to engage in the distribution of certain products, such as automobiles, refined oil, medicines, audio-visual products, and books or newspapers.

Since October 2016, the establishment of most FICEs in the wholesaling and retailing sector is no longer subject to the MOFCOM approval but a relatively straightforward filing formality instead. Foreign investors are required to file the establishment information with MOFCOM when they apply to the local counterpart of SAMR for registering the establishment of the FICE. If a FICE engages in direct selling (i.e. door-to-door salesmen are recruited to sell products directly to ultimate consumers outside the companies' fixed places of business), then its establishment will have to be approved by MOFCOM.

## Franchising

Foreign investors may enter into franchising arrangements with Chinese operators. A franchisor must have at least two direct sales stores and these must have commenced business activities for more than one year before it may qualify as a commercial franchisor. These stores may be located anywhere in the world, thus making it possible for foreign franchisors who do not already have a presence in China, to enter into franchise agreements with franchisees in China. A foreign investor may set up a FICE to engage in commercial franchising activities in China or enter into franchise agreement directly with its Chinese franchisees.

A written franchise agreement must be entered into by a franchisor and franchisee for the commencement of franchising activities. The franchisor must, within 15 days after having concluded the franchise agreement for the first time, file the agreement with MOFCOM or its provincial counterpart. The franchise agreement must fulfil all of the following requirements:

- The franchisee must have the right to unilaterally rescind within a certain period after the franchise agreement is concluded.
- The franchise term must not be shorter than three years, unless otherwise agreed by the franchisee.
- The franchisee has no right to assign the franchise to any other party, without the consent of the franchisor.

Other than for the renewal of a franchise agreement on the same terms, a franchisor must disclose to the franchisee in writing certain information at least 30 days prior to the execution of any franchise agreement. This is:

- basic information regarding the franchisor and the franchised business;
- basic information regarding the franchisor's business resources;
- basic information on franchising expenses;
- information on the prices and conditions of the products, services, and equipment provided to the franchisee;
- information on the services to be provided to the franchisee;
- guidance and supervision over the franchisee's operation;

- information on investment budgets/initial investment for franchised stores; distribution, operations, and other basic information about franchisees in China;
- financial statements and audit reports for the franchisor for the past two years;
- information on franchise-related litigation and arbitration involving the franchisor during the past five years;
- records of major illegal activities committed by the franchisor and its legal representatives;
- the template franchise agreements.

If there are any changes to the franchisor's Administration for Industry and Commerce ("**AIC**") registration information, business resources or the distribution of all its franchisee's stores in China, the franchisor must, within 30 days, file a notice and supporting documents with MOFCOM, or its provincial counterparts, for modification of its franchise registration. In addition, the franchisor must also file an annual update with respect to the execution, cancellation, termination and renewal of any franchising agreement in the previous year with MOFCOM, or its provincial counterparts, by 31 March each year.

Any franchisor that fails to comply with the above filing requirement may be subject to a fine of up to RMB 50,000. If the franchisor still fails to rectify within the time limit, MOFCOM or its provincial counterparts may make a public announcement of such non-compliance and raise the fine to RMB 100,000.



# Chapter 13 Trade and Customs



# Import and Export Procedures

## REGISTRATION FOR IMPORT AND EXPORT

Importing and exporting goods in China requires, first of all, the registration of the company with several government agencies, so that it can function as the importer of record ("**IOR**") or exporter of record ("**EOR**"). The government agencies are:

- MOFCOM, to obtain "Foreign Trade Operator" status;
- China Customs, to be able to transact with the authority on activities relating to the import and export of goods, including customs declaration, and commodity inspection and quarantine (such functions were previously the responsibility of the China Inspection and Quarantine ("**CIQ**") under the now-defunct General Administration of Quality Supervision, Inspection and Quarantine);
- E-Customs, to be able to use the electronic platform for customs declarations and other interactions with China Customs;
- SAFE, for "**Foreign Exchange Registration of Trade Payables/Receivables**";
- the tax authority, for export tax refund.

Alternatively, the company can engage a registered "Foreign Trade Operator" to act as its agent and import or export on its behalf.

## IMPORT AND EXPORT LICENSING

The import or export of certain goods may be subject to licensing controls, depending on the type of goods. Different government agencies issue specific licences in accordance with certain laws and regulations. In most cases, a company must apply to and obtain a licence from the relevant government agency before importing or exporting the goods. The company must submit the licence to China Customs, together with the customs declaration, at the time of importation/exportation.

## STRATEGIC AND HIGH-TECH CONTROLS

China does not currently have a comprehensive export control law; different authorities impose controls via a number of separate administrative regulations, each with its own list(s) of controlled items, such as biological, nuclear and chemical

dual-use items and military items. A comprehensive export control law is expected to be enacted in the near future.

"Dual-use items" refers to products and technology that can be used for both military and civilian purposes. These could be products, materials, software, equipment and technology relating to many industries - including nuclear, missile, biological, chemicals and precursor chemicals, and computers.

## CHINA COMPULSORY CERTIFICATION

China Compulsory Certification ("**CCC**", or "**3C**") is a statutory compulsory safety certification system to safeguard consumer rights and interests, and to protect personal and property safety. Products, whether manufactured domestically or imported, may not be placed in the domestic market unless they are certified and carry the CCC mark. Products subject to CCC include household appliances, motor vehicles, motorcycles, safety glasses, medical devices, lighting apparatus, cables and wires. Products imported for specific purposes can be exempted from CCC, such as products for testing and research, spare parts for trial operation or testing of an imported production line.

## COMMODITY INSPECTION AND QUARANTINE

Import and export commodity inspection and quarantine is a national system to inspect and appraise the product quality, quantity, specification, packaging, safety, sanitary criteria, shipping criteria of imported and exported products. Since April 2018, China Customs has taken on the commodity inspection and quarantine functions. A new agency, the State Market Regulatory Administration ("**SMRA**") is responsible for, among others, standards, certifications and accreditations.

## CUSTOMS DECLARATION

With the integration of the commodity inspection and quarantine functions into China Customs, a single consolidated customs and inspection/quarantine declaration is needed for imports and exports. Enterprises only need to declare goods once for customs clearance by using the e-Customs portal instead of having to declare to both customs authorities and CIQ respectively.

A declaration must be made to China Customs



within 14 days of the arrival of the goods, in the case of importation, and within 24 hours before loading of the goods, in the case of exportation. The declaration can be made by the importer, or the exporter, or by the designated Customs Broker with supporting commercial documents, and licences if required.

Declarations are categorised into a "green channel" or "red channel", based on a risk assessment. If the former, China Customs will generally process a declaration within half a day.

## Customs Duty and Import/Export Related Taxes

### IMPORT CUSTOMS DUTIES AND TAXES

China Customs imposes Customs duty and import Value-added Tax ("**VAT**") on imported goods. For importers, the VAT paid to China Customs is usually creditable.

For certain products, such as cosmetics, liquor, oil products, tobacco, auto tyres, motorcycles, motor cars, expensive jewellery, luxury watches, yachts, solid wood flooring, disposal wooden chopsticks and fireworks, China Customs also imposes a consumption tax.

### EXPORT CUSTOMS DUTIES AND TAXES

Most exports are not subject to Customs duty – except for products such as minerals, steel products and wooden products. The export duty rates range from 5% to 40%.

China Customs does not impose VAT on exported goods. In general, an exporter can recover all or part of the input VAT incurred during the manufacturing or procurement process from the local tax bureau. This can be done via the export VAT refund system.

Export VAT refund rates range from 0% to 16%. Generally, high energy/resource consuming products, or high polluting products attract low VAT refund rates.

Exporters can also get the consumption tax refunded if the tax was imposed during the domestic manufacturing or procurement process.

### CUSTOMS VALUATION

China Customs generally follows the concepts and

principles of the World Trade Organisation ("**WTO**") Customs Valuation Agreement when determining the customs value of goods for duty purposes.

### IMPORT

In general, customs value is determined based on the transaction value of the imported goods, including the cost of transportation and associated charges, and the cost of insurance – before the goods are unloaded at the port of entry in China, i.e., CIF value.

The transaction value may be adjusted to include certain elements, such as:

- selling commission and broker fees incurred by the buyer;
- container and packaging costs incurred by the buyer;
- assists – goods and services supplied by the buyer free of charge or at reduced cost for use in connection with the production and sale of goods to China, such as materials, moulds and tools and engineering design works;
- royalties under certain conditions;
- proceeds of any subsequent re-sale, disposal, or use of the goods by the buyer after importation which accrues directly or indirectly to the seller.

Where the transaction value cannot be applied – e.g., in a related party transaction where the transfer price cannot be shown to be at arm's length – other methods will be applied to determine the value of the goods for customs duty purposes.

### LOCAL SALES OF BONDED PRODUCTS

China Customs has issued specific regulations relating to the determination of the customs value of goods stored or processed under bonded conditions, and subsequently sold into local China. These rules are not within the scope of the WTO Customs Valuation Agreement.

### EXPORT

In general, the customs value of exported goods is the FOB value. Alternative methods will be applied in case the transaction value is not applicable.

### CUSTOMS CLASSIFICATION

China adopts the global Harmonized Commodity Description and Coding System ("**HS**") to classify

goods for import/export. China's HS codes are 13-digits: the first six digits are internationally harmonised, the next four digits are for China's customs purposes, and the final three digits for commodity inspection and quarantine purposes.

For China, the customs classification of a good determines the applicable import or export customs duty rate, licensing requirements, and export VAT refund rate.

Due to the complicated nature of products, as well as the differences in the interpretation of the classification rules, tariff classification inconsistencies may occur between China and other countries, and in some cases, across different ports within China.

To mitigate risks, companies may consider applying for advanced ruling on classification with China Customs, via the e-Customs portal. The classification rulings are legally binding and recognised by China Customs offices at the ports.

## COUNTRY OF ORIGIN AND FREE TRADE AGREEMENTS ("FTAS")

China offers preferential duty rates on goods originating from countries and regions that China has FTAs with. Goods originating in China also enjoy preferential import duty rates when exported to the following countries and regions:

- Association of Southeast Asian Nations ("**ASEAN**"): Brunei, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.
- Asia-Pacific Trade Agreement: Bangladesh, India, Korea, Lao PDR, and Sri Lanka.
- Chile, New Zealand, Pakistan, Singapore, Peru, Costa Rica, Switzerland, Iceland, Taiwan, Hong Kong, Macau, Maldives, Georgia, Australia, Korea.

In order to enjoy preferential duty rates, the goods must satisfy the FTA rules of origin. Each FTA has its own rules of origin. The exporter must also obtain a certificate of origin from the competent authority in the exporting country, or prepare a self-declaration of origin, and pass it to the importer for submission to the Customs authority of the importing country. In China, the competent authority to issue the preferential certificate of origin is China Customs.

## Duty Exemption and Suspension

### PROCESSING TRADE

"Processing trade" is a major scheme under which companies can enjoy bonded treatment in China. Under processing trade, a company can import raw materials, spare parts, packaging materials under bonded condition, provided that it processes and manufactures finished products for export overseas.

Imported bonded materials, and the semi-finished products and finished products processed using the materials, are all subject to customs supervision and control, primarily via a tool called "the Customs Handbook". Companies are required to record all materials imported and the finished products exported, as well as the "unit of consumption" in the Handbook. The "unit of consumption" is a concept similar to the bill of materials. China Customs will periodically reconcile the Handbook record against the actual material/finished product inventory. In this way, China Customs ensures that all bonded imported materials are "exported" by way of finished products and no materials are "smuggled" into the domestic market without paying duty and VAT.

Local sales of bonded imported materials and finished products – as well as surplus materials, by-products, defective and inferior products – are allowed, subject to China Customs approval and payment of the applicable customs duty and VAT.

### BONDED ZONES

China has developed various types of bonded zones for specific functions, such as international procurement, international distribution, entrepot trade, international transshipment, international exhibition, bonded storage, bonded transfer and bonded manufacturing. These zones include: bonded logistics centres, bonded logistics parks, bonded port areas, bonded warehouses, export bonded warehouses, export processing zones, free trade zones, integrated bonded zones and cross-border industrial zones.

The Shanghai FTZ represents a new type of bonded zone. Key trade facilitation policies include simplification of goods movements into, within, and out of the zone, tailor-made Customs and

inspection/quarantine facilitation programs for certain industries, such as financial leasing, biological medicine, software, and e-business.

### CAPITAL EQUIPMENT

To encourage the importation of advanced technology and attract foreign investments, an FIE is allowed to import capital equipment with duty exemption. To be eligible for duty exemption, the company has to invest in a business that is "encouraged" according to the Catalogue or the Catalogue of Preferential Industries in Central and Western China for Guiding Foreign Investment. Equipment imported with this exemption is restricted for self-use by the importing company and should not be moved to another location or sold to local market within five years of importation, unless China Customs gives its approval and the applicable duty and import VAT are paid.

### TEMPORARY IMPORTATION AND EXPORTATION

Upon China Customs approval, companies can import or export goods temporarily without paying duty or VAT, provided that they re-export or re-import the goods within six months. Goods eligible for this exemption are usually products used in exhibition, cultural and sports events, instruments used in Research & Development ("R&D"), testing, installation and maintenance activities, product samples and containers. China Customs may require companies to pay a deposit as a condition of their approval. Companies can apply to China Customs to extend the temporary import/export period for no more than six months each time and for a maximum of three times. China Customs accepts the globally adopted ATA Carnet for temporary import and export. The China Chamber of International Commerce is the agency that issues the ATA Carnet to Chinese companies.

## Customs Audit and Investigation

China Customs has been rigorously carrying out post-clearance Customs audits and investigations in recent years, providing effective supervision and counter-balance to expedited Customs clearance.

### CUSTOMS AUDIT

China Customs examines the authenticity and legality of import and export activities through post-clearance reviews. The scope of a Customs audit covers import and export activities within three years after the release of duty-paid goods or the completion of customs supervision period for bonded or duty-exempted goods. Target companies are normally selected based on a Customs' risk management programme.

China Customs' audits normally involve interviews with company management and/or relevant personnel, reviews of accounting records and customs/trade documents, and examinations of the relevant import/export goods, as appropriate. The China Customs officers will provide a draft audit report for the company to comment on. Within 30 days of receipt of feedback from the company on the draft audit report, China Customs will issue a Customs audit conclusion.

If an audit reveals that customs duty and/or taxes has not been paid correctly, China Customs will request the company to pay the short-paid duty and taxes, normally for the past three years, plus interest. If the non-compliance identified meets the threshold for a possible criminal offence, China Customs will transfer the case to the Anti-Smuggling Bureau ("**ASB**") for further handling.

### CUSTOMS INVESTIGATIONS

The ABS is an special police department within China Customs, specially designated to conduct customs investigations of violations of Customs laws and regulations from a criminal perspective. The ASB may be transferred to the Ministry of Public Security in 2019.

If the investigation reveals criminality, the ASB will transfer the case to the public prosecutor for criminal prosecution before the court. Penalties for criminal offences include penalties against:

- companies: monetary fines with potential confiscation of smuggled goods and any illegal gains; and
- the "person in charge and other directly responsible personnel": monetary fines, and/or detention or imprisonment.

If the investigation reveals administrative violations, the ASB will normally transfer the case back to China Customs for their action.

An aerial night view of a city skyline, likely Shanghai, with the Huangpu River and the Oriental Pearl Tower visible. The city is illuminated with warm yellow lights, and the sky is a deep blue with some clouds. Overlaid on the city are several glowing white lines that form a network of arcs and straight lines, connecting various points across the city, symbolizing digital connectivity or intellectual property. A thick orange vertical bar is on the left side of the page.

# Chapter 14

# Intellectual Property

## Regulatory Environment

China has a comprehensive regime of intellectual property laws that provide a wide range of remedies and channels for enforcement – including civil and criminal courts, several different administrative enforcement authorities, prosecutors and police. Legislation facilitating private prosecution by intellectual property owners came into effect in 1997. These laws are compliant with the requirements under the Agreement on Trade-Related Aspects of Intellectual Property Rights ("**TRIPs Agreement**") of the World Trade Organisation. China is also a party to most of the international conventions on IPRs, including:

- The Paris Convention for the Protection of Intellectual Property Rights
- The TRIPs Agreement
- The Berne Convention for the Protection of Literary and Artistic Works
- The Universal Copyright Convention
- The World Intellectual Property Organisation ("**WIPO**") Copyright Treaty
- The Locarno Agreement for International Classification for Industrial Designs
- The Madrid Agreement for the International Registration of Trademarks
- The Nice Agreement for the International Classification of Goods & Services
- The Patent Co-operation Treaty
- The Strasbourg Agreement for International Patent Classification
- The Budapest Treaty for Deposit of Micro-organisms
- The Geneva Convention on Unauthorized Duplication of Phonograms
- The WIPO Performances and Phonograms Treaty

China established specialised intellectual property courts in Beijing, Shanghai and Guangzhou in November 2014 ("**IP Court**"). These IP Courts have trans-regional jurisdiction over first instance civil lawsuits and administrative cases which concern highly technical subject matters such as patents, plant varieties, circuit layout designs and technology secrets. The IP Courts also have jurisdiction over appeals from first instance copyright and trademark civil decisions, as well as appeals from administrative decisions made by the basic level

courts of the municipalities, where the IP Courts are respectively located. All appeals against decisions made by the State Intellectual Property Office – including the China Patent Office and the China Trade Mark Office – are heard by the Beijing IP Court, rather than the Beijing First Intermediate People's Court.

With effect from 1 January 2019, the Supreme People's Court ("**SPC**"), via the Intellectual Property Tribunal ("**IP Tribunal**"), has jurisdiction to hear appeals from both civil and administrative matters in the following areas:

1. Civil first instance decisions made by specialist IP courts and intermediate courts in invention and utility model patent infringement, new plant species, integrated circuit design, trade secret, software and anti-trust cases. Currently, these are appealed to higher people's courts at the provincial level;
2. Decisions of the Beijing IP court in administrative matters relating to patents, new plant species, integrated circuit designs, trade secrets, software and antitrust, including appeals against Patent Re-examination Board ("**PRB**") and patent office decisions.

The aim is to create a unified ruling standard for Intellectual Property ("**IP**") litigation in China to achieve the following: further strengthen the legal protection of IP rights, enhance the legal enforcement environment for technological innovation and advance the implementation of innovation-driven development strategies.

In September 2018, SPC issued a judicial interpretation concerning the trial of cases by Internet Courts which provides useful guidance for online trial procedures at Internet Courts in China. There are currently three Internet Courts (located in Hangzhou, Beijing and Guangzhou) which can hear cases at first instance that involve disputes regarding:

- e-commerce terms of service;
- service agreements that are executed online;
- loans executed online; copyright and neighbouring rights;
- domain names; and
- product liability in relation to defective products purchased online.

The Internet Courts also have jurisdiction over

internet-related public interest litigation brought by public prosecutors, and other internet-related civil or administrative cases assigned by a higher court and have jurisdiction over domain name disputes. Evidence stored and verified on blockchain platforms are allowed to be used in legal disputes heard by the three Internet Courts. The Internet Courts may consider evidence provided by the parties that can be proven authentic through electronic signatures, time stamps, hash value checks, and tamper-proof verification methods stored on blockchain platforms.

## Patents

Patent protection is available in China for inventions, utility models and designs. An invention is any new technical solution to a process or product, or an improvement to a process or product. A utility model is any new technical solution relating to the shape, structure, or their combination of a product that can be effectively used. A design is a new design of the shape, pattern, colour, or their combination, of a product that has an aesthetic effect and is suitable for industrial application. In order to be patentable, an invention or utility model must be novel, non-obvious and have practical application. A design must be novel. No patent will be granted for scientific discoveries, rules and methods for mental activities, methods for the diagnosis or for the treatment of diseases, animal and plant varieties and substances obtained by means of nuclear transformation.

The duration of a patent right is 20 years for an invention and 10 years for a utility model or design, commencing from the date of the patent application.

The enactment of the *Third Amendment to China's Patent Law*, which came into effect on 1 October 2009, introduced, among other changes, enhanced judicial and administrative protections. Notable changes include provisions for the preservation of evidence of infringement prior to the commencement of legal proceedings, and new operational powers for the local patent administrative authorities to search premises and seize evidence to prove passing off of a patented product.

The latest draft amendment of *Patent Law* for public comment was published by the National People's Congress of China ("**NPC**") on 4 January 2019, which was open for public review and

comments for one month. Notable changes include provisions that the damage compensation is increased from three times to five times of actual damages in case of wilful infringement and the maximum statutory damage is increased from RMB 1 million to RMB 5 million (Amended Art. 72), burden of proof may shift from patent owner to defendant in determination of damage and compensation (Amended Art. 72), a patent license of right is deemed granted by a patent owner to any entity or person upon a written notice and standardized payment made by such patent implementer (Amended Art. 50 and 51), the duration of design patents now is extended from 10 years to 15 years (Amended Art. 43), and a later filed design patent application can claim a priority date of another design patent application on same subject matter filed within six month in China (Amended Art. 30).

## Trademarks/Service Marks

A trademark can be any word, design, alphabet, numerals, 3-dimensional sign, colour combination, sound or any combination of these, which is used to distinguish the source of goods or services. A trademark must be distinctive and cannot include certain words or designs, including national names or flags, generic names of goods, or direct references to the quality or other features of the product or service. Multi-class applications and applications in electronic form are permitted. China essentially operates under a "first-to-file" system but bad faith filings are discouraged and may be subject to opposition or rectification. The current law however tries to curb "unmeritorious" oppositions, by allowing only prior rights owners or interested parties to raise an opposition. The period of validity of a trademark is 10 years from the date of approval of the registration. A registration is renewable for additional 10 year periods. A registered trademark that has not been used for three consecutive years may be cancelled. Trademark licences may be recorded with the Trademark Office during the effective period of the licence.

The use of unregistered trademarks is not prohibited. However, pharmaceutical and tobacco products must bear at least one registered trademark as a condition to sale.

China affords more protection to well-known marks. Although the *PRC Trademark Law* stipulates

reciprocal treatment of well-known marks recognised by the competent authority of a foreign country that is also a party to the Paris Convention and/or the TRIPs Agreement, Chinese national marks continue to dominate the list of approved well-known marks published biannually by the China Trade Mark Office.

The *Trade Mark Law* made efforts to enhance enforcement by trademark owners. For example, the court may order an infringer to disclose its account books or other information in order to assess damages, and if the infringer fails to do so, the amount of damages may be determined by reference to the amount proposed by the trademark owner. There are also increased statutory damages and administrative penalties.

## Unfair Competition

The *Anti-Unfair Competition Law* ("**AUCL**") is China's main legislation which regulates trading practices by prohibiting unfair trade practices and this provides for the protection mark, brand name, packaging or trade dress with certain degree of influence. The law also prohibits unauthorised uses of the enterprise or personal name of another party that could cause consumers to mistake the products or services for the products or services of another party. Trade dress refers to words, drawings, colours or combinations of words, drawings and colours which appear for aesthetic purpose on products or product packaging and which render the products distinguishable.

The amended AUCL came into effect on 1 January 2018 and the revision addresses new economic practices. The amended AUCL contains a new prohibition against the use of technical means by one business to interfere with or sabotage the provision of online products or services by another business, whether by influencing the choices of online users or by other means.

New categories of prohibited acts that contemplate online trading practices have been added, in particular, a prohibition against using the principal part of a domain name, website or webpage name of a certain degree of influence without the permission of its owner. A new "catch-all" provision has also been added which prohibits other acts of confusion sufficient to mislead a person into believing that a commodity originates from another person, or is otherwise associated with another person.

## Copyright

Copyright protects the way in which a work is expressed, rather than ideas in a work. As a general rule, copyright subsists in a work only if the work is original and the subject matter is protectable. China's *Copyright Law* extends protection to a variety of works, including literary works, oral works, music, drama, folk art, choreography acrobatic works, artistic and architectural works, photographic works, cinematography, television and video graphic works, plans of engineering design and product design, maps, illustrations, other diagrams and models, computer software, and other works stipulated by laws and administrative regulations.

Both economic rights and moral rights, including the right to determine whether to publish a work, to get acknowledgement as the creator of a work, to control amendment of a work, and to preserve its completeness, are protected.

In most cases, the period of copyright protection extends for the life of an author plus 50 years. The copyright protection period for film, television, video and photographic works is 50 years, commencing on the date of their first publication.

China has a system of voluntary registration of copyright works that facilitates the proof of subsistence and ownership of copyright in contentious proceedings.

## Software Protection

China has specific rules on software protection. Under these rules, software can be registered with the National Copyright Administration to provide prima facie evidence of ownership. Registration of local software is required prior to protection but foreign software is protected as a literary work and does not require registration as a condition to enforcement. Foreign computer software programs are protected for 50 years.

A software copyright holder or its assignee can licence software for a period up to 10 years. Upon expiry, a licence may be renewed. A party legally holding a copy of software is entitled to load it into his/her computer, make a back-up copy, and alter the software as necessary for use. It is permissible to make a limited number of copies without express authorisation, or payment of remuneration for "fair use", including classroom teaching, scientific research, or as needed by the state.

## Confidential Information and Trade Secrets

Trade secrets are principally protected under the AUCL. The *Labour Contract Law* also offers specific protection of trade secrets against employee disclosure.

Trade secrets are defined as technical or economic information that is non-public (unknown to the public) and can bring economic benefits to a party that has rights in such secrets. Under the amended AUCL which came into force on 1 January 2018, even abstract concepts and theories (which may lack practicability) may qualify as trade secrets. An owner of trade secrets must take reasonable precautionary measures to protect them.

It is advisable to include confidentiality undertakings in employment contracts and technology transfer agreements. In addition, it is necessary to adopt reasonable procedures to protect confidential information that has been revealed to employees, licensees and trading partners in China.

Third parties who obtain, use or divulge trade secrets of others that they know (or ought to know) are trade secrets of third parties will be deemed to have infringed trade secrets. A third-party would also be liable for the misuse of a trade secret if he or she knew, or ought to have known, that the secret was acquired by illegal means (e.g. by theft or in breach of an agreement) by an employee or former employee of the trade secret owner, or by any other entity or individual.

## Customs

Recordal with China Customs is available to trademarks registered with the China Trade Mark Office, patents issued by the China Patent Office and copyright works with certificates issued by the National Copyright Administration or equivalent bodies in other countries such as the US Copyright Office as evidence of ownership in a work. Recordals are valid for 10 years, provided that the rights in the protected work do not expire before the said period, and applications for renewal can be submitted.

China Customs have the powers to detain suspected infringing goods at ports of import or export, upon payment of a security bond by the right owner. If the goods are confirmed to be

infringing, customs may confiscate or destroy the infringing goods and impose fines on the infringer. Customs recordals are helpful measures for facilitating China Custom's detention and seizure of infringing goods at the border. For seizure based on an IPR validly recorded with China Customs, the security bond will be capped at RMB 200,000. If no recordal is filed, the IPR owner will have to pay the bond in a sum equivalent to the total value of the goods, which can be very substantial.

The China Customs introduced an electronic recordal system to increase the reliability and accuracy of filing information. The new recordal system has been officially in use since 1 March 2014.





# Chapter 15 Environmental Protection

## Environment Generally

The *PRC Environmental Protection Law* is the national law governing all environmental protection matters in China. In addition, other laws and regulations such as the *Prevention of Atmospheric Pollution Law*, the *Prevention of Water Pollution Law* and the *Prevention of Soil Pollution Law* have been enacted and revised in recent years to regulate different parts of the environment and to tackle the increasingly challenging environmental issues in China. Different provinces and municipalities have also implemented their own environmental protection regulations – these are applied regionally. FIEs in China are subject to the same regulatory regime of environmental protection as domestic enterprises.

The government has been strengthening environment protection legislation in recent years, and so greater power has been granted to environment authorities, with harsher punishments imposed on polluters. Violation of environment laws and regulations may be subject to administrative fines, cessation of business or in the most serious cases, criminal liabilities on the management in charge.

## Carbon Emissions Trading in China

The concept of carbon emissions trading developed as a result of the increasing awareness of the need to reduce emissions in order to protect the environment and this has been endorsed by the Kyoto Protocol and the Paris Agreement, with China being one of the signatories.

In November 2011, the NDRC issued the Circular Concerning the Implementation of a Pilot Scheme for Carbon Emissions Trading which formally approved seven cities/regions (including Beijing, Tianjin, Chongqing and Shanghai as well as the industrial regions of Shenzhen, Hubei and Guangdong) to implement pilot schemes for carbon emissions trading. The implementation of the seven pilot schemes are based on rules and regulations promulgated by the relevant municipal/provincial governments and the local Development and Reform Commissions ("**DRC**"). These pilot schemes adopt the same structure but with particular requirements that may vary from each other. The pilot period of most of the seven pilot cities/regions has expired towards the end of 2015. Since then,

cities/regions such as Beijing, Shanghai and Tianjin have promulgated transitional arrangements to cater for carbon emissions trading pending the establishment of the national carbon emissions scheme.

On 10 December 2014, NDRC promulgated the Tentative Measures for the Administration of Carbon Emissions Trading ("**NDRC Measures**") which lay down the legislative framework for the establishment of a nationwide carbon emissions trading scheme and set out the general principles covering various aspects of the national trading scheme such as the scope of application, verification and certification of emissions credits, allocation of quotas, reporting requirements and trading of carbon credits.

On 18 December 2017, NDRC officially launched China's nationwide carbon emissions trading scheme by issuing the National Carbon Emissions Trading Market Development Plan ("**Power Generation Sector**") with its first phase focusing on the power generation sector. Approximately 1,700 power-generating enterprises, which could in total generate an annual emission reaching three billion tons of carbon dioxide equivalent, are required to participate in this nationwide trading scheme. The nationwide trading scheme is expected to be later expanded to cover additional sectors, including petrochemical, chemical, building material, and iron and steel sectors.

## Control of Pollution from Electrical and Electronic Products

FIEs engaged in manufacturing, selling and importation of electrical and electronic products ("**EEPs**") in China – except where such products are to be exported outside China, – should be aware of the regulatory requirements under the Chinese legislation restricting the use of hazardous substances in EEPs. Such legislation is the Chinese equivalent of the EU RoHS, and so is known as the "China RoHS". The Ministry of Industry and Information Technology of China ("**MIIT**") has overall control over the implementation of the China RoHS.

In 2006, MIIT promulgated the Administrative Measures for the Control of Electronic Information Products Pollution (commonly known as the "**China**

**RoHS 1**") which came into force on 1 March 2007 and regulated the use of hazardous substances in electronic information products ("**EIPs**") which is defined to mean "products produced with electronic information technologies such as electronic radar products, electronic communication products, radio and television products, computer products, household electronic products, electronic measurement devices, special electronic products, electronic components, electronic application products and electronic materials, as well as the accessories of these products". On 6 January 2016, the MIIT and seven other ministries jointly published the new China RoHS entitled the Administrative Measures for the Restriction of Use of Hazardous Substances in Electrical and Electronic Products (commonly known as "**China RoHS 2**") which came into force on 1 July 2016. China RoHS 2 expands its scope of application from EIPs to EEPs which is defined to mean "equipment and accessory products with rated working electrical voltages of no more than 1,500 volts direct current and 1,000 volts alternating current which function by means of current or electromagnetic fields, and generate, transmit and measure such currents and electromagnetic fields". Similarly to China RoHS 1, China RoHS 2 restricts the use of lead, mercury, cadmium, hexavalent chromium, polybrominated biphenyls ("**PBB**") and polybrominated diphenyl ethers ("**PBDE**") and their compounds as well as other hazardous substances designated by the State in EEPs.

On 12 March 2018, in order to further implement China RoHS 2, MIIT published a Compliance Management Catalogue for the Restriction of Use of Hazardous Substances in Electrical and Electronic Products (First Batch) ("**Compliance Management Catalogue (First Batch)**") and an Exemption List of Applications of the Restricted Substances Provided by the Compliance Management Catalogue ("**Exemption List**"). The Compliance Management Catalogue (First Batch) contains 12 categories of EEPs including refrigerators, air conditioners, electric water heaters, washing machines, televisions, micro-computers, monitors, handheld phones for mobile communication, etc. EEPs being listed in the Compliance Management Catalogue are subject to substance restrictions, and testing of such EEPs should be carried out in accordance with a "Conformity Assessment Scheme" jointly established by the

Certification and Accreditation Administration Commission and the MIIT. Those EPPs on the Exemption List are exempted from these requirements.

## Control of Pollution from Solid Waste

The *PRC Law on the Prevention and Control of Environmental Pollution Caused by Solid Waste* ("**Solid Waste Law**") was enacted in 1995. This longstanding law serves as the overarching legislation governing the treatment of solid waste generated domestically and imported into China. Various pieces of subordinate legislation, such as the Administrative Measures for the Import of Solid Waste, have also been promulgated to further implement the *Solid Waste Law*.

The most recent revisions of the *Solid Waste Law* took place in 2015 and 2016 which have brought significant changes to the management of imported waste. As a result of such revisions, the solid waste to be imported into China is categorized into three new categories subject to three different catalogues, namely the Catalogue of Solid Waste Prohibited for Import (the "**Prohibition Catalogue**"), the Catalogue of Solid Waste Restricted for Import for Use as Raw Materials (the "**Restriction Catalogue**") and the Catalogue of Solid Waste Not Restricted for Import for Use as Raw Materials (the "**Non-restriction Catalogue**"). Solid waste listed in the Prohibition Catalogue is referred to by the Chinese government as "foreign garbage" which is strictly prohibited from being imported into China. Solid waste listed in the other two catalogues could be used as raw materials for the manufacturing of industrial products and is therefore permitted to be imported into China, provided that such solid waste meets the relevant regulatory requirements and passes inspection and quarantine by the relevant authority. In addition, the solid waste listed in the Restriction Catalogue must obtain import license before importation, while such requirement does not apply to solid waste listed in the Non-restriction Catalogue.

On 18 July 2017, the State Council issued a Circular Concerning the Implementation Plan for Prohibiting the Entry of Foreign Garbage and Advancing the Reform of Solid Waste Import Administration System which announces that China will "fully"

prohibit the import of "foreign garbage" through gradual changes of the relevant laws and policies. Subsequently, the Ministry of Ecology and Environment ("MEE") and other authorities jointly published various revisions to the three catalogues mentioned in the preceding paragraph. Amongst others, 56 types of solid waste (which previously were listed in the Restriction Catalogue or Non-Restriction Catalogue) have been moved to the Prohibition Catalogue of which:

- 24 types including plastic wastes, unsorted waste paper, waste raw materials of textile industry, vanadium slag, etc. are prohibited from importing into China from 31 December 2017;
- 16 types including waste hardware, obsolete vessels, compressed automobile scrap, etc. are prohibited from importing into China from 31 December 2018; and
- 16 types including waste and scrap stainless steel, waste and scrap titanium, wood waste, etc. are prohibited from importing into China from 31 December 2019.

## Control of Pollution from Electronic Waste

Among various types of solid waste, China has established a specific regulatory regime for electronic waste. The Chinese regulatory regime on disposal of electronic waste is mainly formulated in the *Administrative Measures for the Prevention and Control of Environmental Pollution by Electronic Waste and the Administrative Regulation on Recycling and Disposal of Discarded Electronic Appliances and Electronic Products*. These measures are the Chinese equivalent of the EU WEEE, and so are known as the "**China WEEE**". MEE (formerly known as MEP), together with NDRC and MIIT, are the key authorities coordinating the enforcement of China WEEE.

The China WEEE sets out various regulatory requirements concerning the disposal of electronic waste. For example, manufacturers, importers and sellers of EEPs should establish a proper system to recover discarded equipment and store, reuse and dispose of it in an environmentally friendly manner. Failing this, penalties are to be imposed. Electronic waste under the China WEEE includes discarded electronic appliances and electronic products set out in the Catalogue of Discarded Electronic

Appliances and Electronic Products, the first batch of which was issued on 8 September 2010. It covers five categories of products only i.e., televisions, refrigerators, washing machines, air conditioners and micro-computers. On 1 March 2016, the revised version of this Catalogue (i.e., the 2014 Version) came into force. The 2014 Version now covers 14 categories of products adding other products such as printers, photocopiers, fax machines, handheld phones for mobile communication.

Manufacturers and importers of EEPs, or their agents, are also obliged to contribute to a fund established by the government to subsidize the recovery and disposal of EEPs.

The China WEEE further requires manufacturers, importers, and sellers of EEPs, to restrict or eliminate the use of toxic and hazardous substances in the equipment. Such requirements tie in the China WEEE to the China RoHS. Thus, FIEs engaged in the relevant industries, should bear in mind both of these measures when doing business in China.

An aerial photograph of a complex, multi-level highway interchange in a city. The interchange features numerous overpasses and ramps, creating a dense network of elevated roads. The surrounding urban landscape includes various high-rise buildings and residential structures. The sky is clear and blue, suggesting a bright day. A vertical yellow bar is positioned on the left side of the image, partially overlapping the text.

# Chapter 16 Product Liability

## General

A company that manufactures, sells or distributes its products in China must meet various general requirements imposed by law on the products.

In addition to the general statutory duties and regulatory requirements, a company engaged in a specific industry such as food, medicine and pesticide is required to observe other statutory duties and regulatory requirements specific to that industry.

## General Statutory Duties

The *PRC Product Quality Law* imposes various general statutory duties on a manufacturer and a seller of products that can be summarised as follows:

### DUTIES OF A MANUFACTURER

A manufacturer must ensure that its products possess the requisite properties for use, conform to the standard, and quality indicated on the product or its packaging, pose no unreasonable danger to personal safety and to the safety of other properties. A manufacturer must also ensure that its products comply with national or industry standards for health and safety. Information printed on a label must be true and accurate and labelling of a product must also comply with specific requirements such as display of a certificate of fitness as to quality, the name and address of the manufacturer in Chinese, the date of production and the expiry date for use, warnings in Chinese or warning signs alerting potential dangers in case of improper use. Obsolete items declared by the government cannot be manufactured, and the origin of the product concerned must be correctly and accurately displayed.

### DUTIES OF A SELLER

A seller must establish a system for inspection and acceptance of products purchased - to verify the certificate of fitness for the quality and other information contained in labels. A seller must also take measures to ensure that the quality of the products is maintained while they are kept by the seller. Items declared obsolete, and which the government has ordered to cease selling, products with expiry dates that have lapsed, and products no longer fit for use, cannot be sold. In no event should a seller tamper with the information relating

to the origin of the product concerned and the information contained in a label or the certificate of fitness as to quality.

## Regulatory Requirements

### RESPONSIBLE AUTHORITIES

As a result of the restructuring of the Chinese central government in the beginning of 2018, various authorities which were responsible for product quality were merged into the newly established authorities.

In 2018, China established the State Administration for Market Regulation ("**SAMR**") which subsumes the responsibilities previously held by the former China Food and Drug Administration ("**CFDA**"), Administration of Quality Supervision, Inspection and Quarantine ("**AQSIQ**") and SAIC and oversees all matters concerning market controls including food and drug administration, industrial product safety, quality inspection, and certification and accreditation. The new National Medical Products Administration of SAMR ("**NMPA**") is now responsible for the regulation of cosmetics, drugs and medical devices. In addition, the General Administration of Customs ("**GAC**") has officially merged with the Entry & Exit Inspection and Quarantine Bureaus (i.e., the former CIQs of AQSIQ). GAC is now also responsible for the quality inspection and quarantine of imported and exported goods.

### STANDARDS

In addition to the requirements provided by the relevant Chinese laws and regulations, the detailed product regulatory requirements are often provided in the relevant Chinese standards. Standard for a particular product may be enacted at five different levels: national standard, industry standard, local standard, group standard and corporate standard. The concept of a "group standard" has been introduced by the newly revised *PRC Standardization Law* which came into force on 1 January 2018. According to this revised Law, a "social group" such as academy, industry association, chamber of commerce etc. is entitled to establish group standard which may provide specific requirements applicable to the members of such a social group. Parties outside the social group may also choose to comply with the requirements of group standard.

National standards (i.e., GB standards) are mandatory in nature and must be strictly observed. In the absence of an applicable national standard, the product may comply with the relevant industry standards, local standards, group standards or corporate standards. Different government departments are placed in charge of supervising, regulating and enforcing compliance with these standards depending on the product category.

## Consequences of Breach or Non-Compliance

If a company breaches its statutory duties or fails to comply with a regulatory requirement, it may be held liable as follows:

### A. ADMINISTRATIVE PENALTIES

This is the most immediate and direct consequence. A fine is almost inevitable but depending on the circumstances, a company may be ordered to rectify the non-compliance and its products may be recalled and it may be ordered to cease manufacturing and/or sale. In a serious case, the manufacturer or seller's business license may be revoked.

### B. CIVIL LIABILITY

Any product sold with quality issues may render a manufacturer and/or a seller liable for repairing, replacing or returning the products concerned, and for payment of loss and damage suffered by a buyer.

If products are "defective" either for posing an unreasonable danger to safety or for failure to comply with national or industry standards, a manufacturer will be held strictly liable unless one of the following defences exists:

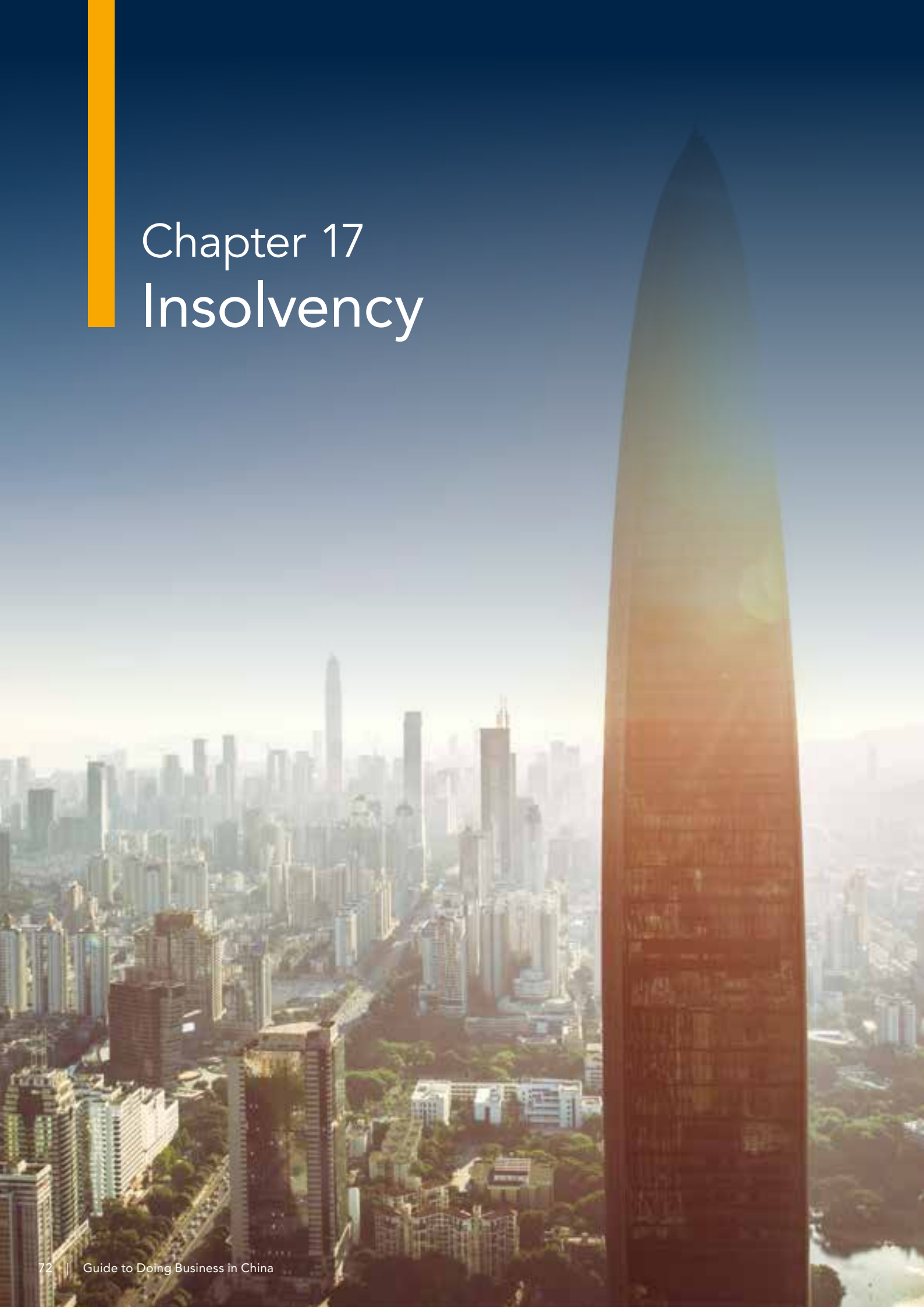
- the manufacturer can prove that the products concerned have not yet been released in the market;
- no defect causing damage existed at the time when the products were released for circulation; or
- the level of science and technology at the time when the products were released for circulation had not reached a level to detect the existence of the defect.

If a defect in the products is attributable to the fault of the seller, or to the manufacturer, or the supplier, whose identities cannot be ascertained by the seller, then the seller will also be held liable.

An injured party may elect to sue for breach of contract or bring an action in tort for damages arising out of defects in a product. For breach of contract, the limitation period will be three years from the date when the injured party knew or ought to have known that his or her rights have been infringed. For an action in tort, the limitation period will be two years from the date when the injured party knew or ought to have known the defect.

### C. CRIMINAL LIABILITY

In the most serious cases, a breach of the statutory duties or a failure to comply with regulatory requirements on product quality may constitute a criminal offence, with the individual concerned and possibly the company employing the individual being held criminally responsible.

An aerial photograph of a dense urban skyline, likely Hong Kong, featuring numerous skyscrapers and a prominent, tall, slender tower in the foreground on the right. The sky is clear and blue, and the city is bathed in warm, golden light, suggesting sunrise or sunset. A thick yellow vertical bar is positioned on the left side of the page, partially overlapping the text.

# Chapter 17 Insolvency



# Introduction

## INSOLVENCY AND RESCUE PROCEDURES UNDER THE ENTERPRISE BANKRUPTCY LAW

The *Enterprise Bankruptcy Law* ("**EBL**") was enacted in 2006 and came into effect on 1 June 2007. The EBL applies to all legal entities, regardless of whether or not they are SOEs and includes Chinese companies operating overseas and foreign companies operating in China, that are FIEs, such as WFOEs and JVs.

Overall, the insolvency regime in China largely follows standard international insolvency approach and recognises the rights of secured creditors and provides for cram down, moratorium, and avoidance provisions.

The court has the most significant role in the outcome of restructuring and insolvency procedures. The debtor's liabilities owed to employees and the state – such as wages, social insurance premiums and taxes – rank ahead of unsecured creditors on the debtor's insolvency.

China has, since 2016, established specialized bankruptcy courts within the Intermediate People's Courts to deal with matters under the EBL and is progressively establishing these courts in various provinces.

China has not adopted the *UNCITRAL Model Law on Cross-Border Insolvency*, and instead relies on principles of reciprocity and the existence of treaties with foreign nations.

### SUMMARY

There are three main options available under the EBL:

- Liquidation;
- Restructuring;
- Compromise.

These options are outlined below. Note that this Chapter does not discuss solvent liquidations.

## Bankruptcy

There are two types of bankruptcy liquidations under the EBL:

- Voluntary liquidations, which are commenced by the debtor; and
- Involuntary liquidations commenced by any

creditor of the debtor entity.

A bankruptcy declaration applies to all assets located around the world and not just to the debtor's assets in China.

### VOLUNTARY LIQUIDATIONS

#### a. Requirements

Before it may file a bankruptcy petition with the relevant People's Court, the enterprise must first meet two tests: the cash flow test and the balance sheet. The cash flow test is met if the debtor is unable to pay its debts as they become due. The balance sheet test is met if the debtor has insufficient assets to pay off its debts.

#### b. Consents/approvals

Should the court accept the petition, it will appoint an administrator to take over the assets and business of the debtor. It is then up to the administrator to decide (but subject to the court's final approval) whether or not to continue operations before the first meeting of creditors, and whether to terminate or fulfil incomplete contracts that were entered into before the bankruptcy application. If the debtor has been involved in any civil action, or arbitration proceedings, prior to acceptance of the bankruptcy petition, such proceedings will be suspended for the period after acceptance of the petition, up to the date the administrator takes over the assets of the debtor.

If investigations find that the debtor deliberately concealed, or transferred property, or that substantial assets are unaccounted for and the debtor is using the bankruptcy mechanism as a means to avoid the payment of debts, then the administrator can take steps to recover the assets on the basis that the transactions underlying the concealment and transfer of assets are void.

### INVOLUNTARY LIQUIDATIONS

#### a. Requirements

Involuntary liquidation occurs when a creditor petitions for the bankruptcy of a debtor due to non-payment of debts as they become due. Only the cash flow test needs to be met. Once the petition is filed, the debtor will receive notification from the court and be allowed to voice any objection it has to the petition before the court makes its decision whether to accept the petition.

## *b. Consents/approvals*

Once the petition is accepted by the court, the procedure is broadly the same as that of a voluntary liquidation. An administrator is appointed who has the power to make various decisions in respect of the management of assets and operations of the debtor.

### THE INDEPENDENT ADMINISTRATOR

The administrator is appointed by the court, and their role is to manage the affairs of the company and control its administration, report regularly as agreed with the court, and satisfy requests made by the creditors' committee.

The administrator's duties and powers include:

- taking control of the assets of the company;
- investigating the debtor's property status;
- managing the company's affairs;
- deciding with the permission of the court, whether the debtor should carry on business prior to the convening of the first meeting of creditors;
- administering and disposing of the debtor's property;
- participating in litigation, arbitration, or other legal proceedings on behalf of the debtor;
- convening the creditors' meeting;
- performing other duties as the court thinks appropriate; and
- seeking the application of avoidance powers, and playing an integral role in a debtor's restructuring proceedings.

There are Supreme People's Court guidelines for:

1. application and announcement procedures regarding the appointment of administrators; and
2. the determination of remuneration of such designated administrators.

The appointment practice varies from region to region in China. Each of the Higher People's Courts and certain Intermediate People's Courts has its own panel of administrators. They will usually be accounting firms, law firms or firms specialising in bankruptcy proceedings. In some cases, individuals are also allowed. To optimize the quality of, and administration over, the various administrators, the local courts may also appoint an administrator from

other provinces or cities for a significant bankruptcy case, or appoint two professional firms, often one accounting and one legal firm, to jointly act as the administrator of one single bankruptcy case.

The administrator is answerable to the court and supervised by the creditors' meetings and committee. The creditors' meeting can apply to the court to have the appointed administrator removed for failing to discharge his/her duties properly. The court has the final say in the appointment of the administrator.

### MORATORIUM AND CERTAIN CREDITOR RIGHTS

Once the bankruptcy court/division accepts a bankruptcy application, the enforcement court (or the enforcement division of the same court) should, in theory, release any attachment in relation to the debtor's property and suspend the enforcement proceedings. If so requested by the bankruptcy court/division, the enforcement court/division should pass the right of disposition of the debtor's seized assets along to the bankruptcy court/division so that the latter will be empowered to take over and realize the debtor's assets previously seized by the enforcement court/division.

The administrator can decide whether to terminate or fulfil the debtor's ongoing contractual obligations. In the case of termination, creditors may prove damages suffered as a result of termination of the contract. In the case of fulfilment of the debtor's contractual obligations, the creditor can obtain payment as a post-bankruptcy debt in priority to pre-bankruptcy debts. Unless they have waived their rights to priority in payment, secured creditors do not have the right to vote on the adoption of settlement agreements, or on adopting plans to distribute the debtor's property. However, secured creditors may exercise their security rights once the court has ruled in favour of the proposed settlement or once the debtor is declared bankrupt (as applicable).

A creditor can ask the administrator to set off debts owed by the debtor against its debts owed to the debtor upon fulfilment of certain conditions under the EBL.

### APPLICATION TIMING

Bankruptcy proceedings begin as soon as the court has accepted the petition. The length of the

proceedings depends on the complexity of the case.

#### **a. Creditor petition**

If a bankruptcy petition is filed by a creditor, the court must notify the debtor within five days of receiving the petition. The debtor can object to the petition within seven days of receipt of the notification. The court will rule on whether to accept the petition within ten days of the expiration of the seven-day objection period. If necessary, the deadline for ruling on acceptance of the bankruptcy petition can be extended for 15 days, subject to approval of the court at the next higher level.

#### **b. Others**

In other cases, the court will make its decision within 15 days of receiving the petition. Again, the deadline for ruling on acceptance of the bankruptcy petition can be extended for 15 days, subject to approval of the court at the next higher level.

### **VOIDABLE TRANSACTIONS**

The EBL gives the administrator powers to avoid transactions entered into by the debtor up to one year before the court accepts the application for bankruptcy. Examples include:

- Transfer of the debtor's assets at no consideration or at a price which is obviously unreasonable.
- Provision of security for debts which do not require security.
- Prepayment of debts which are not due.
- Waiver of claims.

A debt repaid to a specific creditor (except payment of labor remuneration or damages for personal injury etc.) within the six months before the court's acceptance of the bankruptcy application when the debtor was insolvent may also be avoided, unless the debtor's property benefited from the specific repayment.

### **LIABILITY OF MANAGEMENT**

The administrator can apply to the court to seek recovery of:

- improper income obtained by directors and senior management taking advantage of their positions; and
- any property of the debtor misappropriated by

such directors and senior management in the same manner. In each case the relevant directors and senior management will be personally liable.

### **PRIORITY OF CLAIMS**

Secured creditors have priority over the secured assets to the extent of their claims.

They are paid from the sale proceeds of the secured property and have payment priority to the extent of the value of such property, while the portion which has not been fully paid is treated as an ordinary claim. Payment of claims in a liquidation, from unsecured assets of the enterprise, must be made according to the following order:

- i. bankruptcy expenses and debts for common benefit;
- ii. unpaid salaries, various subsidies and basic social insurance premiums of employees;
- iii. outstanding tax; and
- iv. ordinary unsecured credits.

## **Restructuring**

Restructuring proceedings are available to prevent the liquidation of enterprises established in China that have sufficient assets but are experiencing cash flow problems.

### **APPLICATION**

The debtor entity, or its creditor, can apply to court for restructuring. Even if the court has accepted a bankruptcy petition filed by the creditor of a debtor entity, so long as the court has not declared the debtor bankrupt, the debtor or its shareholder (holding more than 10% of the debtor's registered capital) can also apply to the court for restructuring.

### **COMMENCEMENT OF RESTRUCTURING PROCEEDINGS**

The restructuring proceedings begin on the date on which the court makes a ruling for the restructuring.

### **REQUIREMENTS**

A debtor applicant must prove that either:

- the debtor is unable to pay its debts when due, and has insufficient assets to pay off its debts

or is obviously lacking the ability to repay the debts, i.e., the balance sheet test; or

- there is a real possibility that it will lose the ability to repay its debts

Where a creditor is the applicant, it must show that the debtor is unable to pay its debts as they fall due.

## CONSENTS/APPROVALS AND TIMING

The administrator or debtor must prepare and submit a draft restructuring plan to the court within six months (extendable for another three months if approved by the court) as of the date of the commencement of the restructuring proceedings. If the administrator or debtor fails to submit to court a draft restructuring plan within the requisite timeline, the court will make a ruling to terminate the restructuring proceedings and declare the debtor bankrupt.

Within 30 days after receiving such draft restructuring plan, the court must convene a creditors' meeting to vote on the draft restructuring plan.

Such a draft restructuring plan must be adopted by a majority of the creditors in each voting class present at the creditors' meeting, representing at least two-thirds in value of total claims in that class. Classes are split into:

- secured creditors;
- employees;
- agencies with outstanding tax claims; and
- ordinary claims.

The relevant court has the discretion to set up a voting group of deminimus claims within the class of ordinary claims for the purpose of voting on the draft restructuring plan.

Shareholders can attend the creditors' meeting to discuss the draft restructuring plan in a non-voting capacity. However, where the draft restructuring plan involves adjustment of the interests and benefits of the shareholders, a voting group of shareholders is set up for them to vote on such matters.

Once the draft restructuring plan is adopted by all classes of creditors or voting groups, the administrator or debtor must file an application to the court for final approval within 10 days from the date of adoption.

If the draft restructuring plan is not adopted by any class of creditors or voting group, the administrator or debtor is still allowed to apply to the court for approval of the plan in certain circumstances.

The court is expected to approve or reject the draft restructuring plan within 30 days of receipt of the application. If the draft restructuring plan is rejected by the court, the court will make a ruling to terminate the restructuring proceedings and declare the debtor bankrupt.

## SUPERVISION AND CONTROL

The debtor may apply and, with the court's approval, manage its property and affairs under the supervision of the administrator, and assume responsibility for the implementation of the restructuring plan under the supervision of the administrator.

## MORATORIUM

While secured creditors are subject to a moratorium during the restructuring period, they can apply to the court to enforce their security rights, if it is likely that the secured property will be damaged or its value will depreciate significantly which will prejudice their security rights.

## IMPLEMENTATION OF RESTRUCTURING PLAN

The restructuring plan approved by the court will have binding force over the debtor and all the creditors. If, among other things, the debtor is unable or fails to implement the approved restructuring plan, the court can make a ruling to cease the implementation of the restructuring plan and declare the debtor bankrupt at the request of the administrator or an interested party.

If the restructuring plan is implemented, then the administrator's duties will finish when he/she submits a supervision report to the court. Upon completion of the implementation of the restructuring plan, the debtor will be exempted from its repayment liability for the portion of debts that have been reduced or waived in accordance with the restructuring plan.

## Compromise

As an alternative to restructuring (and liquidation), an enterprise established in China can compromise and settle its liabilities with its creditors.

## APPLICATION

The debtor can submit a compromise petition together with a draft compromise proposal either directly to the court, or after the court has accepted a bankruptcy petition against the debtor but before the court declares it bankrupt.

## REQUIREMENTS

These are the same as for bankruptcy, which are detailed above.

## CONSENTS/APPROVALS

A draft compromise proposal must be both:

- approved by a majority of the creditors with voting rights present at the meeting, representing more than two-thirds in value of the total unsecured claims; and
- submitted to the court for approval.

If the creditors' meeting does not pass the draft compromise proposal or the court does not approve the compromise proposal, the court will make a ruling to terminate the compromise proceedings and declare the debtor bankrupt.

## SUPERVISION AND CONTROL

If a compromise proposal is approved, the property and business will be handed back to the debtor. The debtor must discharge its debts and liabilities in accordance with the approved compromise proposal.

## MORATORIUM

The secured creditors are not subject to a moratorium and can exercise their security rights from the date on which the court approves the debtor to commence compromise proceedings.

A court-approved compromise proposal is binding on the debtor and all its compromise creditors (i.e. the unsecured creditors at the time of acceptance of the bankruptcy petition by the court).

## LENGTH OF THE PROCESS

The EBL does not provide a time limit for the court to approve/reject a compromise petition and convene the creditors' meeting to vote on the compromise proposal.

## IMPLEMENTATION OF COMPROMISE PROPOSAL

If the debtor is unable or fails to implement the approved compromise proposal, then the court can make a ruling to cease the implementation of the compromise proposal and declare the debtor bankrupt at the request of the compromise creditors.

Upon completion of the implementation of the compromise proposal, the debtor will be exempted from its repayment liability for the portion of debts which have been reduced or waived in accordance with the compromise proposal.



# Chapter 18

# Dispute Resolution

## General

With the steady growth of foreign direct investment in China, disputes arising out of business activities, or with regulators, have also increased correspondingly. The development of a consistent and sophisticated system of law, resulting from successive law reforms, coupled with the increasing reliability of the judiciary, has made the outcome of dispute resolution procedures more predictable.

## Litigation

Civil and commercial disputes are traditionally resolved by litigation in Chinese courts. As mentioned in Chapter 1 "Legal System", the Chinese court system comprises the Supreme People's Court, the Higher People's Courts, the Intermediate People's Courts and the District People's Courts. Jurisdiction depends primarily on the size of the claims. A considerable number of disputes exceeding RMB 30 million are dealt with, in the first instance, by an Intermediate People's Court. Large claims are dealt with, in the first instance, by a Higher People's Court, although its jurisdiction varies from province to province and municipality to municipality.

The procedure for conducting legal proceedings is laid down in the *Civil Procedure Law* and its judicial interpretations issued by the Supreme People's Court. According to Article 164 of the *Civil Procedure Law*, a judgment granted by a first instance court can, as of right, be appealed to an appellate court whose ruling is final. Under certain exceptional circumstances, e.g., a serious misapplication of law, a serious procedural irregularity or if new evidence comes to light, then the ruling of the appellate court can be reviewed further. China had enacted numerous amendments to the *Civil Procedure Law* over the years since its promulgation in 1991 with a view to enhancing the efficiency and transparency of the civil procedure, and increasing the autonomy of the parties involved in civil litigation. It is worth noting the expanded scope of interim measures available to parties under the current *Civil Procedure Law*: it now covers applications for orders requiring another party to perform, or be prohibited from performing, certain acts, and the preservation of evidence before the commencement of the legal proceedings.

China is currently a signatory to a number of treaties with various countries under which a judgment obtained in those countries can, subject to certain conditions, be enforced in China and vice versa. In respect of Hong Kong, recognition and enforcement of judgments in civil and commercial matters can take place, subject to meeting the conditions set out in the Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters by the Courts of the Mainland and of the Hong Kong Special Administrative Region.

## Administrative Review and Proceedings

The primary piece of legislation for conducting administrative review and proceedings is the *Administrative Procedure Law* ("**APL**"). China's legislative authority had made numerous amendments to the APL since its promulgation in 1989. The current APL has removed a number of practical obstacles that an aggrieved party might previously face when bringing an administrative lawsuit. For example, the current APL has expanded the scope of the administrative acts that can be challenged, refined the rules governing the collection of evidence and created liabilities on the part of the administrative department that has failed to comply with a court ruling.

Under the current APL, an administrative act – e.g., a decision of an administrative department involving an administrative sanction, a compulsory administrative measure, an infringement of the rights of an individual or an enterprise, or an infringement of property rights – is liable to be reviewed administratively and judicially. Unless a decision made by an administrative department is final in law, a party who is not content with an administrative act may resort to administrative review and proceedings. Certain administrative acts such as those relating to national defence and foreign affairs, the promulgation of administrative rules and regulations, the granting of awards to or sanctioning of, and the appointment or removal from office of personnel of an administrative department, cannot be judicially challenged.

To start a process for administrative review, an aggrieved party may lodge an application with the relevant government agency. If the applicant

remains discontented with the outcome of the review by the government agency, then such applicant may commence administrative proceedings in the appropriate People's Court vested with jurisdiction. Any administrative proceedings commenced in the People's Court may be appealed, but the decision of the appellate court is final and conclusive.

## Arbitration and Mediation

Civil or commercial disputes in China can also be resolved through other alternative dispute resolution processes, such as mediation or arbitration. It is important to note at the outset that the parties to a commercial dispute must choose to resolve the dispute either at the court with jurisdiction, or through an arbitration institution.

Mediation is not mandatory under Chinese laws but in practice, Chinese courts encourage the parties to consider mediation before pursuing their claims. Mediation is also taking on growing importance, as the *People's Conciliation Law* came into operation on 1 January 2011. This law provides that the parties who reach a conciliation agreement through conciliation conducted by the People's Conciliation Committee may, within 30 days of the date of the conciliation agreement, jointly apply to the court for judicial verification. Once verified, either party may apply to the court for enforcement upon default by the other party.

CIETAC is probably the most popular arbitration institution to accept both domestic and foreign-related disputes for arbitration. Briefly, a typical arbitration case administered by CIETAC in accordance with its current Arbitration Rules effective from 1 January 2015, involves the following steps listed below.

### APPLICATION FOR ARBITRATION

To commence arbitration proceedings, a claimant must submit to the Arbitration Court a copy of the arbitration agreement, an application for arbitration in writing, and a statement of claim setting out the facts and evidence relied upon. The claimant must also make payment of the prescribed arbitration fees in advance. If the papers are in order, the Arbitration Court will issue a Notice of Arbitration to the parties.

### APPOINTMENT OF AN EMERGENCY ARBITRATOR

Prior to the constitution of the arbitral tribunal, a party may, pursuant to the CIETAC Emergency Arbitrator Procedures, apply to the Arbitration Court for the appointment of an emergency arbitrator and seek emergency relief, either by agreement between the parties or in accordance with the law applicable to the arbitration. The Procedures expressly provide that "the power of the emergency arbitrator will cease and the emergency arbitrator proceedings will be terminated on the date of the constitution of the arbitral tribunal. The emergency arbitrator proceedings will not affect the right of the parties to seek interim relief from any competent court pursuant to the applicable law".

### COMPOSITION OF TRIBUNAL

Within 15 days from the receipt of the Notice of Arbitration, an arbitral tribunal comprising one or three arbitrators will be constituted. Unless the parties agree to appoint a single arbitrator or the claim is less than RMB 5 million, three arbitrators will be appointed, one by each party usually from the panel of arbitrators maintained by CIETAC and the third by agreement between the parties, failing which, by the Chairman of CIETAC.

### DEFENCE AND COUNTERCLAIM

Within 45 days for a foreign-related case, or 20 days for a domestic case, from the date of receipt of the Notice of Arbitration, a respondent will have to file a Statement of Defence (and Counterclaim) with CIETAC. If a respondent also files a Statement of Counterclaim, the Claimant will, within 30 days for a foreign-related case, or 20 days for a domestic case, from the date of receipt of the Statement of Counterclaim, submit a Statement of Defence to the respondent's counterclaim. These deadlines are, however, fairly flexible and can be extended with good cause.

### HEARING

Generally speaking, hearings administered by the Arbitration Court are conducted in Beijing, and hearings administered by a sub-commission/ arbitration centre at its place of domicile. With the approval of the President of the Arbitration Court, a case can be heard in another place, even outside China.



## COMBINING ARBITRATION WITH CONCILIATION

During the course of the arbitration proceedings, the parties may request the arbitral tribunal to mediate the dispute. If mediation is successful, CIETAC will render an arbitral award in terms of the settlement reached through conciliation.

## MAKING AWARD

For a foreign-related case, the arbitral tribunal will usually render an arbitral award within six months of the date of constitution of the arbitral tribunal. For a domestic case, it will usually render the award within four months.

For arbitration cases administered by CIETAC Hong Kong Arbitration Centre, it is worth noting that the 2015 CIETAC Rules expressly provides that "unless otherwise agreed by the parties, the seat of the arbitration will be Hong Kong, the law applicable to the arbitral proceedings will be the arbitration law of Hong Kong and the arbitral award will be a Hong Kong award". Accordingly, a party may enforce such a Hong Kong award in China pursuant to the Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters.

As China has acceded to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards ("**New York Convention**"), reciprocal enforcement of arbitral awards can take place between countries that are signatories to the New York Convention. Enforcement of a convention award can only be refused under the exceptional circumstances set out in the New York Convention, which rarely arises in practice.

For the purposes of enforcement, it is important to draw a distinction between a domestic arbitral award and a foreign related arbitral award. Generally speaking, a domestic dispute is one between two companies incorporated in China that does not meet the following criteria:

- The subject matter of the dispute is located outside China.
- The legal fact that establishes, changes or terminates the legal relationship between the parties takes place outside China.

An arbitral award made in resolving a domestic dispute is a domestic arbitral award, and is enforceable as if it were a judgment delivered by a Chinese

court. Unlike a foreign-related arbitral award, which by definition also includes an award falling within the ambit of the New York Convention, a respondent may, when it comes to enforcement of a domestic arbitral award, apply to the competent People's Court for refusal of enforcement of such a domestic arbitral award if the evidence used for finding fact was forged or the evidence that would have affected the rendering of a just award was concealed from the arbitral tribunal. In other words, the merits of a domestic arbitral award are liable to be re-opened for argument.

Although a dispute arises in China, the arbitration proceedings commenced may, depending on the arbitration agreement made between the parties, take place within or outside China and thus command a wide-ranging international arbitration experience that includes:

- CIETAC
- Hong Kong International Arbitration Centre
- International Chamber of Commerce
- Court of International Arbitration, the International Centre for Dispute Resolution
- London Court of International Arbitration
- Singapore International Arbitration Centre
- United Nations Commission on International Trade Law
- US-based arbitral institutions: the American Arbitration Association, the International Institute for Conflict Prevention and Resolution and the Judicial Arbitration and Mediation Services, Inc.



# Chapter 19 Cybersecurity

## Introduction

China's *Cybersecurity Law* ("**CSL**") was passed on 7 November 2016 and came into operation on 1 June 2017. It is the nation's first comprehensive legislation covering both privacy and cybersecurity. However, despite being brought into force over 2 years ago, many uncertainties remain regarding its application and restrictions. This largely stems from the fact that many of the supplemental measures and guidelines issued by the Chinese authorities still remain in draft format, with the most recent versions departing significantly from previous drafts. It is expected that these supplemental measures and guidelines will be finalised by the end of 2019.

## Application

The CSL applies to critical information infrastructure ("**CII**") operators and network operators in China. CII, as in other jurisdictions (e.g. Singapore and Europe), include key sectors such as finance, transportation, energy, water, government and communications. However, the definition of CII under the CSL retains a broad catch-all phrase allowing the Chinese authorities to identify other industries as a CII if any destruction, loss of function or data leakage by such industry could result in serious damage to national security, national economy and people's livelihood and public interests. So far, some of the additional sectors that have specifically been identified by the Chinese authorities as a CII have included providers of media, e-commerce, e-payment, search engines, emails, blogs, cloud computing, enterprise systems and big data. As far as network operators are concerned, the definition is broad enough to essentially include any business that uses some form of IT infrastructure in China (i.e. owns or operates a computer network, server or website in China), regardless of its industry sector.

CII operators are generally subject to more stringent requirements than network operators under the CSL. However, due to the broad and vague definition of network operators and the ever blurring lines between the obligations on a CII provider and a network operator, the CSL restrictions have the potential of applying to a substantial number of businesses that have operations in China and deploy and use an IT infrastructure – its application is therefore not limited to

telecommunication, technology or internet service providers which are the typical businesses regarded as CII in cybersecurity legislation elsewhere.

### KEY REQUIREMENTS

The CSL imposes stringent obligations on CII operators, including (but not limited to) the following:

- data localization (i.e. store within China all personal information and important data generated in China);
- undergo a security review organized by the Cyberspace Administration of China ("**CAC**") and State Council (the most senior executive authority in China), prior to purchasing any network products and services that may impact national security;
- obtain security certification from qualified institutions before the use or sale of critical network equipment and specialized cybersecurity products;
- execute a confidentiality agreement with IT vendors;
- undergo an annual security assessment of its network security and related risks, and submit reports to the relevant government authority;
- regularly conduct network security training and evaluations of its employees, implement disaster recovery backups and emergency response plans, and regularly perform drills to test the plan; and
- establish a dedicated cybersecurity management team and carry out security background checks.

The CSL also imposes several obligations on network operators, which apply equally to CII operators. These include (but are not limited to) the following:

- implement cybersecurity management and operating rules, and appoint personnel responsible for cybersecurity;
- implement technical measures to prevent computer viruses, cyber attacks, network intrusions, etc.;
- implement the prescribed cybersecurity measures that correspond with the network operator's classification level under the multi-level protection scheme;

- adopt measures relating to back-up, encryption and data classification;
- implement emergency response plans to handle cybersecurity incidents and rectify system vulnerabilities, viruses, cyber attacks, unauthorised access and cybersecurity risks;
- provide technical support and assistance to Public Security Bureaus for the protection of national security, prevention and investigation of terrorist activities or crimes;
- record the status of network operations as well as any security incidents, and preserve logs for no less than six months;
- monitor information published by users for violations of laws; and
- establish complaint and reporting systems for the handling of cybersecurity incidents.

The draft implementing measures and guidelines that have been issued by the Chinese government over the last couple of years, make it abundantly clear that the intention has been to expand many obligations that were expected to only apply to CII operators to the broader category of network operators. For example, under the CSL the data localization requirement initially only applied to CII operators. However, the latest draft measures issued by the Chinese government (discussed below) have introduced strict cross-border transfer restrictions for both CIIs and network operators. This, in essence, means that the data localization rules have been extended to cover network operators as well.

## TRANSFERS OF PERSONAL INFORMATION AND IMPORTANT DATA

On 28 May 2019 and 13 June 2019, respectively, the new draft Measures for Data Security Management ("**New Draft Security Management Measures**") and the new draft Measures on Security Assessment of the Cross-Border Transfer of Personal Information ("**New Draft Cross-Border PI Measures**") were issued. It appears that these drafts are intended to replace the previous draft Security Assessment Measures for the Cross-Border Transfer of Personal Information and Important Data issued on 19 May 2017.

Under the CSL, the New Draft Cross-Border PI Measures and the New Draft Security Management Measures, a CII or network operator cannot transfer or disclose personal information or important data collected or generated during their operations in

China to anyone outside of China, unless:

- they have completed an official security assessment;
- a contract is signed with the intended recipient (which must incorporate specific provisions stipulated by the New Draft Cross-Border PI Measures); and
- for personal information, the express and informed consent of the relevant individual is obtained.

In addition, the prior authorisation of the relevant regulatory authority is also required for the cross-border transfer, disclosure, sale or publishing of important data by CII operators or network operators. The definition of "important data" under the New Draft Security Management Measures only covers data which, if leaked, may directly affect national security, economic security, social stability, public health and security, such as non-public government information, large-scale population, genetic health, geographic and mineral resources – and excludes any information relating to the production, operation or internal management of an entity and personal information.

The above restrictions appear to have extra-territorial effect and may apply to companies that do not have a physical presence in China, but which have operations that involve the collection of personal information of Chinese residents. In particular, the New Draft Cross-Border PI Measures provide that if the business activities of any organisation located outside China results in the collection of personal information of persons located in China, then such organisation will be subject to the New Draft Cross-Border PI Measures as a network operator.

Under the previous draft measures, CII operators and network operators were required to carry out a self-assessment for the cross border transfer of personal information, and only if the transfer involved a CII operator or other thresholds were met would an official security assessment need to be carried out by the relevant local authorities. Now, under the New Draft Cross-Border PI Measures, for every cross-border transfer of personal information by either a CII or network operator, an official security assessment must be applied for and conducted by the relevant local CAC branch office. There is currently no threshold in relation to this requirement and it does not exclude any intra-group cross-border transfers.

The official security assessment must be conducted prior to the cross-border data transfer, and must be completed for each different recipient. However, multiple or ongoing transfers to the same recipient will not require additional assessments. The CII or network operator must apply to repeat the assessment every two years or whenever there is a change in the purpose, type or retention period relating to the personal information transferred overseas.

The documents that must be submitted by the CII or network operator when applying for an official security assessment will include a detailed report on the security risks and measures related to the transfer, the agreement with the intended recipient and a declaration form. If the results of the assessment reveal that the cross-border transfer could present a risk to national security, damage public interest or provide inadequate protection for the personal information, then the transfer will be prohibited. Whilst the CII or network operator can file an objection to the decision, there is currently no detailed appeals procedure set out in the New Draft Cross-Border PI Measures.

A record must be retained by CII operators and network operators for at least five years, which details all of their cross-border transfers of personal information. The local CAC office is obligated to carry out regular inspections of such records to ensure the CII or network operator's compliance with the regulations, the performance of the agreements with the recipients of the data, and that no incidents have occurred that could harm the rights or interests of the data subjects. An annual report must also be submitted to the local CAC office regarding the CII or network operator's cross-border transfers of personal information and any related contract. The exact nature and content of this report is unclear.

Lastly, prior to the sharing of personal information with a third party, the New Draft Security Management Measures requires CII operators and network operators to conduct an assessment of the potential security risks and to obtain the express consent of the data subjects. This requirement is not expressly limited to cross-border transfers and does not exclude intra-group sharing of personal information – therefore it appears that it may also apply to domestic transfers and transfers within the same group. There are certain exceptions to this

requirement, including situations where the data was collected from a public source and the sharing is not in violation of the data subjects wishes, the data subject voluntarily published his personal information, it is necessary for law enforcement purposes or to protect national security, and so on.

## PERSONAL INFORMATION

Outside the context of cross-border transfers, the CSL also includes requirements regarding the handling of personal information, which should be read in conjunction with the related specifications and measures issued by the Chinese authorities. On 1 May 2018, the "Information Technology – Personal Information Security Specification" (National Standard GB/T 35273-2017) (GB/T 35273-2017 信息安全技术 个人信息安全规范) ("**PI Specification**") issued by the Standardization Administration of China came into effect. The PI Specification sets out the recommended practices on personal information protection that apply to all organisations that handle personal information of Chinese residents. Although the PI Specification is not legally binding, compliance is expected by the Chinese authorities and may be taken into account when assessing a company's compliance with related laws (i.e. the CSL). A set of draft amendments to the PI Specification were released on 1 February 2019 for public consultation, which ended on 3 March 2019. The draft amendments propose several changes to the PI Specification, including enhanced notice and consent requirements, and proposed changes in the requirements relating to third party access to data and notification requirements for data breaches.

On top of the PI Specification and the draft amendments, the New Draft Security Management Measures that sit under the CSL impose further obligations on CII operators and network operators in relation to personal information. Unlike the PI Specification, once finalised and brought into operation, the New Draft Security Management Measures will be legally binding and a breach could lead to various penalties (including the shutting down of business operations). The New Draft Security Management Measures introduce requirements such as the need to obtain explicit and informed consent of the data subjects (and specifically sets out the information that needs to be provided to the data subject), an obligation not to force or mislead data subjects to provide their

consent (e.g. bundled consent, default consent, etc.), not to take any discriminatory actions based on the scope of consent provided by the data subject (e.g. reduce service quality), comply with data access requests, implement data encryption and backup measures, and so on. In addition, Under the New Draft Security Management Measures, CII operators and network operators that collect important data or sensitive personal information for business purposes must also file with their local CAC office their rules for collection and use, and the purpose, scope volume, method, type and retention period of such data. The CII operators and network operators must also designate a person to be in charge of the data security for the important data and sensitive personal information.

### MULTI-LEVEL PROTECTION SCHEME

The CSL requires the government to implement a new cybersecurity multi-level protection scheme ("**MLPS**") that will specify the technical and operational cybersecurity measures all network and CII operators must comply with based on their respective assessed level of risk. On 27 June 2018, the Ministry of Public Security ("**MPS**") issued the draft Regulations on Cybersecurity Multi-Level Protection Scheme ("**Draft MLPS Regulations**"), which are intended to update the existing Administrative Measures for the Multi-level Protection Scheme of Information Security issued in 2007.

The MLPS sets out a classification system for networks located in China based on their level of risk, ranging from one to five (one being the least critical). The higher a networks classification, the more stringent the requirements are on the level of security that must be implemented. A network operator's and/or CII operator's risk level is assessed based on the potential impact on national security, social order, public interests and persons, if the network is damaged, destroyed, corrupted, lost, damaged or subject to unauthorized access or disclosure.

Network operators and CII operators are required to carry out a self-assessment to determine their classification level. The self-assessment must initially be done at the design phase, and repeated whenever there is a significant change in the network functions, scope of service or the type of information being processed.

If the self-assessment results in a level 2 classification or above, then the assessment must also be

reviewed by an expert and the classification approved by the Chinese authorities.

Operational and technical measures must then be implemented in accordance with the classification level. This can include using only products and services that have been certified by the relevant Chinese authority, conducting all technical maintenance within China, engaging an accredited encryption testing institute to conduct an initial and annual security assessment, and so on.

### ASSISTING THE GOVERNMENT AUTHORITIES

The Chinese government authorities and the Public Security Bureaus ("**PSBs**") are granted broad investigation and inspection powers, and network operators and CII operators are required under law to assist them. This includes an obligation on CII operators and network operators to provide technical support and assistance to PSBs and government authorities to help protect "national security" and investigate crimes. This may include granting PSBs access to the servers and systems of the network operator. Shared systems for group of companies that store both China generated personal information and important data, as well as other global information, run the risk of the Chinese authorities gaining access not just to the China generated information, but the entire global network.

In particular, on 1 November 2018, a new Regulation on Internet Security Supervision and Inspection by Public Security Bureaus ("**PSB Supervision Regulation**") came into effect. The PSB Supervision Regulation grants broad powers to the PSBs to closely scrutinise internet service providers and network users who provide any of the following services to ensure that they are compliant with their cybersecurity obligations:

- internet access, data centres, content distribution or domain name services;
- internet information services;
- internet access to the public; or
- other internet services (which is up to the PSBs to determine).

The PSBs have the power to conduct inspections either on-site or remotely. If remote access will be used, then the PSB must give advanced notice, but no prior notice is required for on-site inspection. The PSBs powers include the right to enter business

premises or server rooms, inspect and take copies of any information relating to the subject of the inspection or oversight, and so on. PSBs also have the right to use third party service providers who have the relevant technical capabilities to help the PSBs carry out any on-site or remote inspections. Breach of the CSL, the New Draft Security Management Measures and the New Draft Cross-Border PI Measures may result in fines, public naming-and-shaming, confiscation of illegal gains, an order for the suspension or shutting down of operations, the shutting down of websites, revocation of business permits or licences and potential criminal liability.

### **DISTRIBUTION OF CYBERSECURITY PRODUCTS OR EQUIPMENT**

It is worth noting that the CSL also requires cybersecurity products and critical network equipment that will be sold or distributed in China to obtain a security certification from qualified institutions – this applies irrespective of whether or not the distributor is based in China or overseas. Such products and equipment must also be in compliance with national standards. The relevant Chinese authorities are required to issue catalogues identifying the equipment and products that fall within the scope of the foregoing requirements – the items that have so far been identified include firewalls, security audit software, routers, switches, servers, intrusion detection systems, etc.

Given all this, any company involved in the technology industry sector which intends to, or currently distributes and sells cybersecurity products and critical network equipment in China, will likely need to obtain a security certification and ensure compliance with national standards, which may be costly and time consuming. Concerns have also been raised as to the level of proprietary information that may need to be disclosed by companies in order to obtain the required certification.

### **MOVING FORWARD**

The draft measures are likely to be finalised by the end of 2019, and additional interpretations, measures and guidelines are expected to be issued by the government regarding the implementation of the CSL. For now, companies that have a link to China (e.g. business operations in China, networks in China, collecting information from Chinese residents, Chinese-hosted website, etc.), are

advised to conduct privacy and security audits to ensure compliance with the CSL. Even companies that do not have operations in China may have vendors that provide services to them from China, who may be subject to the CSL. Companies should take a close look at their supply chain and carry out a due diligence to determine whether or not additional protections need to be built into agreements with their various vendors.

## Glossary

<b>ABC</b>	Anti-Bribery and Corruption
<b>AIC</b>	Administration for Industry and Commerce
<b>AML</b>	Anti-Monopoly Law
<b>APL</b>	Administrative Procedure Law
<b>AQSIQ</b>	Administration of Quality Supervision, Inspection and Quarantine
<b>ASB</b>	Anti-Smuggling Bureau
<b>ASEAN</b>	Association of Southeast Asian Nations
<b>AUCL</b>	Anti-Unfair Competition Law
<b>Bribery Act</b>	UK Bribery Act 2010
<b>CAAC</b>	Civil Aviation Administration of China
<b>CAC</b>	Cyberspace Administration of China
<b>Catalogue</b>	Catalogue of Encouraged Industries for Foreign Investment
<b>CCC, or 3C</b>	China Compulsory Certification
<b>CEPA</b>	Closer Economic Partnership Arrangement
<b>CFDA</b>	China Food and Drug Administration
<b>China RoHS 1</b>	Administrative Measures for the Control of Electronic Information Products Pollution
<b>China RoHS 2</b>	Administrative Measures for the Restriction of Use of Hazardous Substances in Electrical and Electronic Products
<b>China WEEE</b>	Administrative Measures for the Prevention and Control of Environmental Pollution by Electronic Waste and the Administrative Regulation on Recycling and Disposal of Discarded Electronic Appliances and Electronic Products.
<b>CIETAC</b>	China International Economic and Trade Arbitration Commission
<b>CII</b>	Critical Information Infrastructure
<b>CIIC</b>	China International Intellectual Corporation
<b>CIQ</b>	China Inspection and Quarantine
<b>Circular No.6</b>	Circular on the Establishment of a Security Review System Regarding Mergers and Acquisition of Domestic Enterprises by Foreign Investors
<b>CJV</b>	Co-operative Joint Venture
<b>Compliance Management Catalogue (First Batch)</b>	Compliance Management Catalogue for the Restriction of Use of Hazardous Substances in Electrical and Electronic Products (First Batch)
<b>Criminal Law</b>	Criminal Law of the PRC
<b>CSL</b>	China's Cybersecurity Law
<b>CSRC</b>	China Securities Regulatory Commission
<b>Draft MLPS Regulations</b>	Draft Regulations on Cybersecurity Multi-Level Protection Scheme
<b>DRC</b>	Development and Reform Commissions
<b>EBL</b>	Enterprise Bankruptcy Law
<b>EEPs</b>	Electrical and Electronic Products
<b>EIPs</b>	Electronic Information Products
<b>EJV</b>	Equity Joint Venture
<b>EOR</b>	Exporter of Record



<b>Exemption List</b>	Exemption List of Applications of the Restricted Substances Provided by the Compliance Management Catalogue
<b>FCPA</b>	Foreign Corruption Practices Act
<b>FESCO</b>	Foreign Enterprise Services Corporation
<b>FICE</b>	Foreign-invested Commercial Enterprises
<b>FICLS</b>	Foreign-invested Company Limited by Shares
<b>FIE</b>	Foreign-invested Enterprise
<b>FIEIE</b>	Foreign-invested Equity Investment Enterprise
<b>FIHC</b>	Foreign-invested Holding Company
<b>FIVCE</b>	Foreign-invested Venture Capital Enterprise
<b>FTAs</b>	Free Trade Agreements
<b>GAC</b>	General Administration of Customs
<b>HS</b>	Harmonized Commodity Description and Coding System
<b>IOR</b>	Importer of Record
<b>IP</b>	Intellectual Property
<b>IP Tribunal</b>	Intellectual Property Tribunal
<b>IPRs</b>	Intellectual Property Rights
<b>JV</b>	Joint Venture
<b>M&amp;A</b>	Merger and Acquisition
<b>M&amp;A Regulations</b>	Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors
<b>MEE</b>	Ministry of Ecology and Environment
<b>MIIT</b>	Ministry of Industry and Information Technology of China
<b>MLPS</b>	Multi-level Protection Scheme
<b>MOFCOM</b>	Ministry of Commerce
<b>MPS</b>	Ministry of Public Scheme
<b>NBWD</b>	Neibaowaidai
<b>NDRC</b>	National Development and Reform Commission
<b>NDRC Measures</b>	Tentative Measures for the Administration of Carbon Emissions Trading
<b>New Draft Cross-Border PI Measures</b>	New draft Measures on Security Assessment of the Cross-Border Transfer of Personal Information
<b>New Draft Security Management Measures</b>	New draft Measures for Data Security Management
<b>New York Convention</b>	New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards
<b>NMPA</b>	National Medical Products Administration of SAMR
<b>Non-restriction Catalogue</b>	Catalogue of Solid Waste Not Restricted for Import for Use as Raw Materials
<b>Notice No. 122</b>	Notice on Amending relevant policies on Regulating the Access and Management of Foreign Capital in the Real Estate Market
<b>NPC</b>	National People's Congress of China
<b>NSL</b>	National Security Law
<b>Opinion No.171</b>	Opinion on Regulating the Access and Management of Foreign Capital in the Real Estate Market

<b>PBB</b>	Polybrominated Biphenyls
<b>PBDE</b>	Polybrominated Diphenyl Ethers
<b>PBOC</b>	People's Bank of China
<b>PI Specification</b>	Information Technology – "Personal Information Security Specification" (National Standard GB/T 35273-2017) (GB/T 35273-2017 信息安全技术 个人信息安全规范)
<b>Power Generation Sector</b>	National Carbon Emissions Trading Market Development Plan
<b>PRB</b>	Patent Re-examination Board
<b>Prohibition Catalogue</b>	Catalogue of Solid Waste Prohibited for Import
<b>Property Law</b>	PRC Property Law
<b>PSB</b>	Public Security Bureaus
<b>PSB Supervision Regulation</b>	Regulation on Internet Security Supervision and Inspection by Public Security Bureaus
<b>Qianhai Zone</b>	Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone
<b>QFIIs</b>	Qualified Foreign Institutional Investors
<b>R&amp;D</b>	Research & Development
<b>Restriction Catalogue</b>	Catalogue of Solid Waste Restricted for Import for Use as Raw Materials
<b>RMB</b>	Renminbi
<b>Rorex Regulations</b>	Regulations of the PRC on Foreign Exchange Administration
<b>SAFE</b>	State Administration of Foreign Exchange
<b>SAIC</b>	State Administration for Industry and Commerce
<b>SAMR</b>	State Administration for Market Regulation
<b>SCIA</b>	Shenzhen Court of International Arbitration
<b>Security Law</b>	PRC Security Law
<b>Security Review Rules</b>	Rules of Ministry of Commerce on Implementation of Security Review System for Merger and Acquisition of Domestic Enterprises by Foreign Investors
<b>Shanghai FTZ</b>	China (Shanghai) Pilot Free Trade Zone
<b>SHIAC</b>	Shanghai International Economic and Trade Arbitration Commission
<b>SMRA</b>	State Market Regulatory Administration
<b>SOEs</b>	State-owned Enterprises
<b>Solid Waste Law</b>	PRC Law on the Prevention and Control of Environmental Pollution Caused by Solid Waste
<b>SPC</b>	Supreme People's Court
<b>STAR</b>	China Star Corporation for International Economic and Technical Cooperation
<b>TI</b>	Total Investment
<b>TRIPs Agreement</b>	Agreement on Trade-Related Aspects of Intellectual Property Rights
<b>UNCITRAL</b>	United Nations Commission on International Trade Law
<b>US</b>	United States of America
<b>VAT</b>	Value-added Tax
<b>WBND</b>	Waibaoneidai
<b>WFOE</b>	Wholly Foreign-owned Enterprise
<b>WIPO</b>	World Intellectual Property Organisation
<b>WTO</b>	World Trade Organisation



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