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CHINA UPDATE

In-Progress Legislation on Remedies in Merger Control

Key Points

- Clarification on the types of remedies for merger control.
- Further details on the timeline for negotiation and implementation of remedies.
- Potential buyers of divestiture business must be subject to the approval of MOFCOM, and must satisfy specific conditions.
- Introduction of an "Upfront Buyer" condition.

Background

Since the Anti-monopoly Law of the People's Republic of China came into effect in 2008, the PRC Ministry of Commerce ("MOFCOM") has granted 18 conditional clearances of merger cases where they imposed certain restrictive conditions on merging entities for the purpose of eliminating or reducing the anti-competition effect arising out of a merger. In 2010, MOFCOM issued a regulation setting forth the basic requirements of divestitures; however, a general rule clarifying the types of remedies, requirements, and the procedures of remedies available to MOFCOM is yet to be promulgated.

In the absence of clarification on these matters, MOFCOM released a draft Regulation on Remedies in Merger Control ("Draft Regulation") in March 2013 for comments.

Highlights of the Draft Regulation

Types of Remedies in Merger Control

Similar to the practices in many jurisdictions, remedies in merger control under the Draft Regulation include:

1. Structural remedies, e.g., divestiture of business, which may consist of tangible assets, intellectual property rights, and equity interest
2. Behavioural remedies, e.g. grant of access to networks or infrastructure, license of technology, know-how, and intellectual property right, and termination of exclusive agreements.
3. Hybrid of structural remedies and behavioural remedies.

Behavioural remedies may also include (a) hold-separate requirements with regard to staffing, procurement, sales, and pricing, with no sharing of competitive information, to be implemented through the creation of a fire wall within the merged entity, (b) a commitment with respect to production capacity and output, (c) a commitment of continuing procurement from upstream vendors or continuing supply to downstream customers on reasonable terms and conditions, and (d) a commitment for investment in research and development.

Compared with the competition agencies in the US and the EU, MOFCOM appears to be more inclined to adopt behavioural remedies, as reflected by the fact that divestiture was required only in seven out of the 18 conditional clearances granted to date. In particular, the conditional clearance granted to the *Marubeni-Gavilon* acquisition in 2013 suggested that MOFCOM may impose a hold-separate requirement as an alternative to divestiture, opposed to other jurisdictions (where a hold-separate requirement is typically used as an interim protective measure pending the completion of divestiture). Despite this, neither the Draft Regulation nor the existing practice shed much light on the circumstances when MOFCOM may prefer divestiture to a behavioural remedy.

Timeline for Negotiation and Implementation of Remedies

According to the Draft Regulation, when requesting for a proposal of remedies from merging entities, MOFCOM should specify the anti-competitive effect that concerns them as well as the reasons for the concern. MOFCOM may assess any remedy proposed by merging entities through consultation with other government agencies, trade associations, enterprises and consumers, and by conducting a questionnaire survey or at a public hearing. The merging entities may negotiate for the remedies acceptable to both the merging entities and MOFCOM, and will be obliged to submit the final proposal of remedies at least 20 days prior to the expiry of the MOFCOM statutory review period.

Unless otherwise agreed by MOFCOM, a behavioural remedy must be implemented for ten years. In the case of divestiture, unless otherwise specified in the MOFCOM's conditional clearance, a merging entity must find a suitable buyer of the divestiture business and enter into a binding sales agreement with such buyer (subject to the MOFCOM approval) within six months of the MOFCOM conditional clearance. This period may be extended by up to three months if MOFCOM considers it appropriate. Within three months subsequent to the execution of a sales agreement, the merging entity must complete the divestiture, with an extension by one month available if approved by MOFCOM.

Such timeline is generally consistent with the current practice, though there have been previous exceptions. Nevertheless, the three-month limitation for the closing of a divestiture transaction may be impractical if the divestiture transaction itself would be subject to the merger review of MOFCOM or the divestiture package includes certain assets that are subject to time-consuming process for the transfer of title, e.g., trademarks registered in the PRC.

In the event that a merging entity fails to sign a binding agreement for the sale of divestiture business or to complete the divestiture within the statutory time limits noted above, MOFCOM would mandate an independent divestiture trustee to sell the divestiture business to a suitable buyer. In practice, such sales by a divestiture trustee could be made at an unrestricted price.

Buyer Qualifications in Divestiture

Under the Draft Regulation, a potential buyer of divestiture business must be subject to the approval of MOFCOM, and must satisfy all the following conditions:

1. Be independent from any merging entity.
2. Have necessary resources, expertise, and incentive to be an effective competitor of the merged entity with the divestiture business.
3. Be able to obtain any other approvals from government agencies required for the purchase of divestiture business, where applicable.
4. Not have financing from any merging entity for the purchase of divestiture business.
5. Have satisfied other requirements raised by MOFCOM according to the particularities of the merger case under MOFCOM's review.

Technically, if a potential buyer's market power is too weak to effectively compete with the merged entity even if having acquired the divestiture business, the divestiture to such buyer may not restore the competition within the relevant market, and therefore may not be approved by MOFCOM. On the other hand, if a potential buyer has already acquired strong market power, the divesture itself may present substantial anti-competition concern. In practice, however, there is no information indicating MOFCOM has ever challenged the suitability of a potential buyer in the case of a divestiture transaction.

Upfront Buyer and Crown Jewel Alternative in Divestiture

The Draft Regulation provides that MOFCOM may require a merging entity to identify a suitable buyer of a divestiture business and sign a binding agreement for the sale of the divestiture business with such buyer before it may proceed with the merger, which is commonly known as an "Upfront Buyer" requirement, in the following situations:

1. The competitiveness and viability of the divestiture business may be subject to a high risk before the divestiture, i.e., a perceived risk of degradation of the divestiture business.
2. The identity of the buyer is crucial for the restoration of competition in the market, e.g., a buyer must have certain special expertise to effectively operate the divestiture business in competition with the merged entity.
3. There is a perceived risk that a suitable buyer of the divestiture business may not be found within the statutory post-clearance time limits.
4. The divestiture business is subject to third party rights, e.g., the transfer of divestiture business is subject to the consent of a third party, which consent may be withheld.
5. Other situations determined by MOFCOM.

The foregoing clauses appear to be generally consistent with the Upfront Buyer requirements in the EU.

According to the Draft Regulation, if there is a perceived risk that a merging entity may not find an Upfront Buyer prior to the closing of merger, MOFCOM may require a merging entity to propose an alternative and more attractive divestiture package to divest in the event that the merging entity fails to find a suitable buyer of the original divestiture package. Such requirement, commonly known as a "Crown Jewel Alternative" requirement, is present in the practice of merger control in the US and EU.

On the other hand, the Draft Regulation did not address another requirement present in the practice of merger control in the US and EU which is similar to the Upfront Buyer requirement, i.e., the "Fix-it-first" requirement where a merging entity is required to complete the divestiture, as opposed to the execution of a binding sales agreement for divestiture business, before it may proceed with the merger in certain situations. It will be no surprise if MOFCOM includes the "Fix-it-first" provision in the final version of the Draft Regulation.

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New Clarification by SAT Regarding Secondment Arrangement

Key Points

- Clarifies situations where a non-resident company constitutes "permanent establishment" for corporate income tax purposes.
- Announcement No. 19 clarifies the situations when PE will be established when certain factors are met
- Also clarifies several documents that the in-charge tax bureau should focus on during its PE evaluation

Background

The Announcement on Corporate Income Tax Relating to Personnel Seconded by Non-resident Companies ("Announcement No. 19") became effective on 1 June 2013. These regulations clarify various situations where a non-resident company may or may not constitute Permanent Establishment ("PE") for PRC Corporate Income Tax ("CIT") purpose.

Under PRC CIT regulations, foreign companies are subject to 25 percent CIT if it has establishment or PE in China and local subsidiaries of multinational corporations are often challenged by local in-charge tax authorities over seconding arrangements. Since 2009, and the introduction of State Administrative of Tax ("SAT") regulations on PE investigations for nonresident companies, local tax officers have often been aggressive regarding secondment arrangements.

Highlights of the Regulation

Announcement No. 19 – What Factors Would Trigger PE Risk?

Circular No. 75 originally introduced rules where, if a foreign parent company had assigned personnel to work in a PRC subsidiary, certain factors would be taken into consideration to deem that the foreign parent company has created a PE in China. Announcement No. 19 further clarifies these original rules and addresses the specific situations where employees are seconded by foreign parent to the PRC subsidiary.

If the non-resident company assumes some or all of the liabilities and risks for the work results made by the seconded personnel and is entitled to assess personnel work performance, the company may be deemed as having an establishment in China. Under the context of a tax treaty, if the establishment is relatively fixed and permanent the non-resident company will establish PE. Under Announcement No. 19, PE will be established where all the following factors are met:

1. The domestic company makes payments in the nature of management fees or service fees to the non-resident company which is seconding the employees.
2. The amount of payments made by the domestic company exceeds the wages, salaries, social security premiums and other costs paid in advance or on a commission basis by the non-resident company.
3. The non-resident company reserves a certain amount of such payments made by the domestic company instead of delivering all of it to the seconded personnel.
4. The seconded personnel fail to file individual income tax for the full salary income paid by non-resident company for secondment work.
5. The non-resident company determines the number of seconded personnel as well as their qualifications, remuneration level and working place in China.

The general rule from the above is that if the employees are deemed to work for the foreign employer, that employer will be subject to the PE exposure.

Announcement No. 19 Standards

When comparing standards, those factors listed in Announcement No. 19 do not necessarily go beyond the standards in Circular No. 75.

One important factor is regarding the individual income tax filing position for such seconded employees. Announcement No. 19 suggests that failure to fully disclose personnel income to PRC tax authority for income tax purposes may demonstrate intent from all parties that part of the salary income is paid for overseas work, meaning that such personnel partly work for the foreign company. In certain cases the individual employees may request the employer does not to fully declare their income for PRC individual income tax purpose. In this instance, the employer should better evaluate the impact and risks of such a proposal – under Announcement No. 19 this may increase the PE risk for the foreign employer.

Announcement No. 19 also clarifies situations where a foreign company dispatches its personnel to China for the sole purpose of exercising the shareholder's rights. In these instances, the foreign company shall not be deemed as creating a PE. This clarification may be helpful for those venture capital investors worried about their presence in the PRC portfolio and exercising their shareholder's right.

Announcement No. 19 also clarifies several documents that the in-charge tax bureau should focus on during its evaluation including:

1. Secondment agreement.
2. The company's internal regulations and rules including specific provisions on seconded employee's responsibilities, job description, performance evaluation, risk-sharing and other aspects.
3. Any payment made by the PRC company to the foreign company for such secondment, and the IIT filing record for such seconded employees.
4. Any agreement between the PRC company and the foreign company regarding offsetting payment, waiving the debt, or any related party transactions and other agreements with similar hidden payment.

Conclusion

Announcement No. 19 supplements Circular No.75 and helps to clarify certain questions regarding PE, particularly relating to the perspective of secondment arrangement.

A benefit of Announcement 19 is that companies can now understand the dos and don'ts regarding the related PE risk so they can plan a more appropriate structure based on their commercial needs. Most importantly, they will now be in a situation to better defend themselves against unreasonable PE claims.

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Overview on PRC Laws and Draft Regulations on Personal Information Protection

Key Points

- The collection and use of the personal information of the users must be agreed by the users.
- Service providers must expressed inform the users the purpose, manner and scope of collecting and using personal information.
- The service providers must take active measures to safeguard the personal information of the users.
- Telephone and mobile users are required to provide true and valid identity information for the registration.

Background

Legislation on personal information protection has been a widely discussed topic for years in China. Despite this, there is still an absence of any comprehensive law at the national level aimed at protecting personal information. Given the fact that violation of personal information is becoming increasingly serious, the relevant authorities have issued a series of administrative regulations and standards in the past couple of years and have also drafted several laws and regulations which are in currently in the process of discussion and receiving public comment.

Of these regulations, one of the most important documents is the Decision on Strengthening Information Protection on Networks (the "Decision"), issued by the Standing Committee of the National People's Congress on 28 December 2012, which specifies the principles on the protection of electronic information by which individual citizens can be identified as well as the individual privacy of citizens. To implement the Decision, the Ministry of Industry and Information Technology of China ("MIIT") issued two drafts rules for public opinions on 10 April 2013: (a) Rules on the Personal Information Protection of Internet and Telecommunication Users (the "Draft Protection Rules") and (b) Rules on the True Identity Registration of Telephone Users (the "Draft Registration Rules").

Highlights of the MIIT Draft Rules

The Draft Protection Rules

According to the Draft Protection Rules, "personal information" refers to the identity information of a user which is collected by the telecommunication business operators and internet service providers ("ISPs") during the process of servicer providing. This data collected includes identity information such as the name of the user, date of birth, ID card number, address as well as information related to the use of the service, such as service account number, time and location of using the service. The Draft Protection Rules stipulate that, without the consent of users, the telecommunication service operators and Internet information service providers shall not collect or use the personal information of users. Unlike the Guideline on Protection of Personal Information in Information Security Technology – Public and Commercial Services Information Systems (the "Guideline") issued at the end of 2012, personal information is not classified as general information and sensitive information, and the consent of users is not defined as tacit consent nor expressed consent.

The coverage of personal information in the Guideline is broader than that in the Draft Protection Rule. The former covers sensitive information such as ID card numbers, mobile phone numbers, race, political opinions, religion, gene, finger prints and so on, and the general information which refers to any personal information other than the sensitive information.

Further, as the Decision has specified, ISPs must expressly inform the users of the purpose, manner and scope of collecting and using personal information, the terms for keeping the information, the approach regarding enquiries and updating of information, and consequences of not providing the information. ISPs must take active measures to prevent the reveal, destroy or loss of personal information. Further, their staff members are also obliged to keep the personal information of users secret and must not divulge, distort, destroy, sell or illegally provide others with such information. Anyone violating the Rules will be subject to penalties such as the mandatory modification within a limited time, warning and a fine in an amount less than RMB30,000. If the violation constitutes a crime, the violator will also be subject to criminal penalties under PRC Criminal Law. Collectively, however, these penalties are much less severe than those provided in the Decision.

The Draft Registration Rules

In the Draft Registration Rules, telephone and mobile users are required to provide true and valid identity information for registration. Such requirement is applicable to the user who wants to fix a landline telephone, relocate the telephone, transfer the telephone, open an account for a mobile phone, transfer such account, and apply for additional service items for the landline telephone or mobile phone. For existing users, they are also required to provide the identity information upon the request of the telecommunication business operators to confirm the need of serviced provided.

Although the Draft Registration Rules also provide that the telecommunication business operators and their staff members are obliged to keep the users' identity information confidential, not to sell or illegally provide such information to any third party, and not use such information for any purpose other than the services ordered by the users.

However, the Draft Registration Rules lack detailed provisions on the protection of the personal information and, as with the Draft Protection Rules, the penalties to the violators are very light. Given the cost of the violation is so low, it is will need to be monitored to see how such rules will be effectively enforced.

Conclusion

Given that the above two rules are drafted for the implementation of the Decision, they do not have any creative provision on personal information protection, and it is hoped that the finalized Rules will include more detailed and practicable provisions on personal information protection. From a long term perspective, we are still expecting a comprehensive law at the national level which covers personal information protection in more depth.

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Circular 20 to Strengthen Administration of Foreign Exchange Capital Inflows

Key Points

- Circular 20 to tackle false trading, reduce large foreign capital inflows into China and slow down the Yuan appreciation.
- Banks must maintain their shares of foreign currency loan balance as a percentage of their foreign currency deposits balance.
- Circular 20 increases scrutiny on exporters who channel money into the country disguised as trade payments.
- The circular also brings in regulations to strengthen the SAFE monitoring and analysis system.

Background

On 6 May 2013, the State Administration of Foreign Exchange ("SAFE") issued a Circular on Strengthening Administration of Foreign Exchange Capital Inflows (Huifa [2013] 20) ("Circular 20") intended to clamp down on false trading, reduce large foreign capital inflows into China and help decelerate the pace of Yuan appreciation.

Highlights of the Regulations

The new regulations involve three types of subject, commercial banks, companies and SAFE.

How Circular 20 Applies to Banks

According to the circular, each commercial bank's position of foreign exchange settlement and sale will be determined by its balances of domestic foreign currency loans and foreign currency deposits on the domestic market.

Chinese banks and foreign banks must maintain their shares of foreign currency loan balance as a percentage of their foreign currency deposits balance, set at below 75 percent and below 100 percent respectively. If banks do not meet this requirement, they must adjust limits on positions of foreign exchange settlement and sale. Commercial banks must complete the adjustment of position limits within the first ten working days of each month.

How Circular 20 Applies to Companies

For companies, the circular increases scrutiny on exporters who channel money into the country disguised as trade payments.

SAFE can issue warnings if it finds that a company's foreign exchange capital flows do not match its trade or that the company is channelling unusually large amounts of money into China. If a company fails to explain the situation within ten working days – providing sufficient evidence and a reasonable explanation – it will be placed on its "B list", intended for companies that are to be more strictly monitored. The company will only be moved back onto the "A list" if all the relevant indicators return to its normal range for three consecutive months.

Under Circular 20, a B list company's entrepot trade foreign exchange income must only be settled and transferred after external payments have been made. Entrepot income and expenditure of the same entrepot trade business shall be conducted at the same bank. For newly signed entrepot trade contracts, the settlement currency of income and expenditure shall be the same, whether a foreign currency or RMB.

Extended SAFE powers under Circular 20

The circular brings in regulations to strengthen the SAFE monitoring and analysis system. Where abnormal capital inflows are brought to their attention, SAFE should take the initiative to carry out on-site verification or inspection.

Where a company uses false documents for arbitrage, SAFE can impose severe punishments in accordance with current law. Companies and banks that break the SAFE regulations will be fined or closed, and their practices exposed to the public.

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Circular 21 to Simplify Foreign Direct Investment

Key Points

- Defines "inbound direct investment"
- Explains the situations when investors must register with SAFE
- Allows SAFE-registered parties to deal with certain banks directly

Background

On 11 May 2013, China's State Administration of Foreign Exchange ("SAFE") released a new circular, "Circular on Issuing the Provisions on the Foreign Exchange Administration of the Inbound Direct Investment of Foreign Investors and Supportive Documents (Huifa[2013] No. 21) ("Circular 21") which came into effect on 13 May 2013.

Circular 21 represents a further step by SAFE to simplify and unify the relevant foreign exchange registration procedures following issuance of the Circular on Further Improvement and Amendment of Foreign Exchange Control Policies on Direct Investment, effective in December 2012("Circular 59").

Highlights of Circular 21

Circular 21 contains three documents which cover different aspects of the foreign exchange registration procedures.

1. Definition of Inbound Direct Investment

Inbound direct investment by foreign investors refers to the setting up of foreign-invested enterprises ("FIEs") or projects in China via new establishment, mergers and acquisitions, or other means, through which rights and interests including ownership, rights of control, or operation and management rights are acquired. Notably, such definitions also apply to foreign investors' investments in domestic financial institutions.

2. SAFE Registration Requirements

SAFE foreign exchange administration shall be on foreign direct investment ("FDI") related foreign exchange registration and settlements, account opening and usage, and fund remittances.

The following actions require registration with SAFE branches:

- Remittances of pre-operating expense for establishing FIEs.
- Establishment of FIEs.
- Foreign investors' contribution of capital in the form of foreign exchange, equity, tangible or intangible assets (including onshore lawful profits), or payment of consideration to a Chinese shareholder when purchasing the equity of a domestic enterprise of such Chinese shareholder.
- Capital changes to an FIE such as capital increase, capital reduction, equity transfer.
- Deregistration of an FIE or conversion of an FIE into a non-FIE.
- Equity transfer, onshore reinvestment and relevant matters related to FDI by onshore and offshore institutions and individuals.

SAFE's processing time for a registration application is five business days, which may be extended to 20 business days in special circumstances. This has created a more efficient turnaround than previously, with the timescale for a standard turnaround being only 20 business days for an approval or registration from SAFE.

However, Circular 21 hasn't defined "registration," leaving a question of whether a registration process will contain a review and examination process. For example, According to Article 6 of the Operating Guidelines and Specifications on Matters Relating to the Inbound Direct Investment Business (the "Guidelines"), SAFE is entitled to request an applicant to provide proof of the reasonableness of the transaction consideration under certain special circumstances relating to foreign exchange incomes and expenses.

3. Banking Matters

Circular 21 allows the relevant party who has completed SAFE registrations to deal with banks directly for following banking matters:

- FIE can open a pre-operating expense account, capital account and asset conversion account with a bank.
- To remit money offshore by the reason of capital reduction, liquidation, advance recovery of investment, distribution of profit, FIE can purchase foreign exchange and do outbound payments with a bank.
- To remit money offshore by the reason of the equity transfer of an FIE held by foreign investors, the domestic transferee can purchase foreign exchange and do outbound payments with a bank.

Circular 21 also issued detailed guidelines containing 23 registration forms, providing a full set of registration forms in relation to FDI. Each form provides detailed instructions and specific registration application documents for each specific FDI transaction, making the registration procedures relatively transparent. Circular 21 abolishes 24 regulations for foreign exchange registration and settlement, accounts opening and usage, fund remittances, and thus simplifies and systemizes the foreign exchange administration of foreign direct investment.

Conclusion

Circular 21 has shown clear signs that SAFE is reducing administrative procedures and establishing a registration system in order to facilitate FDI and monitor capital inflows and outflows in a better way. As quoted by SAFE, "it further simplifies, standardizes and clarifies the foreign exchange administration of FDI into China, and offers a registration system for FDI and outbound direct investment".

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External Debt Registration – Administrative Measures Clarified

Key Points

- The Measures have seven sections which specify the administration over the registration of external debts, debt accounts and specifies administration over the use of funds etc.
- The Measures divide debtors into three categories – governmental department of finance, the domestic banks and any other entities in China.
- SAFE grants certain authorization to particular banks in the PRC with authorized banks will be in charge of opening special account, settlement and repayment of the external debts.
- The Measures consolidate previous guidelines and manuals in relation to the registration of domestic loans guaranteed by the external credit line.

Background

On 28 April 2013, the State Administration of Foreign Exchange ("**SAFE**") of the People's Republic of China released the Notice on Promulgating the "Administrative Measures for Registration of External Debts" (the "**Measures**"), which has been effective since 13 May 2013. The Measures has seven sections which specify the administration over the registration of external debts, external debt accounts, administration over the use of funds and foreign exchange settlement and sale. They also cover foreign exchange administration for the issuance of external credit letters of guarantee for domestic loans, foreign exchange administration for the transfer of non-performing assets to external parties, amongst other matters.

Since the issuance of the first foreign exchange regulation in 1996, SAFE has introduced a number of regulations to regulate and control the external debt and its relevant approval or registration work. Compared with previous regulations and rules issued by the SAFE, the Measures are considered to be more systematic, integrated and practical.

Highlights of the Measures

According to the Measures, the debtor shall file with the local department of the SAFE with respect to the execution, revision and termination of the external debt agreements and the external guarantee agreements as well as the funding, repayment, settlement and remittance of the external debts thereunder. The Measures divide the debtors into three categories, namely the governmental department of finance, the domestic banks and any other entities in China.

The filings of external debts by the governmental departments and the domestic banks are processed through independent filing systems, so that most of the provisions under the Measures focus on the registration of the external debts incurred by the PRC companies.

One of the characters of the Measures is that the approval and registration procedures for the external debts have been simplified. SAFE has granted certain authorization to particular banks in the PRC and, once the external debts are filed with the SAFE, the authorized banks will be in charge of opening special account, settlement and repayment of the external debts.

The Measures also consolidate the previous guidelines and manuals in relation to the registration of domestic loans guaranteed by the external credit line. The foreign invested companies incorporated in China are allowed to obtain the loan in RMB from the domestic financial institutions with their offshore credit line or assets as the guarantee. However, in the event that the domestic PRC companies intend to obtain any loan secured by its offshore credit or assets, such loan arrangement shall be subject to the approval from the SAFE, and the amount of the loan shall be within the total budget approved by the SAFE.

The Measures also specified the procedure for the registration of the external transfer of the non-performing assets that have been duly approved by the governmental authorities. A comprehensive operational guideline for registration works is attached to the Measures, which covers the list of application materials, the examination principles and key points, and the authorizations among the departments of SAFE at different levels.

Upon the effectiveness of the new measures, eights rules previously issued by SAFE in relation to the control of the external debts and the disposition of non-performing assets have been terminated.

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