FINAL TRANSCRIPT

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**ACCA - New Opportunities in Retail and Wholesale Distribution in China

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PRESENTATION

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Okay, let's go ahead and get started. First of all, good morning, good afternoon or good evening to all of our participants. This is Dick Mosher. I'm the current Vice Chair of the Council of the Committees of the Association of Corporate Counsel and the past Chair of the International Legal Affairs Committee.

And you've joined us for a Webcast on new opportunities in retail and wholesale distribution in the PRC. This Webcast will last approximately one hour. It's presented by the Association of Corporation Counsel International Legal Affairs Committee and the law firm Eversheds LLP, who's the 2004/2005 International Legal Affairs Committee sponsor.

And today we're going to be talking about new opportunities doing business in the PRC. Let me give you a couple of general guidelines and some information about the Webcast. And then I'll introduce the speaker and turn it over to him.

The Webcast itself will be available approximately an hour after conclusion on the ACC Website, and that includes the slides and the bio and the contact information for our speaker. And it will be accessible on the ACC Website for approximately one year.

respect to questions and answers, we welcome any questions - even if they're not specifically limited to the topic or the slides - as long as they have to do with doing business in the PRC. And you can e-mail me at HAJIME01@msn.com. There's a direct link on the ACC Website as well and I'll pass those questions on during the Webcast to our speaker. We'll also try and reserve a few minutes near the end for questions and answers that we haven't had a chance to cover before that.

I'm very pleased to introduce our speaker today, Andrew Halper, from Eversheds LLP. His full bio is listed on the Website. Let me just give you a few very brief highlights. Andrew is the head of the Eversheds' China Business Group and also a partner in the firm's corporate group. He splits his time - when he's not traveling on business - between the U.K. and China.

And Andrew advises both companies pursuing business in China and Chinese companies engaged in business outside of China. He's a dual national citizen of the U.K. and Canada and has gone to a number of outstanding universities as well as being a member of the diplomatic service serving in Hong Kong and Beijing. So, I think Andrew has a unique background from both a regulatory perspective, a legal perspective and a business perspective. And I thank him for his time and welcome him to the Webcast.

The slides are available on the ACC Website and Andrew will tell us when he moves from one slide to the next. Andrew, thank you.

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Thanks very much, Dick, for that. Good morning everybody - or it's the afternoon here in London in any event.

I think this is a really interesting topic because it actually encapsulates many of the issues surrounding all foreign trade and investment work in China. And that's one of the reasons that I asked Dick to mention to you that throughout the course of this and also at the end, I'll be very happy to take general questions about, basically, structuring deals in China. Even those that don't fall within the gambit of today's talk. Because these issues map across to all sectors in China, really.

And I think it's important, obviously, given the economic importance of the place that people separate myth from reality in China and I think this is a great sector to start, because this is exactly where, really, there was a kind of a set piece in everyone's thinking for a long time. You just can't do this in China. You can't do retail and wholesale work in China. The only way to do it is to do it improperly or to dress up the deals in some way that they shouldn't be presented and hope that you can skate by.

That was to a certain extent true in what I call the bad old days - and I'm on slide two now. It's the first substantive slide. The sector - if I can call it "a sector" - this general area of investment for foreign investors was a great illustration of pretty severe Chinese protectionism. It's true that foreign investment had been welcome for a long time since, really, the very late 1970's, early 80's. And I've set out some of the ways in which it was welcome.

Actually, I should demystify some of these concepts a little bit. JV's - those are obvious. It was eventually also possible to do foreign investment in the form of WFOEs. Now, what is this inelegant acronym? It's Wholly Foreign Owned Enterprise. It refers to nothing more or less than a wholly owned subsidiary established within China, therefore a Chinese legal person holding the subsidiary of a foreign - that is non-Chinese - company.

So, the general wisdom or the prevailing wisdom was you can't do this stuff in China. And it was really true for a very long time. Notwithstanding the opening, there were very severe restrictions and I've set out what those severe restrictions were. One was by sector. Now, I've mentioned there were a series of successive guidance catalogues. Those were catalogues of investment sectors published by the PRC government. They still use them as well.

They've liberalized over the years. They were first issued in the late 90's primarily under pressure from the U.S. government - the U.S. trade route in particular - because the complaint for a very long time was, what are your rules? What are the policies? What are the regulations? You don't publish them.

The Chinese for a very long time relied on what they called Nable Guding (ph), which are inner administrative rules or sort of internal administrative rules. Not available to foreigners. If you got to know people in the ministries pretty well they would show them to you, but not let you take copies. And it was a really, really murky environment. So, they were dragged reluctantly into the light of a bit more transparency. I'd say primarily by the U.S. leading the charge for many years of long discussions with the Chinese. And they eventually started publishing catalogues which they would basically take virtually all potential investments and classify them as prohibited, restricted, permitted or encouraged. And there would obviously be different rules of establishment, different rights, depending on which category they fell into.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Andrew, may I interrupt you for just a minute with a question?

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Yes.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

I know doing for ventures in the PRC over a long period of time we ran into this issue a lot of unpublished regulations. And what would happen is, our proposed partner would tell us that there's a regulation that's about to be published, but we'd have a lot of difficulty getting a copy and knowing whether to rely on that or not.

If you're doing business with PRC and your partner or proposed partner tells you what I used to hear, how best to verify whether or not that's something you can rely on?

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Well, the best way, really, is to actually go and make contact with officials directly yourself. And in fact, to tell you partner - in many cases, I think, it's okay to tell your partner to do it. Otherwise, if it gets back to him or her, it looks like you're trying to do a bit of an end run around them.

We had a case just earlier this week, in fact, in which I'm acting for a U.S. chemical company wanting to establish a chemical manufacturing plant not too far from Shanghai, but not within Shanghai municipality, which has its own regulations and rules, then a neighboring province.

And not withstanding the PRC company law, a minimum registered capital requirement for companies established in the PRC, we were being told by the Chinese party that in fact the minimum registered capital requirement was several multiples higher than the published figures in the company law.

So, we made contact with the officials and we actually got contradictory responses. We did learn at the end of the day that, in fact, they have a local - I wouldn't even call it a regulation - a local policy document that calls for that. So, in that way we were, you know, carrying out a kind of a verification of what this guy was telling us.

We haven't yet determined exactly how to deal with it, because the policy statement itself provided that this is in principle to be applied and thereby signaling pretty loudly that it's open to exception. So, I think we're going to probably get into a lobbying situation. And I would prefer to do it with the full knowledge of the Chinese partner and say, we've got a problem together. We've got to solve it together, but I would not rely on him or her to be the sole channel of communications with officials. I think that's disastrous, really, as an approach.

The question, of course, that you asked is that at point is, well, how do you make contact with officials? And you know, it obviously helps to speak Chinese. But I speak Chinese fluently, but they won't always talk to me. I've often got to send someone from my Shanghai office who's a Chinese lawyer and born and raised in China because they often don't want to talk to foreign lawyers about these sorts of policies.

But one way or another, contact has to be made with them and a request has to be made for the actual policy statement. How you deal with a policy statement which probably has no legal foundation? Well, you enter a negotiating situation. You can't run into a Chinese court and say, this regulation or this policy is void and I want you to declare it so. That's non-starting in China.

So, you've got to find a way to trim your sails to the winds.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Thank you.

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

With pleasure. Now, so, I was talking about the sort of restrictions. The guidance catalogue is one form of restriction and there are some key concepts here, actually, on this slide too that we might as well just spend a couple of minutes dwelling on, because it would help, I think, for the rest of the slide.

The restriction was on scope of business as well. Companies established in China and particularly foreign investment enterprises do not have all the legal powers of a natural person, nor do they have the full range of corporate powers which are commonly set out in the constitutional corporate documentation in any of our jurisdictions. They instead are only allowed to do the things which are set out in their business license as falling within their scope of business.

It's pretty much an illustration of the old line that in a capitalist society anything not specifically prohibitive was permitted and in a communist society anything not specifically permitted was prohibited. And I think this is, in away, relevant to that. So, you know, they would restrict you by scope of business and say you could only do X, Y and Z.

And another technique, which was commonly used in what I call the "bad old days" was the high registered capital thresholds. There's no two pound company or off the shelf company for - with minimalist capitalization. In China, foreign invested enterprises have to be capitalized by the party's making their respective capital contributions. And they would set very high thresholds as a barrier to entry.

Another tactic was to limit the equity proportion of the foreign party. And as I said, there had been a gradual evolution from making foreigner stakes to minority stakes, to equality to permitting majority positions and then finally, to permitting WFOEs. That's what they're called. I didn't invent the term. And that's wholly foreign owned enterprises.

Another restriction was geographical ambert (ph). And in fact, up until the 11th of December last year foreign invested enterprises conduction retailing operations were in fact limited to provincial capitals in China and cities under the central government authority. That would be Beijing, Shenzhen, Shanghai and Chong Ching (ph). Those are cities that function sort of like Washington, D.C. or Mexico City. They're like provinces or states.

And of course, there were very burdensome approvals processes requiring central government approval. So, when we turn to the next slide now what we're going to be chasing is kind of an historical evolution over the last, really, just a few years. When the door starts to open. And it wasn't night and day when WTO accession occurred on 11th of December, 2001 in China.

They had been liberalizing in certain respect prior to that in part because of a recognition that they needed to liberalize their economy, not just to be nice or good guys, but really because they needed the foreign investment, they needed the capital, they needed the technology, the know-how. And they were being battered by waves of investors telling them - and chambers of commerce as well - tell them, look, we need more access.

And it was also a negotiating tactic to deal, again, primarily with the U.S. government on the WTO issues. They were in effect throwing (inaudible) to the West and saying, look, we'll give you this and we'll give you that. And they were doing it, you know, like any country will engage in trade liberalization. On the basis of self-interest we all do it. It's nothing unusual for China to do it.

So, they started, actually, on a kind of a trial basis back in '92 and that's again, typical PRC liberalizing lawmaking with regard to foreign investment. And just because they're in WTO doesn't mean that this paradigm or this pattern won't be continuing. It will be continuing. It still continues in other sectors where they haven't committed under WTO to liberalize because they don't need to liberalize anything which is not explicitly within (inaudible) protocol.

So, typically, though you have kind of a trial project. Again, the rules will be sketchily published. They'll allow it in certain places with certain restrictions. And that's what they did with retail and wholesale. Then they came in more seriously in '99 with something we've called the pilot procedures.

It's the procedures concerning pilot projects for commercial enterprises with foreign investment. A very pretentious title, but basically it started to allow in systematic way retail and wholesale but with extremely high qualifications for investors, as we will see over the next few slides.

I pointed out at the bottom of slide three that foreign investors did try and get around that by going for local approvals. These things are risky and they were shutdown in a lot of cases. Actually, across a lot of sectors there were problems. And telecoms is the most striking sector. It may not be relevant, but to let you know how things went in China before lawmaking was as clear as it is today.

Foreign investment in telecom service and telecom's operations through the 90's became very much the kind of a flavor of the month and there were 43 elaborate structures setup in the guise of joint ventures to permit - very intimate joint ventures - to permit foreign telco operators to do what otherwise national law in China said they couldn't. All of those 43 projects were approved in sort of a nudge and a wink way by the central government. And a few years later, all of them were shut off.

And of course, that set off negotiations. And it wasn't as if everyone was simply booted out without anything, but it was pretty scary going for a lot of companies.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Andrew, let me followup on this one, since two of the four ventures that I was involved in proceeded with local approval only. And in both of those cases, our local partner was the one who really didn't want to go back to Beijing for formal approval. They really wanted to move forward, and naturally, U.S. investors were anxious to move forward immediately. They didn't want months and months of delays going back to Beijing for approval.

But at least in the manufacturing industry - this was white goods manufacturing - I guess we didn't realize the nature of the risk that may have been there in telecommunications or other areas. You're saying this is a serious risk? This actually happens and when it does happen, they first try to negotiate with you?

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Yes, I mean, the central government will - the typical case would be that one puts together this kind of structure. It's a violation of central government rules. It's not so much that they - you know, sometimes they find out about it and start cracking down on you. But in other cases, the Chinese party become predatory in some way and sooner or later the foreign investor ends up going into see its embassy officials and sooner or later asks for those officials to go and make representations to Beijing - to the central government.

And those - I saw this in the Canadian embassy and I know my colleagues down at the U.S. embassy and other foreign embassies were having exactly the same experiences. You know, somebody - a minister counselor for a commercial section in the embassy would go in and see somebody in the Ministry of Foreign Trade in China in Beijing and they would say, you know, we really feel that this is a very, very serious case and we're quite worried about the treatment and we don't like it, but there's nothing we can do because it wasn't established on proper legal ground.

We sympathize enormously. Well, that doesn't help very much. So, I was confronted with this kind of suggestion on any number of occasions. And you know, obviously, one has to be creative and flexible. But at the same time, national law said for a long time that any project of a total investment - in other words, debt and equity - 30 million and over - 30 million U.S. and over had to get central government approval.

So, there's no sense acceding to a Chinese party's suggestion that, well, let's just take this $100 million project and break it up into four projects. Yes, they'll all have the premises, the same Board, the same Chairman. But don't worry, Beijing doesn't need to see it. You end up having all kinds of trouble. You know, if you don't, it's a point of vulnerability later.

And I just think it's a nonstarter, frankly. There are people that will need to be robust and go out in front and venture into grey zones. That's fine, but what we're talking about is normally not grey. It's normally pretty black and white.

So, in terms of what commercial people do with regard to their decision making when, clearly, there are some areas where there just isn't clear legislation and no one knows what the rules are. But it's not as if one is going in and doing something illegal. That's different. People, if they want to be pioneers they have to take chances.

But in many of the cases that we would be talking about, Dick, it's simply a bad suggestion from the Chinese side. I think the name of the game in China is not to say these approvals are just too much trouble. There's a huge stack of government and ministry approvals I need. I just want to find a way to reduce that. I think the name of the game is collect the whole series. You can't play them with your friends, but you should certainly be collecting the whole series and considering them as kind of insurance policies actually.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Andrew, how have things gotten better now?

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Well, there's enormous increase in transparency of rule making. The quality of decision making by officials and the level of education by officials in many of the ministries and even in the provincial governmental department has improved a lot. Much more exposure to the outside world.

There's been a lot of people in China have figured out that Western investors are not all there to rip them off. In fact, there's often a better feeling about Western investors than about other Asian investors. We're all reading the headlines about Japan now. That's a special case, but there have been lots of unhappy stories about Korea and Singaporean and Hong Kong investment - and even investment into the mainland.

So, the sort of feel and the atmosphere has changed. I think it's pretty good, actually, for Western investors. The work force is better educated. People have seen more. They understand more about the outside world. I think the place has matured a lot. And obviously, there's been this factor of liberalization that we're talking about today.

So, to go back to the ground zero or day one for the big liberalization in China in retail and wholesale was last year in the 16th of April when they promulgated these new procedures for administration of foreign investing in the commercial sector.

And that was effective on the first of June. And again, they were meant to be complying their WTO accession commitments and that's what they did. Just in the sector alone, this is a huge step, actually, and everybody in my end of the legal services market thinks this is a very important move by China.

And what's also interesting - this is a very, very small point. It's not on slide four. But it's that the very last article of this new set of regulations explicitly revokes the 1999 regulations. And a lot of the listeners will say, well, big deal. Isn't that what laws are supposed to do? There are supposed to be transitional provisions and so on. Actually, they didn't do that for a very long time and this is very sloppy legislation - legislative craft in China for a long time. And there they've done it. So, it's just a tiny way of illustrating that even at the level of legislative drafting they've upped their gain quite a bit.

We've going to see a little bit later that they still have some pretty strange problems in their legislative drafting, but they are improving a lot. I do exchanges between the U.K. and China with judges from the Supreme People's Court, which is the highest court in China. The higher you go in the court system, the better it gets in terms of the quality of decision making. So, there's a lot of changes across the board.

I don't want to be a Polyanna about it. It's still a place where litigation is rarely a serious option. Where it is a one party state. Judges are in that sense compromised, you know, every time they wake up in the morning they've got to face a day of making decisions which are going to be constrained by politics.

A lot of them are unhappy about it and will tell you candidly in Chinese that that's so. The place is starting, though, to liberalize not just in legislation, but in people's minds as well. I think this is quite clear.

So, let's turn to slide five and talk about some of the changes. After December 11th of last year, wholly foreign owned enterprises are now allowed in this sector. Subject to some restrictions, which we'll talk about a little bit later. The high capitalization and minimal annual turnover requirements, which I'm going to describe in just a moment, have been completely eliminated. And that's a huge change.

The geographical restrictions on wholesalers and retailers have been ended. Those are the ones that happen in certain cities, as I mentioned earlier, and there's a much wider scope of business. It also - franchising commission sales for wholesalers.

And you know, wholesale commercial enterprises themselves are now allowed to engage in retail in a way by way of third party franchisees. And also, I'd like maybe to expound on one of the points in slide five, which is the so called related services or associated services are now possible.

And I took a look at the WTO protocol - the accession protocol. And for wholesalers, there are pretty important. This was assembly, sorting and grading of (inaudible); breaking up (inaudible) and redistributing into smaller lots. Delivery services, refrigeration, storage warehousing, garage services, sales promotion, marketing and advertising, installation and after sale services including maintenance and repair and training services.

Now, to a lot of people, they may say, well, of course we've got to be able to do these things. But just a beautiful illustration of how restrictive things were in China until just December of last year when you had to fight tooth and nail to get any of these things on exceptional basis.

Now, turning onto the next slide, which is slide six, this is where I make reference to the high capitalization and minimum annual turnover requirements. Retail joint ventures -

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Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Andrew, if I could interrupt just a minute and a question came in that might be appropriate to answer now. And if possible, in something a little bit later. I'll let you determine. But two questions, really. One, does China now allow a U.S. company WFOE to sell hardware and software directly to Chinese companies? That's question one.

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

There are some special rules about software. Hardware is okay. There are some special rules about software which are being discussed now. Some of your listeners - some of our listeners may have noticed articles in the newspapers the other day where they're, in effect, attempting to prevent too many sales of Microsoft products in preference for Linux products.

So, I think the situation is a little clear right now. But as a general proposition, retailing can include hardware and software.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Okay.

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Yes, I'm a little worried about what's coming with these - you know, I wouldn't describe China as giving with one had and taking with another, but a little bit later I will illustrate how they sometimes use some of their time honored techniques to just make sure they don't give too much having promised the world. Having promised a lot. But I think the glass is way more than half full here in terms of the liberalization which has occurred in China.

I think its economy has - and believe me, I used to do political reporting on China. I was in the Canadian embassy. I have no illusions about some of the issues in China. But I've got to take my hat off to them and say, they have moved this economy forward in terms of market access in a pretty dramatic way. And if I look at some of the squabbling between the U.S. and Canada, for example, both of whom are probably right - each which is right half the time and each of which is probably wrong half the time.

You can see that even developed economies, you know, people do not readily or easily give up protectionist reflexes. You see it all around the world. The Chinese have done pretty well, actually, I think. So, I'm waiting to see what happens to the software.

But actually, I was talking to somebody today who pointed out that he had been told by the head of Microsoft operations in Beijing last week that they estimate 90% of their software that is sold in China is pirated. But they're chasing much less than they used to the pirates because the thinking is beginning to turn toward - or so I'm told - the thinking is beginning to turn towards the idea that well, you know, it's going to happen anyway. At least this way our products become the ones that people need.

So, they'll make their money off maybe the other 10%. Who knows. I can't speak for them, but it is a huge problem, of course, and now another problem with the reported restrictions on - restriction was not on selling to the public. It was on procurement by government. I think that should be pointed out.

And restriction is mooted. It hasn't been promulgated yet. So, they're trying, obviously, to do things they think they can get away with in terms of WTO commitments.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Okay, and now - I'll defer another question on currency conversion for a little later, but go ahead.

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Yes, but that's always an interesting topic. Far less scary than many people think. On slide six I talk about the relaxation of investor qualifications. And these things are all gone now. It's just striking when you look at it that the retail joint ventures, the procedures require that - of '99 - that foreign parties had to have pretty massive annual sales. And fairly substantial net assets. And the same was true for wholesale joint ventures as well. Again, high level of sales of net assets.

And over onto slide seven, you know, when we're continuing to talk about relaxation of investor qualifications, the Chinese party also has some very high thresholds. I didn't put the figures on the slide. It doesn't matter, they're gone now anyway.

But the new procedures do eliminate all of that. But here's where there's a bit of a sting in the tale. They do encourage foreign parties with quite strong economic resources, et cetera, et cetera. It's there on the slide for people to see - advanced distribution skills and management experience.

Now, what does that mean? People maybe saying, well, what's the point of putting that in a law? What does that actually mean? Well, typically in China what that means is that those kinds of applications get to the top of the in-tray. And other applications can be deferred and studied in a more searching way. And even though it may involve the defacto in position of thresholds, which are not permitted under the WTO accession protocol or under this new legislation.

So, I think it looks, you know, on the surface to be fairly innocent. I maybe that they're more likely to get - such enterprises are more likely to get investment incentives, but there's a problem there as well with the level playing field issues. So, I think this is a danger, you know, in China.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Andrew, I've got to ask the question that I'm sure some of our thinking when they see language like this. It looks like an invitation to a U.S. foreign corrupt practices act issue. In other words, okay, we're going to have to convince someone in the government that we meet this definition and that's going to mean some payments and we're going to have corrupt practices act issues.

Am I blowing this out of proportion or not?

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Well, I wouldn't accuse you of blowing anything out of proportion, Dick. But it's very easy, I think, in China to take rigorous stab. I don't mean to dismissive of people who have to wrestle with the problems on the ground. But actually, I don't think it's hard to maintain a rigorous policy of not giving into any of that in China.

There are some countries that are notorious for being places where you cannot move without paying bribes to everybody and his brother. China's not that kind of place. I'm sure it's true. I know the country pretty well. I lived in Beijing for seven years. I saw a lot in China, but I can say that certainly in some places in smaller localities, you know, you still get a lot of officials who think this is an invitation - the foreign investment is an invitation to (inaudible) themselves. Of course.

But the way it's normally done in China is that on there side, the privatization of state assets process is taking place so that what used to be state enterprises are being turned into companies limited by shares - private companies. And of course, people who are local power potentates will end up receiving those shares and therefore, you know, taking state assets in a way which is apparently legal, actually.

And so, by the time the foreign party sits down to negotiate, the major theft has already occurred. And it's a political issue in China in some ways. There is some disgruntlement about it, but that's just what happens in China. I think it's quite clear that there's a conversion of political power into economic power. That doesn't need to involve a foreign investor in any way.

It's something that's a process which has happened before the foreign investor ever meets the Chinese party. And the resulting entity is, you know, they can be perfectly legal, totally solid entities. It's just that it helps to have connections and you get that kind of position in China.

Foreign parties don't have to worry about paying money or bribes or anything like that. It's a very slippery slope, obviously. It's not just illegal, but it's also very foolish in China commercially because it's an invitation for others to have a handout.

So, actually, maybe my clients just don't tell me, but in 11 years of doing almost entirely China work, I've never heard of a client being asked to pay money. So, I don't know, I don't think they're not telling me. I just think it's not happening and I think they're promoting the right atmosphere in their dealings with their Chinese counterparts.

So, but I still don't like this kind of lawmaking, of course, because it's an invitation to arbitrariness. I just think the way around it is you have to martial your arguments and have to demonstration, you know, that you've got all these qualifications. The problem is, it's those without strong backgrounds are going to have to struggle that much harder.

So, I suppose I'll take your point, Dick, that it could result in that but people have to be rigorous and just not go for that. I think.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Thanks, great.

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Page eight or slide eight is another really big change. And this is the registered capital requirements have been lowered. They used to be quite high - 8.2 million RMB is $1 million U.S., so you can work up a sum. It's about - it used to be 6 million in registered capital.

This is capital that had to be fully paid up. And I presume they're going without the slides in front of them, but they're pretty high - reasonably high registry capital requirements in China for these enterprises previously. And now everything has been knocked back to the company while registry capital requirements, which are basically nothing - 300,000 RMB for resale of 500,000 for wholesale.

Of course, companies will usually need to capitalize more than that because I should warn the listeners, there are debt equity leveraging restrictions in China so that you can't over leverage with debt. If your registered capital isn't high, you can't take out 10 million U.S. and or incur 10 million U.S. debt if you've only got 0.5 million in registered capital.

The ratios in fact, are for the combined debt and equity if it's under 3 million U.S., 70% of that has to be capital. If it's between 3 and 10 million, the ratio is 60/40. If it's 10 to 30 million U.S., the ratio is 50/50 and above that it starts to become more flexible.

So, you can see that in terms of permitted debt levels, you run out of headroom pretty quickly in China with your capital structure if you do not put in enough registered capital. That's the combined registered capital of both parties. So, that's an entire subject in itself, of course.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Andrew, this might be a good point to insert another question that's come in by e-mail here, which is, what's the easiest way for a U.S. company to get money into the PRC and to convert to RMB?

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

That's easy, actually. I mean, there's always a bit of a problem with jiggling the capital structure a little bit, because in the joint venture contract - if you're doing a joint venture, for example, the parties are agreeing to capitalize. The Chinese party will be putting in either RMB in cash or in kind contributions of plant and equipment.

And then because your equity proportions will flow from the respective amounts of capitalization, you've got to match up the foreign currency - the U.S. dollar capitalization. So, you peg it at a certain rate and that's okay with officials.

Once the - the way your bring the money in is well, first of all, you don't bring it in until you've got all your - obviously, until you've got your joint venture contract signed and you've got your full set of approvals and third party consents and licenses and permits and asset acquisitions. You should have very extensive conditions precedent in your joint venture contract, which are specifically conditions precedent to the foreign parties obligation to capitalize.

If you don't have those and rely on them and not waive them, you lose your leverage. Because Chinese parties are always saying, you know, they're not saying it as often as they used to. Just put the money in, you know, that would show good faith. But they will come up with 1,101 excuses why they can't get every little piece of paper that you've agreed that the joint venture needs.

And I think it's extremely dangerous to go ahead without that because those things are critical. If you put in the money, you've lost your leverage. So, you know, we have - we used to sell this thing in Canada called the Roach Motel. A little box with sweet smelling stuff to attract roaches and a sticky floor. And the moto - the advertising slogan was, Roach Motel. Roaches go in and can't go out.

Well, China could be the Roach Motel of foreign investment where the money goes in and doesn't come if people are not careful about relying on the conditions precedent. So, I don't know if that really answers the question. But getting the money in is easy. You can designate the exchange rate. You can peg it at a date certain or you can stipulate that it will be at the midpoint of the buy and sell rate of the Bank of China for the date of contribution. And then you can jiggle the valuations for the Chinese party's assets accordingly to make the numbers work - in a legitimate way.

I mean, we're talking about very modest sort of de minimus modifications. Pretty easy in the world of nonconvertible currency where the RMB isn't floating freely. It becomes a little bit more complicated at such point in time when it floats. But not withstanding the recent request by the U.S. government to let the Chinese do that, I don't think they're about to do that any time soon.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Okay, Andrew. I'll let you get back to your slides here.

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Okay. Now, one thing I did want to say towards the bottom of slide eight, a bit of a warning. We talk about now only the PRC company law requirements are imposed. Well, I mentioned, I think, a little bit earlier the experience that we had near Shanghai where, you know, suddenly for a foreign invested plants you needed to have U.S. 2 million in registered capital according to one of the officials we talked to. And he produced a so-called Opinion - with a capital O - a genuine opinion. That is a policy statement from the local government. That's completely illegal.

So, remember that although the large registry capital requirements have been abolished, you still have a problem to face if you're in a smaller locality and they say, well, yes as a matter of policy, though, we're for the time being requiring three times X rather than X itself for registered capital. So, that's China for you.

And you know, the modernization process and the adherence to national law is sometimes spotty in some of these - or sketchy - in some of these localities. You've got to pick your spot, I think, in a way and go to the more forward thinking places.

So, we're over to slide nine and that's equity ratios have been liberalized as well. And we'll probably move a little bit more quickly through this because I think it's pretty straight forward. The Chinese party had to be majority stake in certain cases. Now, generally speaking, though the requirements for that - there's a bit of a carve out, which I've stipulated there. Books, newspapers, magazines.

If there's more than 30 retail outlets for any of these things, then there's still a requirement for a majority Chinese party stake. And that's more than 30 retail outlets. And the restriction with regard to cars specifically - that is more than 30 retail outlets in cars is going to fall away in December of next year.

One thing that I could say is where I've said sugar and cotton or products from multiple suppliers. We're having a little debate here in the office about whether it's "for" or "and" because - I think the listeners might like this - there are two kinds of commas in Chinese. There are some that are sort of conjunction and there's disjunctive commas.

And my Chinese colleague here agrees with my reading of the text that they've used the wrong kind of comma. So, it probably is "or," but she says it's "and." You still have these kinds of legislative problems in China. You know, is it all those things I've listed and the products from multiple suppliers? Or is it "or?" It's still a fun area of practice in that sense because there's a lot of funny issues that do crop up.

It's not so funny for the clients, of course, when they don't know what the law is.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Andrew, are there issues related to transparencies in investors? I'll give you two examples that I ran into. One, when we wanted to have over 50% ownership, we would structure a 2% owner in Hong Kong that we in effect controlled to get around the limitations at that point. And we never really go into the whole question of how that had to be disclosed or not.

We also ran into Chinese parties that had hidden investors in their companies. Is that still an issue going either direction?

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Yes, let me just ask you though, about that - when you have a 2% investor say or 2 or 3% investor in Hong Kong. You have three parties for the joint venture in effect.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Right. We had 49%. The party in Hong Kong had 2% and the remainder was the Chinese party.

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Well, the problem is that the Hong Kong for foreign investment purposes - for almost all purposes - nearly constitutes a foreign jurisdiction in China despite the fact that it returned to the PRC in 1997. So, actually, having a 2% shareholder in Hong Kong in that scenario still makes the - the way the law should have been applied I think they weren't applying the law properly because normally if they require a majority Chinese stake, that means that you can't overcome that by having a multiplicity of foreign parties so that in the aggregate they have more than 50%. The restrictions really are the foreign party or parties because the plural and singular are the same in Chinese legal text.

The restrictions should have been interpreted in normal Chinese legislative interpretation as the foreign party or parties cannot hold more than whatever - 49%. So, it shouldn't have worked to get around it. But obviously, you're describing a situation in which I presume the Chinese party was happy with doing it that way and it was just a question of, let's do this?

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Right.

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Well, that's the wonderful story of Chinese investment over the years. And it's a good example of, you know, it's not necessarily illegal. It's not, in fact, I would think. But it shouldn't produce the desired effect. But obviously, in your case, it may well have.

So, what's helpful is that the situation has improved so that it's more and more possible not to have to look for the grey and to go straight into the black or white, I think.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

The other part of that question was, do foreign investors in China have to be concerned about hidden investors within the PRC company?

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Well, yes. I mean, you can get reps and warranties from them about who is there. I mean, at the end of the day, of course, in terms of explicit investors, they're investors because they're in the joint venture contract and they're in the business license which stipulates the name and identities of the parties.

But if the Chinese party has hidden investors, then it's much like in the West. You know, you're going to have to get reps and warranties and believe that they're accurate or carry out due diligence or verification and believe you've got the right results. But at the end of the day, you know, you can have change of control provisions and all kinds of things like that, but at the end of the day if they do that, they do that.

There's not a huge amount you can do about it. I mean, if you've just capitalized, there is a kind of change of control of one sort of another and that's a triggering element, I think you're into a negotiation rather than into a meltdown in most cases because it's very unwieldy to get everything out again. The system doesn't work that smoothly.

And that's why thin and hasty in terms of leisure really, really does apply in terms of China. You've really got to spend the front end time getting to common positions with the Chinese party and understanding where they're coming from. It sounds like a platitude, but it's really true. You have to spend a lot more time at the outset with China.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Thank you.

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

And I wanted to say, at the bottom of slide nine, which I wanted to state the obvious, which I didn't put on the slide which is that wholly foreign owned retail enterprises, which do not distribute any of those products which I've listed in slide nine, are not restricted by law in terms of the numbers of stores in China. But that's the way it appears, but a little bit later we're going to come back to that issue.

The next slide is slide 10 where we talk about the scope of business, which is a pretty important concept in the PRC. And I've think I've already explained it, which is, you're allowed to do that which is in your business license.

And I should say, as a matter of process, when our listeners are going and negotiating deals in China they should, right at the beginning, in the first iteration of heads of terms or memorandum of understanding or agreement - whatever you wish to call it - the party should start talking about scope of business and what they want to do, which will get right into product lines all kinds of things like that.

You've got to find out if there's agreement there. And you've got to put, obviously, into your contract interallia (ph), on of the conditions precedents should be the obtaining of a business license that permits the joint venture to do that which is set out in the joint venture contract as its scope of business.

So, if you don't gt that - they used to try and wiggle down the scope of business. If you don't gt what you've been negotiating for, that should be a CP to capitalization. So, what have they done with scope of business? Well, I set out in the slide that they've expanded it quite a lot. It's pretty obvious, I think, what retail enterprises do.

I should explain that related services are stipulated in the legislation as including things like telemarketing and phone marketing; mail order sales; Internet sales; vending machine sales. Again, a catalogue by reverse implication. A catalogue of the kinds of restrictions and stumbling blocks that used to exist when you tried to do these sorts of normal related sales services.

Now they're explicitly made legal on China. On the wholesale side, obviously, you can carry out wholesaling and commissioned agency work and import and export. But the related services, those include the ones that I mentioned earlier. All the sorting and grading of the bulk lots and delivery services and all that stuff.

On approval, incidentally, you can combine the retail and the wholesale within your scope of business. So, that's something that a lot of companies may wish to consider.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Andrew, how detailed do you have to do be? I mean, in the states, of course, we're used to business charters and licenses that basically say, you know, all legal businesses. I guess in the PRC if you're selling a product - if you're selling shoes, do you have to list 14 different types of shoes that you're going to sell?

How broad or how general or how specific do you have to be in these business licenses?

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Well, it kind of depends on the sector. The more high tech it is the more I find people will have to particularize what it is they want to do. You know, if it's something like shoes then I would just put in that it's the design and manufacture and sell domestically and for export of footwear of all sorts. And you just leave it like that and that's enough.

I would tend to view it like this - that the more specific - you know, it's a two-edged sword. The more specific you are unless you are comprehensive and specific, somebody might come to you later and say, you really shouldn't be doing that. It's not in your business license. You didn't specify that and you specified all this other stuff.

But you know, you've got to be particular enough so that everybody is on the same page. Everybody knows this is what this enterprise is setup to do. So, unfortunately, I can't be too perscrptive. I would just say clarity is very important on that. And often the Chinese side will say, listen, you know, it's a little complicated for officials to approve this. There's something lacking so let's just put it in vague terms so that we have an understanding with officials. Don't worry about it. They need the employment locally. Don't worry about it, it's fine.

And in fact, this - your question actually draws me to a broader comment about Chinese contract drafting in general. It's true that the standard, say, asset acquisition deal in the U.K. - I don't remember anymore how long these documents are in the United

States, but certainly in the U.K. they're about 85 pages long. And in China, the name of the game is to get that down to a comfortable 30 to 35.

So, you've got to be as concise as you can, because it is true that local legal culture - or local commercial culture - does not like really long, excessively verbose contracts. That's true. But, you know, the Chinese parties are always saying, don't worry. We'll create the relationship first. This is too complicated for officials to approve. Don't worry.

I think that's folly. I think the thing is to be clear and concise in both languages - Chinese and English. You've got to be sure it says the same thing in both and rather do it that way so that later if there's an argument you can point clearly to what the agreement is.

Now, I haven't really gone into the franchise rules, which are slightly mentioned at the bottom of slide nine. Franchising is a separate issue in China. It falls generally within these foreign invested commercial enterprise rules which we've been discussing. But just as a heads up to the audience, the most basic point to remember about franchising is that you need to have been in operation as a foreign invested commercial enterprise in China for a minimum of one year and have operated a minimum of two stores yourself before you can then franchise to franchisees - third party franchisees or any other franchisee. So, you've got that minimum requirement.

And it does not - although it's not stipulated in the legislation, there's no automatic rollover of status whereby date we've done our one year. We've done our two stores. Today's day 365, we're going to start franchising.

Typically, the approval authority, when they're granting your business license will, we believe, based on the pretty limited experience that all of us in this field have because this is all very new stuff, but we believe the almost inevitable result of every application or almost every application is going to be, no problem. Come back to us in a year and we'll examine your file to make sure you're operated the two stores in accordance with the franchise law requirements and that sort of thing.

So, you're going to find yourself back in front of them again if you're going to get into franchising.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Andrew, I know you've got a couple more slides to go, but I've got another question here that came in that seems pertinent to address now. We've had trouble getting a broad scope of business approved. What options exist to avoid problems in the future with the scope of business that is too narrow?

Are there different forms of WFOEs? I've heard reference to distribution verus trading WFOEs. Is there a difference?

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Well, the differences should fall away. There have been differences because of the restrictions on the - it's been up to the PRC officials with the 1999 pilot procedures to basically dole out whatever specific indulgences they want to or they wanted to in terms of your individual applications.

But now, you know, even companies setup in bonded zones should be able now to apply to get the omnibus powers that people have under retailing or wholesaling. It's also true for existing manufacturing enterprises in China, which are - which have not hitherto been involved in any of the retail or wholesale activities.

Those should be under these new laws able to do these things provided they comply with the new measures and also that they amend their business scope so that they have to go back in front of officials and get approval. This is, you know, you can't get away from officials to a certain extent. They don't completely ruin your life in China. It's not as if you see them every day, but there is a process to be gone through.

So, historically, yes. The answer to the question is there have been some that have just had specific aspects of distribution in their business licenses. But now it should be possible to convert these things to general scope of retailing or wholesaling or indeed both.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Great.

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

It can apply for both. So, the franchising, as I said, is a separate set of issues. And you know, it's quite clear from the legislation on franchising, which unfortunately to my knowledge, is only available in Chinese to date. I haven't seen an English translation or an official one, anyway.

But it's pretty clear from the regulations that there is a concern about kind of protection not of the Chinese market, but protection of consumers and protection of franchisees from unscrupulous franchising practices and overbearing restrictions and that sort of thing. It's quite clear that if a piece of social legislation - it's not necessarily bad. It's how they're running their country and it is a country where commercially people are wily and naive at the same time. And it's a strange combination, but you see this in legislation of the partnership laws in the same way.

There's a lot of kind of - what's the word I'm looking for? It's very protective of people getting involved in those relations. So, going over to slide 11 - there are some continuing prohibitions. There pretty minor, actually.

You know, chemical fertilizers, tobacco and a couple of other things. They're not that onerous. I want to talk just a bit - I know we don't have too much time for this product talk, but on slide 12 I want to amplify a little bit on what I put on the slide and talk just a little bit about the simplified approval process.

Hopefully it won't be too mind numbing, because I want it to sound - because I think it's even more interesting than the stuff I put up on the slide. Yes, it was a very cumbersome process previously. That's the first bullet point.

What are these acronyms? Well, there was the economic and commission, that's the ETC. It's the local version of the state economics and trade commission. And then it had to consult with Ministry of Foreign Trade and economic cooperation - MOFTEC. These two have been combined now. It's the Ministry of Commerce. It's MOFCOM these days.

And this labyrinth business of going up and going down and going to Beijing and back and all that has been simplified and streamlined to a certain extent. So, for certain defined business scope, and there's - well, they're defined rather at length in the legislation articles - Article 10, sub three and 10 sub 4.

So, basically, for an awful lot you can get it approved at the provincial level of the Ministry of Commerce. It carries out the examination and just reports back to the central government MOFCOM for filing.

I wanted to expound on that and say that in wholesale and retail alike there is further restriction. Provincial level approval is only available when the trade marks and business men are owned by the Chinese parties and that the Chinese party is the majority shareholder.

So, you will have still a number of cases where you need to get up to the central government for these things. The approvals for openings retail stores are interesting because it's one thing to establish these enterprises. It's another thing to then go and establish retail stores. They get another kick at the can from a regulatory point of view and you want to go and open individual stores. There's a regulatory process there as well.

At the provincial level they can approve - there are some interesting figures. They can approve to open retail stores for retail enterprises which have been established if the business area of any store does not exceed 3,000 square meters and the number of stores in the province does not exceed three and the total number of similar stores opened by this enterprise in China is not more than 30.

Or, alternatively, they can approve at provincial level if the business area of any store does not exceed 300 square meters and has no more than 30 stores like that in the province and the total number of similar stores in China is no more than 300.

So, just two comments - one, is this is kind of a weird fixation on multiples of three. But secondly and more importantly, obviously they're looking at two different kinds of retail establishments here. And so the thresholds and the restrictions are geared in function of the size of the store if you're going to do big stores as opposed to little photo finishing or whatever - I guess those don't exist anymore.

You know, there's a different set of rules in terms of the numbers you can have. And in other cases where there's no purely provincial approval they are supposed to - at the provincial level - review the applications within a month and submit it onward to the central government MOFCOM - Ministry of Commerce - which should decide on approval within three months.

So, you see, there's a four month process under law. Again, you're not going to get an administrative law remedy very readily against them if it takes five months or six months. But you know, that's not how it works in China.

There is, though, legislative guidance that they should do this all within four months. So, I think that helps a lot, actually.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Andrew, if you could move onto your concluding remarks on the 13th slide then we've got a couple of questions and we'll finish up here in about five minutes.

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Yes, I am indeed at the conclusion. And I think they've delivered on their promises in terms of liberalization. We may have focused a lot on some of the back sliding or the opportunities for them to blunt the force of their liberalization. But I say, hats off, because they've actually - the kicked and screamed for - it was 14 years of WTO negotiations, but they did it.

And it was very controversial in China entering WTO with their specific commitments. There are a lot of sectors which are threatened. There are still some problems. I've highlighted in the second bullet point there what they are. I just wanted to say something about the last bullet point, because your listeners will see four Chinese characters, which is (inaudible). And it really refers to saying different dreams.

It's sharing common undertaking without first ascertained that you share common perspectives and objectives. And if there's anything you have to do in China, it's spend a lot of time getting to understand the Chinese party and limiting the scope of sharing their different dreams.

Thanks very much. I'll be happy to take any further questions.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Okay, we have a couple more that we haven't covered. One question came in, does the concept of retail or wholesale include the manufacturing industry? Or do separate rules apply? And are there any unique considerations for manufacturing?

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

I'm sorry, you blanked out a little bit. I heard the first part.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Okay, no problem. It's short here. Does the concept of retail or wholesale include the manufacturing industry or do separate rules apply? Are there any unique considerations for manufacturing?

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

Well, you know, manufacturing is what people could traditionally do. And they were excluded or restricted heavily from services, including retail and wholesale, which is, you could say, a kind of a form of service.

Generally, if you want to get a business license and you want now to be a manufacturing enterprise, you want to go in most cases or in many cases, anyway, for a broader set of powers which will include the ability to do the kind of buying and selling that we're talking about when we talk about retail and wholesale.

So, in that sense it was always different. You know, manufacturing was always straightforward in terms of getting the approvals. No special approvals were needed. Special approvals were needed for retail and wholesaling and they were very, very, very restrictive.

Now there's a kind of convergence. So, from the Chinese regulatory mind set, you're still coming in and either applying for one or the other or both. So, you have to stipulate in your application. You're going to manufacture and retail and wholesale. But it should be no problem at all getting approval from manufacturing in that sense in as long as it accords with investment guidance catalogue, which itself reflects WTO commitments.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Okay, thank you. And then secondly, a followup question about whether or not China allows U.S. WFOE to sell hardware and software directly to Chinese companies? The followup is, what if the sale is to enterprises and not consumers?

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

I'd have to - you know, frankly, I'd invite that questioner to send me an e-mail so I could follow up on that, because off the top of my head I don't recall the specific restrictions. It should normally - I mean, the consumer sales would have been something which fell under the retail sales restrictions anyway.

So, in that sense, selling to consumers (inaudible) was absolutely forbidden, you know, in that sense, directly by foreign companies or foreign invested enterprises for those kinds of products before. You couldn't open a shop to sell software before. Now you can. I don't see any restriction in this new law which would prevent that.

Selling previously to governmental or to enterprises, I think you said, would also have fallen within the retailing or wholesaling restrictions, I think. Yes, so I think what I'm coming down to as a matter or principle based on this law. These are things which wouldn't have normally been possible before. You could sell from outside of China. You know, you could sell hardware.

China has always bought things from outside. That wasn't the problem. It was conducting these sales operations from within China that was the hard thing. And I should say on that point that it's a fundamental tenant of Chinese foreign investment regulations that if there is a legally mandated - or legal pathway to do something by way of establishing an enterprise in China and then you can do it.

There's a regulation from 2003 which I was just looking at the other day which reiterated clearly that carrying out without - clearly but in blunt terms - carrying out a business fo which you otherwise need a business license. If you don't have the business license, you're not to be doing it. So, that means even from outside of China they would consider that unlawful from the point of view of Chinese law.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Andrew, if people do have followup questions, how can they contact you?

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

On the very last slide, which is slide number 14, I've got my e-mail address and I should have put my telephone number there. But if people send me an e-mail then I'll call them and it would my dime instead of theirs.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Very good. Well, thank you, Andrew, very much. On behalf of the Association of Corporate Counsel and the International Legal Affairs Committee, this was very practical and very easy to understand. We're glad to hear that the investment opportunities are regulations are better than they used to be. And again, I want to thank you very much. It was a great presentation.

Andrew Halper - *Eversheds, LLP - Head, China Business Group*

My great pleasure.

Dick Mosher - *American Corporate Counsel Association - Vice Chair*

Thank you. That concludes the presentation. This will be, again, available in approximately an hour or so and for approximately one year on the ACC Website. Thank you all.
