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China to Introduce REACH Style Regulations for New Chemical Substances

Six years after the issuance of *Measures on Environmental Administration of New Chemical Substances* (“2003 Measures”), the Chinese Ministry of Environmental Protection has recently launched an inter-ministerial consultation on a proposed amendment (“Amendment”) that could become effective in October 2010. The 2003 Measures require manufacturers and importers to notify and register new chemical substances with the Chemical Registration Centre (the “CRC”) of the Ministry of Environmental Protection. The Amendment imposes substantially more obligations in the areas of data collection and environment protection.



The Amendment is inspired by EU's REACH¹ system for the notification of new chemicals and increases requirements for the control and safety of chemicals to be manufactured or imported into China.

The main features of the Amendment are as follows:

- The Amendment applies only to new chemicals, *i.e.* substances other than the approximate 45,000 listed in the *Catalogue of Existing Chemical Substances*. Current participants in the Chinese chemical sector should, therefore, not be immediately affected.
- The Amendment introduces a classification system whereby any new chemical substance should be regarded as “General,” “Hazardous,” or “Of Concern for Environment.”
- Higher volumes would trigger greater requirements in terms of testing and data.
- The Amendment introduces simplified procedures for low volumes (less than 1 ton manufactured/imported each year) scientific research (less than 0.1 ton manufactured/imported each year) and certain polymers.
- It appears that only China registered entities would be entitled to apply for registration of new chemical substances.

¹ *Registration, Evaluation, Authorization and Restriction of Chemicals – as introduced by the European Commission (Regulation 1907/2006/EC).*

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- Most tests may only be carried-out by designated laboratories in China (in particular ecotoxicological tests).
- Various obligations in terms of labeling, packaging, transportation, and distribution apply to registrants and end users in order to manage risks of damage to health and the environment. The Amendment also provides for post-registration follow-up formalities.
- The Ministry of Environmental Protection and its local counterparts will be in charge of monitoring enforcement of the Amendment, with the power to impose financial penalties (in very limited amounts) and corrective measures.

Although experts praise the Amendment as a move of China towards a REACH system, many aspects of this regulation remain rather unclear and broadly drafted. On the enforcement side, it also remains to be seen whether China's existing expertise and infrastructure can support a full scale implementation of the Amendment.

Finally, certain observers expressed fears that the Amendment could be used as a trade barrier to limit the import of foreign chemicals in China.

China's State Secret Law Amendments Submitted to the People's Congress for Second Reading

The China State Secret Law has been a source of continuing controversy for foreign investors. The *Rio Tinto* case is but the most recent example of China's potential foreign business partners finding themselves embroiled in a national security information controversy over what, to most people, would appear to be normal commercial information. Because the State Secret Law potentially concerns parties performing even the most basic due diligence on Chinese State owned businesses, potential investors must ask themselves if they risk running afoul of the State Secret Law.

While China does not often publicly acknowledge paying the slightest attention to the concerns of foreigners over what China regards as domestic legal matters, China nonetheless sometimes takes foreign suggestions into account. China has been quietly reviewing the State Secret Law and various potential amendments are under considering.

The Standing Committee of the National People's Congress ("NPC") has resumed deliberations on draft amendments to the State Secret Law. The draft received a first reading in June 2009 and its full text was subsequently published to universities, research institutions, and the public via the Internet for comments. During the comment period, it was determined that a substantial number of documents were marked top secret without containing actual sensitive information and that township level government offices were, in large part, responsible for this phenomenon.

Proposed amendments seek to streamline the existing law, which took effect in 1989, while also boosting awareness of the importance of safeguarding State secrets. According to a State Secret Bureau statement, the State Secret Law should "not only protect national information security, but also promote information openness and the rational use of information resources in order to protect the people's right to information and participation in government."

The draft amendments include:

The Scope of State Secrets is Clarified

The draft amendments limit the scope of the state secrets to those secrets which involve state safety and interests, and could damage the state's safety and interests in politics, economy, military, and other areas. At least some Chinese experts have also suggested that business secrets be distinguished from state secrets, and protected in a different way.

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Only Central and Provincial Government may Classify a Secret as “Top Secret”

Under the proposed amendments, only the central government and provincial governments and their authorized departments will be permitted to classify documents as top secret, confidential secret, and ordinary secret². Governments at the city level and their authorized departments will be permitted to classify documents only as confidential or ordinary state secrets. In addition, the draft amendments call for subordinate agencies to present documents to superior agencies in order to determine the appropriate level of confidentiality. Superiors are to consider the practical concerns of the subordinate, the prescribed limitations, and the greater security interests of the country.

The Draft Amendments Set Time Limits for Protecting State Secrets

The draft amendments seek to limit the time for protecting state secrets. Top secret documents may remain secrets for 30 years, confidential secret documents for 20 years, and 10 years for ordinary secrets or confidential materials. At the expiration of the protection term, the relevant agency may reassess the classification of the document. Interestingly, the draft calls for the formal announcement of declassifications as they occur and seeks to discourage officials from releasing materials secretly. As explained by the drafters, if the state keeps things confidential after publication, it is not conducive to the goal of public openness and understanding.

The Control Over Personnel With Access to State Secrets is Strengthened

The draft amendments also provide for better oversight and management of personnel with access to classified materials. Standards for employment are to focus on “good political qualities and character” and the selection of supervisory personnel is to be limited to persons who have come up through the ranks of internal management. Confidentiality agreements, exit examinations, and phase out periods are to be implemented for employees leaving positions with access to classified materials.

Punishments on Infringements Will be Enhanced

Finally, the drafters emphasize that “state secrets are protected by law and any acts that endanger national security secrets, must be subject to legal action.” Standing Committee member Zhang Xuezhong stated that the previous approach “was not serious enough,” noting that certain security violations were subject to nominal fines of less than 1,000 RMB. It is unclear what the enhanced penalties will be under the amended State Secrecy Law.

Although the amendments to the State Secret Law are still in draft form, and it is often difficult to predict the timing of Chinese legislative action, the current effort with respect to State Secret Law reform has at least the potential for improvement. The current discussion indicates that some Chinese State actors are aware that China’s expansive definition of state secrets to include all business information is not necessarily consistent with international norms. On the other hand, state secrets are at the very heart of national security concerns and it is often difficult for any government to make substantial changes in this area.

Foreign companies doing business in China should continue to pay attention to developments under the State of Secret Law since “mistakes” can have serious consequences.

2 “绝密级、机密级、秘密级国家秘密”

Chinese Foreign Investment Catalogue Will be Amended

China's State Council has announced a plan to revise the *Catalogue Guiding Foreign Investments in Industry* (the "Catalogue"). According to the State Council notice, China intends to open more sectors to foreign investment and will target high-technology, modern services, new energy, and environmental protection. It will also encourage foreign companies to merge with or acquire Chinese enterprises.

The Catalogue is a tool used by Chinese policy makers to steer foreign investment to targeted industries. It divides various industries into four categories: encouraged, permitted, restricted, and prohibited. One effect of such categorization is the imposition of limitations on the form of foreign investment. For instance, investment in restricted industries may be limited to joint ventures with Chinese majority partners whereas investment in encouraged industries may allow investors to establish wholly foreign-owned enterprises. In addition, restricted industries are often subject to more complex regulatory schemes and may demand higher-level government approvals.

During the last revisions of the Catalogue in 2007, the National Development and Reform Commission ("NDRC") and Ministry of Commerce ("MOFCOM") listed five major policy objectives:

- To encourage foreign investment while improving the overall quality and industrial composition of investment projects, particularly in high-tech sectors;
- To encourage investment in environmentally friendly and energy-saving technologies;
- To curtail and eliminate policies that "solely" serve to promote exports, to address China's trade surplus;
- To encourage balanced development between the relatively prosperous coast and the less-developed western, central, and northeastern regions; and
- To protect "national economic security" and only cautiously open sensitive and strategic industries to foreign investment.

Reflecting these policy objectives, the 2007 version of the Catalogue includes significantly more environmental and energy-saving technologies under the encouraged category. Further, fledgling services sectors, such as logistics and business process outsourcing, were added to the Catalogue as encouraged industries; while new restrictions were placed on certain sectors with historically significant foreign investment, such as the chemical and automotive industries.

In addition, the 2007 Catalogue reversed a long-standing policy favoring businesses devoted solely to export and industries with high demands for natural resources. New to the list of restricted industries were toy, clothing, and shoe manufacturing, as well as the steel, aluminum, paper, and cement industries.

The 2007 revisions evidence substantial changes in the economic policy of Chinese central government and reflect many of the goals and strategies under the Chinese *11th Five-Year Plan on Utilization of Foreign Investment*.

It can be expected that the proposed revisions in 2010 will also be affected by the recent changes in the economic policies of Chinese government. Especially, we note that to cope with recent economic crisis and difficulties in China, the State Council has issued a series of policies to adjust the current structure of Chinese industries and to improve the Chinese economic condition. These policies may also have an impact on the proposed 2010 revisions to the Catalogue.

Chinese Investment in U.S. Gold Mining Company Scuttled by CFIUS

In late December 2009, a Chinese company, Northwest Nonferrous International Investment Co. (“**Northwest**”), backed out of a deal to purchase a 51 percent interest in a U.S. mining company, Firstgold Corp. (“**Firstgold**”), after being informed that the U.S. Committee on Foreign Investment in the United States (“**CFIUS**”) intended to recommend that the President of the United States block the investment.

Firstgold and Northwest had filed a voluntary notice of the proposed investment with CFIUS, a U.S. government agency which reviews potential acquisitions of U.S. companies by foreign entities for national security threats. Although CFIUS itself is not empowered to block proposed transactions, after a review it may recommend that the president do so. It is very rare for a proposed transaction to reach the point where it is put before the president, as problematic proposals are generally withdrawn after objections become known. Only one transaction has actually been blocked by the president. In 1990, President George H.W. Bush ordered China Aviation Technology Import-Export Corporation (“**CATIC**”) to divest its interest in MAMCO, a manufacturer of civilian airplane parts, primarily for Boeing. CATIC was, at the time, the import-export arm of the Ministry of Aerospace Industry of the People’s Republic of China, and the order came shortly after the Tiananmen Square protests of 1989, leading to claims that it was politically motivated.

The recently proposed transaction by Northwest was a US\$26 million investment in Firstgold in exchange for a 51 percent interest in the company. Firstgold is a Nevada-based mining company that holds mining rights to at least four properties in Nevada, some of which were located near U.S. military facilities. Although CFIUS proceedings and decisions are not released to the public, it has been widely stated that CFIUS officials repeatedly cited the proximity of Firstgold’s properties to Fallon Naval Air Station (where the TOPGUN flight training school is located) and other unidentified, sensitive, and classified security and military assets as a national security concern. Other sources have noted that China’s recent substantial boosting of its gold reserves may have been a consideration. It has also been reported that the U.S. government may have been concerned over what other minerals, other than gold, Firstgold might try to extract from their properties, as Firstgold has permission to mine for zinc and uranium.



Background on CFIUS and Exon-Florio

Through the Defense Production Act of 1950 and its various amendments, including the Exon-Florio Act in 1988 (the “**Exon-Florio**” or the “**Act**”) and the Foreign Investment and National Security Act of 2007 (“**FINSA**”), the U.S. Congress has granted the President of the United States the authority to interrupt or unwind certain transactions that are deemed national security threats. There is no statute of limitations on this authority, although the CFIUS review process may provide a safe harbor.

CFIUS’s Composition and Authority

CFIUS is a multi-agency governmental committee that is authorized to evaluate the national security implications of foreign acquisitions of, and investments in, U.S. businesses. These

national security reviews allow CFIUS to identify and address any risk that arises as a result of a covered transaction. After a review, CFIUS may request that the president suspend or prohibit the subject transaction. The CFIUS review process is a voluntary process for potential foreign investors and their U.S. counterparts. Once CFIUS reviews a transaction and decides to take no action or to impose a mitigation agreement, the parties have a “safe harbor” from the president’s Exon-Florio authority. Consequently, voluntary reviews, where appropriate, may better secure a company’s transaction.

CFIUS has grown in importance in recent years after FINSA made it clear that the definition of national security includes businesses involved in “critical infrastructure” rather than only those businesses involved in defense contracting. Industries that may now be implicated under FINSA include energy, commercial air and spacecraft, harbor and port regulation, highway construction, aviation control, public transit, and telecommunications.

CFIUS is comprised of the heads of the Department of the Treasury, Department of Justice, Department of Homeland Security, Department of Commerce, Department of Defense, Department of State, Department of Energy, Office of the U.S. Trade Representative, and the Office of Science & Technology Policy. The Office of Management & Budget, Council of Economic Advisors, National Security Council, National Economic Council, and Homeland Security Council observe the actions of CFIUS and participate in its activities as appropriate.

Review Process

Once a party files a voluntary notice, CFIUS has 30 days to notify the parties whether CFIUS will conduct an investigation. At the end of the 30 day period, CFIUS is required either to clear the transaction, or, if it cannot do so, to begin an additional investigation. If CFIUS conducts an additional investigation, it has an additional 45 days to determine whether the government will seek mitigating actions, recommend that the transaction be prohibited, or determine to take no action. The president then has another 15 days to publicly announce any action he will take.

Contents of Notice

A voluntary notice filed before CFIUS includes information such as the following:

- A detailed description of the assets of the U.S. business being acquired, including the approximate value of those assets in U.S. dollars.
- A detailed description of the business activities, market share, regulated technologies, cyber security plans, and contracts of the U.S. business with the U.S. government.
- Information regarding the ownership of the foreign party and its parent companies, owners, and principals.
- Information regarding the plans of the foreign person for the U.S. business.

Determination of a National Security Threat

The term “national security” is interpreted broadly for purposes of Exon-Florio review. Judgment lies wholly and ultimately within the president’s discretion. CFIUS has stated that in conducting its analysis of whether a transaction poses a national security risk, it will assess whether a foreign person has the capability or intention to cause harm and whether that foreign person’s relationship with the U.S. company is linked to a vulnerability in the U.S. infrastructure, thereby creating a threat to national security. Generally speaking, factors that may affect whether a transaction presents national security considerations include:

- The nature of the U.S. business over which control is being acquired.

- The identity of the foreign person that is acquiring control.
- Whether the U.S. business is undergoing exceptional corporate reorganization.
- Whether the foreign control is being asserted by a foreign government or a state-owned enterprise.

Implications for Investors

The withdrawal of the proposed investment in Firstgold highlights some of the issues faced by foreign investors considering acquisitions of U.S. companies. Of particular note is the fact that the investors in the Firstgold transaction were Chinese. Chinese companies have faced stricter scrutiny under CFIUS both because Chinese companies often have some level of state ownership, and because China is not a military ally of the United States and has been known to do business with countries that are not friendly to the United States (*i.e.*, Iran). Although U.S. officials have stated that the U.S. government is committed to promoting investment, it is clear that Chinese companies face a more stringent hurdle when investing in areas that have any potential connection to national security. Investors should remain mindful that CFIUS has expanded its jurisdiction to look closely at transactions in sectors not traditionally subject to scrutiny.

Although most transactions are likely to be cleared eventually, it is very possible that any Chinese companies with government connections will wind up subject to certain structural requirements (via a mitigation agreement with the U.S. government) that would prevent foreign government persons from controlling the U.S. acquisition or having access to certain technologies. Similarly, transactions with Chinese investors could require a spin-off of U.S. subsidiaries or divisions that control sensitive technology or maintain U.S. government contracts.

Chinese Partnership Law Update

Scope

On March 1, 2010 a new Chinese partnership law will come into effect, opening an alternative mode for foreign investment. The *Administrative Measures for the Establishment of Partnership Enterprises in China by Foreign Enterprises or Individuals* (“**FEIP Measures**”) permits the establishment of Limited Liability Partnerships between two or more foreign enterprises or individuals, or between foreign entities and Chinese individuals or enterprises³. The regulations also apply to partnerships established by Hong Kong, Taiwan, and Macau entities operating in China.

Partnership structures were first permitted in 1997 under China’s *Partnership Enterprise Law*⁴; however, foreign investment via partnerships has remained restricted. The opening of the partnership structure as an investment structure is significant in that it will allow easier entry into certain Chinese markets by eliminating the need for prior approval by the Ministry of Commerce (“**MOFCOM**”) and local agencies. In addition, the use of this partnership structure may, in certain situations, provide beneficial tax results when compared to wholly-owned foreign enterprises and equity or contractual joint ventures.

³ *Measures for the Administration on the Establishment of Partnership Business by Foreign Enterprises or Individuals in China, Order of the State Council (No. 567), November 25, 2009.*

⁴ *Partnership Enterprise Law of the People’s Republic of China, Order of the President of the People’s Republic of China, (No. 55) as amended and adopted at the 23rd session of the Standing Committee of the 10th National People’s Congress of the People’s Republic of China, August 27, 2006.*

Partnership Forms

Under the Partnership Enterprise Law there are two varieties of partnerships open to foreign entities, General Partnerships (“普通合伙”) and Limited Partnerships (“有限合伙”). Similar to common law jurisdictions, general partners are jointly and severally liable for the debts of the partnership whereas limited partners are liable only to the extent of their capital contributions. Under the Partnership Enterprise Law, limited partnerships must include at least one general partner. Both general and limited partners may be persons or enterprises except when such enterprise is a state-funded or owned company, a listed company, public welfare-oriented public institution, or social organization. These entities are limited from becoming the general partner of a limited partnership.

Registration Procedure

The registration procedures under the FEIP Measures are straight-forward. They require interested entities to file the following materials with the relevant local level State Administration for Industry and Commerce (“SAIC”):

- An application form for establishment registration as signed by all the partners;
- Identity certificates of all the partners;
- Power of attorney issued to the representative designated or the agent for all partners;
- The partnership agreement;
- Confirmation letters issued by all the partners for each partner’s financial subscription or actual payment;
- The certificate of the principal place of business; and
- An industrial policy compliance statement.

Pursuant to the *Partnership Enterprise Law*, the partnership agreement should detail each partner’s methods of contribution to the partnership, contribution amounts, and the schedule and amounts of distributions. There are no set maximum or minimum amounts for initial capital contributions.

Regulatory Implications

One important feature of these new foreign partnership enterprises is a relaxation of regulatory requirements for entry into certain industries. Whereas joint ventures and wholly-owned foreign enterprises must seek approval by MOFCOM prior to engaging in investment activity, foreign partnership enterprises need only register with provincial or local branches of the SAIC. Investments in “Restricted Industries,” as defined in the *Foreign Investment Industrial Guidance Catalogue* (the “**Investment Catalogue**”), will still require MOFCOM and/or other agency approval prior to registration. To ensure adherence to these rules, the FEIP Measures require partnerships to submit an industrial policy compliance statement along with their applications to the SAIC.

Tax Implications

Another notable feature of the partnership structure is the way in which a partnership is taxed. Both general and limited liability partners are taxed individually, the partnership itself is not liable for enterprise level taxes. Foreign individual partners are taxed according to the applicable marginal personal income tax rate and foreign enterprise partners at the Enterprise Income Tax (EIT) rate of 25 percent. The “EIT” applied to partnerships is the same as that applied to

other Chinese corporate forms; the tax benefit lies instead in the absence of a tax on dividends. Unless a favorable tax treaty exists, distributions from joint ventures and wholly-owned foreign enterprises to shareholders are typically subject to a 10 percent tax rate. In a partnership, revenue passes directly to partners and therefore avoids this level of taxation.

Conclusions

Foreign investors may be hesitant to deviate from tried-and-true business structures and attempt a partnership for investment in China. However, the partnership form may provide many advantages to small and medium business, as well as venture capital startups. Additionally, the State Counsel has expressed its desire to use the FEIP Measures to “encourage foreign enterprises or individuals with advanced technologies and management experience to establish partnerships in China to boost the development of the modern service industry.” Paired with the recent announcement that the Investment Catalogue will be revised to encourage investment in the service industry, it is clear that China has set a course for substantial growth in this sector with partnership vehicles playing a central role as a flexible alternative to existing corporate entities.

Developments in China’s Indigenous Innovation and Procurement Policies

Background

Foreign investors and business associations are carefully tracking developments in China’s implementation of an *Indigenous Innovation Policy* and accompanying changes in government procurement. Indigenous innovation is a government policy response to perceived over-dependence on foreign technologies, patents, and brands in the Chinese economy. Through indigenous innovation, government planners seek to limit reliance on foreign technology by promoting the development of Chinese owned technology and intellectual property. To achieve these ends, local governments have not only created incentives for domestic development but have implemented a series of discriminatory policies to discourage foreign participation in certain industries.

Implementation

Pursuant to broad policies set by the Ministry of Finance, National Development and Reform Commission, and Ministry of Science and Technology, among others, local governments publish catalogues of “indigenous innovative products.” Preference in government procurement is given to listed products which are subject to an accreditation process. Factors, such as IP ownership, trademark, and local ingenuity are considered in accreditation.

While there have been no explicit restrictions based upon a manufacturer’s foreign-investment status, very few products produced by foreign invested enterprises have received accreditation. This exclusion of foreign invested enterprises is due primarily to the requirement that the Chinese entity fully owns the relevant IP and first registers its trademarks in China. Due to IP protection and global competitiveness concerns, foreign invested enterprises are unlikely to meet these requirements.

On November 15, 2009, the PRC Ministry of Science and Technology and Ministry of Commerce released a notice, Circular 618, of the government’s intent to create a national level Catalogue of *Indigenous Innovation Products for Government Procurement*. Circular 618 proposes six broad areas for accreditation, including computers and application equipment, telecom products, modern office equipment, software, new energy equipment, and high-efficiency energy-saving products. Considering the breadth of the proposed categories and

the fact that government procurement in China includes state owned enterprises, numerous agencies, hospitals, and other large organizations, national level accreditation requirements may have a substantial economic impact on foreign invested suppliers.

Reactions

A collective of international trade associations has requested a delay in the application of the new national level procurement catalogue, raising numerous concerns and the need for clarification. In a joint letter dated December 10, 2009, these organizations emphasized the restrictiveness of the new regulations and potential for dulling, rather than promoting, innovation and development.

Recent high-level talks between U.S. Department of Commerce, Treasury, and State Department officials and their PRC counterparts included discussion of the proposed regulations. Initial reports suggest that China may consider revising the accreditation requirements defined in Circular 618 to reduce the impact on foreign invested enterprises. However, there has been no word as to when revisions can be expected.

Developments in this important area require continuous monitoring, although the involvement of both the United States government and broad-based organizations like the United States – China Business Council should prove helpful.

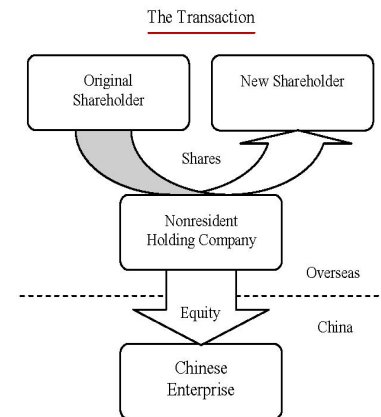
Ministry of Finance Announces Increased Scrutiny of Offshore Indirect Transfers

Scope

On December 10, 2009, the Chinese Ministry of Finance (“MOF”) Tax Policy Department announced a new international tax enforcement initiative targeting offshore indirect transfers of Chinese equity interests.

The covered transaction involves the indirect transfer of an equity interest in a Chinese Enterprise through the sale of stock in a Nonresident Holding Company that holds the equity interest of the Chinese Enterprise.

Deriving its authority from China’s general avoidance rule (“GAAR”) under the Enterprise Income Tax Law (“EIT Law”), Notice 698 creates new reporting standards for offshore indirect transfers. The Notice also allows Chinese tax authorities to ignore the interposition of the Nonresident Holding Company and treat the transaction as a direct sale of the equity of the Chinese Enterprise if it is determined that the primary purpose of the transaction is Chinese tax avoidance. The Notice is retroactive, effective as of January 1, 2008, and therefore may apply to past transactions.



Notice 698 requires the Original Shareholder of the Nonresident Holding Company to disclose whether the Nonresident Holding Company is located in a “Tax Haven” jurisdiction. A “Tax Haven” is defined as a jurisdiction that does not tax foreign source income or taxes such income at a rate below 12.5 percent.

If Chinese tax authorities determine that the Nonresident Holding Company operates in such a jurisdiction, taxes will be assessed against the Original Shareholder of the Nonresident Holding Company based upon the economic substance of the transaction.

Disclosure Requirements

Disclosure is triggered when an “actual controlling” Original Shareholder makes an indirect transfer. Within 30 days after the signing of the transfer agreement, the Original Shareholder must file a statement with the local PRC tax authority overseeing the Chinese Enterprise if either (1) the actual tax burden in the jurisdiction of residence of the Nonresident Holding Company is less than 12.5 percent; or if (2) the jurisdiction of residence of the Nonresident Holding Company does not tax foreign-source income. The 12.5 percent “actual tax burden” rule is problematic in itself, as in certain jurisdictions it may be difficult to calculate the actual tax burden of a transaction due to the interplay of various tax treaties and foreign tax credits.

If a condition applies, the Original Shareholder must provide a copy of the equity transfer contract along with the following materials:

- Documentation reflecting the relationship between the Original Shareholder and the Nonresident Holding Company with regard to funding, operations, etc.;
- Documentation of the Nonresident Holding Company’s operations, personnel, assets, etc.;
- Documentation of the Nonresident Holding Company’s relationship with the resident enterprise; and
- A statement affirming that the Nonresident Holding Company was established by the Original Shareholder for reasonable business purposes.

Note that the establishment and use of a Nonresident Holding Company may have a variety of legitimate business purposes. As such, disclosure under Notice 698 is not tantamount to an admission of guilt. The use of such an entity may, for instance, be based upon legitimate operational and foreign exchange concerns. It is therefore imperative that parties utilizing Nonresident Holding Companies in their Chinese businesses take action, if necessary, to ensure the commercial substance of these structures is evident.

Open Issues

As enforcement of Notice 698 is still in its infancy, a number of important issues remain unclear. There has been no clarification as to the operation of Notice 698’s retroactive application to transactions occurring between January 1, 2008 and present.

Further, the MOF has not defined what will constitute an acceptable business purpose to justify offshore indirect transfers of Chinese equity interests.

Finally, the MOF has yet to establish the penalties for non-compliance with Notice 698 reporting requirements. Shareholders of Nonresident Holding Companies with Chinese assets should, therefore, proceed with caution.

Conclusions

With Notice 698, China has joined the ranks of other major economies in the pursuit of tax revenue previously insulated by the use of offshore transactions.

The impact of Notice 698 has substantial reach, as it applies even where a transaction occurs between nonresident parties, entirely outside of China. Current holding company structures must be reviewed and careful attention must be paid to issues raised by the Notice in future China-related M&A and restructuring activity.

Parties contemplating transactions via holding companies located in jurisdictions with low foreign source income tax rates, must carefully consider that Chinese tax authorities may ignore the Nonresident Holding Company and treat the transaction as a direct sale, taxing the Original Shareholder as if the transaction occurred in China. One likely result of this recharacterization may be the double-taxation of certain transactions.

No More Than Four Representatives Can Be Employed by Representative Offices in China

State Administration for Industry and Commerce and the Ministry of Public Security jointly issued a notice (the “**Notice**”) on January 4, 2010, which will have major impacts on the registration of the resident representative offices of foreign enterprises in China (“**Rep Offices**”). Rep Offices are a common initial step by potential foreign investors in China.

A Rep Office Can Only Have Four Representatives or Less

According to the Notice, a Rep Office can employ no more than four representatives (代表) (including the chief representative). Existing Rep Offices which currently have more than four representatives cannot add any new representatives. For existing representatives above four, the authorities are “grandfathering” the excess representatives, with the result that it will not be necessary to commence deregistration immediately.

In practice, most representatives in the Rep Offices are foreign employees of the parent company who need the title of “representatives” to obtain the visas and work permits in China. The Notice will effectively restrict the number of foreign employees a foreign company may assign to China through its Chinese Rep Offices.

“Foreign” Documents Should be Notarized and Verified

The Notice also requires the local administration for industry and commerce (“**AIC**”) to strictly enforce the legal requirements for notarizing and verifying legal documents issued outside China.

According to the Notice, when setting up a Rep Office or changing the name of a Rep Office, the applicant should submit (i) official incorporation documents evidencing that the parent company has existed for **two years**⁵ or more; and (ii) recommendation letters issued by a financial institution which has business relationship with the parent company. These documents must be notarized and then authenticate by the Chinese embassy or consulate in the relevant country. This process, which in the U.S. requires interaction with state authorities and the U.S. Department of State, as well as the Chinese embassy, can take more than a week, even when things move efficiently.

The Registration Certificate Will be Effective for Only One Year

According to the *Administrative Measures on Registration of the Resident Representative Offices of Foreign Enterprises*⁶, the Registration Certificates for Rep Offices should be effective for one year. However, in practice, the Registration Certificates issued by AICs could have effective terms of 3-10 years.

⁵ The current rules and regulations only require the applicant to submit the incorporation documents evidencing the parent company's legal existence. The Notice specifically requires that the incorporation documents should be able to prove that the parent company has existed for two years or more.

⁶ 《关于外国企业常驻代表机构的登记管理办法, effective from March 15, 1983.

After the Notice took effect, AICs can now issue only one-year-effective Registration Certificates for Rep Offices. For those Registration Certificates with effective terms of more than one year, AICs will change the Certificates when the relevant Rep Offices apply to change or extend their registration.

It is advisable for all the Rep Offices in China and their respective foreign parent companies to be aware of the above changes and comply with the new requirements when setting up new Rep Offices or changing the registrations of existing Rep Offices. On balance, the Notice makes the Rep Office a less flexible and more limited form of doing business. It may make early consideration of the establishment of a wholly-foreign-owned-enterprise (China's version of a wholly owned subsidiary) more necessary.

UTStarcom Inc. – Recent FCPA Case Involving China

As further evidence of U.S. FCPA enforcement focus on China, in December 2009 UTStarcom, Inc. (“UTSI”) agreed to pay a \$3 million settlement to the SEC following charges that the company knowingly engaged in routine and systematic bribery of Chinese, Mongolian, and Thai officials. The UTSI case is insightful in that it identifies several common corrupt practices engaged in by foreign companies operating in China.

Background

UTSI is a Delaware corporation, headquartered in California with the majority of its operations in China. UTSI's China operations are conducted through a wholly owned subsidiary UTStarcom China Co., LTD (“UTS-China”). From 1995 to 2004, over 75 percent of UTSI's sales were to government controlled telecommunications companies in China. The prohibited conduct alleged in the SEC complaint begins in 2002 and continues through 2007.

U.S. Visits for Employees of Chinese Government Customers

The SEC's complaint alleges that UTSI sponsored all expense paid sight-seeing trips for Chinese public telecom employees under the pretense of training visits. Foreign companies' sponsorship of overseas travel opportunities for Chinese employees has long been common practice. Historically, employees of Chinese state owned businesses were poorly compensated, thus a major incentive for doing business with foreign enterprises was the promise of foreign travel. Travel opportunities, such as site visits and inspections, were often built into contracts and accepted as a known cost of doing business with Chinese state-owned enterprises.

While compensation has improved, Chinese state-owned businesses still seek to include foreign travel provisions in contracts and may pressure a foreign party to minimize work on these visits so as to create paid vacations for their employees.

Reasonable accommodation of these requests may be acceptable so long as visits maintain a substantial business purpose—the general rule of thumb being that at least 70 percent of any visit should be dedicated to business-related activities.

From 2002 to 2007, UTSI allegedly spent \$7 million on more than 200 “training trips” for Chinese state-owned telecommunications employees. Little documentation was retained regarding these trips. According to the SEC, there were no UTSI facility visits or other training-related components to these visits. In fact, the SEC complaint alleges that these trips were



purely recreational visits to popular tourist destinations where UTSI had no facilities. UTSI did, however, include these trips as training expenses in its financial statements. As UTSI's state-owned telecommunications customers fall within the FCPA definition of "Instrumentalities," these visits constitute conduct prohibited by the Act.

Paid Executive Training Programs

In addition to employee site visits, the SEC complaint alleges that between 2002 and 2004, UTSI paid for executive training programs at U.S. universities attended by managers and other employees of government customers in China. UTSI spent more than \$4 million on travel, tuition, room and board, field trips to tourist destinations, and cash allowances between \$800 and \$3,000 per person. While UTSI accounted for the cost of these programs as marketing expenses, the programs covered general management topics and were not specifically related to UTSI's products or business.

The complaint further alleges that UTSI senior management believed that these training programs helped UTSI obtain or retain business. The SEC bases this assertion on evidence that management directly approved increases in the budget for these programs for employees of UTSI's largest customer, a Chinese government-controlled telecommunications company. Much like the employee site visits, the executive training programs paid for by UTSI violate the anti-bribery provisions of the FCPA. Moreover, UTSI management's direct decision to increase the budget allocation for executive training programs for their largest customer demonstrates the requisite intent to manipulate government officials.

Employment Benefits to Customers and Customer Family Members

The SEC complaint further alleges that UTSI offered sham full-time employment in the U.S. to certain government customers and their family members, in some cases sponsoring permanent U.S. residency applications. In at least three cases, UTSI paid these individuals for a period of two years each as if they were real employees, even though they never worked for UTSI in any capacity. UTSI fabricated annual performance reviews which were placed in personnel files, improperly accounted for payments to these individuals as employee compensation and falsely stated that these individuals were full-time employees on U.S. residency applications. Payments under the guise of employment compensation fall clearly within the realm of FCPA prohibited conduct. In addition, the sponsorship of immigration applications carries substantial value, particularly for Chinese citizens, and is likely to constitute bribery under the broad language of the FCPA⁷.

Gifts and Entertainment Expenses

In addition to indirect payments, the SEC complaint alleges that as part of a 2004 UTSI bid for a sales contract to a government-controlled telecommunications company in Thailand, UTSI's general manager in Thailand spent nearly \$10,000 on French wine and \$13,000 on other entertainment expenses. According to the SEC, records indicate that UTSI's former Executive Vice President and CEO of UTS-China approved the payments.

⁷ Note also, UTSI's actions with regard to U.S. immigration applications may also result in criminal liability for immigration fraud and the making of false statements to a federal agency.

Consultants and License Fees

The SEC complaint alleges that in 2005, UTSI's Executive Vice President and CEO of UTS-China authorized a payment of \$1.5 million to a Mongolian company for purported consulting services. UTSI's Board of Directors was informed that the \$1.5 million was a license fee paid to the Mongolian government. In turn UTSI accounted for the entire amount as a license fee. No records were maintained to demonstrate what, if any, services the consulting company performed for UTSI.

According to the SEC, the actual license fee was only \$50,000. According to the complaint, this was not a case of willful ignorance or carelessness on the part of UTSI management but intentional. The SEC further alleges that the UTSI Executive Vice President knew full well that the \$1.5 million was not a license fee and that a portion of the fee was used to make payments to Mongolian government officials to help UTSI obtain a favorable ruling in a license dispute.

Later, in 2007, UTSI allegedly hired and paid \$200,000 pursuant to another purported consulting agreement, this time in China. Again, payment was accounted for as a consulting expense but no records were maintained describing what services were provided. The SEC alleges that UTSI utilized this sham consulting company to pay bribes of \$200,000 to obtain a contract from a Chinese government customer. In both instances, under the third-party payment provisions of the FCPA, UTSI did not insulated itself from the conduct of the consulting companies.

Conclusions

While the pattern of conduct alleged by the SEC in the UTSI case suggests that UTSI management willfully bribed foreign officials, the case does identify several pitfalls that unwary U.S. companies may encounter absent willful intent. The FCPA's definitions for "value," "knowledge," and its treatment of third-party payments are important to consider when doing business abroad. In China in particular, below-market employee compensation at state-owned enterprises paired with a business culture driven by Guanxi and gift-giving create an atmosphere ripe for potentially costly mistakes. Training and other visits for government employees must have a legitimate business purpose and be adequately documented. Furthermore, careful due diligence is required in the selection of local agents and consultants, as the "knowledge" standard imposes a positive duty to determine their reputation. Finally, the FCPA's record keeping and internal controls provisions should be taken into account when building a business in China.

- Careful due diligence review of Agents is required to avoid potential problems and to establish a defense that any bribe paid was without the company's knowledge.
- Services rendered by foreign consultants should be adequately documented.
- Customer/client employee inspection and training visits should follow the 70 percent rule or some other rule of reason and require adequate documentation.
- This is not the first FCPA case involving China in these troublesome areas and it will probably not be the last. U.S. enforcement authorities are paying special attention to China; U.S. companies doing business with China should be on guard.