AQ Asia Intelligence

Unlocking Opportunity

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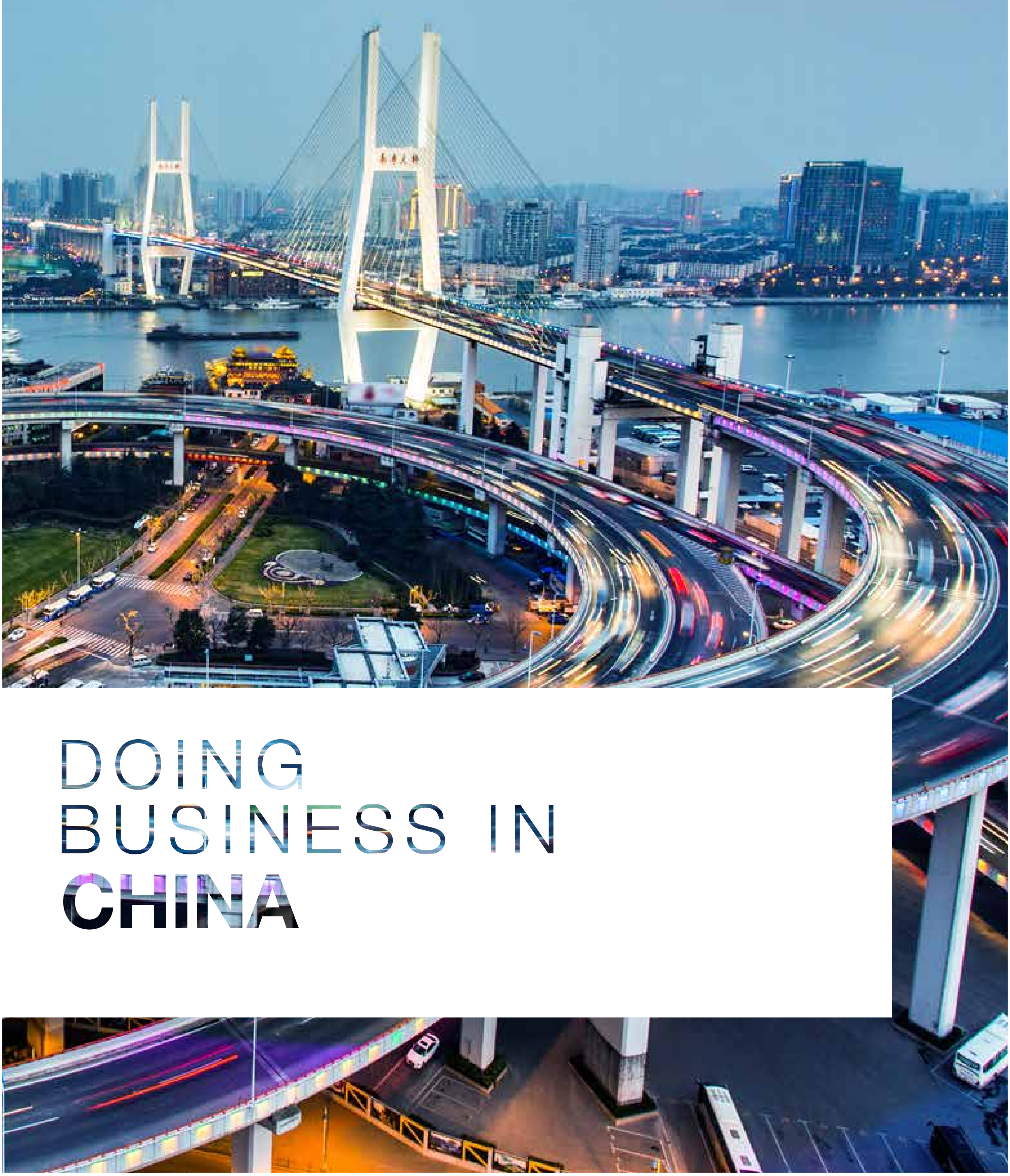
The Power of Together



DOING BUSINESS IN CHINA

Doing business in China

Introduction

"We will accelerate the development of a new open economic system in keeping with the economic globalisation and new industrial revolution. We will further ease market access in the service and manufacturing sectors; relax foreign equity caps in some areas of great interest; advance and improve the negative-list regulation model; and treat domestic companies and foreign companies equally on the supportive policies."

Premier Li Keqiang, Dalian, the opening ceremony of the Annual Meeting of the New Champions, 27 June 2017.

In this publication, we explore the key questions being asked by clients looking to unlock investment opportunities in the People's Republic of China (China):

- Where are the best opportunities for investing in China?
- How are other investors dealing with the key issues?
- How do I deal with regulatory change and ultimately repatriate my funds?

Against a backdrop of regulatory reform, economic transition and heightened regulatory enforcement, we explore and position the investment trends in China, consider the relevance of the new Free Trade Zones, discuss the role Hong Kong might play in China's future plans, and assess the relevant opportunities that these two destinations represent.

Vast opportunities remain for investors, despite China's recent credit downgrade by Moody's. As China is entering a period of more managed growth, investors need to take more time to target their plans towards sectors of the economy that are growing the strongest, and where foreign investors have the most value to add. On the next page, we have summarised the key questions investors and directors of companies in China should ask.

Building on our unrivalled depth of capability and on-the-ground experience, in this publication we analyse the key opportunities, concerns and issues facing foreign companies investing, operating and sourcing in and from China, and how this is changing over time.

We hope that we can add value to your business in China and would be delighted to discuss opportunities with you further.

Wang Junfeng
Global Chairman

Sue Kench
Global Managing Partner

Investors and directors will be well served by considering and asking the following questions:

1. Evidence-based decision making

Is your company's China strategy based on evidence and data? Has your company done its homework?

2. Regular briefings

How often are you briefed on your company's China activities, strategy and risks?

3. Systematic risk management

Does your company have a system in place to assess risks? Are risks elevated to and considered by the board in a timely manner? Is risk management part of your company's DNA?

4. Assess the impact of regulatory change

When did you last receive an update and how susceptible are your overseas revenues to regulatory developments in China?

5. Take compliance seriously

Does your company have clear compliance policies relating to your China business that all relevant staff have been trained on? "Everyone else does it" is not a defence.

6. Due diligence on counterparties

Before consummating a deal, hiring a new employee, or taking on a new Chinese supplier, does your company routinely check government records, consider litigation history, and undertake social media searches to understand the business practices of the Chinese company or individual you are dealing with?

7. Disclosure policy

Does your company have a disclosure policy which includes regular and timely disclosure of material information relating to its China business? What communication should be made public when facing imperfect information and data?

8. Crisis and public relations management

Does your company have a crisis management plan in place and a robust public and investor relations strategy that can be called upon when unexpected business disruption in China occurs?

9. Travel

Do executives check if there are risks in travelling to China before doing so, such as unresolved disputes with large Chinese companies? When facing these circumstances should they defer any non-essential travel?

10. Funds transfer strategy

When did your company last review its inter-company agreements and strategy for funding its China business or repatriation of Chinese profits?

China's Investment Environment

Realising the China Dream – 2020 Goals
Growth | Innovation | Sustainability

While many of our clients are finding China's investment market challenging given the extent of the regulatory changes described below, they are also identifying more opportunities than ever. To understand the likely changes ahead, it is important to consider China's 13th Five Year Plan which provides a roadmap for reform.

As China enters a new period of **growth consolidation**, the shifting needs of its population have driven legislative reforms and brought about a new era of inbound investment. While some industries have continued their rapid growth over the last few years, such as e-commerce and infrastructure development, a push towards **a more sustainable and balanced Chinese population** has created new opportunities in health, elderly care and green industries.

China's 13th Five Year Plan

Infrastructure

30,000km of high-speed rail covering **>80%** of major cities

50+ **new civil airports**

60% Urbanisation ratio of permanent residents

30,000km of **highways** built or upgraded

New airport in **Beijing**

Social & economic development

+50 million urban jobs created

Added value of strategic new industries to reach **15%** of GDP

GDP over **RMB 92.7 trillion** by 2020, annual growth rate **+6.6%**

Financial services

Increased focus on **"green"** finance and financial innovation

Further opening up of **financial markets**

Significant financial market **reforms**

Further **internationalisation** of RMB

Health

Two-child policy fully implemented

At least **2.5** registered practitioners for every 1,000 people

Life expectancy increased by an average of one year

90% of the population to take part in **basic pension fund program**

Environment

5 million new energy vehicles manufactured and sold

RMB **6-10 trillion** invested in **environmental initiatives**

PM10 (Particulate matter) air quality indicators to be replaced with **PM2.5**

Total **farmland maintained** at 1.865 billion mu = 1.24 million km^2

> 32.56 million mu = 21.7 thousand km^2 of new construction land every year

China's **13th Five-Year Plan (2016-2020)** (the Five Year Plan) targets a 6.5% average annual GDP growth rate to drive the development of a 'moderately prosperous society'. Rather than continuing the frenetic and relatively unguided growth of the early 21st Century, the next five years will see the implementation of reforms focussed on nation building and inclusive development. Specifically, the **'Made in China 2025'** policy encourages China to embrace becoming a progressive, global manufacturing and services hub. This national scheme invites both domestic and foreign enterprises equally to invest in high-end, smart, and environmentally friendly **manufacturing**. In addition, investment in service sectors that support production activities, such as industrial design and innovation, project consulting, modern logistics and inspection will be promoted to ultimately **transform China's traditional industries**.

Measures to **reduce income inequality** will benefit the economy-wide pivot from exports to domestic consumption, and an injection of innovation into the industrial sector will seek to increase the efficiency of China's output. The 13th Five-Year Plan indicates that the immediate future will see China seek to **counter the twin evils of poverty and pollution**, implementing supply-side reforms to tackle overcapacity in certain sectors and relying on service-based industries to provide the majority of its growth. For foreign investors, the 'new normal' of more sustainable economic growth presents many opportunities.

The demand for foreign goods is likely to grow in line with the growing size of the Chinese middle class. 'Internet+' and further reforms targeted at increasing internet penetration among China's population will be welcomed by those companies conducting business online, and will facilitate greater trade through **e-commerce** platforms in conjunction with the creation of 12 new e-commerce Pilot Zones during 2016. While the e-commerce industry is subject to increasing regulatory change, including the impending E-Commerce Law currently undergoing public consultations, it is not foreseen that such changes will curtail the sector's growth and they will likely provide greater protection for foreign operators.

The **'Healthy China'** initiative has created a new market for private investors seeking to capitalise on the government's desire to increase both the reach and quality of its domestic healthcare system. Foreign investment is viewed favourably in this field, as it brings with it international best practice and the opportunity to introduce new innovations in medical research and online healthcare platforms. Similar considerations apply to companies specialising in **clean energy** and **environmental management**, as China sets out to meet ambitious emissions reduction and energy consumption targets.

China continues to promote **trade liberalisation** both regionally and globally through its growing Free Trade Agreement (FTA) network and expansionist **Belt and Road** initiative. Recent meetings between China and its regional partners have seen it side firmly with international trade over protectionism, and this pro-trade philosophy may see China develop into a comparatively more attractive investment option for those weary of developments elsewhere. Further, China's recent implementation of its first nationwide negative list is an attempt to increase foreign investment in various sectors. The newly revised negative list will be included in the 2017 Foreign Investment Industrial Guidance Catalogue which is set to ease market entrance for foreign investors. Domestically, China has continued to grow its web of **Free Trade Pilot Zones**, particularly in central and western regions. These inland investment hubs will allow foreign investors to capitalise on the rapid growth of China's lesser-developed areas as the costs of doing business rise in Tier 1 and 2 cities. Some hubs will offer a lower corporate income tax rate of 15% with the regular rate being 25%.

Recent **legislative changes** have emphasised the importance of national security to the Five-Year Plan's fundamental push towards advancing the rule of law. China's new **Cyber Security Law** mandates increased restriction over transmission of personal information and data outside China. While the law secures China's internet to encourage growth and enable innovation in the data industry while enfranchising individuals and improving the protection of personal information, it seemingly struggles to strike a balance between national security and commercial considerations. Furthermore, the recent introduction of the **Overseas NGO Law** has created several hurdles for foreign NGOs operating in mainland China and subjects their activities to supervision by the Ministry of Public Security (MPS).

We anticipate two emerging trends. First, China's growth consolidation phase will present opportunities for innovators across all industries that can cater to the needs of an emerging group of middle class domestic consumers. Second, while legislative changes will present initial hurdles to those operating in previously unregulated industries, others that are willing and capable to adapt will be able to capitalise upon the more orderly business environment that results.

The diagram overleaf illustrates the status of some recent and proposed reforms.

We say…

"China's rapidly evolving economy is presenting a wealth of opportunities for foreign investors, particularly those with the technology, relationships, and risk appetite to exploit them."

Xu Ping, Corporate and M&A Partner (Beijing)

What's in store for 2017-2020?

Status of Recent and Proposed Reforms

Reforms in place

BUILD A NEW OPEN ECONOMIC SYSTEM
- Expedite establishment of FTZs
- Relax investment access

COMPANY LAW
- No minimum registered capital
- No capital verification reports

ENHANCE VITALITY AND DEEPEN REFORM OF STATE-OWNED SECTORS

Encourage investment, innovation and competition from private domestic companies

INCREASE RESTRICTION & SUPERVISION OF USE OF AUTHORITY

Target corruption through punishment and prevention methods

EXPEDITE TRANSFORMATION OF GOVERNMENT FUNCTIONS

Establish law-based and service-orientated government

IMPROVE MECHANISMS TO INTEGRATE URBAN & RURAL DEVELOPMENT

Change hukou household registration system, which will support further investment in housing, schools, hospitals, and transport systems

Reforms Ahead

EXPEDITE MOVEMENTS IN THE MODERN MARKET SYSTEM
- Facilitate proper relationships between the government and the market
- Allow the market to play decisive role in resource allocation

13th FIVE-YEAR PLAN (2016 – 2020)
- Maintain economic growth
- Deepen reforms and boost innovation

BUILD CHINA UNDER THE RULE OF LAW

To increase:
- operational transparency
- certainty in administration & judicial procedures

NURTURE INNOVATION AND ENTREPRENEURSHIP

Encourage development of science and technology for accelerating innovation

ALLOW MARKET FORCES TO ALLOCATE RESOURCES

Better allocation of resources including labor, capital, land, technology, and management

RAISE THE ROLE OF CONSUMPTION

Consumption to become a key driver for China's economic growth

PROMOTE SUSTAINABLE DEVELOPMENT

Shift away from "grow at all cost" mentality towards "green" and "sustainable" development

AIM FOR "MEDIUM-HIGH ECONOMIC GROWTH"

Continue maintaining the steady economic growth of economy

> **"We will expand market access for foreign investors, build high-standard pilot free trade zones, strengthen protection of property rights, and level the playing field to make China's market more transparent and better regulated.… All this will create a bigger market, more capital, more products and more business opportunities for other countries."**
>
> **President Xi Jinping,** Davos, World Economic Forum, 17 January 2017

Opportunities for Investment

KWM Insight: Top 5 areas of concern and Top 5 opportunities in China

With China's new period of growth consolidation pushing towards a more sustainable and balanced Chinese population, we explore the top 5 areas of concern that our clients have in China and outline the top 5 opportunities in China.

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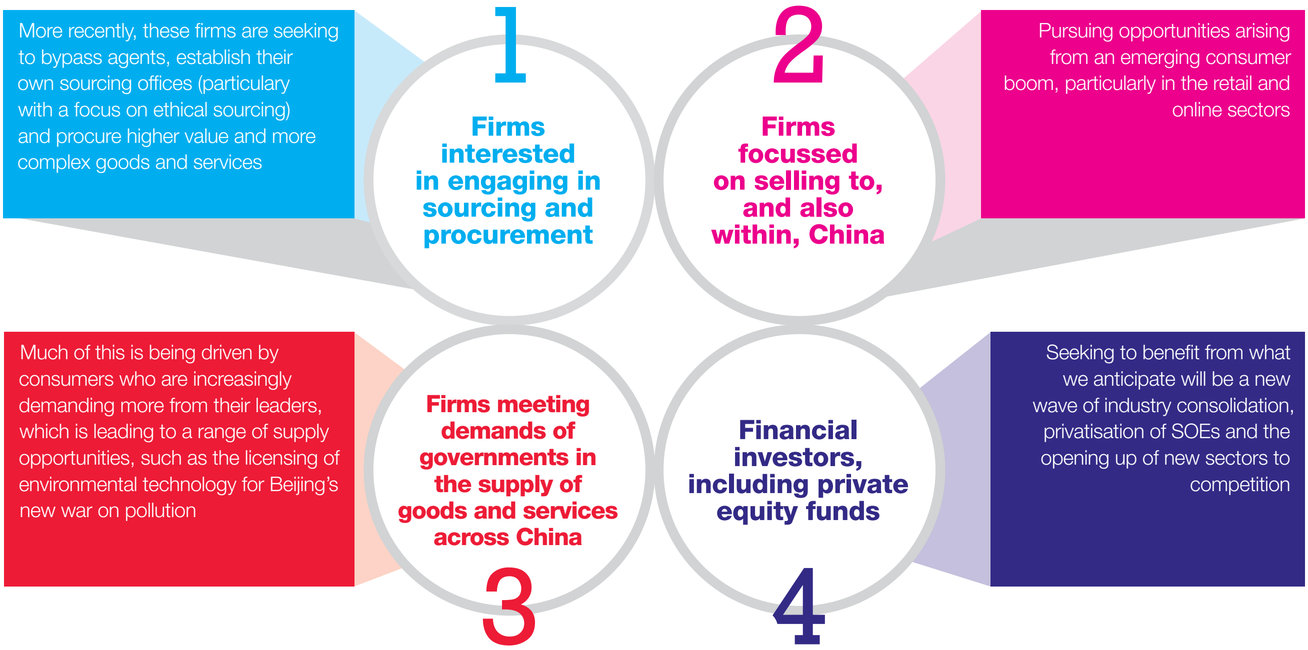
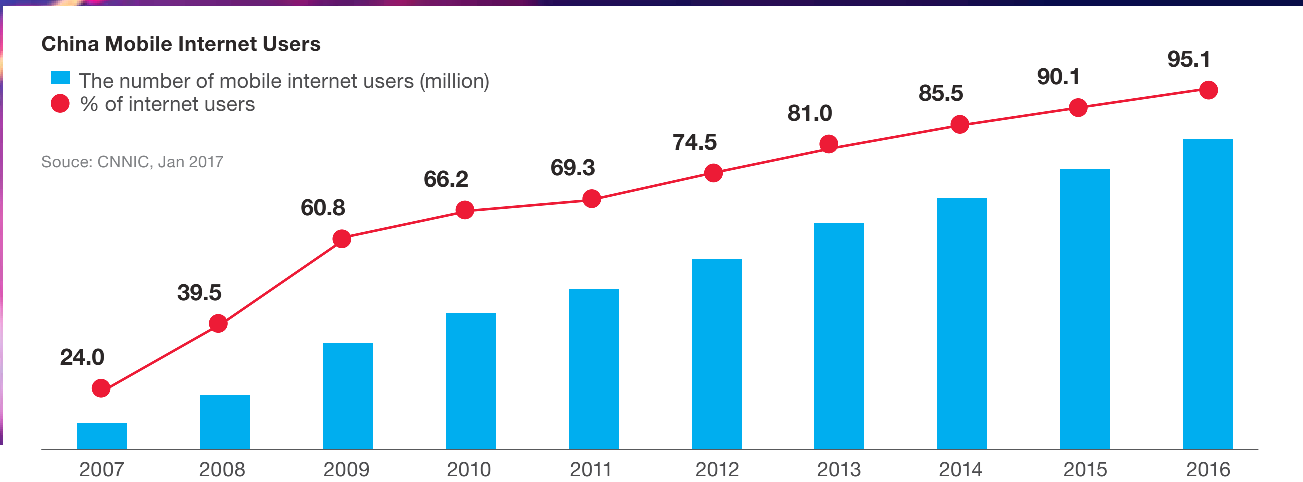
China's Guidance Catalogue

China is steering investments away from low value-added, labour-intensive businesses (particularly those involving conventional, high polluting and resource - intensive technologies) in favour of high value-added, technically - advanced manufacturing and strategic technologies in goods and services. China's '2017 Foreign Investment Industrial Guidance Catalogue' (Guidance **Catalogue**), a kind of 'bible' for foreign investors, reflects this priority. The latest catalogue will take effect on 28 July 2017. The catalogue reflects China's approach to liberalise foreign investment with fewer sectors restricted. Further details are outlined throughout this publication.

Foreign investors in China generally fall into four main groups:





China's e-commerce revolution and its restrictions…

As part of the Five-Year Plan's objective of modernising the Chinese economy, the government's goal is to raise the fixed broadband household coverage rate and mobile broadband subscription rate to 70% and 85% respectively by 2020.

Better access across the country will enable the development of e-commerce in China, which is viewed by many as one way to push China towards further developing a middle class consumer economy. Specifically, lower device costs and better mobile surfing experiences have led to smartphones overtaking personal computers and tablets as the preferred internet gateway for Chinese users. China added about 50 million new internet users in 2016, meaning that more than half of China's population -- over 731 million people -- are connected to the internet. Huge potential for further growth remains, particularly for people aged between 10 and 40 living outside China's major urban centres.

As users increasingly reach for their pockets rather than their desktops, traffic has shifted from websites to apps. The most popular apps are those that allow for instant messaging like WeChat, search engines like Baidu and online news services like Toutiao. Moreover, the shift has facilitated the rapid rise of mobile payment and mobile shopping platforms. Policymakers are adapting to keep pace with such technological change. One area of policy reform is in relation to the "sharing economy", with the PRC National Development and Reform Commission (NDRC) releasing guidelines in July 2017 in relation to the regulation of this area. Another example of policy responding to the popularity of taxi and ride-hailing apps is Shanghai's proposal to implement a specific permit and licensing system requiring operators to establish local servers. China's e-commerce revolution will continue to grow -- representing a major opportunity for innovative companies ready to meet the demands of China's smartphone users.

There are several factors to be aware of in relation to the e-commerce revolution. First, while most e-commerce is set to be conducted by Chinese companies, in recent years' certain key sectors have been gradually opened to foreign investment, e.g., platform-type e-commerce. Though the updated version of the PRC telecom industry catalogue seeks to regulate SAAS (i.e., software as a service), it is not as restrictive as initially perceived. In the recently released 'Guiding Opinion for the Promotion of Health and Rapid Development of Cross-Border E-Commerce' foreign participation in the ownership and control of e-commerce companies in China was not mentioned. However, in practice many foreign companies find it challenging to compete against well-resourced Chinese competition. An illustrative example is the recent acquisition of ride-hailing app Uber by Chinese company, Didi Chuxing. Second, the Chinese government will be scrutinising the industry to ensure all transactions are conducted in accordance with Chinese law.

Finally, rules relating to e-commerce are regularly updated. In April 2016, authorities issued a new policy regulating cross-border e-commerce (CBEC). The policy raises concerns because it requires a wide range of products to be registered with authorities – including cosmetics, health foods, infant formula and medical devices. The policy sparked panic in the CBEC market and CBEC revenue fell by almost one third. Fortunately, the PRC Ministry of Commerce (MOFCOM) has since stated that it aims to promote the stable development of CBEC in China and has adjusted the policy's requirements to mitigate its disruptive market effects. First, MOFCOM announced that the policy's registration and filing requirements will not be implemented until 1 January 2018. Second, in a press release on 17 March 2017 regarding the supervision of CBEC products, MOFCOM announced that CBEC products will be temporarily treated as 'personal items' – making them subject to less regulation and lower taxes.

It is important not to overstate the significance of the MOFCOM announcement. MOFCOM is not the only stakeholder in this debate, the announcement is informal and its measures are unlikely to last beyond 1 January 2018. The various Chinese authorities at the table want to develop the CBEC sector but are anxious to balance its growth with consumer safety. Indeed, the 17 March 2017 announcement indicated that authorities will increasingly monitor safety risks in CBEC products and look to optimise their supervision. Furthermore, the Deputy Director-General of the Financial Department of MOFCOM, clarified that CBEC enterprises will shoulder responsibility for the quality and safety of CBEC products and will be personally responsible for informing and warning consumers when issues arise. Accordingly, companies would be well advised to continue to prepare for filing and registration for their products if such products are being shipped in commercial quantities and to monitor the situation regularly.

It is clear that there will be opportunities for foreign investors to leverage Chinese cross-border e-commerce as a result of the industry's rapid development. However, given that these sectors continue to be heavily regulated, it is important to monitor changes in regulation. For example, China's decision to suspend live video and audio streaming services on Sina Weibo caused the company's market capitalisation to drop by more than US$ 1 billion on the New York Stock Exchange in June 2017. Other companies affected by the decision to suspend live streaming content include Acfun and ifeng.

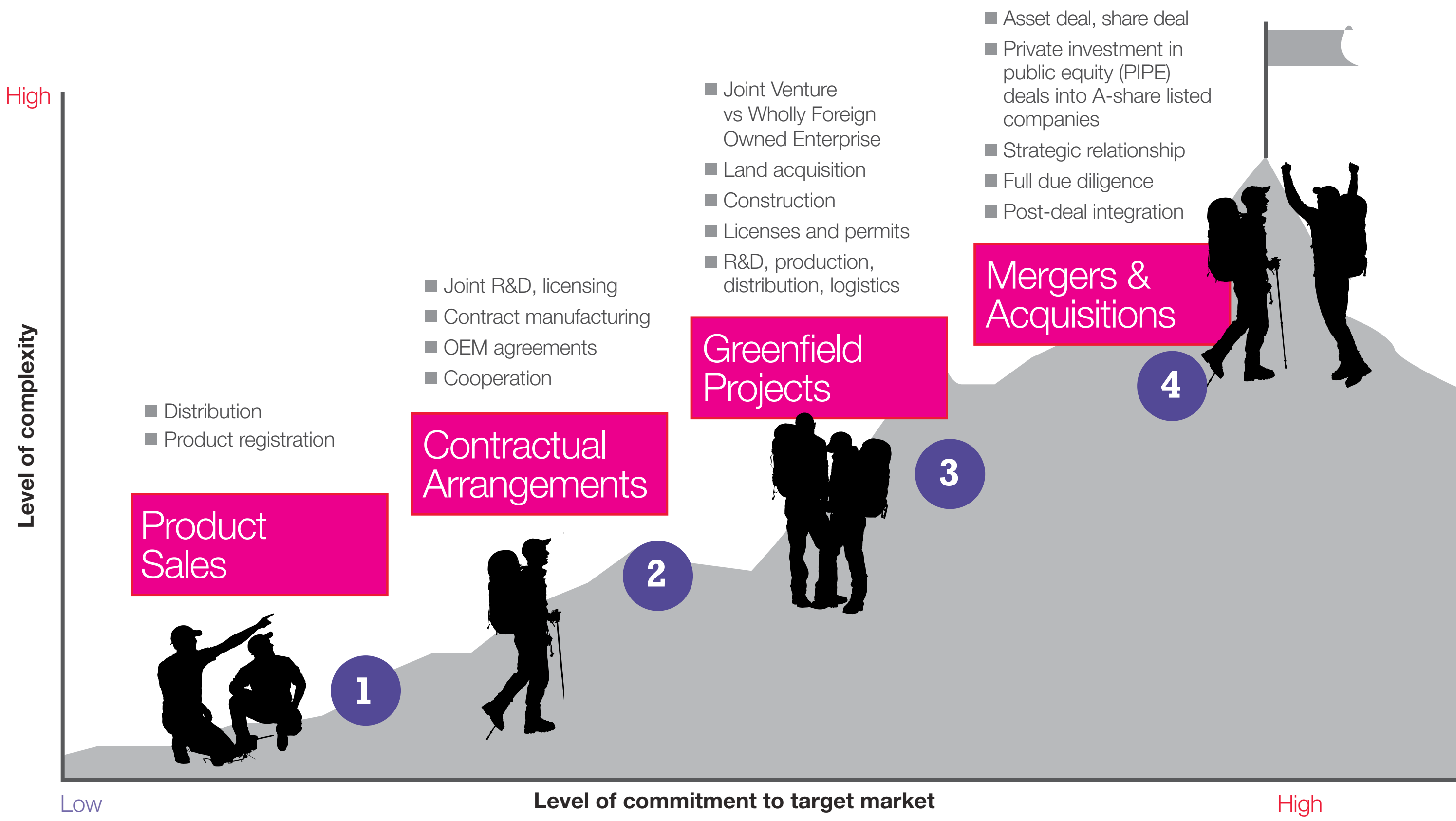
Structuring your business in China

Business Models Available and Considerations

Foreign investment in China typically occurs through the establishment of a new entity on a stand-alone basis, formation of a joint venture, or through a merger or acquisition of an existing business.

Where foreign investment is restricted, parties may consider contractual options instead or a variable interest entity (VIE) structure. Often the level of complexity of the business operation and the depth of integration of the business in China will dictate the type of investment vehicle and strategy.

Which Option?



Greenfield projects

The main forms of foreign invested enterprises (FIE) for investing in greenfield projects in China are set out below:

#	Type of Vehicle	Introduction
1	**Equity Joint Venture (EJV)**	The most commonly adopted structure for joint Chinese and foreign ownership. Shareholders have joint management of the company incorporated as a limited liability legal entity. Profit and loss are distributed in proportion to each party's capital contribution. In certain industries, there may be restrictions on the level of foreign ownership in an EJV.
2	**Cooperative Joint Venture (CJV)**	Similar to an EJV but provides more flexibility in terms of what a party may contribute as registered capital, cooperative conditions, distribution of profits and liability, and return of investment, which may be agreed in the joint venture document. A CJV can be incorporated either as a legal entity with limited liability or a non-legal entity. Typically, it is the preferred investment vehicle for joint construction and management of hotels, commercial complexes, infrastructure and mining projects.
3	**Wholly Foreign Owned Enterprise (WFOE)**	A limited liability company with 100% foreign ownership. Investment vehicle of choice for most foreign investors in industries where there are no restrictions on foreign investment and where there are no strategic reasons for engaging a Chinese partner.
4	**Representative Office (RO)**	Provides basic market entry without formal legal establishment. However, restrictions on direct business activities make ROs unattractive as an entry vehicle in most cases.
5	**Foreign Invested Partnership (FIP)**	Established by two or more foreign entities or individuals with or without a Chinese partner. Profits and losses are distributed according to a partnership agreement. Income tax is assessable on each partner, and not on the partnership.
6	**Foreign Invested Company Limited by Shares (FICLS)**	A minimum registered capital of RMB 30 million is required and foreign shareholders hold at least 25% of the registered capital. FICLS is typically set up for listing purposes and the approval process is similar to other FIEs. FICLSs may be established by means of promotion or by means of a share offer. Provided that certain conditions are satisfied, certain forms of FIEs may be converted into FICLSs.
7	**Special FIEs**	Investment in certain industries require special kinds of FIEs. For example, wholesale and retail entities use foreign invested commercial enterprises (FICE); companies wishing to invest in real estate projects use foreign invested real estate enterprise (FIREE); and foreign invested venture capital enterprises (FIVCE) are used as private equity funding vehicles.
8	**China Holding Company (CHC)**	A foreign investor with substantial operations in China may be eligible to set up a CHC to hold its equity in investments in China.

Setting up offices in China

A number of cities in China have also encouraged foreign investors to establish regional headquarters or head offices. Shanghai's policy to encourage the establishment of regional headquarters or head offices is summarised in the diagram below.

Entity	Requirements	Advantages
Regional Headquarters	Must be established as a WFOE.	**Funding**: a regional headquarters can receive funding once established. Awards may be obtained if a contribution is made to regional economic development. **Capital management**: regional headquarters and head offices can establish a uniform internal capital management system. **Entry and exit**: simplified entry and exit processes (e.g. special travel cards (APEC card), visas, residence permits). **Talent introduction**: Shanghai Hukou, Shanghai Residence Permit and Dependent Card may be obtained if certain requirements are met. **Customs clearance**: customs clearance may be faster if certain requirements are met.
	The registered capital of the WFOE is no less than US$2m.	
	The assets of the parent entity are no less than US$400 million or US$300 million where the enterprise is in the service industry.	
	The registered capital the parent entity has invested and paid off in the People's Republic of China ("PRC") is no less than US$10 million and the parent entity is authorised to manage no less than 3 enterprises; or the parent entity is authorised to manage no less than 6 enterprises.	
Head Office	Must be established as a WFOE or a branch office.	
	If established as a WFOE, the registered capital is no less than US$2m; or	
	If established as a branch, no less than US$2 million has been allocated for its operation by the parent entity; and	
	The registered capital of the parent entity is no less than US$200 million, and the parent entity has set up in the PRC no fewer than 2 enterprises, with 1 registered in Shanghai.	

FIE Establishment Process

We say…

"This migration from an approval to a filing system, due to its national law basis, is a revolutionary step. It lays down the foundation for investors to ascertain their title in onshore equity interests through judiciary procedures rather than languishing in the labyrinth of administrative formalities. It is hard not to exaggerate its importance."

Xue Han, Corporate and M&A Partner (Shanghai)

The NRDC and MOFCOM jointly released a newly revised Foreign Investment Industrial Guidance Catalogue effective July 2017. The Chinese Government has implemented a "negative list" approach for all foreign investment in China. Coupled with this initiative, the government has increased the number of sectors and industries foreign companies may invest in and further relaxed existing restrictions. Based on the catalogue, the negative list has shortened the number of industries that completely ban foreign investment from 36 to 28. The number of industries that are subject to restrictions has also been reduced from 57 to 35. Whilst foreigners are still restricted from sectors such as air traffic controls and compulsory education institutes, investors will be granted a simpler entrance into areas such as China's highway passenger transport, processing of certain rare metals, manufacturing of rail transit equipment and cooking oil. Investments in industries that are not restricted or prohibited are either permitted or encouraged.

FIEs that are not subject to national special administrative measures for admission (i.e., those prohibited and restricted industries set out in the Guidance Catalogue) may now benefit from online record-filing requirements instead of a strict approval process. Whilst the relevant commerce department of the MOFCOM is to lead and oversee the administration of filing across the nation, filings are to be made to the relevant authoritative local commerce departments. The changes aim to decrease processing time for the FIE registration procedure.

In turn, there will be more stringent reporting requirements and a greater focus on post-approval supervision of FIEs during their operations.

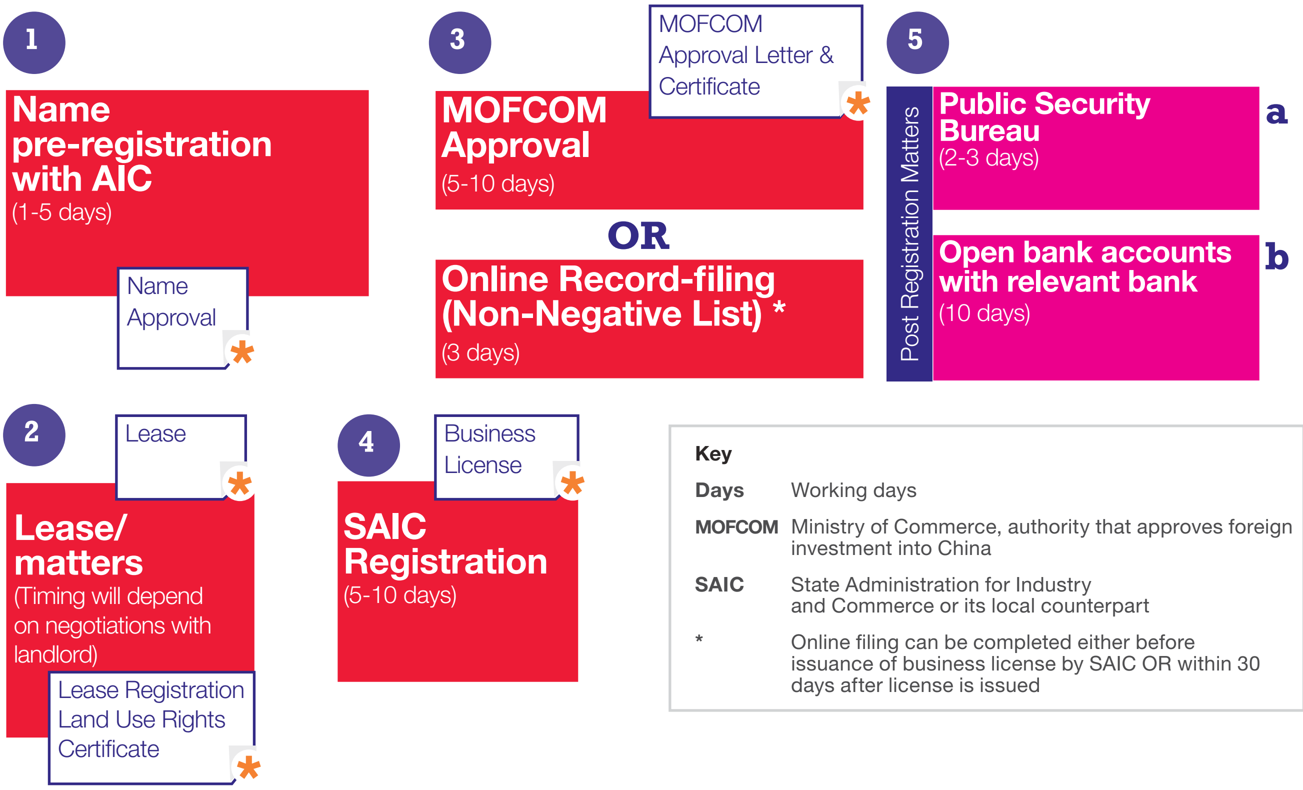
Additional regulatory approvals will be required in sensitive/ restricted sectors or those involving state-owned enterprises (SOEs). If SOE assets are involved, a formal valuation by a licensed appraiser of the relevant assets and approvals or filings from the State-Owned Assets Supervision and Administration Commission (SASAC) and its relevant local counterpart will need to be obtained.

However, the trend is towards a reduction of red tape. For example, the NDRC project approval is generally no longer required for the establishment of manufacturing FIEs in non-restricted industries as a standalone process. Another key reform means that it is possible in certain localities to lodge a single application to obtain a comprehensive Business License, issued by SAIC, that includes a unified registration number to cover the Organisation Code Certificate (originally issued by the Quality Supervision Inspection and Quarantine Bureau), Social Insurance Registration Certificate (originally issued by the Social Security Bureau), Company Stamp Carving Certificate (originally issued by the Public Security Bureau) and Tax Registration Certificate (originally issued by China's Tax Bureau). In addition, it is no longer necessary to register the establishment of new FIEs with the Finance Bureau (national wide) or Statistics Bureau in some provinces (e.g., Jiangsu Province). We expect the cutting of red tape to continue, leading to the gradual reduction of complexity and approval timeframes for new foreign investments.

The most challenging and time-consuming aspects of establishing an FIE are: negotiating and entering suitable leased premises; crafting the relevant business scope; and aligning organisational interests in a manner that enables the client to obtain the various approvals/filings (as the case may be). As such, appointing an individual with strong project management skills is often critical to success and helps expedite the establishment process (i.e., a company is up and running in 2 to 3 months, rather than 4 months or more). Advance planning and coordination can help minimise disruptions throughout the process.

WFOE Establishment Process

The typical regulatory approval process for establishing a WFOE is illustrated below. This is also generally applicable to other FIEs, although timing may differ.



Choosing the right structure from the start…

JV or WFOE?

In sensitive industries and markets, restrictions on foreign investment mean that investors are limited to joint venture structures (JV) with a Chinese partner. Many early JVs did not meet investor needs and were restructured – often due to insufficient due diligence, misaligned interests or management conflicts.

Key reasons for selecting a JV structure are:

- legal restrictions (i.e; in certain restricted industries);
- equity investment into an existing company with a shareholder that does not wish to exit;
- reliance on a Chinese partner is deemed to be strategic or critical (JV contracts can contain a call option mechanism to transform the JV into a WFOE when conditions mature); or
- private equity (in China, private equity investments are often minority positions).

> "In the mid-1990s to early 2000s when many foreign companies were establishing manufacturing for export the joint venture as a model fell out of popularity. In recent years there has been a resurgence of interest in joint ventures as increasing numbers of international companies seek to target the Chinese consumer. In these consumer facing sectors Chinese partners are a very helpful source of capital, relationships and know-how."
>
> **Mark Schaub,** Senior Corporate Partner (Shanghai)

Restructuring your business

Many businesses are finding that they have excess business capacity or surplus land and facilities, therefore companies are considering restructuring options and divestments. Conversely, some multinationals are enlarging their footprint in China by taking stakes in Chinese businesses or looking for potential partners to merge with. Chinese inbound M&A activity reached an all-time high in 2016 in terms of the value of transactions. Investor Group acquired shares in China's largest bank, ICBC. Observing the current trend, it is likely that China is going to have another record-breaking year in terms of inbound M&A deals.

Go Private

In 2016, several US-traded Chinese businesses proposed privatisation plans to return to their domestic capital market. Heavy US regulations in capital markets, the existing economic climate and unfavourable valuations are the main contributing factors of this trend. This introduces a great opportunity for potential purchasers to acquire businesses at a favourable price. Moreover, privatisation can save expenses and management resources as US-listed companies often incur significant costs to comply with US regulations. Chinese companies that have recently privatised include Focus Media, Jumei International Holding, Zhaopin Ltd, and iKang Healthcare Group Inc. Focus Media received more than double its valuation amount on the US stock market upon being listed on the Chinese stock market.

M&A

Foreign investors may also operate businesses in China as a result of mergers or acquisitions (asset, equity, or both), which will result in the creation of an FIE and trigger a foreign investment review upon completion. Foreign investors cannot circumvent restrictions on foreign investment through M&A transactions, and sectors that are closed to foreigners still remain off-limits. These are typically industries that are culturally significant (e.g, traditional Chinese medicine), strategically important (e.g, rare earth), pose serious pollution or health concerns (e.g, radioactive mineral processing) or politically sensitive (e.g, media).

In light of increased enforcement activity by Chinese regulators, investors should prioritise due diligence on targets to cover off any compliance risks associated with competition, anti-bribery and corruption breaches. Investors should also carry out due diligence with regards to home jurisdiction regulatory requirements, including personal data privacy protection constraints.

The Anti-Monopoly Law (AML) came into effect in 2008. If an M&A transaction or a proposed JV meets certain global and Chinese revenue thresholds, it may trigger an anti-monopoly merger review notification to MOFCOM. The revenue thresholds are low and surprisingly easy to trigger: China's Ministry of Commerce (MOFCOM) approved around 395 merger filings during 2016, among which most filings (approximately 98%) were approved without conditions and 324 merger filings (approximately 82%) were cleared within 30 days. Although the large majority of transactions are approved, MOFCOM occasionally imposes conditions or (more rarely) blocks transactions. For example, the proposed US$2.5 billion bid by Coca-Cola for China's top domestic juice-maker and the proposed establishment of the P3 Shipping Alliance were blocked by MOFCOM in 2008 and 2014 respectively. MOFCOM can also impose administrative penalties for failure to comply with the merger review process. On April 28, 2017, MOFCOM published an administrative penalty decision imposing a fine of RMB 300,000 (US$ 48,603) on Health 100 for failing to file the merger control review to MOFCOM regarding its acquisition of Ciming Checkup. In the first half year of 2017, we have seen 10 companies fined for their failures to notify transactions to MOFCOM.

The merger review process can significantly impact the timing of a proposed deal, particularly where the transaction does not qualify for the simplified filing procedure, in which case approval may take about 20 weeks (as opposed to six to eight weeks for the simplified filing procedure). Further, in the above Health 100's acquisition of Ciming Checkup, the transaction process was postponed for more than one year for MOFCOM's assessment of whether this transaction would result in a monopoly in PRC health care industry. Given the increased coordination between competition regulators worldwide, a global strategy will be required if an acquisition in China is part of a larger international arrangement.

In addition, China's changing national security review and other foreign investment requirements must also be considered. National security review is increasingly relevant due to reforms that seek to broaden the scope of "national security" and is likely to increase the number of deals subject to review on national security grounds (discussed further below).

Traditionally, M&A transactions using share-swap structures faced considerable regulatory hurdles due to the absence of specific implementation rules. However, MOFCOM has since provided clear approval procedures for investment into China by way of establishing a FIE, executing a capital increase in an existing enterprise or circumstances in which shares are used as consideration for the acquisition of a Chinese company. Notably, MOFCOM has outlined the specific type of equity that is not eligible for capital contribution, such as equity that has not been paid-up and pledge equity. While details of implementation remain to be seen and cases successfully completed are extremely rare due to the requirement that only a foreign public company can be used as consideration for cross-border share-swap, the introduction of the 'share-swap' approval procedure, in the longer run, is likely to improve the current regulatory situation by providing clarity for these types of arrangements.

Key M&A Developments

- China's regulators have tightened controls over outbound capital flows – increasing deal scrutiny, delays in clearances and additional filings/administrative requirements. Acquisitions that are non-core, non-strategic, speculative (particularly in real estate, hospitality, entertainment, sports), highly leveraged or by inexperienced/newly formed entities will be the toughest to get through. This campaign to stall capital outflows, in part due to the significant decrease in foreign currency reserve, has spilled over to M&A activities irrelevant to outbound investments – including Chinese companies purchasing equity interest in onshore vehicles from foreign interest holders. Although China's foreign currency reserves have more or less stabilised in recent months, we do not expect this panic-driven campaign to abate over the time.
- As noted above, red tape has been reduced for investments outside of the most heavily regulated sectors – creating online filings, requiring fewer documents, and removing the prior approval requirement. Unfortunately, their immediate effect may face more roadblocks. A good example is the price adjustment mechanism which, while a difficult issue, demonstrates a management issue with MOFCOM's local counterparts.
- The Guidance Catalogue has been updated to include a Negative List but is expected to liberalise investment in niche sectors within technology and manufacturing industries. China's State Council has cut its negative list from 122 to 95 in the FTZs. This means fewer restrictions for foreign capital in the FTZs in a bid to ease foreign investor access to sectors which had previously been off-limits. These sectors include aircraft and shipbuilding, electric cars, telecoms equipment, reinsurance and theme parks.

Contractual options

Contractual arrangements appointing Chinese partners to act as distributors or trading and sourcing agents may be appropriate where a foreign party wants to distribute and sell its products in China, or source input material for manufacturing or assembly overseas without having to establish a permanent presence onshore.

Franchising is an option for businesses seeking to launch and expand the market for its branded goods or services. Many defer to contractual distribution models given the regulatory roadblocks that accompany a franchise model in China.

VIE structures

One type of contractual structure that has exploded in popularity, and controversy, is the variable interest entity (VIE) structure. Where a proposed investment is subject to foreign investment restrictions (e.g, "value–added" internet services), parties commonly use a VIE to access the market. A VIE refers to a structure where a wholly or partially foreign owned entity enters into contracts with a Chinese operating company that has the approved business scope and holds the necessary licences to operate in a foreign investment restricted or prohibited sector (Local Licence Company). The first well known VIE structure was adopted by the Chinese online media company, Sina Corp., in its 2000 listing on the NASDAQ. Other high-profile companies that have adopted a VIE structure include China's largest internet companies Alibaba, Baidu and Tudou, interactive digital media advertising company Focus Media and education services company New Oriental.

To obtain control over the operation and management of the Local Licence Company, various contractual arrangements are put in place between the WFOE, the Local Licence Company and its domestic shareholders.

The controversy surrounding the VIE model stems from significant legal risks inherent in its structure. In particular, no Chinese regulatory body has officially approved a VIE structure and controls have tightened over VIE structured candidates wishing to list on the Hong Kong Stock Exchange. In recent years there have been several challenges by regulators based on allegations that VIE structures were used to circumvent industry investment regulations and restrictions. For example, in 2011, Delaware-based Buddha Steel had to withdraw its registration statement for its US public offering because the Chinese authorities considered that its use of VIE agreements contravened foreign-investment restrictions and were against public policy. The introduction of the new Foreign Investment Law is likely to bring greater regulatory certainty in this area.

Free Trade Zones in China

We say…

"Offshore investors considering establishing their investment within one of the existing or recently announced FTZs will have access to more flexible investment and financing structures than are available elsewhere in China. These include cross border financing and investments under the free trade account system, two-way cross-border cash pooling, Renminbi settlement for cross-border e-commerce, trading of gold and other futures and investment in sectors that are still restricted in other areas of China (e.g. TMT business)."

Stanley Zhou, Banking & Finance Partner (Shanghai)

Building on the success of the four existing FTZs, the establishment of seven new FTZs and 12 additional cross-border e-commerce FTZs was announced in late 2016. China's FTZs provide a range of opportunities for investors to trade in goods and provide services prohibited or restricted elsewhere, whilst allowing authorities to road test measures aimed at further market liberalisation and the promotion of cross-border investment and finance. Policies currently being trialled in the FTZs include regulatory reforms to reduce red tape and expedited customs clearance procedures for goods imported through the FTZs.

All of China's FTZs operate on a similar regulatory model, which was pioneered in the Shanghai FTZ and the e-commerce FTZs are modelled on the pilot zone in Hangzhou. Some variations in the regulatory models exist between the FTZs as a result of local policies and the differing sectors of trade on which the respective zones are focused. The announcement of the seven new FTZs signifies an attempt by Chinese authorities to open up China's lesser-developed central and western regions to foreign investment.

The e-commerce FTZs aim to provide transferable experience to businesses nationwide by introducing new models for technical standards, business procedures and regulatory measures. Comments made by Commerce Minister Gao Hucheng suggest that each of these new FTZs aims to stimulate different aspects of the Chinese economy.

7 new FTZs

- The Liaoning FTZ will facilitate new market orientated reforms in a push to stimulate greater competition in China's historically industrial northeast.
- The Zhejiang FTZ will operate predominantly in commodities trading and provide a port through which bulk commodities can flow in and out of the country.
- The Henan FTZ will provide a transport hub for Belt and Road initiatives running through China's central regions and allow the creation of a national transport network.
- The Hubei FTZ will open up central regions to high-tech development and the emergence of new strategic industries.
- The Chongqing FTZ will serve as the centre point for China's push to develop its western regions and facilitate greater investment into these areas.
- The Sichuan FTZ will provide a focal point for the development of China's central regions and link them with coastal areas.
- The Shaanxi FTZ will link Belt and Road developments through central and western regions and neighbouring countries with China's developed east coast.

The investment environments of China's FTZs — as testing grounds for new economic policies — can change rapidly as policies are developed and implemented. Indeed, in January 2017, President Xi Jinping called for a more coherent understanding of what each FTZ seeks to achieve, and more creativity in bringing about these well-defined goals.

Plans by major Chinese cities to create free trade zones

13 comprehensive pilot zones for cross-border e-commerce, including Hangzhou, Tianjin, Shanghai, Chongqing, Hefei, Zhengzhou, Guangzhou, Chengdu, Dalian, Ningbo, Qingdao, Shenzhen, and Suzhou.

Tianjin: Create offshore financial market

Qingdao, Shandong Province: Open financial sector for free trade agreement among Japan, China, South Korea

Shanghai: Act as testing ground for Likonomics

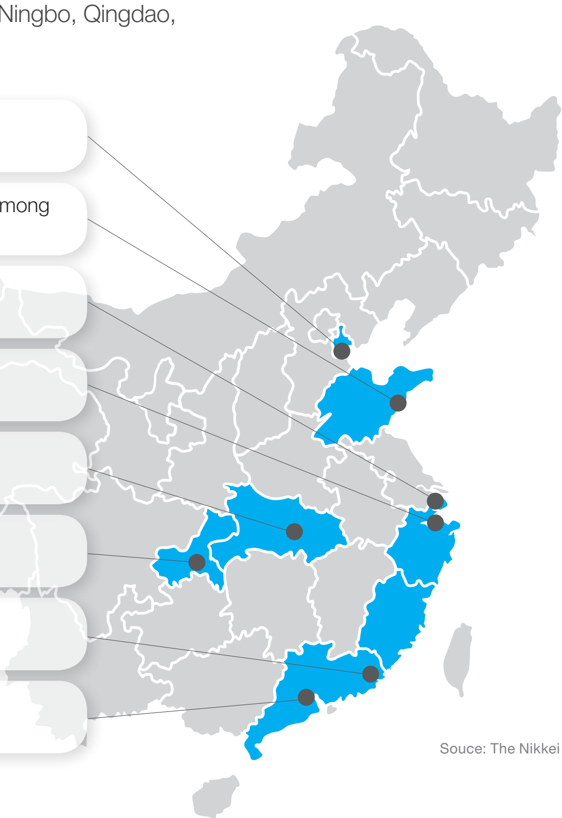
Zhoushan, Zhejiang Province: Serve as center for maritime commerce

Wuhan, Hubei Province: Promote high-tech industry

Chongqing: Serve as center for inland trade

Xiamen, Fujian Province: Serve as center for trade with Taiwan

Guangdong Province: Promote economic intergration with Hong Kong, Macau



Souce: The Nikkei

Considerations for investing in China via Hong Kong

We say…

"Hong Kong offers significant benefits for foreign investors, including generally no foreign investment restrictions, no exchange controls in force on remitting funds overseas, a simple tax system and the lowest corporate tax rate of any major Asian economy, and it is a gateway to the market in mainland China."

Hayden Flinn, Co-Chief Executive (Hong Kong)

Structuring China-related investments through a Hong Kong holding company can provide the following benefits:

Tax advantage - dividends received by a Hong Kong holding company from a Mainland subsidiary are unlikely to be taxable in Hong Kong, no dividend tax is levied on a Hong Kong holding company when distributing dividends to investors, and a lower income tax is levied on the Hong Kong company compared to its Mainland counterparts;

Flexibility - greater ability to tailor multiple investors' rights and obligations and governance provisions in a Hong Kong holding company due to less restrictive corporate legislation;

Funds access - quick access to both domestic and international funds, under a stable regulatory framework; and

CEPA - qualified Hong Kong companies can take advantage of preferential treatment under the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) to invest in areas that are partly or fully restricted to other foreign investors.

A Hong Kong holding company can also provide greater flexibility for exit strategies (as discussed later in this guide).

Financial Market Opportunities

Share market

The significant aggregate growth in China's stock market in recent times (recent short term declines and regulatory interventions notwithstanding) reflects a number of the Chinese government's initiatives to increase trading, including regulatory reform of A-share initial public offerings (IPOs), the launch of the Shenzhen-Hong Kong Stock Connect Program, and the encouragement of margin lending. Further, MSCI's decision to include China's A-shares in its major global index from June 2018 represents an important advance in the integration of Chinese equity markets with global capital markets. However, the short-term impact is expected to be gradual thanks to a two-stage inclusion process, and a reduced number of stocks, expected to initially comprise only 0.73% of the MSCI Emerging Markets index.

IPO reforms

China is taking meaningful steps toward opening up its capital markets to foreign investors through its stock issuance system. While original plans to adopt a registration system to replace the verification system by 2016 have been put on the back burner, the Chinese government is currently focusing on developing a multi-tier capital market and the appropriate regulatory landscape necessary for a smooth transition to the new system. This new registration system will limit the regulatory power of the China Securities Regulatory Commission (CSRC) and to some degree simplify procedures for IPOs. After the registration system is implemented, the share market in China will be more market-oriented and transparent, with the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) benefiting from increased issuance and supervision power.

The stock markets have seen steady growth, with a total of 227 IPOs filed on the SSE and SZSE stock exchanges in 2016, indicating a 3.7% increase from the previous year. It is anticipated that the stock markets will continue to grow in 2017, particularly once the IPO registration system is fully implemented and the backlog of companies awaiting approval has been cleared.

Share market supervision

Retail investors make up the majority of traders on the SSE and SZSE while margin trading accounts continued to grow. Margin lending is, of course, not without risk - as evidenced by the crash of China's stock market in the second half of 2015. This rapid fall prompted the temporary suspension of trading and the imposition of a 6 month selling ban on larger inventory of 5% or more in listed companies. Overall, these interventions were effective in achieving greater market stability, and we believe the CSRC is unlikely to extend these measures.

Restrictions on outbound transfers

The Chinese authorities have also been restricting the amounts that Chinese nationals and companies can transfer overseas and the purposes for which those transfers can be made. MOFCOM reported that overall non-financial outbound investment fell 36% in January from a year earlier and it has been reported that foreign property investment by Chinese companies fell 84% last month.

Encouraging outbound and inbound investments

The "QDII 2" overseas investment scheme pilot is also anticipated to encourage direct Chinese investments in foreign stock markets. Expanding on the original Qualified Domestic Institutional Investor program (QDII), which was limited to institutions, the pilot will allow qualifying individuals to invest directly in securities listed on foreign markets such as New York, London or Paris. Details as to when the pilot will be implemented are yet to be confirmed.

In parallel, the Chinese government continues to encourage foreign direct participation in China's capital markets by increasing the quotas available and simplifying regulatory procedures under the qualified foreign institutional investors (QFII) and RMB qualified foreign institutional investors (RQFII) programs. As of February 2016, the requirement of State Administration of Foreign Exchange (SAFE) pre-approval was abolished for QFIIs that do not exceed a "base investment quota". This was to facilitate the further liberalisation of cross-border capital flows in China. Such transactions will now be subject to a filing system with SAFE. However, QFIIs in excess of the quota will still be required to obtain SAFE approval in accordance with the existing approval mechanisms. The "base investment quota", which may vary between US$ 20 million and US$ 5 billion (increased from the previous upper limit of US$ 1 billion), is to be determined on a case-by-case basis depending upon factors such as whether the QFIIs' assets are mainly inside or outside China, and asset size in previous years. The new reforms also indicate a relaxation of restrictions on inbound and outbound remittances, including the abolishment of the 6-month deadline for remittance of investment principal into China after acquiring SAFE approval.

Qualified foreign parties can also act as strategic investors of A-share listed companies with MOFCOM approval, though they are subject to 36-month lock-up periods. In some cases, where A-share list companies issue new shares to foreign investors in exchange for controlling interests in a target asset, the transaction would be deemed an A-share list companies' acquisition of assets rather than a foreign investors' investment in A-share list companies. Thus, the lock-up periods would be much shorter than under strategic investment (e.g., 12 months). However, this would be subject to substantial discussions with regulators.

The OTC market is also booming in China and presents opportunity for foreign investors. The Chinese National Equities Exchange and Quotations (NEEQ), known as Xinsanban or the 'new third board', launched in 2006, facilitates the OTC trade of shares in unlisted SMEs. There are currently over 11,000 companies listed on the platform, largely from emerging industries like technology. Unlike A-share listed companies, MOFCOM does not have any rules in play for approving foreign investment directly into a Xinsanban listed company.

Shenzhen-Hong Kong Stock Connect

The recent launch of the Shenzhen-Hong Kong Stock Connect, following the successful launch of the Shanghai-Hong Kong Stock Connect in 2014, is likely to boost liquidity and enhance the integration of China and Hong Kong's capital markets. It will also increase Hong Kong's attractiveness as an investment hub, particularly attracting interest from tech firms seeking IPOs in Hong Kong.

While Hong Kong is set to continue as a preferred destination for listing, in light of stabilising growth and the various regulatory reforms underway, Chinese capital markets will maintain their advantage and play a greater role in global capital markets.

Hong Kong's 'cheap' equity valuations

In February of 2017, the daily turnover on the Hong Kong stock exchange exceeded HK$ 100 billion (US$ 12.8 billion). It is suggested that the rally is the result of mainland funds, which are seeking a temporary refuge in Hong Kong pending Beijing's approval for overseas deployment. Hong Kong's benchmark Hang Seng Index is trading 13 times current year earnings, making it the cheapest in price-earnings terms among Asia's 15 stock markets. Furthermore, as the Hong Kong currency is pegged to the US dollar, the Hong Kong Monetary Authority must maintain a lockstep interest rate policy with the US Federal Reserve, which has telegraphed three more increases in rates this year. The net effect of a stronger Hong Kong dollar vis-à-vis the Renminbi (RMB) amid the cheapest market valuations in Asia is drawing in regional funds.

As the RMB is expected to keep falling, Chinese companies and individuals will continue to invest in Hong Kong's stock market to escape their valuation loss. Traders recommend consumer and energy stocks as the winners; because they've been down for so long, they are now the perfect bargains for the rally.

China's third national equity exchange, the growing National Equities Exchange and Quotations (NEEQ), is increasingly popular among small and medium-sized domestic companies. More than 80% of the companies listed on the NEEQ are high-tech companies that do not otherwise satisfy the requirements for listing on the SSE and SZSE. In addition to participating in onshore markets, there are increasing opportunities for investors to acquire equity interests in Chinese companies listing overseas. Alibaba's IPO on the New York Stock Exchange raised US$ 21.8 billion – the third largest in history. This may encourage other Chinese internet businesses to follow suit.

We say…

"China is continuing to open its capital markets to foreign investors through its stock issuance system (QFII and RQFII) and also encouraging direct Chinese investment in foreign stock markets through systems such as QDII2. This is complemented by the integration of China and Hong Kong's capital markets through the Shenzhen-Hong Kong Stock Connect."

Zhang Yi, Chairman of China Management Committee (Hong Kong/Shanghai)

Banking reform

The restructuring and opening up of China's financial markets has been at the heart of China's economic reform agenda for the past two decades with progressive reforms gradually increasing opportunities for foreign investment. President Xi Jinping has emerged as a powerful leader, with a clear and ambitious agenda for market reform. In July 2017, President Xi Jinping announced the setup of a cabinet-level committee to coordinate China's financial regulators, with further details yet to be released.

Although the State still directly controls most aspects of the financial sector, a number of reforms have been instituted in recent years. These reforms, aimed at enhancing the stability, resilience, competitiveness and openness of the financial system and institutions, have resulted in:

- the liberalisation of the interest rate market, including the introduction of a new bank deposit insurance scheme;
- the lowering of entry barriers to foreign companies, allowing more foreign capital into the Mainland and increasing competition within the financial sector;
- the establishment of privately owned banks;
- the creation of a multi-tiered capital market; and
- the validity of cross-border security agreements no longer being subject to approval, registration, filing and other administrative requirements of the SAFE.

The Five-Year Plan focuses on continued financial system reform to promote the development of a modern financial structure. These reforms will focus on supply side structural reforms of the financial market, financial control mechanisms, and a macro-prudential regulatory framework. Additionally, a multi-tiered, differentiated banking system will be developed with an expanded role for private ownership and an increased focus on financial inclusion.

Although regulatory impact and compliance continue to be major concerns for foreign banks and financial institutions, changes in the past few years have nevertheless expanded the permitted scope for qualified foreign banks to conduct business in China. For example, locally incorporated foreign banks are now permitted to take part in asset-backed securitisations, and opportunities now exist for foreigners to participate in niche areas such as automobile financing and equipment financing.

China has progressively opened its market through channels such as Qualified Foreign Institutional Investors (QFII) and Shanghai-Hong Kong Stock Connect, offering non-mainland and foreign professional investment vehicles a path to invest in Chinese markets. Further, the State Council has removed the requirement for foreign financial institutions to establish operating entities, making it easier for foreign investors applying for licences to operate in China.

China has already eased restrictions on foreign banks' access to the domestic banking sector. An example is the removal of operating fund requirements for newly established Chinese branches of foreign parents. The State Council has also recently announced it will lower restrictions on foreign investment in banking and related financial industries to create a fair and competitive environment that puts domestic and foreign companies on an equal footing.

There is an intention to bolster the domestic financial market through the creation of a broad, deep and resilient bond and equity market to rebalance the financial system from an over-reliance on banks. The proportion of direct financing will be increased, while leverage will be reduced through the promotion of equity financing.

In July 2017, China further opened its interbank bond market to foreign investors by implementing the Northbound Trading Link of Bond Connect, a mutual access program established between Mainland and Hong Kong bond markets. This development allows global investors, through an offshore access platform, to fast track and have direct access to China's interbank bond market with a depository balance amount of RMB 67.1 trillion. While the northbound channel is already open for foreign investors to buy and sell listed debt in China's interbank bond market, the Southbound Trading Link that would allow mainland investors' access to Hong Kong listed debt is yet to be implemented and will be explored at a later stage.

Finally, the Chinese regulatory authority heightened focus on the regulation of off-balance-sheet activities, which potentially threatens the stability of the Chinese financial system. In 2016, shadow banking assets grew considerably in China to 64.5 trillion yuan – up 21% from previous year. Those assets accounted for 87% of the country's GDP and 28.5% of total banking assets in 2016. Shadow banking creates multiple layers of investments with high level of leveraging, therefore making financial markets vulnerable if liquidity shocks were to occur.

Renminbi internationalisation

A stated end-goal of China's reform process is to make the Renminbi a freely convertible international currency. Significantly, in 2016 the International Monetary Fund decided to include RMB in its Special Drawing Rights (SDR) basket. This established the RMB's status as a freely convertible currency and is expected to promote further confidence in the use of RMB in trade and financial transactions overtime. However, the RMB internalisation process has lost some momentum in the last year as the rising dollar, dwindling foreign reserves, and waning GDP growth resulted in stronger capital controls. This has also halted the liberalisation of the exchange rate.

Nevertheless, China is already actively promoting the use of the Renminbi to settle international trade contracts. Policy makers are progressing initiatives to support the development of domestic Renminbi markets, as well as developing Chinese bond markets and derivative markets to hedge currency and other risks. The development of outbound investment channels, together with the potential impact of Belt and Road financing, are further supporting the growth of the Renminbi as an international investment currency.

In recent years, the growth of the offshore RMB market has been spectacular. Chinese banks see this as a strategic opportunity to follow their clients abroad and develop their international payments clearing business. Foreign banks see this as an emerging growth opportunity to support their clients who increasingly will need to buy, pay and invest in RMB. The number of official offshore RMB centres continues to grow with the appointed RMB clearing banks in Dubai, New York and Moscow over the last year.

The full implications of RMB internationalisation are only just emerging, but a progressive approach represents a significant opportunity to trade new products, generate returns in new markets and further diversify risk.

If your organisation is active in the global trading and investment markets, now is the time to review potential opportunities, which include:

Cross-border borrowing – Chinese companies may be more inclined to borrow from foreign banks on a cross-border basis to take advantage of the cheaper funding costs for offshore RMB compared to those for onshore RMB.

Cash-pooling – treasurers of multinational corporations will have the ability to make use of cross-border RMB cash pooling products to assist in centralising and mobilising onshore RMB cash.

Cross-border funding – dramatically enlarged cross-border fund channels will allow more flexibility to structure cross-border financing and raise funds, due to the availability of RMB-denominated cross-border guarantees and outbound RMB lending by China incorporated companies to their offshore affiliates.

Asset management and custodian business – the market for cross-border RMB-denominated investments (e.g., RFQII, RMB Qualified Domestic Institutional Investors, RMB bonds and asset-backed securities) will act as a catalyst for more asset management and custodian business.

Offshore market – China has signed bilateral currency swap agreements with the central banks of around 30 countries over the past seven years, including the European Central Bank and the Bank of England. China continues to actively review its currency arrangements to ensure the liquidity of the offshore market and the stability of the offshore rate. The establishment of a sound offshore market will improve the role of the RMB in the international monetary market.

"China is continuing its economic reform agenda through progressive liberalisation of its financial markets, particularly through banking reform, the internationalisation of the RMB and Internet finance."

Wang Ling, Managing Partner, China (Beijing)

Financial innovation driving reform

Faced with a slowing economy, the Chinese government has been quick to implement market-oriented reforms in the financial industry to regulate innovative financial products in an attempt to add impetus to the economy. The emergence of internet finance is providing new options and hastening the pace of financial reform.

The Five-Year Plan emphasises the need for investment in innovation, particularly in areas such as peer-to-peer (P2P) lending and crowd funding, to accelerate the growth of one of the economy's most promising sectors. The need for innovation in the industry must be balanced against the need for regulations to protect both consumers and the economy, evidenced by the closure of numerous P2P credit platforms over the past year.

The Chinese government has already moved to increase regulation of the FinTech sector. In recent years the government introduced a series of regulations in relation to matters such as internet payments, internet insurance, online lending, crowd funding and online sales of funds in an attempt to better protect the interests of lenders and the general public. Nevertheless, the measures imposed on FinTech products have not curbed the exponential growth of the FinTech sector, but rather will ensure a healthier market. Operators that can understand and navigate the regulations will be able to exploit the opportunities presented by continued innovation in the financial services industry.

Many traditional banks are launching new financial products and building online digital channels. This will have the effect of gradually changing China's banking landscape to a digitally based service. Third party online and mobile payments systems such as Alipay continue to grow in popularity and transaction volume within China. They are also expanding offshore to provide payment and transaction management systems for overseas online merchants selling to Chinese buyers.

Entrepreneurial enterprises from within China and abroad have reason to be encouraged by these developments.

Belt and Road initiative

The Belt and Road initiative, Public Private Partnerships

China's Belt and Road policy, called the "Belt and Road Initiative (BRI)" but previously known as "One Belt, One Road", is a government initiative designed to deepen relationships, increase connectivity and encourage trade liberalisation with its neighbours in South East Asia and the Middle East, as well as Europe and Africa. The initiative is now under way as new infrastructure projects commence to revitalise the historic Silk Road trade route with an overland 'Belt', while the 'Road' will create a new maritime route through South East Asia.

47 state-owned enterprises have already begun to invest and participate in 1676 programs throughout the economies involved in the initiative. These investments have boosted local and regional economies, and have enabled the accumulation of valuable experience for Chinese SOEs looking to conduct business activities overseas.

Notwithstanding the considerable focus on outbound investment demonstrated by these projects, many foreign investment opportunities will also arise from the extensive domestic infrastructure developments aimed at linking Belt and Road economies, creating competition and spurring regional growth. Within China, the western and southern provinces will be targeted for development as focus areas under this initiative since the government hopes to increase employment, generate further economic development and promote connection with the surrounding regions.

The Belt and Road initiative holds great promise for the global economy, but it will require a huge amount of finance and innovative funding models. Although new funding initiatives, such as China's Silk Road Fund and the multi-lateral Asian Infrastructure Investment Bank, can provide funding for Belt and Road projects, the sheer volume of investment to support its implementation will require significant contributions from private sector. Foreign banks, managed funds, investment funds, private equity and insurers can play an important role in providing both the capital and financial expertise needed for Belt and Road Projects.

Aside from the SOE-led programs of the initiative, China has also been implementing measures specifically designed to attract private sector capital investment in critical infrastructure projects. Since 2014, the State Council and MOFCOM have been encouraging provincial-level authorities to use the Public Private Partnership (PPP) model as a capital management strategy. The government has flagged 1043 PPP projects, which are worth RMB 1.97 trillion and are based in 25 cities and provinces.

The value of PPPs to governments lies in the sharing of project risks and unlocking private sector efficiencies and expertise. While foreign enterprises should be conscious of Chinese laws that restrict the guarantees that can be given by state entities, they also stand to profit from entering into high-yielding investments that would otherwise be restricted.

During the first eight months of 2016, the deputy head of MOFCOM reported that trade between China and the Belt and Road countries had exceeded US$600 billion, which amounts to 26% of China's total foreign trade volume. With key sectors earmarked for PPPs and represented among the 1043 flagged PPP projects including transportation, infrastructure, clean energy projects, municipal infrastructure and petrochemical infrastructure, there are growing opportunities for foreign business engagement and growth into the future with the **Belt and Road** initiative.

Issues of Interest for Foreign Companies Investing in China

Based on recent experience, the issues that are top of mind for foreign investors are:

Anti-bribery and corruption

While unannounced inspections (i.e,"dawn raids") of companies accused of breaching China's Anti-Monopoly Law and arrests of wayward government officials and executives of SOEs are attracting fewer headlines, enforcement activity is continuing. Foreign firms that utilise third party intermediaries, interact with government officials or deal with SOEs have heightened compliance risks. These investigations are affecting many aspects of business in China, including the process of engaging with government officials and the scrutiny required of new potential business partners.

Throughout 2016, the government continued its campaign against bribery and corruption with new developments to come into force this year. China's Anti-Unfair Competition Law was originally passed in 1993, but wide-ranging draft revisions were first made public in February 2016 and a second draft was publicised for public feedback in February 2017. Among the suggested revisions is a new definition of commercial bribery. This clearer definition would extend the scope of commercial bribery to companies providing, or promising to provide, economic interests to business partners or third parties that might influence a transaction, solicit business opportunities or otherwise gain competitive advantages. This is broader than the existing standard and will bring Chinese law into line with well-recognised international standards such as the United States' Foreign Corrupt Practices Act.

Foreign companies generally want their Chinese partners or vendors to establish anti-corruption compliance programs. However, Chinese SOEs could be resistant where foreign legal requirements overlap with existing Chinese laws enforced by Party Committees or Chinese Discipline Inspection Commissions. In October 2016, these blurred lines were somewhat clarified by the introduction of the new International Organisation for Standardisation (ISO) 37001 anti-bribery standard. Obtaining an ISO certification gives credence to companies when their business partners conduct due diligence. As noted by the General Counsel of the major Chinese company Celanese, it has proven to be "a useful tool and benchmark both [Chinese and foreign] parties can accept".

Competition enforcement

In June 2016, the Opinions of the State Council on Establishing a Fair Competition Review System during the Development of Market Oriented System were promulgated. These Opinions looked at levelling the playing field by limiting government authorities' administrative powers and investigating the entrenched position of SOEs in order to open up competition and create a more accessible and transparent business environment.

On 1 July 2016, China's State Council released a "Notice on Implementing the Fair Competition Review System" and since then the competition authorities have been proactively enforcing this System. In the meantime, extensive industry wide investigations by both the NDRC (responsible for price oversight) and the SAIC (responsible for non-price conduct) continued with large fines imposed on foreign and domestic firms for anticompetitive conduct including resale price maintenance (RPM), price fixing and abuse of dominance.

Abusing dominant market position results in fines for Tetra Pak

On 16 November 2016, the SAIC fined Tetra Pak RMB 667 million (US$ 97 million) for conduct that abused its dominant market position in China between 2009 to 2013. Tetra Pak provides equipment, services and materials used for aseptic packaging of liquid food items in China. Between 2009 and 2013, Tetra Pak held a dominant position in the market that it abused by dealing exclusively with trading counterparties, conducting tie-in sales and other abusive conduct including implementing loyalty discounts which restrict the competition. These practices were determined by the SAIC as prohibited by the provisions of the Anti-Monopoly Law. The penalty accounted for 7% of Tetra Pak's total revenues in 2011 (the year before the SAIC initiated the investigation).

Stricter antitrust enforcement for notifiable transactions

According to the Anti-Monopoly Law and relevant regulations, if businesses enter into certain M&A transactions (or any other transactions involving a change of control), they need to obtain MOFCOM clearance where their turnover exceeds the specified threshold. There have been an increasing number of cases where MOFCOM impose fines to companies for failure to notify before closing. In 2016, there were six cases where MOFCOM has fined nine companies for failure to

notify and in the first half of 2017 alone, there have been seven cases where companies have been fined for the same reason. Companies are advised to notify MOFCOM to receive clearance before closing the transactions if the transactions exceed the specified threshold.

NDRC antitrust enforcement targeting the pharmaceutical industry

At the beginning of August 2016, the NDRC launched further investigations into companies in the pharmaceutical industry that resulted in several pharma companies being fined or probed by the authority, including:

- On 27 July 2016, a local drug maker Huazhong Pharmaceutical was imposed a fine of RMB 1,571,829 (7% of the company's annual estazolam tablet sales in 2015) for entering into monopoly agreements with two competitors in relation to estazolam products, including price fixing conduct and joint boycotting.
- On 9 December 2016, Medtronic (Shanghai) Management was imposed a fine of RMB 118.5 million (accounting for 4% of its sales of the relevant products in 2015) for entering into and implementing agreements with trade counterparts to fix or restrict resale prices of its medical equipment.

Addressing administrative monopoly

Since the implementation of the Fair Competition Review System in July 2016, investigations have focussed on the abuse of power by government authorities. A recent investigation into government-affiliated electricity supply found that 12 provinces, autonomous regions and municipalities issued anti-competitive regulations. Another found that a construction regulator had abused administrative power by demanding local concrete producers fix prices. The regulator was required to abolish the policy.

A ban on barriers to competition on the internet with new Advertising Laws

- According to Chinese judge Liu Yijun, the evolving character of the Anti-Unfair Competition Law has led to an expansive interpretation of a 'competitive relationship'.
- With an ever-increasing number of anti-unfair competition cases relating to the internet sector, Liu said that courts are tending to dispense with the requirement that competitive relationships exist only between horizontal competitors.
- Liu was of the opinion that the objective of the law has expanded from protecting free competition alone to protecting consumer and public interests, and from protecting private rights to market regulation.
- Accordingly, a new policy framework that contained radical guidelines to change existing internet regulations, including a blanket ban on ad blocking and stricter advertising guidelines, took effect from 1 September 2016.
- All software that filters, covers, prevents or allows advertisements to be fast-forwarded is prohibited. This is said to encourage and enforce the fair economic development of the internet while banning some ads (e.g. for prescription drugs and tobacco), with pharmaceutical ads requiring review.
- Although in effect, these laws encourage fairer economic competition, and foreign companies currently maintaining web browsers in China or considering launching new websites should be conscious of the advertisement features they utilise.

Advertising and food security

China's Advertising and Food Safety Laws have a much broader scope than many companies operating in China appreciate. For example, advertising claims appearing on the labels of imported foods that would be acceptable in other jurisdictions may be unlawful in China and result in substantial fines.

Food safety

Following several food safety scandals connected with infant formula, food labelling laws and decreasing confidence of Chinese customers in domestic supply chains, the National People's Congress (NPC) passed a new food safety law, which came into effect on 1 October 2015, and imposed stricter controls and supervision on food production, distribution, sales and recalls.

Compared to the 2009 Food Safety Law, the new law imposes much heavier civil, administrative and criminal penalties for offenders and their supervisors. The key changes introduced include stricter regulation on infant formula production and sales, reform of supervision on the health food, more stringent requirements for food labelling, higher tax rates, a positive list for food businesses involved in cross-border e-commerce and hefty penalties for any breaches in relation to food safety.

There are now stricter requirements for vendors that use either online platforms or their own websites to sell food. Such vendors are required to obtain telecommunication licenses and make a filing with the China Food and Drug Administration to obtain a food production licence or operational licence. Vendors need to closely follow the regulations, ensure that they do not carry out any business operations outside the scope of their food production and operation licence and fully comply with the food safety laws and standards. Vendors need to carefully conduct examinations for the food sold on-line and may face claims from consumers for their non-compliance activities.

Vendors operating in the category of health food products, such as food for special medical purposes and infant formula, need to display their product registration certificate, record-filing proof and any advertisement approval in their online stores.

Food manufacturers are encouraged to establish internal tracing systems to make records for the food production process. Food manufacturers are required to closely follow food standards and labelling requirements, and any non-compliant conduct may lead to liabilities.

Advertising Law and food labelling

China's current Advertising Law came into effect in September 2015, introducing significant changes in regulations related to food products such as health foods and dairy products, healthcare products, medical devices and pharmaceuticals and education and investment products. The law requires advertisements in such industries to be reviewed and approved by the relevant authority before being published online.

The law further gives greater regulatory power to the State Administration for Industry and Commerce, which in addition to fines, can carry out on-site searches, issue questionnaires and requests to review bills, advertisements and other relevant information.

The law introduces a number of other regulations for advertisements that need to be strictly adhered to. Non-compliance can result in heavy fines. For instance, online food vendors are not permitted to make health protection claims in relation to their non-healthcare foods. Moreover online vendors of infant formula are not permitted to make unsubstantiated claims such as that the formulas improve intelligence, immunity or protect the digestive system.

Foreign companies exporting their goods to China need to pay close attention to Chinese regulations on food labelling and advertisements, particularly as claims appearing on the labels of imported foods that would be acceptable in other jurisdictions may be unlawful in China and can potentially result in substantial fines.

Steps required

New measures significantly affect foreign and domestic companies that are involved in the marketing, distribution and online sales of food products, and there is an increasing need for companies to revisit their marketing, labelling and sales strategy in China to avoid compliance issues.

We advise clients to do the following to ensure compliance with the new regulations:

- review their marketing practices, including the content of their websites and online stores;
- ensure that all materials are reviewed before being published online;
- ensure advertisements have been approved by authorities if they are for medicinal or health foods, medical devices or drugs; and
- monitor ongoing regulatory developments as we anticipate further reform.

National security

Since China's introduction of the National Security Law (NSL) in July 2015, the concept of "national security" has been given a very broad definition. The new law has also imposed additional restrictions and review processes for foreign investment activities on the grounds of national security. Notably, in addition to covering military, territorial, and cultural spheres, the NSL extends to regulating China's financial and economic sectors, as well as cyber security.

Cyber security

The Cyberspace Administration of China's 2016 directives recommended stringent controls on cyber security but also emphasised a common standard across the country. As such, in 2015, Beijing suspended regulations that required companies in the financial industry to prove, through data disclosure and testing, that their equipment was 'secure and controllable'.

Furthermore, a number of invasive national security and counter terrorism regulations have been rolled back, such as the requirement for technology firms to provide decryption support to competent authorities in terrorist activity investigations.The new Cyber Security Law, which took effect on 1 June 2017, has a heightened focus on national security in line with the growing role of the internet and big data collection in Chinese society. The new law will pose commercial challenges but also present some opportunities. Foreign enterprises operating in China will have particular interest in laws that stipulate the following:

- operators of critical information infrastructure (CII) should make sure their internet products and services pass a security review if they could be seen as posing security risks; and
- personal information and important data gathered and generated during operations in China must be stored in China, unless the transfer of such information and data to abroad is due for business needs and can pass the security assessment.

Despite these heavy impositions, the rules allow for a more stable and secure internet environment in China, which provides for the development of the data industry and may promote innovation. The rules also expand the range of rights relating to personal information and offer unprecedented protection for individuals. Under the new Cyber Security Law, it is prohibited to share a person's personal information with other parties, without their consent, unless the information has been processed in such a way that it is impossible to identify the individual or to restore the information. Moreover, when personal information has or may be divulged, tampered with or destroyed, network operators and service providers must inform users of the risks and give them the option to have their information deleted.

Finally, it is evident that China has adopted a more inclusive approach in framing cyber security norms.

The environment and business

China's 'new normal' of slower economic growth is setting in with high hopes of beginning a gradual reduction in the pollution levels water, soil and air. Promotion of green development is a key objective under the Five-Year Plan and ever since the latest Minister for Environmental Protection, Chen Jining, took office in 2013, public interest in and scrutiny of environmental issues has intensified. There were a series of regulations promulgated by the PRC during 2015 to 2017, including amendments to the Air Pollution Protection Law, Soil Pollution Protection Law, Water Pollution Protection Law, Environmental Assessment Law, Environmental Protection Taxation Law and intensification of supervision measures. Notably, significant reform in relation to the environmental assessments and pollution discharge permits has been implemented. More importantly, as a result of the PRC Environmental Protection Law, which took effect on 1 January 2015, there has been an exponential rise in the number of administrative and criminal proceedings.

Environmental considerations must therefore be factored into investment decisions, particularly when acquiring or developing industrial land or engaging in sourcing activities in China. With the intensification of supervision, wastage discharge companies will have to pay greater attention to ensure they comply with environmental law. Foreign businesses should take heed of the following developments from last year to ensure they are prepared to comply with China's increasingly progressive attitudes towards reducing pollution and mitigating climate change:

- In March 2016, the NDRC issued the 'Administrative Measures for Guaranteed Purchase of Renewable Energy-generated Power' to establish a limited priority purchase system. This will require grid enterprises, including electric power dispatching institutions to purchase electric power generated by renewable energy projects.
- In June 2016, the Ministry of Industry and Information Technology introduced its 'Industrial Green Development Plan', which intends to lower the GDP energy consumption of above scale companies by 18% by 2020 compared to the 2015 level.

- In July 2016, the Ministry of Environment consolidated this intention by allocating RMB 100 billion for inspections of iron and steel facilities to ensure their compliance.
- In August 2016, the Ministry of Environmental Protection announced that RMB 13 billion would be put towards improving and protecting urban drinking water systems.
- In September 2016, the NDRC significantly amended the 10-year-old Environmental Impact Assessment Law to simplify approval procedures for construction projects and to impose large administrative penalties, calculated with reference to the total project investment and the degree of adverse impact attributable to the project.
- September 2016 also saw President Xi Jinping ratify the UNFCCC Paris Agreement on Climate Change. The agreement came promptly into force in November 2016 and marks an exceptional shift as China will be bound by transparency requirements and binding emissions reduction targets which it is on track to meet. The agreement not only holds the Chinese government to account from the international community, but the Chinese people as well. An increasingly educated middle class is becoming more conscious of the health effects of the heavy smog that hangs over their cities.
- In December 2016, the Standing Committee of the NPC had its Environmental Tax Law adopted by the legislature. This took place shortly after red alerts for dangerous air quality were announced in Beijing and 23 other cities. China has collected pollutant discharge fees since 1979, but this marks the first time a tax levy has been implemented. The levy is intended to improve taxpayer awareness, forcing companies to upgrade their technology and shift to cleaner production. Four categories of pollutants will be taxed including air, water and noise pollution as well as solid waste. Interestingly, after being hotly debated, carbon dioxide is not currently included in the scope of taxable pollutants.
- As of January 2017, China's central government has suspended 101 coal power projects worth an estimated investment of RMB 430 billion. More projects could be scrapped to achieve China's overall goal to boost cleaner renewable energy, while cutting coal-burning power to 55% of the country's total installed capacity from 59% in 2015.

In general, we see great opportunities for investors and innovators in the areas of environmental smart-tech and renewables. China's radical improvement of its environmental awareness and climate change mitigation at an international, government, corporate and civilian level is a prime example of China's development and economic shift.

Taxation on real estate and transfers

Parties holding or transferring real property in China may be subject to increased taxes in the future. The government is reinforcing collection of land value-added tax on property transfers and proposing a national network to record property owner identities with the intention of instituting an appropriate framework to overlay real property tax.

China's tax authorities have also been reinforcing the administration and collection of enterprise income tax (including withholding tax) on the transfer of taxable Chinese assets, which have no reasonable business purpose and result in the avoidance of enterprise income tax liability in China. In addition, China's tax authorities have been stepping up the efforts on transfer pricing administration, particularly on the cross-border remittance of service fees, royalties and cost-sharing payments.

Employment

Experience shows that structuring and preparing employment contracts for executives and other staff, including localising internal employment policies and handbooks, should be dealt with prior to market entry to help institutionalise company values and corporate culture in onshore operations. This will also align with employee hiring criteria, rights to dismiss, and long-term retention policies.

Criminal liability of executives

High profile cases continue to emerge of both Chinese and foreign (as illustrated by the detention of GSK's Mark Reilly) company executives being detained, arrested and/or prosecuted in China. Foreign companies therefore have real concerns on how to ease the minds of incoming executives tasked with running onshore operations. This issue is particularly acute given the government's ramped up efforts to crack down on compliance in a legal environment that is not always entirely predictable.

Managing joint venture relationships

Although WFOEs are increasingly common, JV structures (both EJV and CJV), continue to be widely used. However, many JV relationships that are not invested with the appropriate levels of resources, skills, and personnel end in embittered legal disputes and lengthy negotiations over divergent interests and expectations that aggregate over time. We provide some tips on how to avoid disputes on page 47.

Political issues

Developments abroad may affect Chinese regulatory attitudes towards companies operating in China. It would be prudent for companies to ensure that China issues are considered when making strategic decisions in other parts of the business. For example, a trade complaint overseas may result in Chinese officials visiting your Chinese offices, and any Trump-inspired tariffs affecting Chinese exports may affect the ease of doing business in China. Your political position to support activities against China's national reunification or ethnic unity may also invite dawn raids from Chinese governmental agencies.

China's capital flows

Newly announced policy changes are designed to encourage overseas companies to play a bigger role in China's economy – presenting opportunities for foreign investors wishing to tap into China's market potential. These changes are playing out in the context of decisions by China's policymakers to impose tighter restrictions on foreign currency conversions and outbound capital flows.

China is rapidly opening up its market to foreign investors with China's State Council announcing that greater access would be granted to foreign firms across a range of sectors, including financial services, manufacturing, resources, telecommunications, internet, transport, education and infrastructure. However, maintaining stability in the domestic financial system in an environment of freer capital flows and greater exchange rate volatility is challenging and requires careful management of China's domestic monetary system, which includes moving away from a model which allocates capital according to centrally dictated quotas, and towards one which allocates capital according to market forces.

In 2015, for the first time since the opening up of China over three decades ago, China's capital flows reached a tipping point – outbound direct investment exceeded foreign direct investment. China has become a global net capital exporter. These capital out flows are partly reflected in direct investments by government-owned and private Chinese enterprises seeking to expand internationally as part of the 'Go Global Strategy'. But significantly, they are also due to certain enterprises and individuals moving money out of China in the face of continuing depreciation of the currency (particularly against the US dollar), and in search of better returns. This has resulted in a flight from the RMB to other currencies that has in turn put pressure on the exchange rate.

In the short term, this has been managed by China, in part, through selling some of its massive stocks of dollar-denominated securities and buying RMB. Therefore, to reduce pressure on the RMB and slow the outflow of capital, authorities are also imposing a range of administrative controls on the overseas use of its currency. Chinese regulators have increased efforts to rein in shadow banking, targeting off-balance sheet transactions and wealth management products. To curb capital outflows, tougher restrictions are reported to have been imposed on certain outbound investments by some Chinese companies, overseas bankcard transactions, and offshore RMB loans. Concerned about speculation, China's insurance regulator has also revised policies on related-party transactions and insurance company shareholding rules.

While the regulators are increasing their scrutiny, the restrictions fall far short of an outright ban on overseas investments by Chinese companies. Indeed, top regulators have publicly emphasised that Chinese investors can still make genuine outbound investments – and are encouraged to make investments that are consistent with their corporate strategies and consistent with national strategies, such as the Belt and Road Initiative.

And herein lies the dilemma. As the Chinese economy continues to experience the "new normal" of single digit GDP growth and structural reforms, and the US dollar strengthens over time, foreign investors may sell more RMB assets and Chinese households may seek investments in other currencies. All this adds to pressure on the RMB exchange rate, which, in turn, may result in more capital outflows – breaking this vicious cycle might be challenging.

In our view, there will be further reform and further opening up, particularly of China's financial markets, attracting more foreign investment to balance RMB outflows. And in this respect, recent remarks from President Xi on trade and investment liberalisation and openness, as well as the State Council's announcements on greater foreign access, present cause for optimism – particularly against a backdrop of protectionist tendencies in other parts of the world.

Small and medium sized enterprises

Small and medium sized enterprises (SMEs) can have it tough due to troubles with accessing credit, tax rates, employment issues and expensive raw material prices. Yet SMEs are enormously important to the Chinese economy, making up about 80% of the manufacturing employment. In response the twenty-fourth session of the 12th NPC introduced draft amendments to the SME Promotion Law, to address challenges facing both domestic and foreign SMEs. The proposed amendments include a nationwide online registration system for movables financing to encourage financial institutions to provide non-fixed collateral financing for SMEs; a standardised list of approved business administrative fees; a dedicated SME rights protection organisation to enforce a proposed prohibition on SOEs delaying payment to small suppliers; a public procurement requirement to source more goods from SMEs; and the inclusion of SME related work in regional government work reports to establish a performance requirement.

Overseas NGOs

In line with recent moves towards establishing a rules-based legal system and enhancing national security measures, China's Overseas NGO Law (ONGOL) imposes new restrictions on the actions of foreign non-governmental organizations (NGOs) and subjects them to oversight from the Ministry of Public Security MPS.

New Legislative Regime

The ONGOL came into effect on 1 January 2017, and applies to all overseas NGOs (including those established in Hong Kong, Taiwan and Macau) conducting any form of activity in Mainland China. The ONGOL defines overseas NGOs as foundations, social groups, think tanks and other non-profit, nongovernmental social organizations legally established overseas. The broad nature of this definition has caused concern among groups including trade industry bodies and foreign universities regarding the law's potential application to their activities in China. In the absence of further guidance in the form of more restrictive regulations, it would seem that all such non-profit groups should carefully consider their status under the ONGOL and their intention to launch any activity in Mainland China.

At its core, the ONGOL has three main components:

1. **Registration requirements**

   All overseas NGOs conducting activities in mainland China must register a representative office or, if conducting temporary activities for a period of one year or less, operate in conjunction with a Chinese partner organisation who will ensure the requisite registration procedures are followed before such activities commence.

   No activities may be undertaken by overseas NGOs that do not have a representative office and have not registered their temporary activities. At present, it is unclear how authorities will treat existing WFOEs with overseas NGOs as their ultimate owner. Greater guidance is expected throughout 2017 as the MPS issues further guidelines in relation to compliance with the ONGOL.

2. **Limited activities**

   The ONGOL prohibits overseas NGOs from undertaking certain activities. They cannot engage in or finance profit-making or political activities in Mainland China, recruit members or solicit donations. These are along with broader and more politically conventional restrictions regarding activities that would threaten China's national reunification or ethnic unity. These prohibitions will likely impose a greater burden on NGOs conducting politically sensitive work that may find the ONGOL presents a significant barrier to their fundamental goals. Further restrictions are placed on matters such as the source of funds used by overseas NGOs and how they must be managed, and both prospective and retrospective reporting obligations are imposed in relation to all activities undertaken.

3. **Increased supervision**

   The ONGOL places the MPS in charge of monitoring overseas NGOs and their compliance with the ONGOL. This change has proven to be one of the most controversial, as civil society groups have claimed that this represents an attempt to restrict the influence of certain NGOs and prevent them from conducting politically sensitive activities.

Other Regulated Sectors

Many of the greatest opportunities for foreign investors are in sectors that continue to be subject to regulation and active enforcement. As a result, companies must ensure that they have a contingency plan in the event that China enforces existing laws or strengthens new regulations. One example is in the travel and entertainment sectors where many overseas operators establish offices in China and employ staff to attract Chinese consumers to overseas venues. A decision by a Chinese court in July 2017 to impose prison terms on a number of employees of an Australian listed company highlight the risks.

We say…

"Companies seeking to do business in China should be aware of certain regulatory reforms including the oversees NGO Law and Cyber-Security Law as well as ensuring they do not engage in bribery, corruption, gambling or other illegal activities."

Wang Rongkang, Corporate and M&A Partner (Shenzhen)

Free Trade Agreements

China continues to grow its network of free trade agreements, which promises to provide significant benefits for eligible investors. The much-anticipated China-Australia Free Trade Agreement (ChAFTA) has now been in operation for over a year, and on 1 January 2017, the third round of tariff cuts came into effect.

ChAFTA is the most comprehensive FTA China has signed to date.

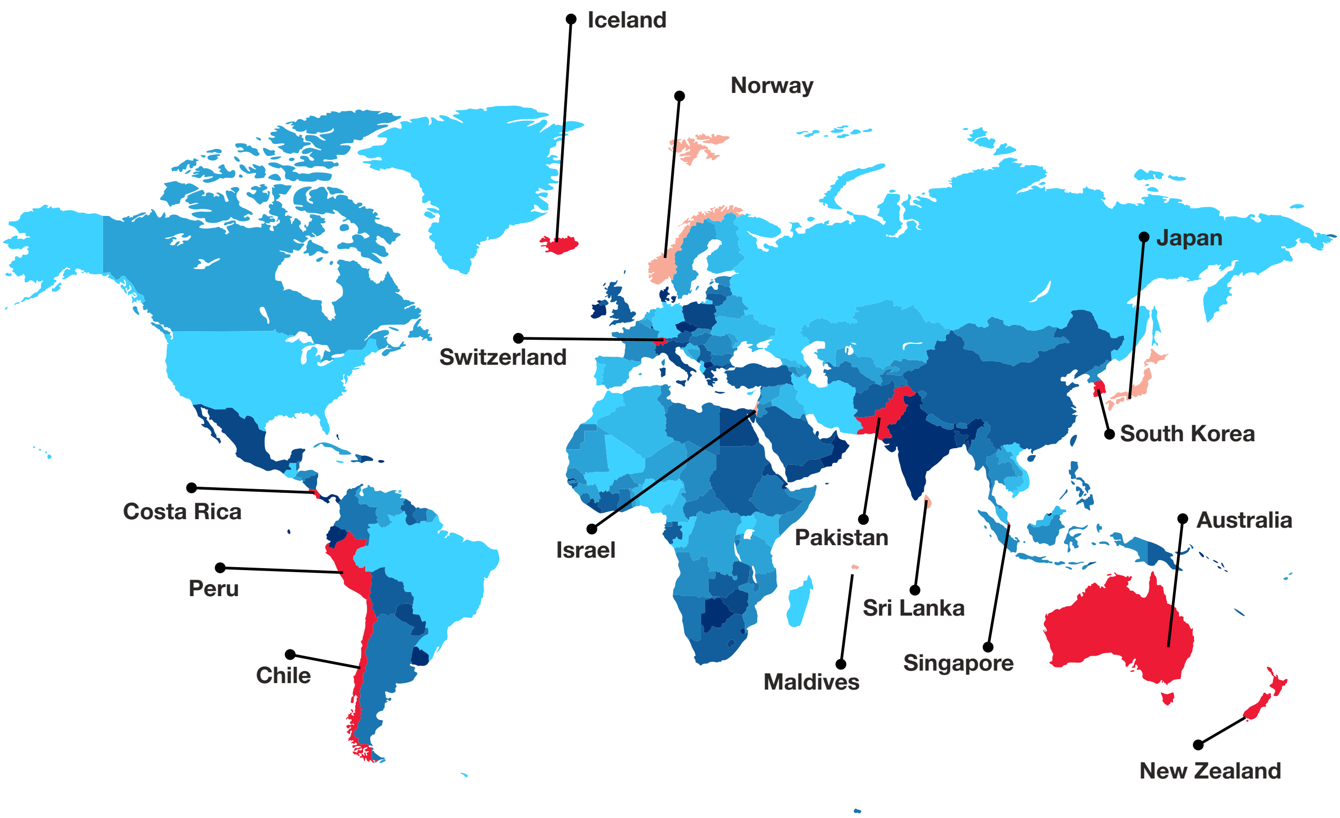
Key benefits of ChAFTA include:

- **Removing tariff imports** – when it took effect, 92.9% of resources, energy and manufactured products from Australia were able to enter China duty free. By 2020, this will have increased to 99.9%.
- **Workforce mobility** – ChAFTA introduced measures to reduce some of the barriers to labour mobility between Australia and China through changes to each country's existing immigration and employment structures. These changes provide improved access for a range of Australian and Chinese skilled service providers, investors and business visitors.
- **Agricultural technology and services** – Australian businesses may now take a majority stake in joint ventures that provide services incidental to agriculture, forestry, hunting and fishing in China. Australian R&D providers may offer services in China through wholly-owned subsidiaries and are treated no less favourably than corresponding Chinese service providers.
- **Services** – ChAFTA provides for new or significantly improved market access for services not included in previous FTAs (other than China's agreements with Hong Kong and Macau). Key beneficiaries include those in the banking and financial services sector, professional services suppliers and education services exporters looking to expand into China. Gains are also being made in industries such as health and aged care, construction, manufacturing and telecommunications.
- **Financial Services** – streamlined licensing requirements and approval processes allow Australian banks and financial institutions to operate on a more level playing field. For the first time, China has also granted Australia a RMB 50 billion quota under its RQFII program, permitting Australian financial institutions to invest their offshore Renminbi into Chinese onshore financial instruments and securities markets.
- **Investor-State Dispute Settlement (ISDS) Mechanism** – an ISDS mechanism allows Chinese and Australian investors to bring claims before an international tribunal if a change in regulation unduly disrupts ChAFTA's guarantees to investors, offering protection against sovereign risk.
- **Most Favoured Nation** – a "most favoured nation" provision is included in ChAFTA to ensure that Australia's competitive position is future-proofed against more beneficial treatment granted to other countries in the future.

With the demise of the Trans Pacific Partnership, many nations with traditionally liberal trade policies have been forced to defend the benefits of trade to their respective populations. China continues to pursue opportunities to enter into agreements with many of its key trading partners. They are seen as the key driver of the Regional Comprehensive Economic Partnership (RCEP), a trade agreement currently being negotiated with Australia, the members of ASEAN, India, Japan, the Republic of Korea and New Zealand. Once concluded, this agreement will cover nearly half of the world's population and around a third of all global trade. Together with the other major agreements currently under negotiation and in conjunction with China-driven developments, this agreement is a further step towards China establishing itself as a regional and global economic leader and achieving a global framework on investment policy covering the majority of worldwide investment flows. As tariffs are lowered and barriers to trade removed, investors may expect to see an increase in opportunities to service China's growing middle class' demand for foreign goods and services.

China's Bilateral Free Trade Agreements

China is currently in the process of negotiating Free Trade agreements with Gulf Cooperation Council, Norway, and Japan, Sri Lanka, Maldives, and an FTA upgrade negotiations with ASEAN.



Source: http://fta.mofcom.gov.cn/english/fta_qianshu.shtml
China has also entered into an FTA with the Association of South-East Asian Nations (ASEAN). This FTA is currently being upgraded. Note: ASEAN countries have not been shaded.

Key
- China's Free Trade Agreements
- China's Free Trade Agreements under Negotiation

Business Insight

Investing in education

> **"If planning for a year, grow rice;**
> **If planning for a decade, plant trees;**
> **If planning for a lifetime, educate people."**
> Chinese Proverb

China's education industry

The education sector is increasingly seen as a potential goldmine for investors looking to capitalise on the rapid expansion in both industry size and market activity. The size of the industry in 2015 was RMB 1.6 trillion, with this figure expected to increase to nearly RMB 3 trillion by 2020. The rising middle class and the relatively recent implementation of China's two-child policy means the largest market for education in the world can only be expected to grow.

The State Council's *Guiding Opinions* as well as the Five-Year Plan indicate that China will encourage non-governmental players, including foreign investors, to participate in the education industry through independent investment, joint ventures, partnerships and other arrangements. It is evident that overseas education companies, particularly those with an emphasis on innovation, will have the opportunity to invest in the growing Chinese market.

Investment strategies

There are two main strategies for investing in education: establishing an educational facility in the country or utilising a structure that allows for advertising and the recruitment of students without a campus in China. The appropriate structure for a company investing in education in China will depend on the strategy chosen, as legislation and regulations will differ. Although China has gradually begun to open its education market, under current regulations foreign investors can only operate non-compulsory education institutions (e.g. pre-schools, senior secondary schools, universities, vocational school and training centres. Chinese partner institutions are required to hold majority control if the education institution is a pre-school, a senior secondary school or a university), while investment in compulsory education (primary and junior secondary) and specific educations (e.g. military, police and religious education programs) is still prohibited.

The limitations imposed by Chinese law mean that a foreign educational provider wanting to provide courses or teach students in China must establish a Sino Foreign Cooperative School. This is effectively a joint venture between a recognised foreign education entity and a Chinese entity. Such a venture must comply with the China's Guidelines for Running a Sino Foreign Cooperative School, which include guidelines pertaining to equity ownership, board composition and the reinvestment of profits. New York University Shanghai is one example of a Sino Foreign Cooperative School currently operating in China. The aforementioned regulations do not apply where the school is exclusively for the children of foreign workers. However, these schools are strictly non-profit, so their utility as a vehicle for investment is negligible and other options are more attractive.

If the purpose of establishing a presence in China is primarily to build the presence of the education provider, a WFOE may be the appropriate strategy. A WFOE is unable to provide courses or issue degrees. However, they are able to recruit students, develop internships and exchange opportunities, and advertise the services and courses they provide in their home country. Given the exponential increase in the number of Chinese students seeking overseas education, the ability to advertise to and recruit these students, without the financial investment or regulations that comes with establishing a campus overseas, is a significant advantage.

Potential growth opportunities

Online education

With the explosion of the internet, the concept of online education is fast becoming more and more popular. Online education can be integrated with traditional education strategies and can utilise technologies to provide personally customised education options. Online education also allows for more diversified business models. Currently the online education system is characterised by a lack of quality educational businesses, a disorderly market and a lack of differentiation between providers, offering investors a potential gap in the market to exploit.

There has been an exponential increase in the number of online education start-ups, including the three internet giants of Baidu, Alibaba and Tencent entering into the education industry. The different market segments (i.e. pre-school education, K12 education, higher education etc.) are progressing at varying rates and each requires different approaches. Foreign investors must be careful in selecting a business model, as although some companies have experienced rapid growth, others have experienced difficulty due to unclear profit models.

Pre-school education

Pre-school education does not fall within the scope of compulsory education, meaning it is difficult for the government to make significant investments in this sector. Consequently, public kindergartens account for only 33% of the total number of kindergartens and cannot satisfy the demand for pre-school education for children. This highlights a gap in the market that foreign investors can potentially fill. Importantly, as pre-school is not classified as compulsory education, investors are not entirely banned by the current regulations prohibiting investment in this segment.

Additionally, the Ministry of Education plans to increase the enrolment rate in pre-school education to 75% by 2020 and, on this basis, under the second action plan for 3-year pre-school education, preferential policies in land use, tax and other aspects will be implemented. Further, the market for pre-school education can only be expected to grow with the implementation of the two-child policy. Therefore, a favourable environment exists for investors wanting to capitalise on the reforms to the early education market sector.

China's life sciences and healthcare industry

Foreign investment in the life science and healthcare industry in China experienced continuous double-digit growth from 2011 to 2015 (the period of China's 12th Five-Year Plan). Recognising the potential opportunities arising from China's aging population and increased demand for improved healthcare in China, investors have been setting up various forms of foreign invested medical institutions. The gradual lifting of foreign investment restrictions, as well as the liberalisation measures in the FTZ regions and the "Mainland and Hong Kong Closer Economic Partnership Arrangement" assisted this.

Reform has previously focused on strengthening public healthcare infrastructure and healthcare service networks, developing comprehensive medical insurance systems, improving drug supply systems and reforming the public hospital system. Bolstered by a substantial increase in the national medical expense budget, 2017 will see the advancement of reforms in the grading of medical treatment, the introduction of a modern governance mode for domestic hospitals and further improvements in medical insurance. Moreover, the National Development and Reform Commission's website outlines a commitment to creating a regulated domestic market free from fake medical goods, thereby facilitating the international competitiveness of Chinese brands looking to expand overseas. Further opportunities are likely to arise from a new wave of healthcare reform that will focus on the following areas outlined in the Five-Year Plan:

eHealthcare

This is already a growing market in China. Numerous start-ups, in collaboration with active healthcare investment funds, are developing a new "internet + healthcare" industry including wearable devices, healthcare applications, online healthcare information services and direct patient care tools.
For medical institutions, healthcare software, regional online healthcare information platforms, remote diagnosis, smart hospital systems and medical institutions are currently being "informationised". Concerns regarding the data privacy and cross-border data exchange of patients may increase along with the development of big-data in the healthcare industry. Under the double scrutiny of two highly regulated sectors (healthcare and information services), foreign investors need to be careful when navigating through many regulatory challenges. Currently, as online medical services and internet hospitals are under strict supervision, companies participating in the eHealthcare market must keep up with the latest laws.

Biologics

China has been left behind in the biologics industry for systematic reasons. To combat this, the Chinese government is encouraging spending in R&D. We foresee more technology transfer, joint development and various R&D collaborations to upgrade the biologics industry. For other pharmaceutical and medical device investors, further mergers and acquisitions are expected. The higher quality management standard being applied means a number of smaller players may be squeezed out, while larger players are looking to add portfolios and expand their capacity.

Senior care

China is becoming an increasingly ageing society. Forecasts indicate that by 2025, over 20% of the population will be aged 60 years or older. Additionally, the consumption potential of China's elderly population is predicted to increase from RMB 4 trillion (US$580 billion) in 2014 to RMB 106 (US$15.3 trillion) trillion by 2050.

The Chinese government recognises the enormous market potential in senior care and is pushing for "across-the-board" liberalisation of the aged care market. The Five-Year Plan highlights the need to open the market to create conditions for private capital investment and to integrate healthcare and elderly care systems to achieve a more "Healthy China". To boost investments and innovation in this sector, China has recognised the importance of attracting foreign capital and know-how to accelerate development of aged-care products. The Guidance Catalogue explicitly encourages foreign investments in aged care institutions and will provide major opportunities for all kinds of private capital in the industry. These changes in regulation and demographics introduce significant investment prospects for both domestic and foreign enterprises.

Foreign businesses

Foreign companies operating in aged care or healthcare industries can now take advantage of the incentives offered by the Chinese government, which have until now only been applicable to domestically owned companies. Tax incentives as well as administrative fee deductions and waivers are now being offered both to domestic and foreign companies.

Foreign companies can also take advantage of country-specific polices that provide unprecedented opportunities not offered in the past. For example, Hong Kong entities are currently permitted to set up wholly-owned hospitals in China. Further, the ChAFTA will also provide unique opportunities for Australian investors to set up wholly-owned for-profit aged care facilities.

Domestic businesses

The need for accelerated reform in the health and aged care industries will boost M&A activity across the healthcare sector. Local companies can seek suitable counterparties in China and abroad that can increase their operations inside China. There is a growing need for the pharmaceutical sector to expand and grow their distribution and R&D facilities. Therefore, we predict more transactions in the healthcare and aged care industries with further opportunities for public-private partnerships.

The national "Internet+" initiative can also be used by foreign and domestic businesses to launch innovative enterprises in smart healthcare. Both foreign and domestic enterprises with advanced medical research and technology capabilities can offer technological innovations in electronic health records services and internet based information on health.

Entering the aged care and healthcare sector

We advise

Review Operations

Review Operations to see whether there are opportunities that the Chinese market can offer for your business.

Research

Research country-specific regulations for the aged care and healthcare sectors that offer unique opportunities for your enterprise to enter the Chinese market.

Established Providers

Look for established healthcare and aged care providers that are looking for partnerships in order to utilise know-how and advance technology.

Increased Foreign Capital

Act quickly, as increased foreign capital flows into China and rapidly developing healthcare and aged care sectors could potentially eliminate the preferential treatment of those sectors in the future.

Maternal and infant care

The implementation of the two-child policy will increase demand for maternal and infant products, thereby providing investment opportunities. Despite a slowdown in economic growth, the market segment has maintained double-digit growth since 2011.

Foreign material and infant care brands dominate the Chinese market, which means the relaxing of the family planning policy will likely increase consumption in different market segments – such as infant formula and other infant related supplies.

Foreign companies can capitalise on the growing market by taking advantage of bilateral trade agreements and expanding their product and service offerings as well as through establishing joint ventures with leading Chinese companies.

We remain optimistic about the overall outlook for China's life science and healthcare industry. As the government continues to open up the industries we believe opportunities for foreign investment in the life science and healthcare sectors will expand.

Chinese medicine

On 1 July 2017 the Law of the People's Republic China on Chinese Medicine came into effect. The new legislation recognizes the importance of Traditional Chinese Medicine (TCM) to Chinese health and aims to provide equal weight to both Chinese and Western medicine. Foreign investment in TCM is still heavily restricted.

Reform of the sale model in healthcare industry

Introduced in 2016, the "two-invoice system" (only 2 invoices can be issued during the purchase from the manufacturer to the hospital, i.e. one invoice is issued by the manufacturer to the distributor, and one invoice is issued by the distributor to the medical institution) has been under intense attention. This system is being promoted for the purchase of medicine and consumables in the public hospitals in the experimental provinces and cities. The detailed implementation regulations are promulgated at the provincial level and may vary from one province to another. With the promotion of the "two-invoice system", we see the traditional sale model undergoing reform to create a model where several layers of distributors are involved in the distribution chain of medicines and medical devices into medical institutions. As we anticipate a broader application of the "two-invoice system" in the future, manufactures and distributors need to develop a new sale model to comply with regulations and remain competitive in the Chinese market.

Key Concerns

The following chart is illustrative of the evolution of key concerns facing foreign investors in China. While corruption and intellectual property infringement have remained key issues, rising labour costs, unclear or conflicting laws, and human resource constraints have been the predominant concerns for the past three years. Another increasing concern is Chinese protectionism. This is due to the rise of enforcement actions by Chinese authorities in the areas of anti-bribery, corruption and competition, which raises questions as to whether Chinese authorities are disproportionally targeting foreign companies. Chinese authorities strongly deny this.

European businesses also listed the Chinese and global economic slowdown and competition from Chinese privately owned enterprises as issues impacting their confidence when considering whether to engage in future business in China.

Although China has seen multinational corporations' regional headquarters relocate elsewhere lately (i.e. ADM and GM), this trend reflects more a desire to take advantage of further opportunities in the South East Asian region rather than a reaction to business challenges in China.

Emerging issues for foreign firms

	2013	2014	2015	2016	2017
1	NEW Labour costs	– Labour costs	– Labour costs	Λ Inconsistent regulatory interpretation / unclear laws	– Inconsistent regulatory interpretation / unclear laws
2	– Inconsistent regulatory interpretation / unclear laws	– Inconsistent regulatory interpretation / unclear laws	– Inconsistent regulatory interpretation / unclear laws	V Labour costs	– Labour costs
3	– Non-management level human resources constraints	– Non-management level human resources constraints	– Non-management level human resources constraints	Λ Obtaining required licenses	Λ Increasing Chinese protectionism
4	Λ Corruption	Λ Management-level human resources constraints	– Management-level human resources constraints	V Management-level human resources constraints	– Management-level human resources constraints
5	V Management-level human resources constraints	Λ Obtaining required licenses	NEW Increasing Chinese protectionism	NEW Industry overcapacity	V Obtaining required licenses

Key
Λ Increased concern
V Diminished concern
– No change from previous year
NEW New/emerging concern

Source: American Chambers of Commerce 2017 China Business Climate Survey

Respondents have again identified inconsistent interpretations of regulations and unclear laws and enforcement as their top challenge in China, followed by rising labor costs. But after dropping out of the top five concerns, increasing protectionism returned as the number 3 challenge this year.

Dealing with regulatory change

A Shift of focus

The Fifth Plenum of Chinese Communist Party has affirmed the importance of China's 'economic rebalancing' with innovation and entrepreneurship being championed as key components. Concrete measures are being put in place to assist new businesses in labour, capital, land, technology and management, all of which have been tightly controlled by the state and monopolised by SOEs in the past.

China has lowered its expected growth (albeit marginally) but this will take some pressure off more development provinces to approach economic progression more sustainably. While this transition takes place, the legal landscape will become more complex for foreigners to navigate. However, in the long run it will result in less arbitrary and more predictable applications of the law. Until then, we have set out some key takeaways for commercial clients to keep in mind when investing and operating in China:

Measures and supervision

To maintain appropriate oversight and control of investments, firms should:

Conduct due diligence – regardless of the structure of investment, conduct thorough due diligence through fieldwork rather than relying solely on data rooms (nothing beats a random physical site inspection);

Conduct risk assessments – assess risks from both a legal and practical perspective to clarify and prioritise actual versus theoretical dangers;

Use unique transactions – treat each transaction as being unique and avoid wholly relying on standard documents;

Involve headquarters – keep headquarters continually involved and apprised of developments and ensure good corporate governance to maintain communication lines;

Understand cultural differences – take time to understand the different local customs and practices, both between China and the West, and between provinces within China;

Conduct post transaction audits – conduct regular internal audits post-transaction to manage compliance issues proactively; and

Maintain a strong compliance culture – China's Criminal Law criminalises government bribery and commercial bribery with sanctions ranging from short-term detention to life imprisonment. China's anti-bribery legislation applies to all Chinese citizens as well as foreign investors and legal entities operating in China. While Chinese law does not require businesses to institute anti-bribery systems and controls, many businesses in China have done so in order to comply with the anti-bribery laws of foreign jurisdictions that have extra-territorial reach, such as the U.S. and UK.

The Chinese competition authorities are now actively enforcing the AML and have been imposing significant fines of up to 10% of turnover. Foreign companies should review their existing practices to ensure their China businesses are compliant with Chinese competition laws. Moreover, senior executives and other front line staff should be trained to respond effectively to the unique investigation procedures of the Chinese anti-trust authorities.

We say…

"Great regulatory change is occurring, as China focuses on the role of the consumer and transitions from a manufacturing to a services based economy. Once the world's factory, China is now positioning itself to be the world's shopping mall, a leading hi-tech and e-commerce hub, a strategic and prominent infrastructure investor and builder, as well as a net importer of resources, food and agricultural commodities."

Martyn Huckerby, Corporate Partner (Shanghai)

Managing JV relationships

For those who adopt a JV structure in China, particularly those engaged in a 50-50 split, we recommend the following to manage inherent conflicts:

Know your partner – due diligence on your JV partner is imperative;

Effective management costs – identify and engage committed, capable hands-on management who are able to act diplomatically at all times, but assertively when needed;

Deadlock mechanisms – ensure JV documentation specifies detailed dispute resolution and deadlock mechanisms. It can be difficult to resolve deadlock in China due to regulatory requirements (for example, corporate actions taken by a JV must be approved by the relevant authority who in turn seeks unanimous partner consent prior to providing approval), which results in inability to progress matters;

Corporate governance – ensure JV documentation expressly provides for detailed corporate governance provisions that facilitate operations;

Repatriation of profits – clarify in JV documentation the timing and requirement to repatriate profits, how to deal with trapped cash and withholding tax issues;

Compliance – establish a compliance committee or engage personnel to oversee compliance of domestic laws;

Risk control – establish a committed and professional risk control team to manage and address prevailing issues, especially as monetary damages are often insufficient and injunctive relief is rarely available; and

Dispute resolution mechanism – select an appropriate dispute resolution mechanism that will maximise chances of enforcement in China, as examined in the disputes section of this guide (see below).

Officers and directors liability protection

Directors, senior management and/or legal representatives in a FIE are subject to statutory obligations of fidelity and diligence, as well as contractual duties and liabilities set out in relevant employment agreements or articles of association. Personal liability can be limited to individual actions determined by a court to be against the interests of the relevant FIE, i.e., misappropriating funds, conversion of business opportunities, and seeking improper personal benefits for him/herself.

To effectively mitigate the risk of potential liabilities, a company may:

- purchase D&O liability insurance;
- clearly allocate duties and responsibilities in the articles of association;
- establish proper internal controls and supervision to monitor business activities; and
- educate directors or individuals in other positions of authority to expressly raise objections to any resolutions that may violate laws and record the same in relevant minutes.

Improving intellectual property protection

As China transitions from the low-cost manufacturing centre for the rest of the world's inventions to a leader in research, technology and innovation, there is a growing interest in protecting intellectual property rights (IPRs). Similarly, as China makes great strides towards encouraging a more market based economy, the authorities are demanding more respect be had for genuine branding. Although the enforcement of IPRs remains inconsistent, with local provincialism still creating challenges, a national court system is now in place to hear Intellectual Property claims with a large number already being processed.

In order to begin to bring China into line with international IPR standards, a State Council statement from January 2017 suggested that a cooperation mechanism between China and other countries on IPRs should be promoted. The statement also recommended that efforts should be made to attract IPR-related international organisations to open arbitration and mediation branches in China. Further, a plan was issued by the State Council in July 2017 which addressed 39 central government agencies and courts to promote the development and protection of IPRs. Despite this progress, all FIEs should still take the following steps to protect themselves:

IP registration – registering trademarks and patents by respectively submitting and designating China in its international trade mark application pursuant to the Madrid Protocol and using the Patent Cooperation Treaty application process to harness the 30-month priority period;

IP policy – implementing corporate policies that emphasise confidentiality obligations and other intellectual property protection measures including specifying invention ownership and inventor remuneration;

IP ownership structure – considering whether it is eligible to reduce enterprise income tax under the national High and New Technology Enterprise program before centralising intellectual property ownership offshore;

Actively voice concerns – communicating any intellectual property concerns through MOFCOM's Mechanism of Regular Communication with FIEs; and

IP due diligence – identifying intellectual property issues before initiating any transactions with domestic Chinese companies. Potential problems may arise if proper due diligence is not carried out. For example, the seller may want to sell intellectual property to which it is not entitled, trademarks may not be properly registered, and product lines may depend on technology and licenses attached to the company which may be cancelled if there is a change of control.

Labour and workforce

End to labour dispatch arrangements?

Many companies hire staff through a labour dispatch arrangement to circumvent issues that typically arise in direct engagement relationships. Since March 2014, enterprises (other than representative offices) must have no more than 10% of their workforce engaged through a labour dispatch arrangement. Any labour dispatch positions must only be for temporary (i.e., less than 6 months), auxiliary (i.e. not part of main business) or substitution purposes (i.e., covering employees who are on a period of leave). Moreover, any companies that do exceed the 10% standard will have a two year transition period in which their percentage of employees engaged through a labour dispatch arrangement must be reduced below 10%. During that period, no new employee shall be employed under a dispatch arrangement.

Managing employment disputes

We anticipate that companies will continue to experience an increase in the number of labour disputes due to employee friendly labour legislation and staff becoming increasingly aware of their legal rights and entitlements.

Disputes often involve employee claims of wrongful termination, insufficient severance payments or insufficient payment of social securities. Employers can minimise labour disputes by ensuring that they have a robust human resource strategy that fully aligns with local employment laws. Firms must strictly follow and document/record the processes on which employees have been consulted (i.e. underperformance management process), and retain clear written records, including robust employment contracts (e.g. taking into account the enforceability of noncompetition clauses).

Taxation and customs

China's Tax Bureau's increasingly robust approach, particularly to transfer pricing and inter-company arrangements, is often leading to investigation of practices of foreign companies operating in China. China's tax authorities have been reinforcing the administration and collection of enterprise income tax (including withholding tax) on the transfer of taxable Chinese assets, which have no reasonable business purpose and result in the avoidance of enterprise income tax liability in China.

During 2016, China's national tax regime underwent a number of important changes. As the host of the G20 and the OECD Forum on Tax Administration, China is playing an increasingly larger role on the international financial regulation stage. Foreign investors doing business in China should take note of the latest developments and undertake proper tax planning, assessment and proactive measures in order to minimise any potential tax exposures.

Key developments include:

Tax administration

Thanks to the completion of China's 'Golden Tax III Project', the digitalisation of tax data, and the utilisation of it by the authorities, has allowed for great advancements in the efficiency of tax administration. In November 2016, the requirements for tax collection and administration under the "Thousands Groups Project" were raised in a public document for the first time.

"The Public Notice on Matters relating to Financial Accounting Statements that are submitted together with the CIT Returns Filed by the Thousand Groups and Enterprises within These Groups" (PN67) reflected the expansion of targets of the tax administration to large business groups and the importance of taxpayers' data.

The intentions set forth in PN67 are to come into effect from December 2016 with the aim of standardising and normalising the submission of data from the Thousands Groups project. Ultimately, this will enable the Chinese tax authorities to take the next step in strengthening the collection, analysis and utilisation of data, which will impact relevant taxpayers.

At this stage however, the accounting standards and systems do not require all enterprises to deliver statements on a monthly or quarterly basis. Nonetheless, large business groups in the Thousand Groups project should remain up to date on any developments in the interpretation and implementation of these changes to tax administration to ensure they remain compliant.

VAT reform complete

In an effort to eliminate double taxation, China has taken steps to replace Business Tax (BT) with a consumption-oriented Value Added Tax (VAT). In March 2016, the Ministry of Finance and the State Administration of Taxation jointly issued the Notice on the Comprehensive Roll-out of the Business tax to Value Added Tax (B2V) Transformation Pilot Program (Circular 36). The notice clarifies the VAT exemption policies for cross-border taxable activities of the newly included B2V industries while adjusting the scope of previously taxable cross-border activities.

In May 2016, it was announced that the 4-year reform process was complete with the VAT now being generally imposed on the sale of goods and the provision of services. As noted in Circular 36, the scope of the VAT extends to cover construction, real estate, finance, hospitality, food, beverage, healthcare and entertainment. This applies to the import and sale of all goods in China and that the provision of all services in China will be subject to VAT. Those doing business in China should be aware that the authorities are taking a hard line on compliance and should accordingly evaluate their cross-border taxable activities to ensure their tax payments are in line with the new regime.

Transfer Pricing

China has once again intensified its efforts in investigating transfer pricing cases. In addition to traditional cross-border transactions, greater attention has been directed towards more sophisticated and complicated transactions, particularly on the cross-border remittance of service fees, royalties and cost-sharing payments. In June 2016, the State Administration of Taxation issued the Public Notice Regarding Refining the Reporting of Related Party Transactions and Administration of Transfer Pricing Documentation 'Public Notice No.42'. Public Notice No. 42 sets out new transfer pricing compliance requirements including:

- Annual Reporting Forms for Related Party Transactions;
- Country by Country Reporting; and
- Transfer Pricing Documentation.

These new requirements all reflect substantial changes to the existing rules and replaces Circular 2 (i.e. 'Transfer Pricing Trial Measures in China'). We advise that all of our tax paying clients in China should consider taking the following measures:

- evaluate their current related party transactions under the new thresholds;
- prepare any documentation and disclosure requirement to cover any discrepancies; and
- undertake measures and collect data to ensure their transfer pricing documentation reports are consistent and up to date.

Innovative incentives

In order to support China's strategy to promote the structural transformation of China's economies through "Mass Entrepreneurship and Innovation", the China's Ministry of Finance (MOF) and State Administration of Taxation jointly released Circular 101. Circular 101, also known as, the Notice on Enhancement of the Income Tax Policies for Equity Incentives and Equity Investments with Technology will apply tax incentives to qualified equity incentive plans of eligible non-listed companies. This not only builds upon the current favourable tax treatment for such companies but also effectively reduces the maximum tax rate from 45% to 20%. Circular 101 will provide an advantage to entrepreneurs as well as those in domestic venture capital and private equity markets.

Customs

Following the announcement of the 2016 Customs Tariff Implementation Plan, China has relaxed certain tariff rates in order to increase domestic consumption of certain goods. In addition, new Customs Audit Regulations were released and include measures to significantly improve customs administration. However, other challenges have been created for cross-border royalties and payments to related parties. Finally, amendments have been proposed to standardise the taxation of cross-border e-commerce business, which may affect those with enterprises operating online in China. Other duty rates to be aware of are the retaliatory tariffs, which can be applied to goods originating from countries, or regions that violate trade agreements.

We say…

"China's tax authorities have been stepping up the efforts on transfer pricing administration, particularly on the cross-border remittance of service fees, royalties and cost-sharing payments."

Tony Dong, Tax Partner (Beijing)

Exit Strategies – How do I get my funds out of China?

Getting Profits Out of China

Annual dividend payments or ongoing transfers of funds to shareholders or affiliates through inter-company agreements are still effective means of profit repatriation. However, the State Administration of Foreign Exchange now requires approval for transfers over USD 5 million and companies are being encouraged to delay making offshore payments to help the authorities preserve the value of the Chinese currency. It is therefore more important than ever for businesses to have a strategy in place for dealing with such matters.

Preparing ahead

Given the need to factor in Chinese approval requirements upon the sale of a business, the best way to prepare for a successful exit is to ensure it is structured with that potential in mind at the outset. Common exit strategies include an asset sale, equity sale, or a combination of the two.

If clients are looking for short-term investments with a clear exit strategy, a special purpose vehicle in Hong Kong could be the ideal choice due to:

Ease of transfer – the ability to transfer shares in the Hong Kong holding company without the need for onshore regulatory approval under most circumstances.

IPO – favourable and efficient pre-IPO investment environment.

Structuring considerations - we usually find that sellers generally prefer an equity sale as it attracts less tax and is more straightforward. In some circumstances, a merger may be considered given it might be eligible for tax-deferrals. With Chinese tax authorities paying greater attention to whether related party transactions use arm's-length pricing, parties need to ensure that a deal's negotiated transaction price is reasonable.

In addition, Bulletin 7 issues by China's State Administration of Taxation should now be included as a necessary item on every deal checklist. Bulletin 7 requires the payer of transfer proceeds to withhold and pay withholding tax on the capital gains derived by an offshore non-resident enterprise. It could therefore potentially affect certain indirect transfers of Chinese taxable assets, particularly if such indirect transfers are deemed to lack reasonable business purpose and results in the avoidance of China's enterprise income tax (including withholding tax). Further, a direct sale of assets will be subject to various taxes including income tax, value-added tax, business tax, land value-added tax, deed tax, and stamp duty, although exemptions may apply to certain asset transfers. As such, parties must consider any tax costs and tax exposures upfront during the deal negotiation phase.

In preparing for a transaction, foreign parties should factor in longer negotiation times with any Chinese counterparties who may often wish to re-open issues. Executing detailed minutes of each meeting will assist in recording parties' intentions and provide a clear discussion roadmap. Companies should also settle in advance plans for employees as the sale of assets or a merger is a material change in circumstances under PRC employment laws, and staff will have the right to claim for termination compensation upon the transaction taking effect, even if they stay on as employees. The seller paying all severance pay prior to transfer often deals with this.

Repatriating profits and unwinding an investment

The repatriation of funds when a foreign investor dissolves an FIE in China has traditionally been a complex process. However, the SAFE, the lead agency in foreign exchange control in China, has recently implemented reforms to relax restrictions on outbound capital flows for FIEs. When applying for repatriation with relevant government authorities, it is important to be aware of the different treatment, especially in relation to tax, imposed on the different types of funds, which may be apportioned into: the original contributed registered capital by the foreign investor into the FIE, any accumulated and undistributed profits and, in some cases, shareholder loans from the offshore parent company.

As of February 2016, the lock-up period for Qualified Foreign Institutional Investors to repatriate their investment principal has been reduced from 1 year to 3 months from the date of inbound remittance of investment principal, allowing earlier repatriation of invested funds. This reform, which applies across the board to all types of funds will bring other funds in line with pension funds, insurance funds, mutual funds, charitable funds, endowment funds, government and monetary authorities, and open-ended China funds, for which the 3 month lock-up period applied prior to the reform.

Parties can repatriate dividends to their shareholders in any financial year provided that the company has met statutory financial obligations to settle previous years' losses, pay requisite taxes, and allocate sufficient monies to its reserve fund and employee bonus and welfare fund. Importantly, companies should take advantage of any bilateral Double Taxation Avoidance Agreements, which their country has, in place with China that may effectively reduce the dividends tax rate by 50%.

In practice, dividend repatriation is made no more than once a year, as documentary requirements to convert funds into foreign currency for transfer are determined on an annual basis (i.e. tax payable, audit reports). Parties should negotiate suitable conditions and incorporate clear and detailed profit distribution terms into relevant documentation (i.e. JV contracts and articles of association). If funds are not repatriated, parties may reinvest or redeploy undistributed profits inside and/or outside China.

Liquidating an FIE in China will typically take between 6 to 18 months. The tax deregistration process is the most complex and time-consuming aspect as authorities seek to verify that an entity has fully complied with its tax obligations for at least three years prior to the dissolution process. Due to the nature of the liquidation process, we recommend that clients avoid establishing temporary stepping stone structures, such as representative offices, if the intention is ultimately to graduate to a more permanent FIE in the near future. Clients would be better served focusing efforts in structuring an FIE that can be scaled up for long-term plans.

Currency restrictions (foreign exchange controls)

The Chinese government is tightening capital controls to slow down the significant capital outflow and currency devaluation. Recent changes in capital controls include:

Repatriation of profits – the PRC authorities are using formal and informal means to slow down the repatriation of profits, for example by encouraging banks to require additional documentation before facilitating offshore remittances. However, the PRC authorities have also been keen not to discourage foreign investors concerned about these capital controls. In March 2017 SAFE announced that foreign companies are free to remit profits out of the country using normal procedures to reassure investors that new capital controls are not overly restrictive. It remains important for businesses to have a strategy in place for responding to changes in government policy. Subsequent comments by President Xi Jinping and Li Keqiang in June and July 2017 have also sought to reassure foreign investors about their ability to remit profits out of China. However, what is clear is that a patient methodical approach to compliance with the documentary requirements will be required.

Restrictions on outbound investment transfers – Applications for outbound investment transfers approval have become subject to uncertainty and intense scrutiny, causing prolonged delays. Chinese authorities have been restricting the amounts that PRC nationals and companies can transfer overseas and the purposes for which those transfers can be made. Those restrictions have resulted in outbound investments to decrease considerably. MOFCOM reported in February 2017 that overall non-financial outbound investment fell 36% in January from a year earlier and it has been reported that foreign property investment by Chinese companies fell by 84% for the same period. This has been an immediate consequence of more stringent capital control regulations imposed by China.

Outbound transfers to repay foreign loans over USD 1 million will require an interview with SAFE, reinforcing the restrictive attitude of PRC authorities on outbound transfers.

Implement transfer strategies – the Chinese Tax Bureau is one of the world's most aggressive tax collectors. Its increasingly robust approach, particularly in relation to transfer pricing and inter-company arrangements, is frequently leading to investigations of practices of foreign companies operating in China. In addition, China's tax authorities have been stepping up their efforts on transfer pricing administration, particularly on the cross-border remittance of service fees, royalties and cost-sharing payments.

It is important for companies operating in China to pay close attention and have a well thought plan if they are intending to repatriate profits out from China or make an outbound investment. This will ensure that their business operations or interests of shareholders are not compromised due to a changing regulatory environment.

When Disputes Arise

Increasing use of arbitration

Disputes involving foreign investment have increased considerably. We are seeing larger disputes having a significant cross-border element requiring coordination in various jurisdictions and companion cases for offshore litigation filed in China.

Despite extensive reform of the judicial system, foreign investors continue to have concerns about the influence of external parties and local protectionism on the People's Courts, particularly in lower tiered cities. While these concerns are diminishing, it may explain in part why many foreign investors sometimes prefer arbitration for foreign-related disputes. The primary reason however driving the increase in the use of arbitration is that, unlike court judgments, arbitration awards rendered in China are enforceable in more than 150 countries pursuant to the New York Convention. Similarly, arbitration awards rendered in other convention countries are also enforceable in China and our research shows these awards are increasingly being enforced.[1]

There are more than 200 arbitral institutions inside Mainland China. The choice of institution can be complicated and clear dispute resolution clauses are critical. When drafting a dispute resolution clause, the following should be considered:

Interim measures

While disputes arbitrated in jurisdictions outside Mainland China may provide an additional assurance of impartiality, interim orders and partial awards (for example, preserving a party's property in China) rendered in commercial disputes before international arbitration institutions are generally not enforceable in China. On the other hand, if the arbitration is conducted in Mainland China, parties can apply for interim measures such as asset or evidence preservation before a local Chinese court.

Institutional arbitration

To ensure an arbitral award is enforced in China, we recommend choosing institutional as opposed to *ad hoc* arbitration when arbitrating against Chinese parties. This is because ad hoc arbitration is generally not permitted in China. Although the Supreme People's Court (SPC) granted an exception for the use of *ad hoc* arbitration in China in the *SPC Opinions on Providing Judicial Safeguard to the Construction of Free Trade Zones* issued on December 30, 2016, *ad hoc* arbitration can only be used in limited circumstances. Only those companies registered in free trade zones may choose *ad hoc* arbitration, and the *ad hoc* arbitration clause must meet certain requirements. Generally, *ad hoc* arbitration awards rendered in China should still be viewed as problematic. Similarly, while foreign *ad hoc* arbitration is recognized in China, enforcement of a foreign *ad hoc* arbitration award may nonetheless encounter enforcement obstacles in China.

Common domestic arbitration institution choices include the China International Economic and Trade Arbitration Commission (CIETAC), the Shanghai International Arbitration Centre (SHIAC), the Shenzhen Court of International Arbitration (SCIA), the Beijing Arbitration Commission (BAC), and the Shanghai Arbitration Commission (SAC).

1 See Meg Utterback, Li Rongui, and Holly Blackwell, *Enforcing Foreign Arbitral Awards in China – A Review of the Past Twenty Years*, available at http://www.kwm.com/en/knowledge/insights/enforcing-foreign-arbitral-awards-in-china-20160915. From 2011 to 2015, Chinese courts recognized 86.4% of foreign-arbitration awards.

Where a neutral offshore venue is preferred (notwithstanding the interim measures issues noted above), parties to China-related contracts select the Hong Kong International Arbitration Centre (HKIAC), the Singapore International Arbitration Centre (SIAC), the International Court of Arbitration of the International Chamber of Commerce (ICC), as well as a host of other internationally-recognized arbitral institutions. CIETAC is also now administering cases in Hong Kong.

We often see arbitration clauses specify that the language for arbitration is both Chinese and English. Conducting arbitration proceedings in both languages can be a very expensive exercise. We recommend carefully considering whether such requirement is necessary and agreeing on a single language if possible.

For parties that wish to incorporate additional international elements into a Chinese seated arbitration, they may also consider whether to incorporate certain requirements that at least one or more of the tribunal members must be from a country other than that of the contracting parties or must be from a country with a common law legal system or that the parties agree to conduct the arbitration in accordance with the IBA Rules on the Taking of Evidence in International Arbitration (to the extent permitted by Chinese law).

Choice of law and forum

Be aware that Chinese law must govern some business relationships, such as Sino-foreign JV contracts, equity or asset transfer agreements and investment agreements involving the natural resources sector.

Similarly, some business disputes, such as real estate disputes, Sino-foreign JV disputes, and disputes involving Sino-foreign exploration and exploitation of natural resources in China, must also be resolved before Chinese courts or domestic or foreign arbitration tribunals (they may not be resolved by foreign courts).

China has an increasingly sophisticated network of international investment treaties. While investor-state arbitration against China is rare, foreign investors should keep this option in mind if an investment is damaged or destroyed by government action.

Disputes involving foreign investors in China often relate to IP litigation (patent, trademark, technology transfer and licensing disputes) and disputes with joint venture partners. Chinese courts are increasingly sophisticated in these areas, particularly in first and second tier cities, and may provide a better and more effective forum for successfully resolving these types of disputes. When negotiating contracts concerning these types of transactions, parties should confer with legal counsel to consider whether a dispute would be more aptly resolved in a Chinese court or in domestic or offshore arbitration.

A new global marketplace

What makes King & Wood Mallesons ‘the’ law firm in Asia?

A key differentiator for King & Wood Mallesons is our unique insight and expertise in one of the world’s fastest growing economies – Asia. With access to a global platform, a team of over 2000 lawyers in 26 locations around the world, works with clients every day as they look to Asian markets to unleash their full potential. Our AQ, or Asia Intelligence, is our unique approach to helping you open doors and unlock opportunities in Asia, and globally.

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Together, we're helping businesses across the globe make smart choices to shape their future world.

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