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# China News Alert Issue 82

## Headlines

### Regulations on Investment Companies by Foreign Investors

The Department of Commerce has adopted Regulations of Investment Companies by Foreign Investors, which specify the qualifications, required documentation, examination and approval procedures, business scope and related items for foreign investors setting up investment companies in China. Under the Regulations, foreign investors can set up direct investment companies by way of wholly foreign-owned entities or joint ventures. The investment activities of investment companies will not be subject to restrictions based on the companies' address of registration, but are not permitted to directly engage in manufacturing activities. The Regulations are applicable to investors of Taiwan, Hong Kong and Macao in China who establish investment companies in Mainland China.

The Regulations provide that the minimum registered capital of the foreign-invested investment company must not be less than USD 30,000,000, and set out different capital thresholds for foreign investors in different circumstances. Foreign investors may also establish investment companies in the name of their wholly owned subsidiaries.

Investment companies engaging in the import and export of goods or techniques must comply with the Measures for the Record and Registration of Foreign Trade Operators promulgated by Department of Commerce. Investment companies engaging in commission agency, wholesale, retail and licensed franchises must comply with the Measures for the Administration on Foreign Investment in Commercial Fields.

The Regulations specifies that investment companies may apply to establish local branches of multinational companies. Approved local branches are permitted to

1. import and sell (except on a retail basis) the products of the multinational company and its affiliates,
2. import materials, accessories, parts, and fittings,
3. provide service outsourcing to enterprises both in China and overseas,
4. provide logistics and distribution services,
5. set up finance companies, subject to the approval of CBRC, and provide finance related services to investment companies and their funded enterprises,
6. engage in overseas project contract business and overseas investment, and set up financing lease companies to provide related services with the approval of Department of Commerce and
7. sub-contract other enterprises in China to manufacture or process their own or the parent companies' products for sale overseas.

Investment companies may undertake the following businesses, with the approval of the Department of Commerce:

* invest within prescribed foreign investment field;
* provide the following services to funded enterprises:
  + assist in the purchase of machinery, office equipment, and materials, parts and components required during the production and sale of products in China and overseas, and provide after sales services;
  + balance foreign exchanges between funded enterprises to approval and supervision of foreign exchange management departments;
  + providing technical support, employee training and internal human resource management to funded enterprises;
  + help the funded enterprises in seeking loans, and provide security.
* set up scientific R&D centres or organizations, engage in R&D of new products and state-of-the-art techniques, transfer R&D results, and provide related technical services;
* provide consultation services to investors;
* undertake parent companies' service outsourcing businesses.

Upon the approval of local authorities, the investment companies can also undertake the following businesses:

* distribute products manufactured by funded enterprises in domestic and overseas markets and provide related services, including transportation and storage;
* export domestic goods by way of agency, distribution or export procurement organizations (including internal organizations), and deal with tax rebates according to related regulations;
* purchase and process products from funded enterprises and sell the products in domestic and overseas markets;
* provide technical training to domestic sellers and agents of funded enterprises, and to domestic companies that have entered into technology transfer agreements with the parent company or its affiliates;
* import test-marketing products before the launch of related products by funded enterprises;
* provide machinery and office equipment operating lease services to funded enterprises or establish operating lease companies;
* provide after sales services on imported products.

### Restructuring Subordinate Businesses of State-owned Enterprises

The deputy chief of the State-owned Assets Supervision and Administration Commission (SASAC) affiliated to the State Council, Mr Shao Ning has outlined the requirements relating to restructuring of subordinate businesses of state-owned enterprises. Mr Shaoning emphasised the following issues:

* Proper compensation for employees: referring to national policies governing employee compensation during the process of adjusting employment relationships. Mr Shao Ning stated that unrealistic comparisons should not be made between regions and enterprises with different levels of income and capacity to pay employee compensation. Mr Shao Ning warned that inappropriate comparisons with enterprises capable of bearing higher employee compensation could lead to social instability.
* Allocating shares to employees and managers: Mr Shao Ning urged strict compliance with the Opinions for regulating restructuring of state-owned enterprises issued by the State Council, and strict regulation of the stock allocation, ratios of allocated stock rights, and sources of funding for purchasing shares. Mr Shaoning stressed that acquisition of free stock rights should be forbidden.
* Transfer of property rights: Mr Shao Ning stated that asset disposals during the restructuring process should be in accordance with the Provisional methods for transferring state-owned property rights. Property transfers should be open and transparent, and asset transfer transactions tightly regulated.

According to Mr Shao Ning, the mode of "collective leadership" of restructured state-owned enterprises in which equity is owned by all employees has tended to lead to errors in decision-making, or a lack of sense of responsibility and insufficient authorization to managers, making it difficult to establish effective operation command systems. In addition, the lack of direct market competition faced by units engaged in subordinate businesses of state-owned enterprises, and their dependence on state-owned enterprises over a long period, has resulted in poor management.

## Corporate & Commercial

### Remuneration for chiefs of central enterprises

Following the promulgation of the Provisional methods governing performance assessment on chiefs of central enterprises at the end of last year, the State-owned Assets Supervision and Administration Commission (SASAC) has issued Provisional methods governing remuneration of chiefs of central enterprises. The Methods provide that the chiefs' remuneration will consist of a base salary (determined by factors such as business scale, degree of management difficulty and responsibility, and comparable average salaries), performance salaries and middle and long-term incentive compensation (such as stock options).

### SASAC Survey on debt-to-stock swaps

The State-owned Asset Supervision and Administration Commission (SASAC) has announced that it is to launch a survey on enterprises that have been approved by the State Council to covert their debts into stocks.

The scope of the survey covers all "debt-to-stock" enterprises approved by the State Council, including enterprises that have registered new companies for the purpose of debt-to-stock swaps, and those whose debt-to-stock swap facility has been stopped.

In relation to enterprises that have registered new companies for debt-to-stock swaps, the survey will examine, among other things,

1. information about new companies' shareholding structures,
2. disposal of share rights,
3. the efficacy of shareholder meetings and the boards of directors and supervisors,
4. new companies' restructuring and hiving-off of non-business assets,
5. changes in employment;
6. business performance and
7. major problems facing such enterprises.

In the case of enterprises that have not registered new companies for debt-to-stock swaps, the survey will investigate

1. the amount of debt-to-stock swap approved by the State Council,
2. major reasons for not registering new companies,
3. whether or not the enterprises will continue to carry out debt-to-stock swaps,
4. whether or not enterprises have disposed of debt proposed to be converted into shares,
5. whether or not enterprises will conduct restructuring,
6. changes in employment in restructured enterprises,
7. enterprises' business performance and
8. major problems facing enterprises.

In relation to enterprises whose debt-to-stock swap facility has been stopped by the State Council, the survey will look into

1. the amount of debt-to-stock swap approved by the State Council,
2. major reasons for stopping the debt-to-stock swap,
3. whether or not enterprises have made reliable and effective plans for disposing of debts according to related requirements,
4. whether or not interest on debts has been recalculated and
5. enterprises' business performance and stability.

Based on the findings of the survey, the SASAC will commence drafting a report on debt-to-stock swaps in February 2005.

### New rules for Shanghai property transactions

From 25 November 2004, all state-owned and collectively-owned enterprises applying to transfer entire property rights in the Shanghai property market are required to present, except for agency transactions submitted in accordance with the regulations, evidentiary materials which have been deliberated by the workers' representative assembly or workers' congress.

The Rule on Managing Shanghai Property Right Trade Market, provides for a "one-vote veto right" as regards entire property right transfer in employee representative meetings or employee meetings in state-owned and collectively-owned enterprises. The new rule also stipulates that agreements on property right transactions of state-owned and/or collectively-owned enterprises must include terms such as arrangements for employees (including retired employees).

Not only is the function of the workers' representative assembly clarified, the interest of employees of state-owned enterprises are also reflected in transfer price of state-owned property rights. According to the Rules, the transfer price must be based upon evaluation results, while at the same fully utilizing the price discovery mechanism in the property rights market, as well as considering other factors such as supply and demand in property right transactions, market prices of similar assets, employee arrangements and the introduction of advanced technology.

Property right transactions can be conducted through transfer agreements, auction, invitation to tender and competitive bidding, as well as through any other form permitted by applicable laws. Upon the disclosure of property right information, if there is only one transferee, the property right transaction may be conducted by means of transfer agreement. In the case of two or more proposed transferees, auction, invitation to tender or competitive bidding may be utilised to establish ultimate transferees and transfer price.

It is estimated that in 2003 the total value of transactions in the Shanghai property right transaction market amounted to RMB324,400,000,000. From January to October 2004, the total value of transactions was RMB300,315,000,000, a year-on-year increase of 18%.

## Funds

### Launch of Shanghai Exchange Traded Fund

The CSRC has approved the launch of the Shanghai Stock Exchange exchange traded fund (the SSE 50ETF), and the fund will open for subscriptions between 29 November and 24 December. The manager of the fund is China Asset Management Co. Ltd, and the fund trustee is the Industrial and Commercial Bank of China.

A consortium of eighteen securities brokerages have been selected to assist in issuing the SSE 50ETF. Guotai Junan Securities and Galaxy Securities are the lead underwriters of ETF; Shenyin & Wanguo Securities and Galaxy Securities are the co-lead underwriters and listing coordinators; Shenyin & Wanguo Securities, China Merchants Securities, China Securities and Haitong Securities are the co-lead underwriters. In addition, securities brokerages such as Guangfa, Guosen, Everbright, Citics, Beijing, Huatai, United, Changjiang, Shanghai, Xiangcai, Guolian and Zhongjin securities are members of the underwriter syndicate.

While investors can buy and sell shares in the fund through member securities brokerages of the stock exchange, subscriptions and redemptions must be handled through the 18 selected securities brokerages.

### Rules for exchange traded funds

The Shanghai Stock Exchange and China Securities Depository & Clearing Corporation Limited, with the approval of the CSRC, have jointly issued the Detailed Rules for Implementing Exchange Traded Fund Business and the Detailed Rules for Implementing Exchange Traded Fund Registration and Clearing.

According to the Detailed Rules for Implementing Exchange Traded Fund Business, at the request of a fund manager, the Shanghai Stock Exchange will provide a code and fund abbreviation for on-line issue, subscription and redemption of the relevant exchange traded fund on the Shanghai Stock Exchange. The fund manager may sell fund through both on-line and off-line methods. Members of the Shanghai Stock Exchange with qualifications to sell funds can accept subscriptions from investors.

Transactional charges for exchange traded funds will be based on the existing standard charges for securities investment funds. In the 3 years prior to listing on the stock exchange, the Shanghai Stock Exchange will appropriately deduct share application and redemption fees.

Each day before the opening of the stock market, the manager of an exchange traded fund must provide the Shanghai Stock Exchange and China Securities Depository & Clearing Corporation Limited with a list of subscriptions and redemptions and also disclose the information through the channels specified by the Shanghai Stock Exchange.

## Bonds

### Rules on Government Bond Sell/Buy Backs

Following the approval of the CSRC, the Shanghai Stock Exchange and China Securities Depository Clearing Corporation have jointly issued Detailed Rules for Implementing Transactions of Government Bond Sell/Buy Back on the Shanghai Stock Exchange.

Government bond sell/buy backs are agreements between government bond sellers and purchasers pursuant to which the seller undertakes to repurchase the bonds at an agreed price on a specified future date. In this instance, the seller is known as the "long holder", and the purchaser is known as the short seller.

According to the newly adopted Rules, a system of performance bonds applies to the government bond sell/buy back transaction. The long holder and the short seller must pay a performance bond based on a certain ratio. Bond types and periods for repurchase will be determined by the Shanghai Stock Exchange. Transaction costs are based on the current criteria for repurchasing government bonds at par value for the same term. Transaction terms are for 7, 28 and 91 days, with a performance bond ratio of 1.5%, 3% and 5% respectively.

Government bond sell/buy-back transactions are limited to institutional investors opening securities accounts under the name of legal persons at the Shanghai branch of China Securities Depository Clearing Corporation.

## Trust

### New accounting method for trust companies

The Accounting Method of Trust Business (initiated by the Ministry of Finance in cooperation with the China Banking Regulatory Commission (CBRC)) is to be formally issued in early December. It will be open to public consultation for one month, following which the new method must be used for accounting of trust assets from the start of 2005.

The formulation of the accounting method is seen as a key step by the CBRC towards establishing trust regulations, as well as in paving the way for trust and investment companies to engage in asset securitization business from next year. The most important function of the new accounting method is to establish an individual legal person status for each trust project.

The accounting method provides for independent account management, operation and disposal of trust assets. Separate booking and accounting, and preparation of accounting statements will be required for each trust project.

Previously, trust assets and business assets were accounted for in the same books, making it impossible to distinguish assets, liabilities and equities under various trust projects except through different subsidiary accounts. With independent accounting, trust assets and trustee assets are separated for accounting purposes. In addition, the accounting method sets out principles of accounting treatment for trustors, trustees and beneficiaries, and provides for the three parties' respective rights and liabilities.

The method provides that when a trust terminates, the gap between the value of trust liquidation assets received by a beneficiary and the book value of "trust benefits" should be accounted for as current profits and losses. In trustee's accounts, trustee remuneration regulated to be directly assumed by the relevant parties, such as trustors, and not by the trust projects should be directly accounted for in the trustee's accounts as "handling fee income" pursuant to the corresponding contracts, and shall not in any way be related to trust projects. In addition, due to the numerous parties involved in the assets securitization process, the accounting system leaves a vacuum with regards to off-sheet treatment of assets securitization. Therefore, the issuance of this method shall substantially strengthen the legality and functionality of trust companies operating as SPVs (Special Purpose Vehicles).

## Real Estate

### Rules on the Settlement of Payment of Construction Works

The Ministry of Finance and Ministry of Construction have jointly issued the Temporary Rules on the Settlement of Payment of Construction Works, which deal with payment default in the construction sector. The Temporary Rules provide for a standardised payment of project price agreement, under which the site owner should pay 10% of the project price within one month of signing the contract. During the construction process, at least 60% of the project price should be paid to contractor. After completion of the project, any deferred payments together with accrued interest should be paid to the contractor. In the event of default on payment, the contractor and owner may decide to sell the project at a discount or by auction in accordance with law. In the event that payment is not settled following the completion of the project, the project may not be put into service, or ownership registration procedures completed.

## Capital Markets

### Election of Listing Approval Committee members

The China Securities Regulatory Committee (CSRC) will hold an election for new members of the Listing Approval Committee when the incumbent team's term expires. The election will be the first since the reform of the Listing Approval Committee. The Committee comprises 25 members, 12 of which will be replaced in the election.

The Department of Public Offering Supervision is to publish the list of candidates for election as well as its opinions on the candidates' respective qualifications and abilities. In the past, the CSRC has not disclosed its reasons for selecting members of the Listing Approval Committee.

Of the 12 members to be replaced in the election, four are lawyers, one is an accountant, two are from securities companies, two are from fund companies, two are from stock exchanges and one is from a university. The 12 members include both full-time and part-time members.

### CBRC investigates guaranteed return Renminbi financial products

The China Banking Regulatory Commission has declared that a number of renminbi-based financial products offering fixed returns violate applicable laws. According to the CBRC, due to the nature of the financial products in question, selling banks cannot promise minimum or fixed returns. Rather, the financial products have "expected" returns, which means that investors bear the risk of return on investment. In addition, the CBRC has stipulated that selling banks should provide risk caution advice on financial products that are of an investment nature.

It is understood that the CBRC's intervention has been prompted by fears that increasingly fierce competition in the market for renminbi-based financial products may lead to a full blown "price war" among banks. At least 2 billion yuan has been invested in renminbi-based financial products launched by banks in Nanjing since October. Insiders generally hold that these investments are safe, and that the banks will be able to pay out guaranteed returns upon maturity of these products.

### Registration of non-transferable shares

The Securities Association of China (SAC) recently issued a Circular on improving registration of non-transferable shares of share-transfer companies within Share Transfer Agency System, which requests leading underwriters and share transfer agents to implement procedures relating to the registration of non-transferable shares in the Shenzhen branch of the China Securities Depository Clearing Corporation.

According to the Circular, issued shares of delisted joint-stock companies will continue to be registered and deposited by securities depository and clearing bodies in accordance with the provisions of the Guidance on subsequent actions following delisting of joint-stock companies. At present, once share transfer companies are entered into the Share Transfer Agency System, leading underwriters only declare transferable shares to securities depository and clearing bodies. Declarations of registration of non-transferable shares has not been carried out, which affects share transfers based on agreements, registration of share pledges, share transfers ordered by the courts and share swaps. .

The Circular requires that share transfer companies to inform related shareholders when handling registration of non-transferable shares. The companies must open share transfer accounts of non-listed companies at outlets of their leading underwriters according to guidelines issued by the Shenzhen branch of the China Securities Depository Clearing Corporation, and implement procedures to verify share rights. Verification of non-transferable shares of share transfer companies should also be handled by their lead underwriters.

The Circular also requires lead underwriters to encourage corresponding share transfer companies and shareholders to implement procedures on share right verification in accordance with guidelines set out in the Circular on improving mutual entrustment of leading underwriters for share right verification and the Supplementary Circular on improving mutual entrustment of leading underwriters for share right verification. Lead underwriters are required to coordinate with the Shenzhen branch of the China Securities Depository Clearing Corporation to improve registration of non-transferable shares of share-transfer companies.

## Insurance

### China Reinsurance Group and Huatai are authorized to organize asset management Ltd

Mr Wu Xiaoping, Deputy Chairman of the China Insurance Regulatory Commission (CIRC) has announced that the CIRC has approved applications by China Reinsurance Group and Huatai Property Insurance Ltd to set up asset management companies. It is foreseen that Huatai Insurance Asset Management Company will make its debut in January next year.

At the end of April this year, the CIRC adopted Temporary Rules on Management of Insurance Asset Management Companies to provide legal guarantees for insurance asset management groups. In addition to the above-mentioned companies, Xinhua Life, Kangtai Life and CPIC have also submitted applications for establishing asset management companies, and are expected to be granted licenses soon. It is estimated that as at end of October, the balance of China's insurance capital reached RMB1,030 billion, with a year-on-year increase of 32.5%. Of this total, bank deposits accounted for 48.9%, government loans for 23.4%, financial securities for 10.9%, and portfolio investment for 7.1%.

### Hong Kong-Mainland agreement on insurance supervision cooperation

The Agreement of CIRC and Hong Kong SAR's Cooperation in the Supervision and Surveillance of the Insurance Industry. was officially executed on 26 November 2004. The agreement concerns exchange of insurance supervision regulations, information support, and high-level exchange visits and cooperation.

## Foreign Investment

### Public consultation on franchise

The China Department of Commerce is seeking public opinions regarding the Temporary Methods on Enterprises With Foreign Investment Participation in Franchise Operations, which are applicable to a variety of service sectors, including the retail, entertainment and catering sectors.

The Temporary Methods provide that twenty days prior to the formal signing of a franchise contract, the franchiser should provide the proposed franchisee with a draft written contract setting out basic information relating to the number of licensed franchisees, franchisee locations, the level of franchise fees, conditions for the return of security, and any disputes or pending lawsuits in which the franchiser is involved.

The Temporary Methods also prohibit foreign-invested enterprises from engaging in the businesses listed in the Guiding Catalogues of Industries Utilizing Foreign Investment or carrying out illegal direct sales.

## Taxation

### SAT Issues Circular on Deducting Input Tax

The State Administration of Taxation (SAT) recently issued a Circular on problems relating to the deduction of input tax by general VAT payers after obtaining special payment documents for import VAT. The Circular provides that whether or not taxpayers that have paid import VAT have paid for the imported goods, tax payment receipts obtained from customs can be used to deduct input tax. Applications for deduction of input tax should be made within the period set out in the Circular of SAT on issues about intensifying management of special payment documents for import VAT. Tax payers who fail to apply for deductions within the prescribed period can still apply for deduction before 11 January 2005. An application can still be made even where the relevant tax payment receipts are lost, provided related certificates issued by customs are submitted.

## WTO

### Development of the Chinese tourism industry

Following China's entry into the WTO, China's tourism sector continues to enjoy rapid growth. All of the large multinational hotel groups have moved into the Chinese market. Liberalisation of the travel agency sector is also developing rapidly. The National Tourism Administration approved the foundation of the first wholly foreign-owned travel agency in July 2003, four years ahead of the schedule set down in China's WTO accession agreement. Currently, there are 5 wholly foreign owned travel agencies and 13 joint venture travel agencies in China. China is also encouraging the larger domestic tourist enterprises to tap into the overseas market. By the end of this year, the destinations for organized tours will reach 63. The National Tourism Administration has also executed Memoranda of Understanding with two Caribbean countries and three Latin-American countries.

It is estimated that foreign investment in the Chinese tourism industry accounts for 11% of the total volume of foreign investment in China. The World Tourism Organization has forecast that China will be the largest tourist receiving country and the fourth largest tourist generating country by 2020.

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