

## CHINA UPDATE

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## New Measures Issued by NDRC to Regulate Mandatory Filing for Private Equity Funds in Pilot Areas

### Key Points:

- **General principles for the operation of equity investment enterprises have been specified**
- **Mandatory filings are required for large and midsize private equity funds**

On 31 January 2011, the National Development and Reform Commission (NDRC) promulgated the “NDRC Notice on Further Regulating the Administration on Development and Filing of Equity Investment Enterprises in Pilot Areas,” which took effect on the same date. This Notice was issued to the local governments of Beijing, Tianjin, Shanghai, Jiangsu province, Zhejiang province and Hubei province – the municipalities and provinces appointed by the NDRC as pilot areas to implement filing management for equity investment enterprises.

### Implementation Areas

According to the Notice, the filing management applies to equity investment enterprises established in the Beijing Zhongguancun Science and Technology Park, Tianjin Binhai New Area, Wuhan Donghu New Technological Industries Developing zone and Yangtze River Delta region (the pilot areas).

### Regulating the Establishment, Capital Raising, Investment Fields and Risk Control of Equity Investment Enterprises

The Notice emphasizes that equity investment enterprises must be established in accordance with

relevant provisions of the PRC Company Law or the PRC Partnership Enterprise Law. Equity investment enterprises may raise capital through private placement only from specific offerees possessing risk identification and tolerance, and are not allowed to directly or indirectly market to nonspecific offerees by issuing announcements in the media (including on company websites), putting up notices in the community, distributing leaflets to the general public, sending text messages to unspecified recipients, or holding seminars, lectures and other public or disguised public offerings.

Capital payment may take the form of a commitment, which means that investors make capital commitments by signing subscription agreements during the fundraising period of equity investment enterprises and pay their commitments in installments according to the articles of association or partnership agreements of the enterprises.

The investment scope of equity is limited to the equity of non-publicly traded enterprises. Idle money during the investment may be deposited only with banks or be used to purchase fixed-income investment products such as treasury bonds.

Equity investment enterprises should not provide a guarantee to other enterprises except their portfolio companies. When the entrusted management institutions of equity investment enterprises are sino-foreign joint venture or foreign-invested enterprises, the assets of equity investment enterprises shall be entrusted to domestic custodian institutions.

### **Building Equity Investment Enterprises' Information Disclosure Systems**

The Notice prescribes that, in addition to the disclosure of information regarding the investment operation to investors according to the articles of association or partnership agreement of the enterprises, equity investment enterprises should submit an annual business report and annual financial statements audited by an accounting firm to the NDRC as well as the local assisting filing authorities within four months after the end of every fiscal year. The entrusted management and custodian institutions of the equity investment enterprise are also required to provide an annual asset management and asset custody report to the NDRC as well as the local assisting filing authorities within four months after the end of every fiscal year.

If the following events occur in the course of investment activities, equity investment enterprises must promptly report to the NDRC as well as the local assisting filing authorities within 10 business days of occurrence:

- Amendments to the articles of association, partnership agreement and entrusted management agreement of the equity investment enterprises or entrusted management institutions;
- Increase or decrease of the capital or external financing of the equity investment enterprises or entrusted management institutions; or
- Divisions, mergers or other material events involving equity investment enterprises or their entrusted management institutions.

### **Improving the Filing Procedures of Equity Investment Enterprises**

The Notice specifies that all equity investment enterprises registered with the Administration for Industry & Commerce in pilot areas that mainly engage in equity investments in non-publicly traded enterprises and equity investment funds of funds are subject to the mandatory filing requirement, except when:

- The equity investment enterprises have registered as venture capital enterprises pursuant to the Interim Management Measures on Venture Capital Enterprises;
- The size of the equity investment enterprise falls below RMB 500 million or its foreign exchange equivalent; or
- The enterprise is funded and established by one single entity or natural person, or by two or more investors that are wholly owned subsidiaries of the same entity.

Equity investment enterprises that fail to file according to the Notice will be publicly announced on the NDRC's website as "equity investment enterprises and entrusted management institutions evading filing administration." Equity investment enterprises that fail to comply with the Notice will be urged by the NDRC to achieve compliance within six months; otherwise, they will be publicly announced on the NDRC's website as "non-compliant equity investment enterprises and entrusted management institutions."

## New Tax Incentives for Software and Integrated Circuit Enterprises

### Key Points:

- **Circular 4 renews a number of existing tax preferential treatments and introduces new incentives**
- **China's Ministry of Finance, State Administration of Taxation and related departments are expected to issue further guidance**

On 28 January 2011 the State Council published a circular titled "Certain Policies for Further Encouraging the Development of the Software Industry and Integrated Circuit Industry" (GuoFa [2011] No. 4) (Circular 4). Among the highlights, Circular 4 renews and extends certain tax benefits for software and integrated circuit enterprises. Some of the key tax incentives are summarized below:

- The VAT incentive under "Several Policies of the State Council on Encouraging the Development of the Software Industry and Integrated Circuit Industry" (State Council [2000] No.18) (Circular 18), which expired at the end of 2010, will be extended. According to Circular 18, payers of general VAT will receive a refund of any VAT liability in excess of the effective rate of 3 percent for any sale of self-developed and manufactured software products.
- Qualified software enterprises and integrated circuit enterprises will be eligible for business tax exemption on income derived from software development and testing, information system integration, consulting and operation maintenance, and integrated circuit design services. The Ministry of Finance and State Administration of Taxation will formulate detailed measures.
- Certified integrated circuit manufacturing enterprises with integrated circuits of no more than 0.8 micrometers will receive tax exemption for two years starting from the first profit-making year, and a 25-percent statutory rate (half the regular rate) for the following three years ("two-year exemption and three-year half reduction").
- Certified integrated circuit manufacturing enterprises with integrated circuits of no more than 0.25 micrometer or with total investments of more than RMB 800 million are entitled to a reduced corporate income tax rate of 15 percent. If the enterprise has been in operation for more than 15 years, it will receive tax exemption for five years starting from the first profit-making year, and a 25-percent statutory rate (half the regular rate) for the following five years ("five-year exemption and five-year half reduction").
- State-approved key integrated circuit projects will be eligible for special measures to resolve cashflow problems arising out of their inability to absorb input VAT as a result of centralized procurement activity. The Ministry of Finance and related departments will formulate detailed measures.
- Upon certification, newly established integrated circuit design enterprises and qualified software

enterprises are entitled to “two-year exemption and three-year half reduction” corporate income tax preferential treatment starting from the first profit-making year. Materials imported by certified integrated circuit design enterprises and qualified software enterprises will receive bonded treatment.

- Qualified integrated circuit design enterprises falling under the state planning framework will receive the same tax incentives available to key software enterprises falling within the state planning framework provided under Circular 18. The National Development and Reform Commission shall formulate separate measures.
- Qualified integrated circuit packaging, testing and key and specialized materials manufacturing enterprises and special integrated circuit equipment manufacturing enterprises will be eligible for certain tax incentives. The Ministry of Finance and State Administration of Taxation will formulate detailed measures.

Circular 4 provides that the tax incentives will be adjusted from time to time to reflect developments in the software and integrated circuit industries. In any event, “two-year exemption and three-year half reduction” and “five-year exemption and five-year half reduction” benefits will expire by 31 December 2017. If an enterprise is eligible for corporate income tax incentives in addition to Circular 4 benefits, it must choose the one that is most preferential.

Circular 4 renews a number of tax preferential treatments available under Circular 18 and

introduces certain new tax incentives. It reaffirms the Chinese government’s determination to develop and promote the software and integrated circuit industries, an effort that is in line with the country’s 12th five-year plan. For some tax benefits, Circular 4 provides only a framework, and it is expected the Ministry of Finance, State Administration of Taxation and related departments will issue detailed regulations to offer further guidance.

## 2011 PRC National Standardization Guidance

### **Key Points:**

- ***Standardization efforts will focus on areas such as agriculture, consumer products, information technology and energy***
- ***Representatives of companies and industry associations will have an opportunity to comment on draft standards***

At the end of January 2011, the Standardization Administration of China (SAC) issued the “Guidance on Establishing Projects for National Standardization in 2011.” The projects will focus on the following industries and areas:

- Modern agriculture
- Services and social development
- Food quality, consumer products quality and safety

- Energy conservation and environmental protection
- New-generation information technology
- Biology
- High-end equipment manufacturing
- New energy
- New materials
- New energy vehicles

Industry members and specialized technology standardization committees are responsible for the collection, selection and application of the projects. During the process of drafting standards, comments to the draft – in particular, comments from representatives of companies and industry associations on highly technical issues – will be solicited. It is not unusual for government officials to receive and consider comments and suggestions from multinational corporations related to draft standards for their industries. Certain “selected” stakeholders may be asked to participate in the review process. For example, according to a notice issued on 28 February 2011 regarding solicitation of comments for national technical standards for printers and electrographs, 15 companies and organizations have been asked to provide comments including Panasonic, Lenovo and Foundertech.

Recently, the Ministry of Environmental Protection promulgated the “Standards on Pollution Discharge of the Rare Earth Industry,” effective as of 1 October 2011. These are the first national standards on pollution discharge to be issued during the 12th

five-year-plan plan. They include specific and strict standards on the discharge of waste water, gas and radioactive materials for rare earth industry enterprises. A number of rare earth enterprises may not be able to comply with such standards, although there is a two-year transition period. Consequently, exports in this sector are expected to decrease significantly in the following two to three years.

National standards for various industries are expected to appear gradually in 2011.

### The Transformation of Economic and Trade Communication Between Mainland China and Taiwan

#### Key Points:

- ***Investment activity between mainland China and Taiwan has increased with the implementation of the Economic Cooperation Framework Agreement (ECFA)***
- ***China-based investors are considering Taiwan as their R&D center for expansion into overseas markets***

With the execution and implementation of the ECFA between mainland China and Taiwan, the cross-strait economic and trade communication changed dramatically in 2010. The following is a summary of the main changes.

#### **Mainland China Has Changed From “Factory” to “Market”**

Under the ECFA framework, lower taxation for the “early harvest list” has greatly reduced expenses for

Taiwan-based enterprises invested in mainland China and improved confidence for Taiwan-based investors. In connection, mainland China has gradually changed from “factory” to “market,” and investments from Taiwan have increased greatly.

### **Investment by Mainland China Enterprises Into Taiwan on the Rise**

Taiwan is equipped to become a regional financial center and a place of global strategic importance in the field of high technology in Asia, and may provide opportunity for China-based investors, especially high-tech and R&D companies. These investors may choose Taiwan as their R&D center for expansion into overseas markets, and even list stock on Taiwan’s market prior to entering an international capital market.

As for direct investment, it is worth mentioning that in November 2010, the Administrative Measures for Investment by Mainland Enterprises in Taiwan (the Measures) were issued by the Ministry of Commerce (MOFCOM) and the Taiwan Affairs Office of the State Council. Since then, the guidelines for direct investment by China mainland enterprises into Taiwan have become clearer. In addition to the general conditions of mainland enterprises, the Measures set out relevant procedure for investment activities in Taiwan.

Enterprises shall submit their applications to the National Development and Reform Commission (NDRC) for review and approval. The application for the establishment of an enterprise or non-enterprise legal person in the Taiwan Region shall be submitted

to the MOFCOM for approval. Examinations will be conducted in accordance with the Tentative Measures for Approval of Overseas Investment Projects. The NDRC and MOFCOM examination must be conducted in consultation with the Taiwan Affairs Office. Mainland China enterprises are required to register with the NDRC, MOFCOM and Taiwan Affairs Office within 15 working days of completing registration formalities in the Taiwan Region, and shall be responsible for any procedures when altering or terminating their investment.

With increased activity and tighter cooperation, it is anticipated that, under the terms of the ECFA, cross-strait economic and trade communication has entered a new era.

### **Hong Kong Market Regulator Requires More Thorough Due Diligence by Sponsors on Listing Applicants**

#### **Key Points:**

- ***Hong Kong’s Securities and Futures Commission (SFC) conducts reviews on the quality of the sponsors’ pre-IPO due diligence work***
- ***The SFC noticed deficiencies in the work performed by some sponsors, which are undermining the integrity of the market and transparency in fundraising exercises***
- ***The SFC has asked the relevant sponsors to take appropriate actions to address these concerns***

Hong Kong has a robust financial infrastructure and is an international financial center. In 2006, Hong Kong was the second largest IPO fundraising market in the world after London. In 2009, Hong Kong raised a total of HK\$248 billion in IPO activities and became the largest IPO center in the world. Companies listed on the Hong Kong Stock Exchange include mainly companies incorporated in Hong Kong or overseas whose business is typically in Hong Kong or PRC. From an investor protection perspective, true, accurate and complete disclosure in the listing documents is crucial. And it is a regulatory requirement that sponsors be closely involved in the preparation of the new applicant's listing documents by, among other responsibilities, conducting thorough due diligence on the applicant's business operation, major stakeholders, third-party professionals' work and other details. In March 2011, in view of the importance of the sponsor's due diligence work and recent findings through day-to-day inspection, the SFC issued a Report on Sponsor Theme Inspection Findings (Report) and laid out the regulator's main concerns and suggestions on this topic.

#### **Supervision and Theme Inspection of Sponsors' Work by SFC**

The SFC reviews the quality and compliance of the sponsors' work on a routine basis to ensure the integrity of the market and transparency in the fundraising activities. The SFC conducted a larger-scale survey on all sponsors in Hong Kong in October 2009 and established a team to conduct a

Sponsor Theme Inspection on 17 sponsors in particular. The inspection has covered:

- The due diligence work undertaken by sponsors in respect of listing applicants' business activities as well as the financial information and material information provided to the Hong Kong Stock Exchange; and
- Sponsors' overall internal systems and controls relevant to sponsor activities.

#### **SFC's Key Findings During the Theme Inspection**

In the Report, the SFC elaborated on the common types of deficiencies that were identified during the Theme Inspection and provided case examples of sponsors' due diligence work for each type.

The main types of deficiencies include, among others:

- Insufficient due diligence on the applicant's major business stakeholders such as major suppliers, customers and bankers. The SFC noted that the interview practices adopted by some sponsors could not effectively verify the identities of the interviewees and sponsors did not follow up on unsatisfactory responses. This directly affects the quality and reliability of information obtained and undermines the ability of the sponsors to properly assess the listing applicant's financial conditions.
- Insufficient due diligence on material changes in business shortly before listing. A sponsor is required to conduct inquiries as to any material change in the listing applicant's financial

information after the last audited balance sheet date. The SFC noticed suspicious changes in the sales of a listing applicant immediately before listing, such as a significant increase in export sales to a single new customer.

- Failure to maintain proper documentation of due diligence. The sponsor is expected to document its due diligence planning as well as conclusions it has reached. In the Sponsor Theme Inspection, the SFC came across cases where the sponsor was unable to produce relevant records to show to the SFC's satisfaction that it had properly considered and disposed of certain issues, which were *prima facie* material in the relevant circumstances. For instance, the SFC noted that some lists did not include a few entities related to the listing applicant that, based on the business scope described in their respective business licenses, could be engaged in competing businesses.

#### SFC Actions

It is suggested in the Report that the SFC will continue its efforts to enhance the sponsor regulatory framework for better investor protection and market quality. In particular, the SFC is considering issuing a circular requiring sponsors to confirm that they have "made reasonable due diligence inquiries such that it has reasonable grounds to believe and does believe" that the listing documents "contain sufficient particulars and information to enable a reasonable person to form a valid and justifiable opinion of the shares and the financial condition and profitability of the new applicant." The circular would also require

the sponsor to "use reasonable endeavors to ensure that all information provided to the Stock Exchange during the listing application process is true in all material respects and does not omit any material information and, to the extent that the sponsor subsequently becomes aware of information that casts doubt on the truth, accuracy or completeness of information provided to the Stock Exchange, it will promptly inform the Stock Exchange of such information."

#### Civil Procedure Law to Be Amended Substantially

##### Key Points:

- **Amendments will address areas ranging from simple proceedings to claims for public interest**
- **There is no timetable for publishing the draft amendments**

The Legislative Commission of the National People's Congress is drafting significant amendments to the current Civil Procedure Law (2007). The amendments will cover at least the following aspects:

- **Simple proceedings** – the current provisions regarding simple proceedings (a concept similar to summary judgment) are limited (only five provisions), but in practice, simple proceedings are applied to 50 percent to 80 percent of cases. It is, therefore, necessary to detail the proceeding and particularly introduce a proceeding applicable to small claims.

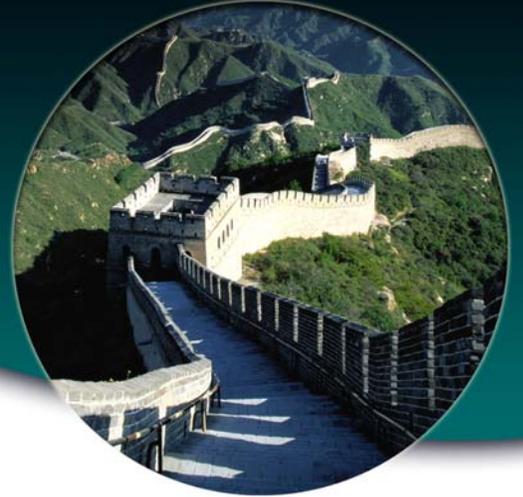
- **Rules of evidence** – the current Civil Procedure Law allows the courts and the parties to collect evidence. In reality, however, the courts' involvement in evidence collection has become less and less, and the parties usually face significant difficulties in collecting evidence mainly because they do not have the necessary statutory powers. The proposed amendments could grant more powers to the parties and lawyers in evidence collection.
- **Pretrial procedures** – this amendment would introduce certain procedures for evidence exchange and issue spotting before trial, which does not exist under the current Civil Procedure Law.
- **Public interest claims** – this amendment would allow private claims for public interest, such as environmental protection, where the victim is not a specific individual.
- **Judicial confirmation of private mediation** – there are two types of mediation in China: i) judicial mediation that is administrated by the courts and where the results are legally enforceable, and ii) private mediation that is administrated by mediation organizations and where the results are not enforceable. In March 2011, the Supreme Court issued an interpretation allowing mediation agreements made under the administration of the People's Mediation Organizations to be confirmed by the courts, and therefore legally enforced. It is expected that this system will be further confirmed and clarified in the Civil Procedure Law.

Other changes related to retrial, judgment enforcement, service of documents and false litigation are also being considered, but there is no timetable for publishing the draft amendments.

## Upcoming Events

On Tuesday, April 26, Squire Sanders partner **Lisa G. Han** will take part in a free, one-hour webinar, "[Winning Strategies for China: Key Exporting Business & Legal Issues for Biomedical Products Makers](#)." Topics to be covered include:

- Why China? Demographics and Trends
- Does China Really Want Your Product? Segment and Product Assessment
- Building the Foundation: Product/IP Protection, Regulatory (SFDA) and Other Legal Issues
- Go-to-Market: Channel Development, Pricing, Importation
- Profitable Growth: Infrastructure, Competitiveness



## CHINA UPDATE

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