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China Working Group News

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IN THIS ISSUE

Contributions to this newsletter are always welcome and should be sent to Caroline Berube at cberube@hjmasialaw.com or David Dali Liu at liudl@junhe.com.

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From the Co-Chairs

Welcome to the first ever Asia Pacific Forum China Working Group newsletter. We are proud supporters of the 19th Annual IBA International Arbitration Day 2016 and the Asia Pacific Arbitration Group (APAG) Meeting. The China Working Group (CWG) is a new addition to the IBA Asia Pacific Forum. The CWG was formed in order to advise the IBA on activities in China and to keep IBA members aware of various events and initiatives in the region. Since China is one of the largest growing markets, it is of vital importance that the CWG provide advice on issues specific to China, including opportunities with governmental organisations and legal associations.

Our objectives include:

- advising the IBA on activities in China and keeping IBA members aware of various events and initiatives in the region;
- providing advice on issues specific to China including opportunities with governmental organisations and legal associations;
- reaching out to non-members, including in-house counsel and academia in China;
- promoting IBA conferences, projects, and programmes and supporting IBA members with interests in China by making known important legal developments in China; and
- acting as a central hub for information and ensuring that IBA members based in mainland China have the opportunity to become more involved, by planning and participating in events.

The CWG is made up of the following leading international legal professionals in China:

Co-Chairs

Caroline Berube	HJM Asia Law
David Dali Liu	Jun He Law Offices

Members

Victor Ho	Allen & Overy
Janet Yung Hui	Jun He Law Offices
Wun Lap (Dominic) Hui	Ribeiro Hui
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Jingzhou Tao	Dechert
Tim Wang	Clifford Chance
Graham Wladimiroff	Akzo Nobel (China) Investment Co Ltd
Ariel Ye	King & Wood Mallesons
Nancy Zhang	Jincheng Tongda & Neal
Jonathan Zhou	Fangda Partners
Ning Zhu	Chance Bridge Partners

On 7 October 2015 the first ever CWG meeting took place during the IBA Annual Conference in Vienna. Some key points were raised during a committee meeting that shed light on the importance of maintaining strong information flows in China. It was explained that the APF was doing well in China but it was not experiencing the levels of success that the committee had anticipated. The committee went on to unanimously echo the importance of China, stating 'we're not successful in Asia if we're not successful in China'.

The CWG will aim to better understand the needs of Chinese lawyers and recruit more speakers and attendees to IBA events from China. The group has many interesting ideas for 2016, including reaching out to young lawyers by organising a young lawyers' training programme and organising a 'China Day' event, more details on which will follow later this year.

This newsletter will feature articles related to China on various topics including government control and the rule of law, pricing sustainability, an update on employment and patent law, foreign debt and China's new third board. This will be the first of – hopefully – many newsletters the CWG will produce this year, keeping IBA members up to date on the latest developments in the region.

Do not hesitate to contact the group's Co-Chairs, Caroline Berube at cberube@hjmasialaw.com and David Dali Liu at liudl@junhe.com if you have any further questions or comments!

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Governmental control and the role of law in China

This article considers how in its move to a market-based economy, China has developed a unique system of law. There is now a developed body of commercial and other laws, but the level of governmental control remains significant. The practice of law in China requires a hybrid approach that starts with the law as written, but takes into account a variety of other factors.

Introduction

In assisting Japanese clients doing business in China for more than 20 years, I am keenly aware of the element of control that continues to be imposed by the Chinese government.

The People's Republic of China (PRC) first opened its doors to foreign investment in 1979. It adopted a market-based economy beginning in 1992, and became a member of the World Trade Organisation (WTO) in 2001. Over this period, restrictions on foreign investment have clearly been relaxed, but foreign investment continues to be highly regulated.

Since 1979, China has undertaken significant efforts in enacting a large body of law, which is now at a level similar to that of many other developed countries.[1] For example, China has a body of commercial law that includes corporate and securities laws. It also has civil laws covering areas such as contracts and property law (although there is no compiled body of civil law). When it comes to business, Chinese laws are in many ways similar to those in Japan and western countries. However, there are key differences. The Chinese government would be the first to admit that China's legal system is a uniquely socialist system that is different from civil law and common law jurisdictions. In this article, I outline a few of the unique characteristics of Chinese law.

The role of law in China

When I started my China-related practice many years ago, the purpose of Chinese laws was not always clear to me. At some point, I realised that the overriding role of Chinese law was for the Chinese government to maintain control over the country, which seemed to explain everything, particularly the laws regulating foreign investment.[2]

When it comes to business, Chinese laws are set up to regulate the conduct of business, as are the business laws in most other countries. The key characteristic in China is the greater level of control over business by the government, especially over foreign investment.

There was a large internal debate when China opened the door to foreign investment in 1979. Some Chinese officials feared that this would allow foreign powers to take over China. Instead, it was concluded that there was an opportunity to take advantage of foreign investment, but under the control of the Chinese government.

The 'government' in China essentially means the Chinese Communist Party.[3] Against that background, China adopted a 'socialist market economy'. While 'socialist' may sound somewhat incompatible with traditional notions of a 'market economy', the real meaning of this 'socialist' modifier is the level of governmental control.

As the market economy in China has matured, China is now aiming to be a 'nation governed by law'. I would characterise this as more a 'rule by law' that, in practice, is somewhat different from the traditional concept of the 'rule of law'. Chinese-style rule by law requires that there should be a law in place in order to reduce the arbitrariness of rule at the whim of individual governmental officials. However, the laws put in place continue to maintain a very heavy level of ultimate control by the Chinese government.[4]

Examples

Approval

In China, the entering (incorporation) and exiting (dissolution) of foreign investment (eg, investment through a foreign-owned entity) are both subject to pre-approval by China's government, in most cases, by the Ministry of Commerce ('MOFCOM').

In addition, for those areas (such as telecommunications, publications) that are strictly regulated but where foreign investment is not strictly prohibited, the related industrial authority must also be consulted during MOFCOM's review process.

The standard for the aforementioned approvals is not usually crystal clear and is intentionally not mentioned in regulations. Given that investment is welcomed more than withdrawal, the standard of approval for dissolution and withdrawal of foreign investment is even more ambiguous. In practice, most dissolutions are granted a green light on a case-by-case basis.

Unanimous resolution to dissolve a joint venture

Besides the Company Act, there is the Law on Chinese-foreign Equity Joint Ventures (the 'JV Law') that is specifically applied to sino-foreign joint ventures. The JV Law has many articles that are mandatorily applied and which favour the Chinese party to some extent. For example, the dissolution of the company must be unanimously approved by both the Chinese party and foreign party (while for domestic companies, it could be decided by a resolution of the shareholders meeting, the voting threshold of which can be agreed by the investors); and the JV agreement can only be governed and construed in accordance with PRC laws.

State-owned entity ('SOE')

In China, there are many SOEs, either owned by state government or local government, in many industrial areas. Foreign investors must pay more attention in doing business with SOEs. Acquisition of any equity/assets of SOEs is subject to (1) approval from such SOE's supervisory authority (from government authorities or a high-level SOE shareholder, as the case may be); and (2) a valuation from a competent and licensed appraiser (usually local domestic appraisers). The process for the above approval and valuation can take quite some time. In addition, as stipulated by relevant regulations, the price for the acquisition cannot fall below 90 per cent of the appraisal price.

Antitrust

In recent years, China is trying to assert itself globally in the antitrust area. Not only do some transactions happening abroad still undergo review and clearance in China, but some cases already approved in other jurisdictions are rejected by the Chinese authority (for example, in the widely reported 'P3 Network' case, a proposed alliance of the three biggest container carriers was approved by the United States and European Union before being rejected by China).

Although the threshold for reporting antitrust cases to the Chinese authority has become clearer in recent years, the standard for obtaining clearance is still far from clear. Further, the time required to obtain a ruling on clearance is substantially longer than other major jurisdictions (usually around six months).

Conclusion

The Chinese legal system has developed substantially since China moved to a market-based economy several years ago. There is now a large body of Chinese commercial and other laws. However, the level of governmental control remains much more significant than in other major jurisdictions. For this reason, I have often referred to my China-related practice as a 'hybrid legal practice', meaning that there is a base of law to draw on, but it is also very important to consider other factors, such as politics, economics and culture.

Notes

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1 I have compiled a commentary on Chinese laws that includes Japanese translations prepared by our firm of almost all Chinese laws.

2 I was a bit afraid that this conclusion was perhaps too sensational and might offend the Chinese people. When I made a presentation of this conclusion at a Chinese institute of which I am a director, I was told that 'this is always true in China. Even Karl Marx and Mao Zedong have said the same thing. It is also explained in Chinese textbooks.' See, for example, Zhu Jingwen, Jurisprudence (2008).

3 This is set out in the preface of the Chinese Constitutional Law.

4 It has been said that Japan has also had its own unique approach to a market economy, particularly in the last half of the twentieth century, when the role of government was more pronounced in setting 'industrial policy'. Since then, there have been significant policy changes and legal reforms in Japan, aimed primarily at rolling back the substantive role of government in the marketplace. Over the last 25 years, China's approach to its economy has evolved tremendously. While the government has ceded some power to the marketplace, it retains a level of control unlike that of most other large countries.

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Investment in China: pricing sustainability and company values

Any analysis or discussion on China will invariably advocate the principle that there are aspects to China that make it unique, whether it is the culture, the sheer size of the country, all of the above and more.

Lately much has been written about the economic slowdown in China, which is seen as a normal next step in a transition to a more mature economy. Recent analysis though often equates slowdown to demise. I will happily contribute to the discussion on another occasion. However, for the purposes of this article I would argue only that at this stage in its development China would seem to be moving away from a manufacturing to a more service-driven economy. At the same time, the commoditisation of manufacturing goods and the oversupply in these markets continues unabated. However, this does not mean that China is no longer an interesting market for manufacturing companies nor that manufacturing companies have stopped mergers and acquisitions activity in China.

The key message of this article is that any multinational corporation ('MNC') investing today, whether services or manufacturing, will not only base an acquisition on the company strategy, the financial analysis and the legal due diligence of the target, but also put a heavy emphasis on considerations of sustainability and business ethics. For these reasons, as well as for reasons of the relatively weak rule of law in China, due diligence in China needs to be far more expansive than just going down the classic due diligence list. Furthermore, and for the same reasons, much of post-integration design and planning needs to be brought forward to the due diligence stage.

Due diligence in China

Beyond the question of whether investing in China fits the strategy, the risk appetite and the financial targets, an analysis on whether to acquire in China will quickly be customised to cater for the specific challenges of investing in China. The very choice of acquisition or greenfield will in part depend on a calculation of the 'clean up' and integration cost of an acquisition in order to be able to compare to greenfield.

Depending on your products, your profitability and your reputation, your company will have – and your stakeholders will expect you to have – a certain risk appetite. Does this appetite match the risks attaching to opportunities in China? Do you actually have a good understanding of the risks?

Completion of a due diligence in line with a standard checklist will help value the target, potentially provide ammunition for a negotiated purchase price reduction, contribute to mitigating risks, now or after closing, and possibly provide some indication of the quality and integrity of management. However, in the case of China, there is likely to be a different emphasis. For instance, an MNC acquiring a local company will often be heavily reliant on existing management. China is a network society at a local level. In addition, culture and language barriers can be significant. Depending on where the target is located, the MNC's existing local management may not be willing to relocate.

The seller's understanding of sophisticated sale and purchase agreements may be quite limited. More importantly, the enforcement of warranties and indemnities could be highly problematic as the buyer needs to enforce the contract in the seller's locality where the network may run deep. These factors lead to a shift away from reliance on a sale and purchase agreement to a more thorough due diligence.

In addition, sustainability and business ethics will introduce expectations and due diligence requirements over and above the traditional due diligence and put integration considerations on the radar of the MNC at the same time.

Sustainability

Sustainability is focused on radical efficiency and delivering more value from fewer resources. Resource efficiency is not only about increasing yield and reducing waste. It's about encouraging the move to more sustainable, less harmful materials. It's about using more renewable energy and raw materials where possible, and it's also about developing new products and ingredients that can help our customers do the same.

Increasingly companies are putting their sustainability performance at the centre of the company's strategy and as a key aspect of its licence to operate. It is furthermore an important recruitment tool among the younger professionals joining the work force. Arguably not having a sustainability agenda is no longer acceptable for MNC's. To back it up, companies will link sustainability performance to executive remuneration.

The value of an acquisition is therefore not only linked to the cost of getting the target up to the high, international sustainability standards of the company (and what impact that cost will have on the viability of the acquisition), but also the potentially negative impact the acquisition will have, even if for a number of years, on the sustainability agenda and targets. Ultimately raising standards can add to the reputation and goodwill of the company, but only if well- managed within an acceptable timeframe.

Due diligence may need to encompass additional questions, such as whether the target can meet standards within an acceptable timeframe. Can the acquirer get the necessary (revised) permits to run the targets up to company standards in an acceptable timeframe? Will plant, property and equipment need to be scrapped because it does not meet global Health, Safety and Environmental ('HSE') standards, and, what is the financial impact of the replacement cost? What is the source of energy? Carbon? Are there alternatives? What is the cost of a switch?

Finally, in an environment where laws are often not enforced (until something goes horribly wrong), can the new colleagues be trained and monitored, and persuaded to set the necessary standards?

Business ethics

Boards make statements about values and ethics as a reflection of good governance and often over and above what is legally required. They set standards for themselves and for employees. Stakeholders assume companies have and comply with these standards.

Authorities in Europe and in the United States will set high compliance standards and, to back it up, they will criminalise and set examples. Authorities in emerging markets will at least adopt anti-bribery legislation, HSE legislation and competition law legislation. Unfortunately, enforcement is often lacking and social norms, business practices and short-term thinking do not always keep up with national legislation. Applying company values globally and consistently, while making a profit, ends up becoming a huge challenge, but there is and can be no compromise.

Even if due diligence as a rule includes an 'ABC' approach and competition law analysis, there can be significant challenges in identifying practices at the target as well as remedying the issues after acquisition, particularly if local management stays in place. Due diligence in this area will need to be much deeper. This means not just relying on public sources, interviews with employees and inspection of the books of the target. An investigative approach involving potentially third-party service providers may be required.

If the pre-acquisition analysis is not carried out properly and thoroughly, the consequences can have a huge impact, not only on the valuation of the business, but also on the reputation of the company and its executive ie, their ability to do acquisitions and therefore their perceived ability to manage growth in the emerging markets.

The due diligence on business ethics should therefore possibly include questions like: can you actually clean up the non-compliant issues and skeletons from the past? How much will that impact the valuation? What really defined the success or potential success of the target? Does it depend on networks which will be partially dismantled, perhaps for compliance reasons or reputational reasons, or does it depend on networks which you will not control post-acquisition?

Do you need to redo the valuation to cater, for example, for bogus contracts and customers? Quality of information is often a challenge in China. How recent is your market intelligence and what is the quality like? Does the chamber of commerce filing contain any useful information? Do you really know who the shareholders are?

Increasingly companies are requiring their supply chain to meet their higher standards. This means that suppliers of the target and distributors of the target may fall away. This is potentially a further value reduction with respect to the target. Do they meet the company's sustainability standards? Human rights standards? Can they be brought up to required standards or replaced quickly enough and at what cost?

Integration

In Europe, North America and other parts of Asia, one tends to think in the context of the rule of law. In other words, there is an assumption that professional relationships are managed through rights and obligations, in the framework of legislation, regulated by the authorities. In China the situation can be far more complex. What interests does the local government have in the success of the sale and the continued success of the business? Is the present owner really going to be out of the picture? How dependent is the success of the target's business on a network you do not want to be associated with?

Of course we need a good contract, but will it actually be enforceable or is it perhaps more like a roadmap and is the protection otherwise afforded to an agreement actually to be achieved through another route? In order to avoid acquiring a business which loses a significant part of its value post-closing due to major integration challenges, it is essential to ask many integration-related questions up front.

With respect to integration some of the following questions could therefore be considered at the due diligence stage: how much of a stretch is it for the existing management team to adjust to the new owner's standards within an acceptable timeframe? Do you have the resources to manage the target towards the standards you want it to meet? Do you need to put a few outside managers on the ground for a few years to manage the transition? Will you get the same favourable tax treatment which may be relationship-based?

Post-acquisition compliance is not a given. In an environment where enforcement is weak, employees of the target (and the company) will feel less compelled to live up to the company values and perhaps even the law. Strong management, additional training and compliance audits over a longer period are required.

Conclusions

External lawyers can play a major role in translating the cost of resolving non-compliance and terminating parts of the existing network of the target into purchase price financials. Putting a number to the due diligence findings, even if an educated guess, will help make the analysis workable for your client.

Questions will remain. To what extent is there sufficient value to the acquisition left once the deductions have been made for the expected cost of changing practices at the target to meet the acquirer's standards? Does the expected growth in the market still justify this additional cost?

As growth slows in parts of the Chinese market the room for a 'non-compliance deductible' will shrink. Equally, the need to value the target properly 'as is' as well as projections for once it is part of the acquirer's group will increase. Lawyers can contribute significantly beyond the transactional by being aware of and understanding the need for, and the cost and management implications of setting higher standards on integrity and sustainability.

Pricing the risk, amending the valuation for risk and cost and charting a route to a successful post-acquisition integration are all areas where the lawyer can be of assistance. Ultimately the lawyers may also need to be willing to forfeit the income generated by a long contractual negotiation, where the better advice to the client is not to go ahead. This will be a longer term investment in the client relationship and the reputation of the firm which is what the MNC is usually looking for.

Note

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Understanding China's new third board

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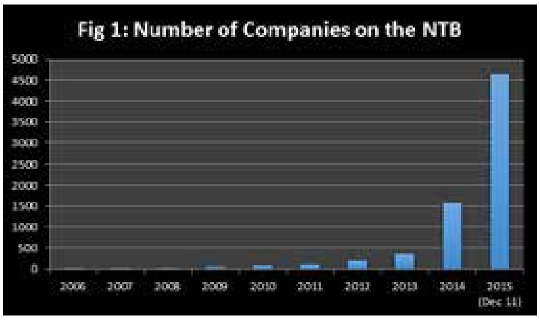
The number of listings on China's New Third Board ('NTB') have skyrocketed recently and have made big news in both the Chinese and foreign media. This paper discusses some of the policies surrounding the NTB and how it fits in with China's capital markets regulations.

Background

When it first launched in 2006, the NTB was limited to companies in the Zhongguancun Science and Technology Park (in Beijing). In August 2012, the NTB was expanded to Shanghai's, Tianjin's and Wuhan's Science and Technology Parks. In September 2012 the National Equities Exchanges and Quotations Company Ltd ('NEEQ'), the operation management institution for the NTB, was founded. Finally, in early 2014 the NTB was opened up to all of China. This opening up has significantly increased the number of companies that can, and have, listed on the NTB (see Fig 1).[1]



The effects of this change can also be seen by looking at the 2014 annual report.[2] For example, with respect to industries, although 79 per cent of the companies were in 'manufacturing' or 'information transmission, software and information technology services,' the list of industries is quite broad and includes such industries as 'culture, sports and entertainment' (1.78 per cent), 'health and social work' (0.70 per cent), and 'education' (0.25 per cent). Similarly, with respect to geographic location, although 61 per cent of the companies are in Beijing, some other regions are well represented including 13 per cent of the companies in Guangdong (where none of the original Science and Technology Parks were located).

NTB Policies

This section discusses some of the policies surrounding the NTB.

Listing Requirements

CURRENT REQUIREMENTS

The requirements to list on the NTB are, compared to other exchanges, not very stringent. Article 2.1 of the *Business Rules of National Equities Exchange and Quotations (for Trial Implementation)*[3] (the **'**Business Rules**'**), provide that:

- the company must be legally established and have existed for at least two years;
- the company must have a specific business scope and capacity for continuous operation;
- the company must have efficient management mechanisms and operate in accordance with the relevant laws and regulations;
- the equity ownership of the company must be clear and the equity must have been issued and transferred in accordance with the relevant laws and regulations; and
- the listing of the company must be recommended and continuously supervised by a host dealer.

In addition, in accordance with the Company Law of the People's Republic of China[4] (the 'Company Law'), all companies that wish to list, need to be (or reorganise into) a 'joint stock limited company' ('JSLC') and meet all the requirements of that corporate form.

As can be seen from these requirements, a company need only meet a bare minimum standard in order to list on the NTB. In contrast, listing on the other boards requires meeting significantly higher standards. For example, to list on the Main Board a company must, inter alia, have:

- a net profit of over RMB¥30m (US$4.6m) for the last three fiscal years;
- a net cash flow over RMB¥50m (US$7.7m),

or cumulative turnover of over RMB¥300m (US$46m), for the last three fiscal years; and
- no offsetting losses for the previous fiscal year.[3]

As such, it can be seen that the NTB is meant to serve companies that have passed a very initial startup phase but that have not yet necessarily become profitable or financially viable.

Proposed two layer system

The growth of the NTB has led to increased diversity of companies listed therein with respect to their quality, size, etc. In response to this, on 24 November 2015 the NEEQ promulgated a draft plan for the stratification of the NTB.[4] This proposal, if passed as per the draft, would bifurcate the NTB into an 'innovation layer' and a 'base layer'. Access to the innovation layer would only be allowed if one of three standards are met. For example, the first standard would require:

- an average net profit over the past two years of at least RMB¥20m (US$3.1m);
- an average net return over the past two years of at least 10 per cent; and
- an average daily number of shareholders over the past three months at least 200.

The other two standards, though based on different indicators,[5] are all similar with respect to the required maturity of the company. The proposed scheme would require companies in the innovation layer to report each year to show that they continue to meet the standards. Any company that fails to meet the standards for two years will be dropped to the base layer and companies in the base layer that come to meet the standards can be upgraded to the innovation layer.

Market maker system

On 25 August 2014 the market maker system for the NTB was formally launched.[6] The market maker system filled an important gap in the NTB because of the rules restricting the method of trading on the NTB. According to the rules, shares on the NTB may only be traded via: (1) a market maker; (2) private agreements; (3) bidding; or (4) in any other form approved by the China Securities Regulatory Commission (CSRC).[7] However, the bidding process has not yet been set up and no other forms have been approved by the CSRC. Thus, prior to the setup of the market maker system, private agreements were the only option. The introduction of the market maker system solves various problems the NTB had, such as low liquidity, difficulty in valuing a company, and limited financing options.

Qualified Investors

Consistent with the view that the NTB is meant for startup companies, NEEQ policies limit who can invest in stocks on the NTB. In particular, only three kinds of entities may invest:

(1) Companies with a registered capital of RMB¥5m(US$774k) or more.
(2) Partnerships with a paid-in capital of RMB¥5m (US$774k) or more.
(3) Natural persons who
    (i) own securities (on other exchanges in China) of RMB¥5m (US$774k) or more; and
    (ii) have more than two years of investment experience.[8]

As stated above, the requirements for listing on the NEEQ are quite easily met. As such, being able to list on the NEEQ is little guarantee that an investment is, in any way, safe. Therefore, these policies are meant to limit investment to appropriate investors.

Understanding the NTB policies

The NTB policies can only be properly understood by looking at its purpose in the context of the Chinese capital markets system. The hierarchy of China's capital market system can be seen in Fig 2.

Fig 2: Hierarchy of China's Capital Markets

Two things happen as one goes up the pyramid in Fig 2. First, the requirements for listing become harder to meet. Second, above NTB the restrictions on who can trade and the methods of trading are removed.

As such, one can see that China's policies with regards to capital markets are calibrated to connect companies to the appropriate investors for financing. Meeting the requirements to list on the NTB is comparatively easy and, as such, little guarantee that the company will have a bright and profitable future. Therefore, Chinese policy protects investors who cannot afford to lose significant amounts of money and without investment experience from investing in NTB companies while providing a platform for investors with the capital and experience to invest in these companies. This policy also protects the companies. Were a company to take on a significant number of inexperienced investors as shareholders at an early stage of development, it could cause serious problems for the strategic direction of the company because the general meeting of the shareholders holds significant power.[9]

In addition, one can see the board on which a company lists as an important indicator regarding the company's 'maturity'. The higher a company is on the pyramid, the more 'mature' it is. The proposed two-layer system for the NTB (discussed above), if carried out, would be in line with this function.

Conclusion

As China has opened up the NTB, an increasing number of companies have begun to utilise it. In order to ensure that the NTB continues to serve both startup companies and investors, Chinese regulators have been careful to balance giving such startups a platform to find funding and ensuring that only appropriate investors invest in such companies. As China's policies evolve, we should expect to see further structures meant to appropriately match companies to investors.

Notes

1 All data referenced in this section can be found at on the NEEQ's market data site: www.neeq.cc/marketnewsMouth.
2 Only the annual report breaks down the listed companies by industry and geographic location. As such we are currently limited to the 2014 annual report for such data.
3 Administrative Measures for Initial Public Offering and Listing of Stocks, Article 33.
4 Circular on Seeking Public Comments for the Proposals for the Stratification of Companies Listed on the National Equities Exchange and Quotations (Draft for Comment).
5 The second standard is based on compound growth rate of operating income plus the operating income plus share capital and the third standard is based on market value plus shareholders' equity plus number of market makers.
6 See press release at www.neeq.com.cn/news_releases?key=&date=2014-08-25 (in Chinese).
7 Business Rules, Article 3.1.2.
8 Detailed Rules of the National Equities Exchange and Quotations for the Investor Suitability Management (for Trial Implementation), Articles 3 and 5.
9 Company Law, Article 99.

The latest foreign debt administration measures in the Shanghai free-trade zone

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China is further liberalising its government controls in the economy field with a set of new financial and political policies, with the intention of allowing foreign investors to participate in the Chinese domestic market and encourage domestic investors to expand their overseas businesses. The major changes in recent years are the establishment of free-trade zones and various revolutionary practices in free-trade zones.

Context

China has already established four free-trade zones (the 'FTZs') in Shanghai, Tianjin, Fujian and Guangdong, respectively. The purpose of setting up these FTZs is for the Chinese government to evaluate how to further open its domestic market to the world and how to help the domestic players participate in overseas markets more efficiently.

The China (Shanghai) Pilot Free-Trade Zone (the 'Shanghai FTZ') is the first FTZ established in 2013. Since its establishment, the Shanghai FTZ has implemented various new policies which are not available elsewhere. Thus, it is considered an important place to solve what might otherwise be considered 'missions impossible' for either foreign or domestic investors, including that of the subject matter discussed in this article - foreign debt administration.

China is a foreign exchange control country and the cross-border movement of funds is strictly regulated. To name one example, if a foreign invested enterprise ('FIE') registered in China (with the exception of companies registered as FTZs) wants to borrow from offshore entities (the 'Foreign Debt'), it will need to register the Foreign Debt with the State Administration of Foreign Exchange ('SAFE') and the total amount of Foreign Debts will be subject to a cap (the balance between the FIE's total investment amount and its registered capital or 'borrowing gap'). Further, if such company is a domestic company, it must obtain prior approval from the National Development and Reform Commission ('NDRC') pursuant to the Interim Rules on Foreign Debt Administration issued by the NDRC, the Ministry of Finance and SAFE on 8 January 2003, which, based on our experience, is very difficult to obtain in practice. With the development of cross-border transactions in recent years, the Chinese government began to realise that such regimes seem convenient for companies doing cross-border transactions but not very efficient. Therefore, new developments in this regard have been cultivated within the Shanghai FTZ.

On 20 February 2014, the Notice of the People's Bank of China Shanghai Head Office on Providing Support to China (Shanghai) Pilot Free-Trade Zone to Expand the Cross-Border Use of RMB was released (the 'PBOC Notice'), which relaxed certain restrictions mentioned above. According to the PBOC Notice, a company established in the Shanghai FTZ (the 'FTZ Company') (either an FIE or a domestic company) is allowed to borrow RMB denominated Foreign Debt ('RMB Foreign Debt'), and the total amount of such RMB Foreign Debt could be up to 1.5 times of its paid-in capital, which might be higher than the borrowing gap. In addition, domestic companies are not required to obtain prior approval from the NDRC for such RMB Foreign Debt under the PBOC Notice. However, the FTZ Companies still need to register such RMB Foreign Debt with SAFE and also the People's Bank of China (the 'PBOC') as the Foreign Debt is denominated in RMB.

On 21 May 2014, the Circular on the Implementation Rules on Separate Accounting Business in the China (Shanghai) Pilot Free-Trade Zone (Interim) and the Rules for the Prudential Management of Risk Relating to Separate Accounting Business in the China (Shanghai) Pilot Free-Trade Zone (together, the 'Circular 46') was released in the Shanghai FTZ, which aims to facilitate the free movement of cross-border funds through a new bank account system, that is, the free trade account (the 'FTA'). According to Circular 46, an FTZ Company may use the FTA to freely transfer its funds (denominated in either RMB or foreign currencies) from the Shanghai FTZ to outside mainland China (and vice versa). However, transfer of funds from the Shanghai FTZ to other parts of mainland China outside the Shanghai FTZ (and vice versa) will be administered as a cross-border transaction and is subject to foreign exchange control.

Further to Circular 46, on 12 February 2015, the Circular on the Implementation Rules for Macro-Prudential Management of Offshore Financing and Cross-border Capital Flows for Separate Accounting Business in the China (Shanghai) Pilot Free-Trade Zone (Interim) ('Circular 8') was released, which further eased restrictions on Foreign Debt administration. According to Circular 8, an FTZ Company (either an FIE or a domestic company) is allowed to use the FTA to borrow Foreign Debt (denominated in either RMB or foreign currencies) up to twice the amount of its capital (paid-in capital plus capital reserves).

Circular 8 further provides that an FTZ Company can choose any of the following three regimes to obtain Foreign Debt:

(1) for an FIE, to borrow Foreign Debt in accordance with the existing Foreign Debt administration rules of the SAFE (in this circumstance, the amount of Foreign Debt shall not exceed the borrowing gap);

(2) for an FIE and a domestic company, to borrow RMB Foreign Debt in accordance with the PBOC Notice (in this circumstance, the amount of Foreign Debt shall not exceed 1.5 times of the company's paid-in capital); and

(3) for an FIE and a domestic company, to borrow Foreign Debt through the FTA in accordance with Circular 46 and Circular 8 (in this circumstance, the amount of Foreign Debt shall not exceed twice the amount of the company's capital (paid-in capital plus capital reserves)).

(Note: upon an FTZ Company's choice of any one of the regimes above, it is not allowed to change the regime again unless it files an application to the PBOC and provides a reasonable explanation.)

According to Circular 8, if an FTZ Company chooses to use the FTA to obtain Foreign Debt, no approval, registration and filing will be required for such Foreign Debt except that the FTA opening bank will need to complete post-filing with the SAFE and the PBOC.

In addition, to provide further flexibility to the FTZ Companies, on 17 December 2015, the SAFE released the Circular on the Implementation Rules for Further Developing Foreign Exchange Reforms in China (Shanghai) Pilot Free-Trade Zone (the 'SAFE Circular'). Previously, companies that borrow Foreign Debt (denominated in foreign currencies) can only covert it into RMB when there is a need for RMB payment. However, according to the SAFE Circular, an FTZ Company will be able to covert such Foreign Debt whenever it thinks fit, and after the conversion, it may deposit the RMB funds in the FTA and make payment when necessary.

Notes

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1 On 14 September 2015, NDRC issued the Notice on Filing and Registration Reform in respect of Issuing Foreign Debt by Enterprises, aiming to encourage domestic investors to make oversea bonds offerings. However, this Notice also made a reference that offshore bank loans are subject to the same requirements for oversea bonds offerings as stipulated therein, including, among others, a prior filing with the NDRC for offshore bank loans no matter whether the borrower is an FIE or a domestic company. Thus, this requirement contradicts with the regime where an FIE only needs to register with SAFE to obtain Foreign Debt without any prior filing with the NDRC and a domestic company needs to obtain prior approval (instead of a prior filing) from the NDRC. This issue is being discussed fiercely in China and it is still not clear for the market to what extent this Notice would apply. So, in this article we will deem this Notice as not applicable for Foreign Debt.

News corner: employment update

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'Second child'

The Amendment of the Law of Population and Family Planning in the People's Republic of China ('PRC') came into effect on 1 January 2016. The main feature of this new law is that a 'second child' is now formally allowed in law. There are in addition some further amendments in relation to the maternity leave for a second child, and the previous 'late birth' additional maternity leave has been abolished.

Supreme People's Court

The Supreme People's Court held a meeting for judges of different levels on 24 December 2015 to discuss various questions on civil disputes. The latest administrative guidelines given to the various levels of the judiciary are set out below:

- The courts should maintain a good balance between the legal protection provided to employees and to the survival of enterprises, and try to find a point which is beneficial to both sides.
- Different methodologies should be adopted in different situations. For cases involving small and medium-sized enterprises, the courts should encourage mediation and settlement between the parties to avoid causing hardship to these enterprises in these difficult times, while effective measures should be adopted to protect the rights of employees in cases where big enterprises have infringed the rights of its employees. For cases which may have an impact on certain sectors, certain measures should be adopted to resolve the conflicts on a timely basis.
- Judges should take into account the legal provisions and the system as a whole and avoid making rulings which simply focus on an issue without taking proper consideration of the system in general.

The Supreme People's Court also appears to be moving towards the following:

- Even where there are agreed figures of damages in the relevant contractual documents for damages arising from breach of non-competing obligations, any party may make a claim to adjust the figures if such figures are considered either too high or too low; and
- Termination of the bottom tier under the forced distribution system, if agreed by parties in the contractual documents, may be enforceable.

Beijing Courts

The Beijing High Court jointly issued guidelines on various issues with the Beijing Labour Arbitration Committee in *Minutes of the Seminar Held by the Beijing High People's Court and the Beijing Labour Arbitration Committee for Labour Disputes Concerning the Application of Law to Cases of Labour Disputes (II)*. Among various opinions, the Court takes the view that the statutory limitation of one year is applicable to claims for double salary in cases of failure to offer open-term contracts to employees, which means employees can only claim a double salary for up to 12 months.

Shanghai Courts

The Shanghai High Court issued Research and Reference No 11 [2015], and provided the following guidance:

- sick leave pay should be 70 per cent of the normal daily salary unless otherwise agreed by the parties, and agreed sick leave pay should not be lower than 70 per cent of the normal daily salary; and
- work during the nursing period of one hour is not considered as overtime work.

Shenzhen Courts

The Shenzhen Intermediate Court issued a set of guidelines for employment disputes on 2 September 2015, with the main points as follows:

- employers have an obligation to provide the payroll records of two years from the first demand by the employee to claim any remuneration, provided that the employee shall provide satisfactory proof of such first demand. In this connection, remuneration in the Shenzhen City Employee Wage Payment Regulations is extensively defined, and also includes overtime work pay and bonuses;
- employees in illegal termination claims, once having made a decision on claiming severance payment or reinstatement, cannot later request to change that decision; and
- an employer shall pay the employee his or her legal costs up to RMB5,000 in the event that an unfavourable ruling is made.