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New Regulations For PRC Holding Companies — Summary and Preliminary Analysis —

With effect from April 7, 2003, the former Ministry of Foreign Trade and Economic Cooperation ("MOFTEC")[1] of the People's Republic of China (the "PRC" or "China") has substantially revised various regulations governing foreign-invested companies of an investment nature (commonly known as "Holding Companies").

Highlights

- Holding Companies may now provide human resources management services to their Invested Entities.[2]
- Holding Companies may now provide certain services to all their affiliates, and not only to their direct shareholders and Invested Entities.
- Holding Companies may now own non-listed shares in companies limited by shares ("CLS") that have less than 25% foreign investment.
- Registered capital and borrowing regulations with respect to Holding Companies have been relaxed.
- Holding Companies may lease equipment to their Invested Entities under operating leases.
- On the negative side, the provision of certain services by Holding Companies is now subject to a new requirement: a Holding Company must have made equity investments of at least US$30 million in total in all of its Invested Entities before its articles of association may be revised to include the provision of those services. These services (detailed below) include distribution, transportation, systems integration and other services to Invested Entities, and consultancy services to the Holding Company's affiliates.

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1 Pursuant to a decision of the National People's Congress on March 17, 2003, MOFTEC will be merged into a newly created Ministry of Commerce, which will be responsible for both foreign and domestic trade and investment.

2 "Invested Entities" are PRC companies in which a Holding Company directly owns an equity interest which, together with the investments of other foreign investors, represents at least 25% of such PRC company's registered capital (for the purpose of calculating the foreign ownership percentage, investments of Holding Companies as well as those of foreign investors are considered "foreign").

1285 Avenue of the Americas
New York, New York 10019-6064
(212) 373-3000

1615 L Street, NW
Washington, DC 20036-5694
(202) 223-7300

Alder Castle, 10 Noble Street
London EC2V 7JU England
(44-20) 7367 1600

2, rue du Faubourg Saint-Honoré
75008 Paris, France
(33-1) 53.43.14.14

Fukoku Seimei Building 2nd Floor
2-2, Uchisawaicho 2-chome
Chiyoda-ku, Tokyo 100, Japan
(81-3) 3597-8120

2918 China World Tower II
No. 1, Jianguomenwai Dajie
Beijing 100004, People's Republic of China
(86-10) 6505-6822

12th Fl., Hong Kong Club Building
3A Chater Road, Central
Hong Kong
(852) 2536-9933

Regulations Affected

MOFTEC's Decision to Amend the Interim Provisions Governing the Establishment of Companies of an Investment Nature by Foreign Investors and Their Supplemental Provisions dated March 7, 2003 (the "Decision") amends several articles of the three principal sets of regulations governing Holding Companies:

- the Interim Provisions Governing the Establishment of Companies of an Investment Nature by Foreign Investors, dated April 4, 1995 (the "Holding Company Provisions");
- the Supplementary Provisions to the Interim Provisions Governing the Establishment of Companies of an Investment Nature by Foreign Investors, dated August 24, 1999 (the "First Supplementary Provisions"); and
- the Supplementary Provisions (2) to the Interim Provisions Governing the Establishment of Companies of an Investment Nature by Foreign Investors, dated May 31, 2001 (the "Second Supplementary Provisions").

MOFTEC has yet to consolidate these three sets of provisions into a single document and has also not revised the Explanation of Questions Regarding the Interim Provisions Governing the Establishment of Companies of an Investment Nature by Foreign Investors, dated February 16, 1996 (the "Explanation"). This piecemeal approach creates some inconsistencies between the Decision and the underlying regulations.

The main amendments set forth in the Decision are explained below.

Capital Contributions to Holding Companies

Under the Holding Company Provisions, foreign investors of the Holding Company had to make all their capital contributions in foreign currency. The Decision revises this rule, allowing foreign investors to also use Renminbi funds obtained from dividend distributions, sale of equity interests or liquidation proceeds for their capital contributions to the Holding Company. Such contributions in Renminbi will likely be converted into the currency of the Holding Company's registered capital at the prevailing rate on the date of the contribution.

Investments in PRC Entities

The Decision is a further step in the gradual liberalization of permitted investments:

- Holding Companies have consistently been allowed to hold equity interests in wholly foreign-owned enterprises and in Chinese-foreign equity joint ventures and cooperative joint ventures.
- The Explanation categorically prohibited any investment in a CLS. The Second Supplementary Provisions partly lifted the prohibition by allowing Holding Companies to hold unlisted shares in a foreign-invested CLS (i.e., a CLS with at least 25% foreign ownership interest). Under the Decision, Holding Companies may now also invest in CLSs with less than 25% foreign shareholding. In both cases, Holding Companies may only hold unlisted shares of CLSs.

- Holding Companies were also not permitted to hold equity interests in limited liability companies ("LLCs") with less than 25% foreign ownership interest. The Decision does not address such investments, but the Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, promulgated by MOFTEC and several other authorities on the same day as the Decision (the "M&A Provisions") expressly allow Holding Companies to acquire equity interests of less than 25% in LLCs.[3]

Debt-Equity Ratio

The First Supplementary Provisions provided that a Holding Company may take out loans up to a maximum of four times its registered capital. The Decision expands this limit to six times the amount of the registered capital for Holding Companies with registered capital of at least US$100 million. As before, MOFTEC may approve higher borrowing limits.

Provision of Services

Services to Invested Entities That May Be Provided from Inception

Under the Holding Company Provisions, Holding Companies are permitted to provide certain services to an Invested Entity if the services are approved by a unanimous board resolution of the Invested Entity. These services may be included in the initial articles of association (the "Articles") of the Holding Company and, upon approval of the Articles by MOFTEC, will become part of the Holding Company's approved scope of business.

The Decision has slightly amended the list of such services.

Holding Company Provisions (prior to the Decision)	Holding Company Provisions (as amended by the Decision)
• Assist, or act as agent for, Invested Entities in the purchase, domestically and abroad, of (i) machinery, equipment and office equipment for the own use of the Invested Entities, and (ii) raw materials, spare parts and components required for production.	• No change.
• Assist, or act as agent for, Invested Entities in the sale, domestically and abroad, of products manufactured by Invested Entities, and provide after-sales services.[4]	• No change.
• Balance foreign exchange among Invested Entities with the consent and under the supervision of the relevant department of exchange control.	• No change.

[3] The M&A Provisions provide detailed rules on acquisition of equity interests in LLCs and shares in CLSs by foreign investors and Holding Companies. A Paul, Weiss translation and analysis of the M&A Provisions is available on request.

[4] See Footnote 5 below.

• Assist Invested Entities in *recruiting personnel and providing technical training, market development and consulting.*	• Provide *technical support, staff training, enterprise internal human resources management and other services* to Invested Entities *in the process of product manufacturing, sales and market development*.
• Assist Invested Entities in seeking loans and providing guarantees.	• No change.

As a result, Holding Companies may now also provide human resources management services to Invested Entities. This allows foreign investors to centralize this critical corporate support function at the Holding Company level, which they were not allowed to do before. Moreover, the list of services with respect to manufacturing, sales and market development is open-ended: Holding Companies may provide "other services" to Invested Entities. In practice, however, MOFTEC may require that those services be specifically listed in the Articles as approved by MOFTEC.

Services to Invested Entities Subject to Satisfaction of Additional Requirements

Under the First and Second Supplementary Provisions, certain other services (the "Additional Services") may be provided by Holding Companies only after they have satisfied certain requirements (the "Additional Requirements"), which cannot be fulfilled immediately upon establishment. Accordingly, MOFTEC does not allow these Additional Services to be part of a Holding Company's scope of business under its initial Articles. After a Holding Company has satisfied the Additional Requirements, it has to obtain MOFTEC's specific approval for amendments to its Articles and scope of business before being able to provide the Additional Services.

Through the Decision, MOFTEC has expanded the scope of Additional Services.

Scope of Additional Services under the First and Second Supplementary Provisions (Prior the Decision)	**Scope of Additional Services (Under the Decision)**
• Act as domestic or international distributor of the Invested Entities' products.[5]	• No change.
• Provide transportation, warehousing and other general services.[6]	• No change.
• Conduct systems integration and resale of Invested Entities' products as part of the system integration.[7]	• No change.

[5] Provision of these services must be authorized by a unanimous board resolution of the Invested Entity. The First Supplementary Provisions originally listed agency services for Invested Entities as Additional Services, which are subject to the Additional Requirements. However, such agency services are also listed in the Holding Company Provisions and thus not subject to the Additional Requirements. The Decision eliminates this discrepancy by deleting agency services from the list of Additional Services.

[6] Provision of these services must be authorized by a unanimous board resolution of the Invested Entity.

• Import and sell small quantities of imported products for market testing purposes.[8]	• No change.
• *Leasing services not permitted.*	• *Lease of equipment to Invested Entities under operating leases.*

The right to lease equipment to Invested Entities is a welcome addition to Holding Companies' business scopes. "Ordinary" foreign-invested enterprises (other than finance companies) are not permitted to lease equipment to other companies as part of their regular business, and they may import equipment only for their own use.

MOFTEC has made the right to provide Additional Services subject to more onerous Additional Requirements than was previously the case.

Additional Requirements Under the First and Second Supplementary Provisions (Prior to the Decision)	**Additional Requirements Under the Decision**
• The Holding Company must have received $30 million in capital contributions.	• Same requirement.
• *No requirement regarding equity investments by the Holding Company.*	• *The Holding Company must have made at least $30 million of equity investments in Invested Entities.*
• *The Holding Company must own at least a 10% equity interest in the relevant Invested Entity.*	• *No requirement regarding the size of the Holding Company's equity interest in the relevant Invested Entity.*

The new Additional Requirement for a Holding Company to have invested US$30 million in Invested Entities before it can provide the Additional Services to its Invested Entities delays the point in time when the Holding Company can become fully operational. In many cases, the foreign investor will not have made equity investments of US$30 million until it identifies, negotiates, obtains approval for, and funds new investment projects. Under the Holding Company Provisions, investors have two years to make their capital contributions to the Holding Company.

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[7] The full wording of the Decision is: "Carry out systems integration on products purchased from Invested Entities and subsequently sell such products domestically and offshore. If the products of the Invested Entities cannot completely satisfy the requirements of the systems integration, a Holding Company is permitted to purchase domestically or offshore other products to complete the systems integration, provided that the value of such products shall not exceed 50% of the value of all products that are needed for the systems integration."

[8] The full wording of the Decision is: "Prior to the commencement of production of an Invested Entity, or prior to the commencement of production of new products by an Invested Entity, in order to carry out market development for such products, [a Holding Company] may import from its parent company in small quantity products that are identical or similar to the products manufactured by the Invested Entity for domestic trial sale, provided such products are not subject to import quota administration."

Note however, that there is a general requirement under the Explanation that Holding Companies must use their registered capital to make "new" investments of US$30 million. The Explanation narrowly defines "new" investments as capital contributions to newly established or existing foreign investment enterprises, but does not include acquisition of equity interests in foreign investment enterprises from third parties. MOFTEC has in practice taken a less restrictive view. The Decision, however, does not refer to "new" investments. Accordingly, we believe any equity investment (other than transfers of equity interests from an affiliate of the Holding Company) could count towards satisfying the US$30 million investments in Invested Entities.

Although the Decision does not address grandfathering, it is likely that Holding Companies that have already have received approval to provide the Additional Services would not need to satisfy this new Additional Requirement under the Decision. The pre-approved Holding Company could be grandfathered and may continue to provide the Additional Services.

Services to Third Parties

In addition to services to Invested Entities, the Decision significantly expands the scope of services a Holding Company may provide to other entities.

Scope of Services Under the First and Second Supplementary Provisions (Prior to the Decision)	**Scope of Services Under the Decision**
• Provide consultancy services to the Holding Company's direct shareholders.	• No change.
• *Consultancy services to affiliates not permitted.*	• *Provide market information, investment policy and other consultancy services to affiliated companies of the Holding Company.*[9]
• *After-sale services to affiliates not permitted.*	• *Provide after-sale services to the Holding Company's parent company.*[10]
• Technical training services to Invested Entities' agents and distributors and under technology transfer contracts.[11]	• No change.
• Export of products not subject to quota or export license requirements that are not	• Export of products not subject to quota or export license requirements that are not

[9] "Affiliated company" is not defined in the Decision or the documents amended by the Decision. There is also no consistent definition of "affiliated companies" in PRC regulations. In addition to companies under common control with the Holding Company, these consultancy services can possibly also be provided to companies which have a lower ratio of common ownership with the Holding Company.

[10] This is an Additional Service and subject to fulfillment of the Additional Requirements. "Parent company" is not explicitly defined in the Decision or the documents amended by the Decision. The term is intended to refer to the ultimate owner of the foreign (and domestic, if any) interest in the Holding Company.

[11] This is an Additional Service and subject to fulfillment of the Additional Requirements. The full wording of the Decision is "Provide relevant technical training to domestic distributors and agents of products manufactured by Invested Entities, as well as domestic companies and enterprises that have entered into technology transfer agreements with [the Holding Company] or its parent company".

produced by Invested Entities *as distributor*.	produced by Invested Entities *as distributor, as agent or through a purchase office*.
• *Off-shore construction projects not permitted.*	• *Participate in off-shore construction projects.*[12]

Thus, the Decision allows Holding Companies to provide more services to a broader range of affiliates than was previously permitted. This coincides with the wishes of some foreign investors, who want to build their Holding Companies into profit centers for services to other group companies investing in China.

The Decision also expands the scope of trading activities with non-affiliated entities that Holding Companies may conduct and for the first time allows them to participate in construction projects.

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Creating a single vehicle for various types of investments in China and centralising service functions are two of the main objectives of foreign investors in establishing Holding Companies in China.

MOFTEC was — and still is — very restrictive with regard to the investment methods available to Holding Companies. The right to hold unlisted shares in CLSs with less than 25% foreign investment granted under the Decision does not exceed what foreign investors are allowed to do directly under the M&A Provisions or indirectly through other types of foreign-invested enterprises. Holding Companies continue to be denied access to capital markets — they may neither list themselves nor hold listed shares in other companies.

With regard to services, the Decision represents a more significant step forward. Holding Companies may now provide various support services to their Invested Entities, and also act as market access and investment consultants for other affiliates. Foreign investors should consider whether they can benefit from the enlarged scope of permitted services to rationalise the organisational structure and improve the efficiency of their China-based investments.

[12] This is an Additional Service and subject to fulfillment of the Additional Requirements. The full wording of the Decision is: "In accordance with relevant State regulations, participate in foreign construction contracting with Chinese enterprises having foreign construction contractor operating rights".