International Capital Flows

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1. Introduction

After decades of financial autarky,[1] in the early 1980s China began a gradual reintegration into the international financial system.

In 1980, China joined the World Bank and the International Monetary Fund (IMF). In 1988, it signed the Multilateral Investment Guarantee Agency Convention.

On December 1, 1996, China accepted the regime of Article VIII of the IMF Articles of Agreement and implemented the convertibility of the renminbi (RMB) with respect to current account transactions.[2]

Accordingly, exchange contracts concluded with parties subject to Chinese jurisdiction for non-current transactions in violation of Chinese exchange controls are not enforceable by the courts of other IMF members having accepted the Article VIII regime.

Since 1993, the authorities have committed the country to achieve convertibility of the renminbi in capital account transactions.[3] While the currency remains officially non-convertible for capital account transactions, the windows opened to capital flows have become ever wider and more numerous. The current five-year plan projects full capital convertibility by 2010.

China's large and long-running current account surplus and its concomitant accumulation of international reserves, which exceeded USD 1.53 trillion as of the end of 2007, the highest of any country, have attracted increasing pressure to make the renminbi convertible and to open its borders to international financial flows.[4]

Beginning in the 1990s, the Chinese authorities gradually made it easier for Chinese companies to raise capital abroad, and they have opened the domestic financial markets to foreign investors, thus rendering the renminbi partially convertible in practice even on the capital account. However, this cloistering of the domestic financial markets has engendered pricing anomalies[8] that have accentuated the pressure to merge the financial market's domestic and foreign compartments.

China has not only become a leading country for the attraction of foreign direct investment,[5] it is also gradually emerging as a powerhouse of global finance.[6] In 2003 and 2004, TLC acquired operations from Thomson and Alcatel and in 2004 Lenovo acquired IBM's personal computer unit. In June 2007, CIC paid USD 3 billion for a 9.3% of Blackstone Group's initial public offering. In December of the same year, it spent USD 5 billion for a 9.9% stake in Morgan Stanley. (Within six months, Blackstone shares lost 40% and Morgan Stanley's even more.) In February 2008, the Chinese aluminum giant, Aluminum Corporation of China Limited (Chinalco), acquired a 9% stake in Rio Tinto for USD 14.05 billion.

As China's integration into global finance progresses, its proportionately reduced ability to isolate its financial markets portends an increased risk of the contagious spread of trends, not only toward China from abroad, but in the opposite direction as well. This was most recently demonstrated by the "mini-crack" in the Chinese stock markets in March 2007, which jarred financial markets all over the world.[7]

The Anti-Money Laundering Law was adopted by the 24th Meeting of the 10th Session of the National People's Congress (NPC) on October 31, 2006 with effect on January 1, 2007. On the heels of this reform, in July 2007, China was admitted as a full member of the Financial Action Task Force on Money Laundering established by The Group of Seven nations 1989 to set standards to prevent money laundering and to share best practices among national regulators.

On August 21, 2007, the State Administrationn of Foreign Exchange (SAFE) announced that Chinese citizens, who could already buy or sell USD 50,000 of foreign currency every year, will be able to open accounts at Bank of China branches across the country to trade securities listed in Hong Kong.

1.1. The gradual liberalization of capital account transactions

On November 6, 1984, the Bank of China (BOC) issued 20 billion yen of Samurai bonds, which was the first overseas bond issue in modern Chinese history.[9]

In 1989, the SAFE allowed domestic enterprises to invest overseas with their own foreign exchange earnings, subject to depositing 5% of the amount in a special account. Their profits had to be repatriated and converted at State counters. In the same year, the State Council imposed a ceiling on the short-term external debt of financial institutions. Both direct borrowing and borrowing for onward lending had to be registered with SAFE. Enterprises could only extend foreign guarantees within the limits of their own foreign currency assets.

From November 1991, individuals were allowed, admittedly within very low limits, to purchase foreign currency for overseas travel, studies, emigration and family support.

On January 1, 1994 the foreign exchange market was unified at a rate of RMB 8.7 to the US dollar. The authorities adopted a market-based managed float within a band of +/- 0.3% in any single trading day. A foreign exchange market was established in Shanghai (the China Foreign Exchange Trading System – CEFTS) involving trading among banks and among banks and enterprises. The foreign exchange retention and quota systems were abolished and the Foreign Exchange Plan was discontinued.

Within months of the opening of the Shanghai and Shenzhen stock exchanges to channel domestic savings toward State-owned enterprises (SOEs) in need of financing, the government instituted an overseas market for issuing and trading of their shares (so-called B shares) to enrol foreign investors in their project. In 1992, nine companies issued B shares and trading in B shares totalled USD 3.1 billion. As of the end of 2006, 109 companies had raised RMB 38 billion from the issue of B-shares.

Chinese companies were then allowed to issue and list their shares on overseas stock exchanges, mostly in Hong Kong.[10] On July 15, 1993, Tsingtao Brewery Co. Ltd listed shares in Hong Kong, thereby becoming the first Chinese enterprise to complete an overseas listing. According to the CSRC 2007 Report, as of the end of 2006, 143 domestic companies had issued H-shares and obtained listings on the international capital markets, raising a total capital of USD 95 billion. Of these, 126 were listed only on the Hong Kong exchanges, ten were listed in Hong Kong and New York, four in Hong Kong and London, one in Hong Kong, New York and London and two in Singapore. As of March 31, 2008, 107 Chinese companies listed H shares on the Hong Kong Stock Exchange's Main Board with a market capitalization of USD 575 billion and another 40 were listed on the Exchange's GEM market for small companies with a market capitalization of USD 833 million.

The legal segmentation between A, B and overseas listed shares engendered distortions. For instance, A shares trade at excessive prices relative to their earnings, while B shares have traded at deep discounts relative to A shares.[11] Development of the B share market has stagnated and its market capitalization as of the end of 2003 was barely 2% of the total market capitalization of the Chinese markets.

The most popular vehicle for Chinese companies to raise capital abroad has become the listing of an overseas company to raise funds to invest in China. In this approach, an overseas company is constituted or an already listed compnay is acquired. The greater reliability of the accounts and documentation set down according to overseas professional and legal standards has contributed to this preference from the viewpoints of both investors (more transparency and accountability) and issuers of securities (downward pressure on the cost of capital). According to some estimates as many as several hundred Chinese companies may have obtained listings on foreign markets. As of March 31, 2008, 88 such overseas companies, called Red Chips, were listed on the Hong Kong Stock Exchange's Main Board with a market capitalization of USD 585 billion and another 40 were listed on the Exchange's GEM market for small companies with a market capitalization of USD 2 billion. As of 2006, 33 American Depositary Receipts (ADRs) in companies carrying on their main businesses in China were traded on the NASDAQ and 16 on the New York Stock Exchange and countless others traded on the OTC Bulletin Board [OTCBB].

Also, the government moved to open the market for A shares to foreign institutional investors. The CSRC and the People's Bank of China (PBOC) promulgated on December 1, 2002, for immediate effect, the Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors (QFIIs). By June 2006, there were 40 licensed QFIIs holding securities assets worth RMB 34.7 billion, of which RMB 22.3 billion (64%) was invested in A shares, RMB 6.0 billion (17%) in funds, RMB 2.6 billion (7%) in convertible bonds, and RMB 3.7 billion (11%) in treasury bonds.[12] By the end of 2007, 49 institutions had obtained QFII licenses and the value of their securities had risen to USD 26.5 billion (RMB 200 billion) from their initial investment quota of USD 10 billion.

On February 18, 2005, the PBOC, the MOF, the National Development and Reform Commission and the CSRC jointly announced that approved international organizations would begin issuing renminbi bonds on the domestic market.

On May 13, 2005, the PBOC announced that the first foreign financial institution had been admitted to the interbank bond market.[13]

The authorities have also loosened the spout on outward financial flows. For instance, individuals were allowed to buy up to USD 5,000 to finance travel abroad for extended trips.

To buoy the B-share market by creating openings for Chinese residents' investments, the China Securities Regulatory Commission (CSRC) promulgated on February 19, 2001, its Notice Regarding B-share Investment by Chinese citizens, allowing domestic individual investors to open B-share accounts and trade B shares in foreign currency.

Gradually, the restrictions on outflows of Chinese foreign direct investment were relaxed. By 2001, Chinese overseas direct investments totalled USD 8.4 billion, involving 6,610 projects.[14] Since 2004, a series of reforms has been implemented to facilitate overseas direct investment by Chinese enterprises. The Chinese establishments of multinational corporations were permitted to lend to their foreign affiliates. The proceeds from overseas initial public offerings or bond issues by Chinese companies could be deposited abroad for up to two years, up from the previous six months. The ceiling on enterprises' settlement account balances was raised from 20% of their foreign exchange proceeds to 30–50% and in 2005 it was hiked to 50–80%.

In 2006, Chinese overseas non-financial direct investment flows had reached USD 16.1 billion, ranking 13th in the world and, by the end of 2006, accumulated Chinese direct investments abroad reached USD 73.3 billion (about 15% of accumulated foreign direct investment in China).

In June, 2007, the CSRC adopted measures to allow domestic institutional investors to invest in foreign securities but a combination of rising prices on the Chinese stock markets as of the end of 2007 and expectations of the renminbi's continued appreciation have dampened enthusiasm for this vehicle on which only a fraction of the USD 50 billion quota had been used as of that time.

As of the first quarter of 2008, the authorities have announced as a priority the stemming of inflows of short-term foreign capital seeking to profit from the expected appreciation of the renminbi. According to some observers, inflows of short-term capital in 2007 alone amounted to USD 200 billion, surpassing foreign direct investment by foreigners of USD 82.6 billion in the same year, and the total might well reach USD 500 billion. To the same end, they have reduced domestic banks' quotas of short-term foreign debt to 30% of the 2006 level.

One reliable indication of the degree of liberalization of China's international capital flows is that by 2008 the perennial discount at which H shares, and to an even greater extent B shares, traded with respect to A shares has been reduced on and some A shares have actually traded, if only briefly, at a premium relative to their A share counterparts.

1.2. Introduction to the exchange regime

The current regulations on the foreign exchange system came into effect on April 1, 1996.

The PBOC regulates the foreign exchange market in accordance with the orientation of monetary policy and developments in the foreign exchange market. Under authorization from the PBOC, the SAFE and its branches act as the regulatory organ for foreign exchange.

Article 3 of the Foreign Exchange Regulations defines foreign exchange as:

- foreign currencies, including bank notes and coins;
- payment instruments denominated in foreign currency, including bills, bank certificates of deposit and certificates of postal deposit etc.
- securities denominated in foreign currency, including government bonds, corporate debentures and stocks etc.;
- Special Drawing Rights and European Currency Units; and
- other assets denominated in foreign currency.

Article 5 makes the rules applicable to domestic entities, individuals, foreign establishments and foreign nationals in China.

Foreign currency is prohibited from circulation in China.[15]

Article 19 requires that, unless the State Council stipulates otherwise, all foreign exchange receipts for capital account transactions must be repatriated.

All foreign exchange receipts for capital account transactions must be placed in specific foreign exchange accounts opened at designated foreign exchange banks; such receipts can be also sold to the designated foreign exchange banks upon approval by the exchange administration agencies.[16]

External borrowing is subjected to approval.[17]

The issue overseas of bonds in foreign currency by financial institutions is subject to prior approval by the SAFE.[18]

External guarantees may only be given by financial institutions and enterprises approved by, and registered with, the SAFE and its agencies.[19]

Article 25 establishes a regime of registration of all external debt.

When FIEs are terminated, the proceeds on liquidation owed to the foreign investors may be repatriated net of tax.[20]

Foreign exchange operations are the exclusive domain of financial institutions approved by the SAFE and its agencies.[21] They must open specific accounts for their clients' foreign exchange operations.[22] They must respect official asset and liability ratios[23] and submit to investigations by competent authorities.[24]

Foreign exchange trading must respect the principles of transparency, openness, fairness, and honesty.[25]

Severe financial and criminal sanctions apply to especially grievous infractions of the Foreign Exchange Regulations.

Fines for evasion may range between 30% and 500% of the illicit amounts.[26]

Criminal offences include:

- the payment, in violation of regulations, in renminbi or in kind, of imports that require payment in foreign exchange or of similar types of expenses;
- the payment in renminbi of local expenses on behalf of others and obtained in return for foreign exchange;
- investments in China on the part of overseas investors in renminbi or with goods purchased locally without the authorization of the exchange administration agencies;
- purchases of foreign exchange with invalid documents, contracts and bills;
- illegal arbitrage activities;
- processing external borrowing without authorization;
- issues of bonds denominated in foreign currency abroad without authorization and in violation of the relevant regulations;
- the provision of guarantees for external obligations without authorization and in violation of the relevant government regulations;
- using foreign exchange in China for pricing or settlement;
- pledging foreign exchange or subjecting it to liens without authorization; and
- changing the designated use of foreign exchange without authorization.[27]

Parties penalized for violations may within 15 days appeal to the exchange administration agencies at the next higher level that must decide within two months. If the party contests the decision as reviewed, it may appeal to the people's courts.[28]

1.3. Recent reforms of the foreign exchange market

The PBOC regulates the foreign exchange market in accordance with the orientation of monetary policy and developments in the foreign exchange market.[29]

Since July 21, 2005, the PBOC, with the authorization of the State Council, has instituted a new exchange rate regime departing from its prior peg to the US Dollar and moving toward a determination with respect to a basket of currencies. The exchange rate regime corresponds to a managed float based on market supply and demand. As of that date, the exchange rate was adjusted to RMB 8.11 per US dollar. As of March 8, 2008, the central bank was fixing the reference rate for trading the RMB at 7.1115 against the dollars.

The daily trading price of the US dollar against the RMB in the inter-bank foreign exchange market floats within 0.5 per cent around the central parity published daily by the PBOC, while the trading prices of the non-US dollar currencies against the RMB will be allowed to move within a band to be announced separately by the PBOC.

On August 8, 2005 the PBOC announced a reform of the conditions of access to foreign exchange trading intended to attract more entities, including non-financial enterprises and non-banking financial institutions, while maintaining scale of operations thresholds that only the largest enterprises might meet:

- for non-financial enterprises, annual foreign exchange receipts and expenditures under current account in excess of USD 2.5 billion, or goods imports and exports totalling more than USD 2 billion;
- for insurance companies, a registered capital of no less than RMB 1 billion or equivalent amount of foreign exchange, for trust companies and finance companies a registered capital of no less than RMB 500 million or equivalent amount of foreign exchange, and for fund management companies a registered capital of no less than RMB 150 million or equivalent amount of foreign exchange.

Non-financial enterprises intervening on the inter-bank foreign exchange market may only deal in spot transactions based on their real need to hedge transactions. Non-bank financial institutions can deal in all spot transactions except those that require approval of the SAFE.

The foreign currency forward market is accessible to policy banks, commercial banks, trust and investment companies, financial leasing companies, finance companies and auto finance companies, provided that they obtain the approval of the CBRC to deal in financial derivatives. Other non-banking financial institutions must obtain the approval of their regulatory authorities. Non-financial enterprises require the approval of the SAFE.

The SAFE determines the maximum amount of trading between domestic and foreign currencies for non-financial enterprises and non-banking financial institutions on the basis of the amounts of their foreign exchange tenders, their capital and their operating capital.

Forward transactions in the inter-bank foreign exchange market are subject to the following conditions:

- both parties use the PBOC's Centre quoting system to trade and negotiate to determine the currency, amount, maturity, exchange rate and delivery arrangements;
- forward transactions can be delivered at full amount at the maturity date or at net between forward price and spot prices, entailing that the means of delivery and currency be specified in the contract; and
- participants of the foreign exchange forward market can require their counterparts to deposit a certain amount of margins at the Centre.

Six months after market participants become qualified to deal in forward transactions, they may deal in swaps that combine spot and forward transactions, or combine different forward transactions.

2. Overseas debts and guarantees

Between 1990 and 1995, China issued some USD 5 billion worth of bonds abroad.[30]

In the wake of the Asian financial crisis in 1997, the Chinese authorities began a review of foreign indebtedness. According to the Bank of International Settlements, the debt load corresponded to USD 86 billion in June 1997, up from USD 75 billion in June 1996. Offshore affiliates of PRC entities were also considered to have significant foreign-debt obligations not included in official figures.

2.1. The general framework governing foreign debts

Originally, the State Plan quota was administered by the State Administration of Exchange Control (since renamed SAFE) through a registration process. In fact, only a few ministries and State agencies may solicit foreign loans. Functional ministries and local governments may only contract foreign loans in connection with projects and enterprises or through allocations from the central government. The Provinces receive the remainder of the quota that is administered by Provincial SAFE offices. Most of this quota goes to a few domestic financial institutions (BOC and CITIC for instance). State-owned enterprises must generally pass through a financial institution to receive foreign loan proceeds.

While the SAFE monitors the performance of the borrowing financial institutions, it does not supervise the ultimate local borrowers. The government does not provide any guarantees with respect to the loans contracted by financial institutions. The SAFE reviews the creditworthiness of the issuers but this procedure is not intended to constitute a warranty of the result of the investigation.

As not all the foreign borrowing contracted by Chinese financial institutions is ticketed to specific projects, there is a market for intermediation of these loans.

Article 78 of the 1983 regulations implementing the law on sino-foreign joint ventures allows joint ventures to borrow foreign currency for their projects. The loans must be reported to SAFE or one of its branches.[31]

Foreign banks may not engage in any lending without SAFE approval.

Lest their contracts be null, all PRC enterprises must obtain approval from the competent SAFE office before securing international commercial loans.

To qualify under the administrative measures on domestic institutions borrowing international commercial loans of January 1, 1998, domestic borrowers must:

- have been profitable in the preceding three years;
- have permission to carry on an import/export business;
- be in an economic sector encouraged by the State;
- have adequate financial control systems;
- have net assets corresponding to at least 15% of total assets for trading activities, or net assets of not less than 30% of total assets for non-trading activities;
- their aggregate balance of international commercial obligations and foreign-related security obligations may not exceed 50% of net assets expressed in foreign exchange; and
- have an aggregate balance of international commercial loans plus foreign-related security obligations of not more than the foreign exchange revenue for the previous year.

2.2. Registration of foreign loans to Chinese entities

Contracts of debt subscribed by Chinese entities are subject to controls under the Rules for Implementation of registration of foreign debts, promulgated by the SAFE on November 10, 1989 (the Foreign Debt Rules), which implement the interim provisions on statistics and monitoring of foreign debts.

Foreign debts refer to debts obtained directly from abroad and payable in foreign currency. They include:

- international financial institutions' loans such as those provided by the IMF, the World Bank, Asia Development Bank, the UN Agricultural Development Foundation and other international or regional financial institutions;
- foreign government loans, such as official aid loans;
- loans provided by banks, banking groups and other non-banking financial institutions outside China's territory;
- trade credit by foreign banks to Chinese importers or banks for purchasing equipment from foreign exporters;
- foreign enterprises' loans from non-financial institutions abroad;
- issues by domestic institutions of foreign currency bonds on overseas money markets;
- international financial leasing provided by foreign leasing companies for domestic institutions;
- financing provided by foreign exporters for Chinese importers that enables Chinese importers to pay three months or more after the goods entered China;
- debts repayable in foreign exchange through compensation trade, including debts to be repaid with foreign exchange earnings generated from exports;
- foreign currency deposited by foreign institutions or individuals at domestic financial institutions;
- loans provided by foreign banks or sino-foreign joint venture banks located in China for domestic enterprises including foreign investment enterprises;
- debts transferred home by institutions registered outside China and repayable by domestic institutions;
- foreign debts owed by Chinese institutions resident abroad;
- loans obtained by FIEs in the names of foreign partners for capital or equipment to the exclusion of equity contributions and repayable by the FIEs;
- guarantees provided by Chinese parties for debts owed by foreign parties; and
- debts owed by wholly foreign-owned enterprises (WFOEs) to their parent companies.[32]

The authority designated to carry out the required registration of the above debts is the SAFE.

The SAFE is also responsible for registering foreign debts owed by ministries and commissions under the State Council and those of companies and banks and non-banking financial institutions the headquarters of which are in Beijing; its local branches are responsible for registration of foreign debts owed by local governments, financial institutions, enterprises, offices of the central government and the headquarters of financial institutions resident in their areas. Any foreign debts owed by Chinese institutions resident abroad that are not registered outside China's territory must be registered at the departments of foreign exchange control where they are located.[33]

Registration procedures take the form of lines of authorizations for debts contracted by domestic banks and non-banking financial institutions, as well as for those of the MOF, the MOFCOM, the PBOC, the Ministry of Agriculture and the Bank of China contracted toward foreign governments and international financial institutions.

Debts owed by other domestic departments and enterprises (including FIEs) are registered on an individual basis.[34]

For foreign debts of financial institutions entrusted by enterprises and non-profit organizations, the debtor specified in the loan agreement accomplishes the procedures of registration.

According to article 6, reimbursement and payment of interest abroad are made on the strength of the registration card and a document of approval for payback with interest from the department where the debt was registered.

The local departments for the administration of foreign exchange may, depending on the seriousness of the case, impose fines of no more 3% of the renminbi equivalent to the amount of foreign debts involved where parties violate the Rules as well as where any of the following events occurs:

- intentional avoidance of the procedures for registration of foreign debts or delay in doing so;
- refusals to send required information to the department of foreign exchange, concealment of information or communication of false information;
- forgery and alterations of debt registration cards;
- improper uses of bank accounts for payment of foreign debts, in which cases both the borrower and the bank are subject to fines.[35]

2.3. Guarantees by domestic parties of obligations of foreign entities

The Measures for the Control of Provision of Security to Foreign Parties by Organizations within the People's Republic of China, adopted by the PBOC on September 25, 1996, regulate foreign guarantees, mortgages, and pledges subscribed by Chinese companies (the Foreign Security Measures). The provisions do not apply to wholly foreign-owned enterprises.

Article 12 prohibits the granting of security to foreign parties without the approval of the SAFE or its competent departments. Article 17 makes void contracts without the SAFE's approval. Security providers must register foreign securities with the SAFE of the place where they are located and the certificate that is issued is a prerequisite for any payments ultimately to be made in connection with the security.[36]

If security is provided to foreign parties without approval or without registration, the SAFE may issue warnings, or suspend or revoke the security provider's right to carry on that business.[37]

Article 2 includes in the scope of the Measures guarantees in the form of letters of guarantee, standby letters of credit, promissory notes and bills of exchange, mortgages of real property interests, pledges of moveable property to organizations outside China or foreign-invested financial institutions within China.

Except with the approval of the State Council in relation with loans from foreign governments or international economic organizations for on-lending purposes, State organizations and units may not provide security to foreign parties.[38]

Articles 5 and 6 of the Measures impose prudential ceilings on foreign guarantees:

- for financial institutions, the aggregate of the outstanding amounts of guarantees to foreign parties, of guarantees in foreign exchange within China and of their foreign exchange debts may not exceed 20 times their own holdings of foreign exchange;
- for non-financial enterprise-legal persons, the outstanding amount of guarantees to foreign parties may exceed neither 50% of their net assets nor the amount of their foreign exchange income during the preceding year;
- domestic enterprises may only provide guarantees to foreign parties for foreign debts of their direct subsidiaries or for foreign debts of enterprises in which they have shareholdings up to the proportions thereof in such enterprises; and
- when domestic trading enterprises may not provide guarantees to foreign parties, unless the ratio of their net assets to total assets is at least equal to 15%, and for non-trading domestic enterprises, the ratio must be at least 30%.

Article 7 prohibits guarantees to foreign parties for enterprises that incur operating losses.

Guarantees of FIE obligations must concern loans used in accordance with State industrial policies and a foreign loan may not be converted into renminbi without approval.[39]

The SAFE and its local departments are responsible for the control and registration of security to foreign parties.[40]

In evaluating whether to allow the provision of foreign guarantees, the SAFE takes account of the scale of the operation, the asset-debt ratio and the profit and loss situation of the secured party.[41]

Guarantees to foreign parties for domestic enterprises and for FIEs of a term of up to one year are approved by the SAFE of the province, autonomous region, municipality directly under the central government, municipality with independent planning power or Special Economic Zone where the security provider is located. Guarantees to foreign parties for FIEs of terms of more than one year or for organizations outside China are first submitted to the branch of SAFE of the province, autonomous region, municipality directly under the central government, municipality with independent planning power or Special Economic Zone where the security provider is located and then passed up to the SAFE in Beijing for final approval.

Foreign guarantees should be set down in writing. Providers of guarantees have the right to monitor the financial and asset conditions of the secured party. Their consent is required if the underlying obligation is changed, in which event the security provider must apply to the SAFE for approval lest the guarantee be without effect. After the security provider has performed its obligations, it may seek compensation from the secured party. If the creditor fails to perform its obligations in accordance with the provisions of the debt contract, the security provider is released from its obligations.[42]

3. Shares in Chinese companies listed on Chinese stock markets circulating abroad (B shares)

The first so-called B shares were issued in 1992 in order to offer foreign investors a vehicle to investing in Chinese companies, without instituting capital account convertibility, by restricting their ownership and trading to offshore residents.

As of December 2005, the 109 companies that had issued B shares, raising about USD 5 billion posted a market capitalization of almost USD 1 trillion.[43]

The Securities Law provided that specific measures in respect of B Shares would be adopted by the State Council.[44] On December 25, 1995, the State Council adopted the Regulations For Domestically Listed Shares Held Overseas of Companies Limited by Shares (the B Share Regulation).

A and B shares rank *pari passu* in terms of all their rights within the company, and, other than as regards the residence of their holders, they differ only in terms of the currency in which they are traded and in which distributions are effected (renminbi for A shares, United States and Hong Kong dollars for B shares listed at Shanghai and Shenzhen respectively).[45] B shares are listed on the Shanghai and Shenzhen stock exchanges.

Whereas, originally, A shares are issued to and traded exclusively among Chinese nationals residing in China, B shares, though they are issued in China and traded on stock markets in China, circulate only among residents (including individuals, companies and organizations) abroad (including Hong Kong, Macao and Taiwan), including non-resident Chinese nationals, and foreign residents in China.[46]

3.1. Issues of B shares

The Regulations of the State Council on Foreign Capital Stocks Listed in China by Joint-stock Companies, the so-called B-Share Regulation, was adopted at the 37th Executive Meeting of the State Council on November 2, 1995, and was promulgated by the State Council on December 25, 1995.[47]

Unless otherwise stipulated in the company's bylaws, B shares and A shares enjoy the same rights, interests and duties.[48]

Investors in B Shares must be:

- natural persons, legal persons and other organizations from foreign countries;
- natural persons, legal persons or other organizations from Hong Kong, Macau and Taiwan;
- Chinese citizens living abroad; or
- other investors in foreign capital stocks prescribed by the CSRC.

Investors in B Shares are required to prove their identity and qualification as investors[49] and changes in ownership must be disclosed.[50] But under article 22, B shares may be held by nominees.

Owners of rights and interests in foreign capital stocks listed in China must release information about changes in ownership.

Article 2 of the B-Share Regulation limits the total amount of B share issues approved by the CSRC to the ceiling set by the State. For issues of B Shares with a face value in excess of USD 30,000,000, the approval of the State Council is required.

The B-Share Regulation adds substantive requirements to those applicable to the issue of A shares:[51]

- State regulations with respect to foreign investment must be respected;
- the contributions of the promoters to the equity of any new company must be equivalent to at least RMB 150 million (the corresponding amount for A share issues is RMB 30 million);
- B shares issued to the public must account for at least 25% of the capital unless the issuer has a capital in excess of RMB 400 million subject to a floor of 15% (in the Issue and Trading Regulation the floor is set at 10%); and
- where issues of B shares are intended to increase the capital of companies already listed in China, the last issue of shares to the public must have been fully subscribed and the net value of the company's total assets must exceed RMB 150 million.

Applicants to issue B shares must complete the following procedures. First, the people's government of the province, autonomous region or municipality directly under the central government, and competent department of the State Council in charge of the issuer's activity, must recommend them to the CSRC.

The CSRC then consults with relevant departments of the State Council to decide which applications will be approved.[52]

The documentation, which must be filed with the CSRC in cases of initial issues of shares as well as capital increases, includes many of the same elements as required for A shares:

- the names of the promoters, the number of shares to be subscribed by each, the types of capital contributions and a capital verification certificate;
- corporate resolutions approving the issue;
- documents of support from the people's government of the relevant province, autonomous region or directly administered municipality or the State Council authority in charge of enterprises;
- the company's articles of association;,
- a prospectus;
- a feasibility study including an approval, where relevant, from the fixed asset management authority;
- financial statements for the previous three years signed by at least two certified public accountants;
- an asset evaluation report signed by at least two professional appraisers or, where the sale of State-owned assets is concerned, a confirmation issued by the State Assets Administrative Department as well as a State equity approval document;
- a legal opinion on relevant matters signed by more than two lawyers,
- the underwriting plan and the underwriting agreement; and
- such other documents as required by the CSRC.[53]

The B-Share Regulation provides that any adjustments made to the accounts of an issuing company to comply with standards applicable in the country of the issue must be clearly explained.[54]

All documents must be prepared, filed and disclosed to the public in Chinese. In the event of discrepancies between the Chinese version of any such documents and foreign language translations that may have been made available to foreign investors, the Chinese text in each case prevails.[55]

B share issuers must employ registered accountants, who meet State standards to audit and review a company's financial reports according to national standards.[56]

Only securities institutions approved by the PBOC and the CSRC may act as lead underwriters of issues of B shares.[57]

Companies issuing B shares are obligated to open foreign exchange accounts with a domestic bank authorized to handle foreign exchange transactions. The lead underwriter is obligated to pay into such foreign exchange account the proceeds of the foreign issue within the period specified in the underwriting agreement.[58]

3.2. Rules specific to the trading of B shares

The B-Share regulation sets down a certain number of trading rules of significance for foreign investors.

Trading of B Shares must be transacted by securities brokerages approved by the PBOC and the CSRC.[59]

Transactions, retention, liquidation and settlement, transfers and registrations of B Shares must be carried out in conformity with Chinese laws and regulations as well as the other rules stipulated by the CSRC.[60]

Article 24 authorizes the circulation of depositary receipts and share certificates for B shares.[61]

Dividends on B shares are declared in RMB but paid in foreign currencies[62] and are net of withholding taxes.[63]

Capital gains on B-share trading are in principle taxed at a rate of 20%, withheld at the source. In general, China's quite extensive network of tax treaties with developed countries provides for a reduction of the rate to 10%. Often, the countries of residence of the foreign beneficiaries of the capital gains will grant credits for taxes paid in China.

3.2.1. Shanghai Stock Exchange rules applicable to trading in B shares

B-Share trading can be conducted during hours when both the Shenzhen exchange and New York banks are open for business.

All B shares must be traded on the floor. Trading is conducted on a computerized auto-matching system. Short-selling and cross trading are prohibited.

B shares are traded in lots of 100 shares.

While the settlement cycle remains T + 3 days, turnaround trades may be booked on the day of purchase.

B-share prices are quoted and settled in American dollars. Conversion rates are calculated on the basis of the weighted average exchange rate of the dollar over the preceding week. The conversion must be carried out at the B share counters of approved institutions.

Approved B-share dealers must enter into clearing agreements with a bank approved by the PBOC. To qualify for approval, a bank must be located in Shanghai, have a licence to engage in foreign exchange business, and must have a good international reputation as well as considerable experience in international securities clearing and settlement.

B-Share trading on the Shanghai Exchange gives rise to stock exchange fees (1.0% of the value of the transaction) and transfer taxes (0.3% of the transaction value). There is no stamp duty payable on B share trades.

Dealers in B shares on the Shanghai Exchange must be approved by the PBOC. General approval entitles operators to act as agent for the trading of B shares and for the placement of an issue of B shares. Special authorization from the PBOC is required in order to act as underwriter of any B share issue.

The qualifications for a local dealer to obtain authorization to deal in B shares include: a permit to conduct B share foreign exchange business, adequate telecommunications equipment, and permission from its controlling supervisory authority.

Overseas dealers seeking to deal in B shares require a recommendation from a domestic securities dealer, paid-up capital of at least USD 10 million, local business experience of at least five years, a good reputation, suitable premises and sufficient staff. The agency agreement under which the foreign dealer proposes to carry on B-share dealing must be approved by the Shanghai branch of the PBOC. Overseas dealers in B shares hold seats on the Shanghai Stock Exchange through local brokers acting as nominees. While the overseas broker may have its own traders on the floor, its commissions are shared with the domestic nominee. Overseas operators may act as underwriters or sub-underwriters provided they obtain permission from the Shanghai PBOC.

3.2.2. Shenzhen Stock Exchange rules applicable to trading in B shares

The issue, underwriting, listing transfer and settlement of Shenzhen listed B shares must be conducted on the Shenzhen exchange by dealers approved by the PBOC. Such authorized dealers may engage foreign dealers, which are approved by the PBOC to handle the purchase and sale of B shares by persons living outside the Mainland.

The qualifications for becoming an authorized B-share dealer under the Shenzhen rules include: a relatively strong international securities business, a good professional reputation, experience in developing international securities business, respect of their commitments in the context of the Shenzhen exchange and respect of the laws and regulations applicable there.

Once approved as a B share dealer, foreign operators may underwrite and co-manage issues of B shares.

While foreign brokers own their seats, they are not full members with voting rights.

Requirements applicable to the listing of B shares on the Shenzhen exchange are comparable to those applicable on the Shanghai exchange, which also requires that the company has been in operation for at least three years, unless its activities are in the technology field or special permission has been obtained.

All disputes relating to B shares are governed by Chinese law.

Trading hours on the Shenzhen exchange are the same as those for A shares.

B shares are traded on a computerized auto-matching system.

Shenzhen B shares are quoted and settled in Hong Kong dollars.

While short selling and off-floor trading are prohibited, cross trading is not.

B shares are traded in lots of 2,000 shares.

Purchased shares may only be sold on T + 3, thus allowing time for clearing and registration.

Clearing of B shares on the Shenzhen exchange is the responsibility of the Shenzhen Settlement registration and Clearing Corporation, which has in fact delegated its tasks to three banks: Citibank, Standard Chartered and Hong Kong and Shanghai Bank.

B share trading on the Shenzhen exchange gives rise to the following charges: brokerage fee, 0.7% of the value of the transaction; stock exchange fee, 0.5% of the transaction value. There is no stamp duty payable on B share trades.

4. Shares of Chinese companies listed on overseas stock markets

As early as 1992, the CSRC authorized nine companies to issue on the Hong Kong Stock Exchange the shares of specifically created Hong Kong subsidiaries carrying on the essence of their activities in China, thus giving rise to the so-called H-share market.

The overseas share listings have been carried out in stages. At first, the Chinese authorities allowed major industrial companies to list overseas (power plants, petrochemicals, transportation, telecommunications). Subsequently, Chinese companies obtained so-called back-door listings on the Hong Kong Stock Exchange achieved by acquiring Hong Kong listed companies. As the results of these indirect listings did not prove very encouraging, smaller yet profitable companies were given a chance to list in Hong Kong. Apparently, some of these listings were carried out without formal approval from the Chinese regulatory authorities. The state of underdevelopment of the Chinese capital market and the tight controls on bank loans encouraged many enterprises to seek funds abroad. Another of the motivations for Chinese companies to seek foreign listings was the substantial tax preference.[64]

The legal framework applicable to Chinese companies seeking to list their shares overseas is built upon the Special Regulations concerning Issuing and Listing of Shares Overseas by Companies, adopted at the 22nd Executive Meeting of the State Council on July 4, 1994, promulgated by the State Council on August 4, 1994 and effective as of the date of promulgation (the Overseas-Share Regulation).[65]

In effect, the Overseas-Share Regulation creates a separate class of shares within Chinese companies in addition to the class of shares encompassing A and B shares.[66]

The Overseas-Share Regulation is intended to incorporate into Chinese law standards required by supervisory authorities responsible for foreign securities markets. It has even been observed that the requirements applicable to overseas shares under the Chinese regulations are more constraining than those applicable to Hong Kong listed companies. The authorities have in fact promoted the conclusion of agreements with regulatory authorities intended to pave the way for the listing of Chinese company shares. Such agreements have been signed with stock exchange authorities in, *inter alia*, Hong Kong, Singapore, Tokyo, New York, London, Frankfurt and Toronto.[67]

4.1. The approval process

Chinese companies limited by shares (CLSs) intending to issue shares abroad are required to obtain the prior approval of the CSRC.[68] The shares may be listed on foreign stock exchanges and they ground trading in derivatives.[69] The shares must be registered and, while their nominal values are priced in renminbi, they are subscribed with foreign currency.[70]

For Chinese companies seeking to be listed abroad:

- the issue must comply with the domestic laws, regulations and rules concerning overseas listings;
- the uses of the raised funds must comply with national policies on industrial development and those on the uses of foreign capital as well as national regulations on investments in fixed assets;
- the net value of their assets may not be less than RMB 0.4 billion and their after-tax profits for the last year may not be less than RMB 60 million with promise of increases; based on the expected price-earnings ratio, the sum of the raised funds may not be less than USD 50 million;
- they must possess standardized corporate governance structures and well-established internal administration systems with reasonably stable senior management;
- they must have available reliable sources of foreign funds to cover bonuses and dividends once the shares have been listed; and
- the operations must comply with foreign exchange controls.[71]

The CSRC consults with the NDRC and the State-owned Assets Supervision and Administration Commission (SASAC) about whether the applicants respect national industrial development policies and those concerning foreign uses of capital use.[72]

4.2. The Overseas-Share Articles of Association Regulation

The Overseas-Share Articles of Association Regulation, with its full 166 articles, practically constitutes a company law for Chinese companies issuing shares abroad. Its general purpose is to impose upon foreign listed companies standards that will permit their corporate functioning, as well as documentation that will meet the standards set by foreign regulators.

For instance, the Regulation imposes on relevant companies the obligation to include certain measures in their articles of association, yielding a final product closely modelled on Table A of the Hong Kong Companies Ordinance. One indication that the transplant has not taken hold easily is the fact that, in Chinese law, the equivalent of the business registration certificate (issued by the State Administration for Industry and Commerce) would prevail over the objects stated in any company's articles of association. Furthermore, the Chinese practice of stating briefly the scope of any company's business will not sit well with directors and senior management on whom a duty is imposed toward shareholders to ensure that their company's activities remain within their intended scope.

Chinese companies listing their shares overseas must prepare their accounts not only in compliance with Chinese practice but also international standards and whatever standards may prevail in the country of listing.

The Overseas Articles of Association Regulation also imposes a requirement of publication of an annual report within 120 days of the end of the business year and one interim report within 60 days of the end of the second quarter of the business year.

Article 113 of the Regulation provides an affirmative answer to the ubiquitous question concerning the enforceability at the instance of *bona fide* parties of agreements subscribed with directors or senior management personnel of companies acting in an irregular manner.

Article 114 defines the fiduciary duties assumed by directors, supervisors and senior management personnel of Chinese companies listing their shares overseas:

- not to cause the company to act beyond the scope of business stipulated in its business licence;
- to act honestly in the best interests of the company;
- not to deprive the company of its property in any way, including (but not limited to) any opportunities that are favourable to the company; and
- not to deprive shareholders of their individual rights or interests, including (but not limited to) rights to distributions and voting rights, unless pursuant to a restructuring of the company adopted by the shareholders' general meeting in accordance with the articles of association.

In general, directors and senior management must perform the duties incumbent upon their offices with such care, diligence and skill as would be exercised by a reasonable and prudent person in similar circumstances. Article 116 contains a long but non-limitative list of violations of fiduciary duties the general thrust of which is to proscribe disloyal conduct by managers, and directors (taking bribes, the pursuit of personal gain, favouritism among shareholders and indiscretions with respect to confidential information).

Article 117 takes specific aim at nepotism in the appointment of directors, supervisors and senior managers.

According to article 118, fiduciary obligations do not necessarily cease upon relinquishment of office and continue for such time as is fair under the circumstances.

But to whom are these fiduciary duties owed? While article 114 would appear to orient the duty toward the shareholders, other articles, not to mention a long-entrenched tradition, would seem to favour priority protection of State or public interests. And in at least one judicial decision, the company itself was compensated for ill-begotten gains of its directors.

A couple of examples of departures from generally applicable Chinese company law may be found in the model articles of association for overseas listed companies. One concerns the provisions for a company's redemption of its shares, a practice proscribed for locally listed Chinese companies, while permitted under specifically regulated conditions in the case of overseas listed companies. Another difference involves the organization of shareholder meetings: while both regimes provide for a written quorum system, in the case of the overseas listings "more than 50%" of shareholders must signal their intention to attend, whereas for Chinese-listed companies the number is "50%".

Article 71 of the model regulations requires that certain matters be adopted by special resolution (two thirds of votes cast):

- increases or decreases of the share capital, and issues of any class of shares, warrants or similar securities;
- issues of debentures;
- partitions, mergers, dissolution or liquidation of the company;
- amendments of the articles of association; and
- and other matters which, according to an ordinary resolution of the shareholders' meeting, are deemed to have significant impact on the company and thus give rise to the adoption of special resolutions.[73]

Disputes involving owners of overseas listed shares of Chinese companies are subject to Chinese law.

The provision for the settlement of disputes involving Chinese company shares listed overseas leaves much to the imagination. The first order solution is that decided by mutual agreement of the State Council authorities and the regulatory authorities of the foreign country concerned. In the absence of such provision, the parties are free to agree on a manner of resolution of their disputes or to have them settled by reference to laws or regulations. A specific method of settlement is provided for cases involving Chinese company shares issued in Hong Kong. It is interesting to note that Chinese law is *a priori* applicable, though the parties may make another choice, and arbitration institutions from either Hong Kong or China may be designated by the parties.

4.3. Rules specific to overseas listings of Chinese company shares

In principle, shares listed on foreign exchanges are to be floated at the same time as shares on the domestic market.

Dividends and other payments on shares listed overseas are calculated in renminbi and paid in foreign currency.

Companies issuing shares on overseas markets must maintain their accounts in compliance with both international standards and principles generally accepted in China. In practice, such companies will produce at least a third set of accounts to reconcile differences between international accounting standards and the standards of the country where the issue takes place. Any inconsistencies between the information contained in the various language versions must be explained publicly.

5. Investments by Qualified Foreign Institutional Investors (QFIIs) in A shares

The authorities launched the QFII programme to allow foreign investment banks, insurance companies and annuity funds to enter the domestic capital market. By the end of 2006, QFIIs owned an equity value of more than RMB 24 billion (about USD 3 billion) in 214 listed companies.

Originally, permission for qualified foreign financial institutions to trade in A Shares was given under the Provisional Measures for Administration of Domestic Securities Investment by QFIIs that were issued by the CSRC and the PBOC with effect as of December 1, 2002.

Then on August 24, 2006, the CSRC, the PBOC and the SAFE jointly issued the Measures for the Administration of Investment in Domestic Securities by QFIIs (the QFII Measures), which replace the 2002 measures. In the same year, 2006, the CSRC issued its Circular on Implementing the Administrative Measures for Securities Investment in the Territory of QFIIs to complete and specify the framework (the CSRC QFII Circular).[74]

Article 2 of the QFII Measures defines QFIIs as "overseas fund management institutions, insurance, securities and other asset management institutions" that must be approved by the CSRC to invest in A shares, subject to limits set down by the SAFE.[75]

The following types of foreign institutions may qualify as QFIIs:

- fund management organizations with more than five years in asset management and with securities assets in the latest accounting year of not less than USD 5 billion;
- insurance companies in operation for more than five years and with securities assets in the latest accounting year of not less than USD 5 billion;
- securities companies with more than 30 years in the trade, paid-in capital of not less than USD 1 billion, and with securities assets under their management in the latest accounting year of not less than USD 10 billion;
- commercial banks with gross assets in the latest accounting year ranking them among the top 100 worldwide, and with securities assets under their management of not less than USD 10 billion; and
- other institutional investors (pension funds, charity foundations, donation funds, trust companies or government investment management companies, etc.) in operation for more than five years, and with securities assets under their management of not less than USD 5 billion.[76]

Candidates for QFII status must emanate from States the regulatory frameworks of which are "sound and proper" and their home securities regulatory authorities must have signed memorandums of understanding with the CSRC concerning their co-operation. Candidates must be financially "sound and trustworthy". They must satisfy the CSRC's and their home State regulators' rules on asset ratios and risk control. Their employees must meet the requirements for practitioners in their home countries. They must maintain sound management structures and proper internal controls. They must carry on business in accordance with the relevant regulations and they must not have been subjected over the three previous years to serious punishments by the competent authorities of their home country.[77]

Each of the CSRC and the SAFE answers applicants within 20 working days of the filing of their applications.[78] Unless otherwise stipulated by laws or regulations, or revocation by the CSRC, QFII licences are valid indefinitely.[79]

QFIIs' activities on Chinese territory are subject to joint regulation by the CSRC and the SAFE.[80] In addition, the PBOC is entitled to require communication of information about QFIIs' activities from the QFIIs, custodians, securities companies, stock exchanges and clearing institutions.[81] Subject to CSRC approval, stock exchanges and clearing institutions may create special rules governing QFII activities.[82]

After obtaining a licence from the CSRC, QFIIs then must apply to the SAFE for determination of the limits on their holdings. In the event of failure to obtain the SAFE's authorization, the authorization of the CSRC is considered to be void.[83]

In granting licences, preference is given to institutions proposing to manage closed-end pension funds, insurance funds and mutual funds with mid- and long-term investment objectives.[84]

QFIIs must, within three months from obtaining the CSRC's authorization, remit the principal from outside the country into their special renminbi account that willl be treated by the SAFE as convertible currency, and the amount remitted may not exceed the amount approved.[85]

QFIIs must employ domestic commercial banks as custodians and appoint domestic securities companies to manage the domestic securities trading activities.[86] When it is in their interest, QFIIs may replace their custodians.[87]

QFIIs may use only one custodian.[88]

Custodians must have paid-up capital of not less than RMB 8 billion and they must be qualified as foreign exchange banks and to conduct renminbi business.[89] Domestic branches of foreign-invested commercial banks with more than three years of continual operation are eligible to apply for authorization to act as custodians.[90] Applications to act as custodian must be approved by the CSRC and the SAFE.[91] Custodians must, within two business days, report to the SAFE all QFIIs' remittances (in or out); they must report to the SAFE and the CSRC, within five working days from the end of each month, QFIIs' income and expenditure on their renminbi special accounts, and they must in a timely manner report their violations of the laws and regulations to the CSRC and the SAFE.[92]

Custodians must separate their own assets from those of QFIIs.[93]

Custodians open renminbi accounts for their QFII customers with securities registration companies and must advise the CSRC and the SAFE thereof within five working days.[94]

QFIIs may invest in the following renminbi financial instruments:[95]

- stocks quoted and traded in stock exchanges;
- bonds quoted and traded in stock exchanges;
- securities investment funds;
- warrants quoted and traded in stock exchanges; and
- other financial instruments permitted by the CSRC.[96]

QFIIs' holdings of any company's shares may not exceed 10% of their total number and the sum of all QFIIs' holdings of any company's shares may not exceed 20% of their total number.[97]

QFIIs must respect the Guidelines for Foreign Investors set down by the MOFCOM,[98] as well as the Administrative Measures for Strategic Investment in Listed Companies of Foreign Investors,[99] and the requirements with respect to information disclosure, such as in the event of their acquisition of numbers of shares beyond the legal thresholds for public announcements.[100]

QFIIs' special renminbi accounts are used for their remittances and their trading activities as well as for settling their expenses.[101]

As nominal holder of shares, QFIIs may exercise partial or split voting rights, depending on the holdings of foreign investors under their names.[102]

QFIIs may mandate three domestic securities companies to trade securities on the Shanghai and Shenzhen stock exchanges.[103]

Repatriations of QFII profits after tax are subject to the SAFE's approval.[104] Reinvestments of remitted capital must be approved according to the above-mentioned procedures.

QFIIs inform, within five days, the CSRC, the SAFE and the PBOC of changes of their custodians, of their authorized representatives, of their controlling shareholders, of their registered capital and of litigation and other significant events.[105]

QFIIs must reapply for their authorizations from the CSRC when they change their business name and when they are acquired.[106]

QFIIs must surrender their CSRC and SAFE permits when they repatriate the total amounts of their principals, transfer their investment quota or if they are in bankruptcy or receivership.[107]

Article 37 of the QFII Measures authorizes the CSRC, the PBOC and the SAFE to issue warnings to, or impose penalties against, QFIIs, custodians, and securities companies, provided that penalties may not be cumulated for the same infraction.

6. Foreign investments in State shares and legal person shares

Specific provisions address the takeover by foreign parties of interests in SOEs and State-owned assets, in particular:

- the Notice Regarding the Transfer of State Shares and Legal Person Shares of Listed Companies to Foreign Parties jointly issued by the CSRC, the MOF and the State Economic and Trade Commission (SETC) effective from November 4, 2002; and
- the Tentative Provisions on the Use of Foreign Investment to Restructure State-Owned Enterprises jointly issued by the SETC, the MOF, the State Administration for Industry and Commerce (SAIC), and the SAFE, to be effective from January 1, 2003.

The Notice renders possible the purchase by foreign investors of State shares and legal person shares of PRC-listed companies. Foreign investors purchase them after their conversion into B shares.

Except where approved by the CSRC, the acquiring party must make an offer to all the shareholders of the target company if it intends to hold or control (whether individually or acting in concert with other parties) more than 30 per cent of its outstanding shares.

In takeovers of non-listed shares, the offer price may not be lower than the higher of: (i) the highest price paid by the acquiring party within six months prior to the general offer announcement, or (ii) the most recent audited net asset value per share of the target company.

The notice provides that State shares and legal person shares must be paid in cash. The purchase price must be paid in full before the shares can be legally registered in the name of the foreign investor. Following completion, there is a 12-month lock-up period.

Approval for the transfer is usually obtained at the central government level and involves the SETC and (for the sale of State shares) the MOF, while for "major matters" approval is to be given by the State Council.

Restructuring of SOEs may involve purchases of the interest held by government entities or legal persons, increases in the registered capital to be subscribed by the foreign investor or a transfer of the target's domestic creditors' rights to the foreign party.

7. Strategic investments by foreigners in listed companies

On December 30, 2005, the MOFCOM, the CSRC, the SAT, the SAIC and the SAFE jointly issued the Measures for Strategic Investments by Foreign Investors in Listed Companies (the Foreign Strategic Investor Measures) enabling foreign investors[108] to acquire A-shares of listed companies, provided that they have "finished reforming their non-tradable shares", as well as those of newly listed companies, as part of long- or mid-term investments through merger and acquisition on a significant scale.[109] Such investments are subject to the approval of the MOFCOM.[110] They must abide by the relevant national laws, rules and related industrial policy, and they may not harm national economic safety and social public interests. They must be consistent with the maintenance of normal market order, and they may not be the fruit of speculation. They must comply with limits on foreign investments in certain sectors such as those concerning State assets.[111] They must not impede fair competition, cause excess concentrations of domestic sectors or exclude or limit competition.[112]

Except subject to special approvals, investments are implemented in stages, provided that the initial investment may not be less than 10% of the shares issued. Shares so acquired are subject to a three-year lock-up period.[113]

A candidate to implement strategic investments in listed companies must comply with the following requirements:

- it must be lawfully constituted and operated by foreign legal persons or organizations with sound credit and experienced management;
- the total amount of its overseas real assets, or of that of its parent company's, may not be less than USD 0.1 billion or the total amount of real assets under their supervision must be no less than USD 0.5 billion;
- it must have established sound governance structures and internal control systems; and
- it must not have been subjected to any severe penalty by overseas supervision organs in the three preceding years.[114]

Where the strategic investment is made in a newly listed company, and after receipt of the approval from the MOFCOM, the application is submitted to the CSRC for approval. After the offering is completed, the company must register with the SAIC.[115]

Qualified foreign companies may carry out their strategic investments in China through their foreign subsidiaries, provided that they provide the MOFCOM with an irrevocable acceptance of joint and several liability with the investor-subsidiary. If that subsidiary were subsequently to be transferred, the MOFCOM's approval appears to be required by article 23 of the Strategic Investors Measures, and the transferee would be expected to honour all the commitments of the original parent.

Within 15 days after receipt of the MOFCOM's approval, approved applicants must open their foreign exchange accounts in the foreign exchange bureau where the competent registration office for listed companies is located.[116] They have 15 days from opening the foreign exchange account to commence their investment operations and 180 days to complete their investment lest the approval lapse.[117]

The business licence issued by the SAIC and the foreign exchange registration certificate identify the invested enterprise as "a foreign-invested joint limited company (A share acquisition and merger)".[118]

Subject to the following exceptions, strategic investors in A-shares may not trade their securities during the term of their investment commitment. They may acquire A-shares in the context of public offers under the Securities Law. They may sell non-tradable shares after the concerned company undergoes reform of its shareholding structure and subject to any applicable time limits. Shares held by strategic investors before the initial public offering may be sold after the expiration of the lock-up period. In the event of bankruptcy, liquidation or hypothecation, shares may be transferred with the approval from the MOFCOM.[119]

If the foreign strategic investor's share of the capital of the listed company falls below 25%, notices must be sent to the registration authorities and its registration certificates must be modified.[120]

If the strategic investor were to transfer its A-shares, it would have to obtain SAFE approval before remitting the proceeds.[121]

8. Overseas investments by Chinese individuals and enterprises

Non-financial sector overseas investments are subject to approval by the NDRC and by the MOFCOM and their use of foreign currency is regulated by the SAFE.

As of July 1, 2006, the SAFE cancelled the requirement of approval for purchases of foreign exchange to finance foreign investments if investors can satisfy their needs from their own funds.

Conversely, as the outward flows of investment have grown and concerned ever greater and more strategic projects, the attention of other administrative authorities has intensified.

8.1. The SAFE's regulations on overseas investment

The first important measures for foreign exchange control relating to overseas investment were issued by the SAFE on March 6, 1989. Proceeding timidly at first, the authorities have gained confidence, especially since they weathered the crisis that swept through neighbouring countries in 1997 and as they have observed their foreign reserves pile up, they have picked up the pace of capital liberalization in the context of the country's entry into the WTO.

In October 2002, the SAFE instituted a pilot program in six coastal provinces allowing provincial authorities to approve enterprises' purchases of foreign currency to finance overseas investments.[122] The program was extended to 14 provinces in 2003 to 24 in 2004 and nationwide in 2005.

As of July 1, 2006, the SAFE implemented its Circular on Foreign Exchange Policy Adjusting on Some Overseas Investment to facilitate multinational operations of domestic investors (the 2006 SAFE Circular). The Circular covers conduct of all kinds of domestic investors, other than individuals, that obtain rights and interests, such as ownership or management rights, by establishing sole proprietorship enterprises, joint venture and cooperative enterprises, mergers and acquisitions, portfolio investments, capital contributions and conversions of stock.

Foreign investors must obtain approval from their departments of tutelage prior to making foreign investments.

Overseas investments may be financed by foreign currency on account or purchased with renminbi as well as by domestic loans. The SAFE no longer examines foreign currency purchases to finance overseas investment for branches.[123]

Once an application has been filed with the SAFE, domestic investors may make payment of early-stage expenditures to foreign beneficiaries with approval of the local branch offices of the SAFE, even before obtaining official approval. Such early stage expenditures include:

- deposits for purchasing stock in foreign enterprises and rights and interests in compliance with local laws and regulations;
- deposits paid in connection with bids on overseas projects; and
- expenditures for market research, office rent and facilities, recruitment and services of overseas intermediary organizations.[124]

In general, the early stage expenditures may not exceed 15% of the total overseas investment.[125]

Where the domestic investors are unable to complete their overseas investment within six months from the day of remittance of the early stage expenditure, the balance of the overseas currency must be repatriated.[126]

8.2. The NDRC's Circular on overseas investment approvals

On October 9, 2004, the NDRC promulgated the Interim Measures for the Administration of Examination and Approval of the Overseas Investment Projects to liberalize the outward flows of investment, including toward the Hong Kong and Macao SARs and toward Taiwan. The former rules for approval of overseas investment projects were not cancelled but, in the event of conflict, the Circular prevails.[127]

The Circular applies to the operations in which Chinese residents[128] assume ownership and other related rights and interests in foreign interests in exchange for consideration in the form of money, securities, material objects, intellectual property or technology, stock rights and creditor's rights.[129]

Overseas resource development projects and overseas investment projects requiring large amounts of foreign exchange are subject to State approval.

Resource development projects in which the Chinese party's investment amounts to USD 30 million or more are subject to approval of the NDRC and are then transmitted to the State Council for approval, while those in which the Chinese party's investment is USD 200 million or more are subject to review by the NDRC at the provincial level.

Outside resource sectors such as oil and minerals, projects requiring large amounts of foreign exchange refer to those in which the Chinese party's foreign exchange amount of USD 10 million is subject to approval by the NDRC, whereas those involving USD 50 million or more are subject to review by the NDRC and are then submitted to the State Council for approval.[130]

For projects below those thresholds, enterprises decide independently and reports are filed with the NDRC for the record.[131]

Investments in Taiwan and countries without diplomatic relations with China are subject to approval no matter what their amounts.[132]

Within 20 working days from acceptance of the project application, the NDRC must decide and, where relevant, forward its opinion to the State Council.[133]

When the NDRC disapproves an application, it must provide reasons in writing and inform applicants of their rights to apply for administrative review or to initiate an administrative lawsuit.[134]

In the event of excesses of more than 20% of the Chinese party's investment compared with the amount approved, an amendment must be sought from the NDRC.[135]

The criteria on which the NDRC renders its decision are stipulated to be the following:

- the project must abide by the laws and regulations of the State and the government's industrial policies, it must not harm the sovereignty, safety and public interests of the State and it may not violate the rules of international law;
- it must comply with the requirements of sustainable economic and social development and contribute to the development of strategic resources needed for developing the national economy;
- it must comply with the State's requirements for adjusting the industrial structure and promote the export of technology, products, equipment and labour services and absorb the advanced foreign technology;
- it must comply with the administrative prescriptions of national capital projects and the foreign loans; and
- the investors must dispose of appropriate financial resources.[136]

Before making any binding commitments, the investors must have obtained approval documents or record-keeping certificates issued by the NDRC.[137]

Where approval documents or certificates are obtained through malfeasance, such as by providing false materials, the NDRC may cancel the approval.[138]

The NDRC may conduct supervision and check on the implementation of investors' projects and treat any problems revealed in the process.[139]

8.3. Overseas investment by insurance companies and social security funds

On August 9, 2004, the China Insurance regulatory Commission (CIRC) and the China Banking Regulatory Commission promulgated for immediate effect the temporary measures on overseas use of foreign exchange insurance funds (the Overseas Investment of Insurance Funds Measures). The CIRC and the SAFE are competent to regulate the overseas foreign exchange activities of insurance companies.[140] They have powers to investigate and conduct on-site inspections.[141]

The Measures apply to Chinese insurance companies, wholly foreign-owned insurance companies, Sino-foreign joint venture insurance companies and branches of foreign insurance companies duly registered with the CIRC. Foreign exchange insurance funds include capital, undistributed profits, reserves and guarantee deposits received in foreign exchange.[142] Their activities in Hong Kong are treated as foreign for these purposes.[143]

Article 3 requires that insurance companies using foreign exchange funds abroad must respect the principles of safety, liquidity and profitability, prudence and independence.

To qualify for carrying on operations abroad in foreign exchange, insurance companies must satisfy the following conditions:

- they must hold permits for conducting foreign exchange business;
- they must possess total assets at the close of the previous year of not less than RMB 5 billion;
- their foreign exchange funds at the end of the previous year may not be less than USD 15 million or equivalent value in a freely convertible currency;
- their solvency margins must comply with relevant stipulations of the CIRC;
- they must have at their disposal a specialized fund management department or an insurance asset management company;
- their internal management systems and risk control systems must comply with the stipulations of the Risk Control Guidelines for Use of Insurance Funds; and
- the number of their professional managerial personnel with over two years' overseas investment experience must meet regulatory stipulations.

In connection with the applications, candidates must also produce, where relevant, any overseas trust or asset management agreements. The SAFE must render a decision within 20 days. Negative answers must be explained in writing.[144]

Increases in foreign exchange funds abroad must also be notified to the SAFE and overseas uses must be approved.[145]

Overseas foreign exchange insurance funds may only be held as:

- bank deposits;
- bonds of foreign governments, international financial organizations and foreign companies;
- bonds that the Chinese government or Chinese enterprises issue overseas;
- money market products including bank bills and negotiable certificates of deposit; and
- other investment objects and instruments within the scope specified by the State Council.

Deposits may only be placed with overseas branches of Chinese commercial banks or foreign banks with long-term credit ratings of A or above granted by an internationally recognized rating institution over the three previous years. Only bonds with credit rating of A or above granted by an internationally recognized rating institution are eligible investments. Money market products must have regular earnings and ratings of AAA or equivalent granted by internationally recognized rating institutions.

Overseas uses of foreign exchange funds are confined within certain limits :

- the total amounts to be invested may not exceed 80% of the balance of a company's foreign exchange funds at the end of the previous year, plus where relevant the amount of increases in foreign exchange funds received;
- actual investment may not exceed the amount of foreign exchange investment approved by the SAFE;
- the deposits on account in any single bank may not exceed 30% of the amount of foreign exchange investment approved by the SAFE to the exclusion of foreign exchange accounts used for operations;
- the balance of all bonds with A credit ratings, not including Chinese government and Chinese enterprises overseas bonds, is calculated at cost and may not exceed 30% of the amount of foreign exchange investment approved by the SAFE;
- the balance of all bonds with below AA credit ratings, not including the overseas bonds of the Chinese government and Chinese enterprises, is calculated at cost and may not exceed 70% of the amount of foreign exchange investment approved by the SAFE;
- the balance of the bonds issued by the same company or enterprise in which an insurance company invests is calculated at cost and may not exceed 10% of the amount of foreign exchange investment approved by the SAFE; and
- where an insurance company invests in the Chinese government or Chinese enterprises overseas bonds, their balance is calculated at cost and may not exceed the amount of foreign exchange investment approved by the SAFE.

Foreign exchange funds may be entrusted for management to overseas institutions that satisfy the following conditions:

- they must be specialized in investment management;
- they must be authorized to carry on this business according to the law of the country or region where they are located, including as regards prudential indices;
- their paid-up capital and net assets must both be at least equal to USD 60 million or equivalent in freely convertible currency;
- the assets under their management must not be less than USD 50 billion or equivalent in freely convertible currency;
- they must have sound corporate governance structures, internal management systems and risk control mechanisms with no record of serious violations of laws or regulations in the country or region of origin over the previous three years;
- they must have over ten years' experience in international asset management; and
- their countries or regions of origin must have sound financial supervision systems.[146]

Article 16 directs that overseas foreign exchange insurance funds be dedicated as a priority to Chinese government and Chinese enterprises overseas bonds, while articles 17 and 18 require that foreign exchange funds be deposited with qualified Chinese banks, branches of foreign banks, Sino-foreign joint venture banks and wholly foreign-owned banks within the territory of China. The solidity of the custodians is guaranteed by requiring that their paid-up capital correspond to at least RMB 8 billion while, for Chinese banks, their freely convertible capital must be at least the equivalent of RMB 1 billion, provided that for branches of foreign banks, the paid-up capital of their head offices is the reference.

Custodians must report to the CIRC and the SAFE:

- within five days after opening, domestic custody accounts or settlement, accounts for overseas use by insurance companies;
- within two days after insurance companies' outward remittances of principal and earnings;
- within five days after the end of each month on the balances of domestic custody accounts;
- within ten days after the end of each quarter, statements of uses of foreign exchange insurance funds; and
- within one month after the end of each fiscal year, statements of overseas uses of foreign exchange insurance funds for the previous year.[147]

The following funds are held in the domestic custody accounts:

- foreign exchange transferred by internal accounts;
- foreign exchange insurance funds remitted from outside China;
- income from principal and interest on bank deposits;
- bond interest and the proceeds from bond sales;
- interest income earned on money market products and the proceeds from sales of such products; and
- all other income in foreign exchange.[148]

Domestic custodians may choose overseas escrow agents, which must then be obligated in the same manner as the custodian.[149]

To ensure the reliability of foreign escrow agents, they are required:

- to have paid-up capital not less than USD 2.5 billion or equivalent in freely convertible currency;
- to have long-term credit ratings of A or above over the previous three years;
- to be qualified as custodians by the supervisory authority of the relevant country or region; and
- the country or area concerned must have a sound financial supervision system and the supervisory authorities must have signed and implemented a memorandum of understanding for supervision cooperation with their Chinese counterparts.

Domestic custodians and overseas escrow agents must separate their own assets from assets in their custody and they must open and manage different accounts for overseas foreign exchange funds of different insurance companies.[150]

Overseas commercial banks may not cumulate the functions of trustee for management of overseas funds, domestic custodian, and overseas escrow agent.[151]

Insurance companies must report within five days to the CIRC and the SAFE in the event of lawsuits with material consequences brought against them as well as if they were severely punished by foreign authorities.[152]

Violations of the applicable regulations may entail administrative sanctions imposed by either or both the CIRC and the SAFE competent offices. In serious cases, the CIRC may order the suspension or the cessation of insurance activities.

The CIRC has the authority to require replacement of domestic custodians, and both it and the SAFE may order an insurance company to replace its overseas trustee.[153]

8.4. Domestic residents' roundtrip investment through offshore special purpose vehicles

The SAFE has more than once changed its policies on the controls applicable to foreign currency raised abroad through overseas listings. At first, its hands-off policy facilitated the raising of funds abroad for investment in China.

After some equivocating,[154] the SAFE finally issued on October 21, 2005 its Notice Regarding Certain Issues relating to Foreign Exchange Administration of Equity Financings and Return Investments by Domestic Residents through Offshore Special Purpose Vehicles, which entered into effect on November 1, 2005.

Residents in China, whether individuals or enterprises, may set up offshore special purpose vehicles to raise funds by way of equity financing outside the territory to exploit their assets or interests in China. The vehicles may be used to purchase or exchange the equity of Chinese parties in domestic enterprises, to establish FIEs to take over domestic assets by contract; to purchase domestic assets and then establish foreign-funded enterprises using such assets as investments, and to increase investments in domestic enterprises.

Prior to creation of the vehicle, an application is made to the sub-branch of MOFCOM at the local level to register its overseas investment.

Applicants must submit, *inter alia*:

- the shareholding structure of the offshore vehicles and the details of any overseas financing;
- the commercial proposal; and
- approvals of foreign exchange fund sources and approvals of any competent authorities.

When assets or equities of domestic enterprises are transferred to special purpose vehicles, an application is made to the SAFE including:

- the methods used to price the assets or equities;
- approvals of the overseas investment by the foreign investment administrative departments
- the foreign exchange registration certificate for Overseas Investment; and
- where state-owned assets or equities are involved, documents confirming their value by the administrative department of state-owned assets.

Private enterprises in China may attract financing through overseas-listed special-purpose vehicles, which are then able to revert the funds raised to China to implement their plan for the uses announced in their business plans and prospectuses.

The process is labelled as consisting of "verification and confirmation", rather than "examination and approval".

After completing the financing through special-purpose vehicles, the domestic residents may, in accordance with their commercial proposal, repatriate the funds.

When the Chinese-origin capital returns with the added overseas financing, whether as loans or equity investments in Chinese assets or equities, the usual formalities must be completed with the competent SAFE department in compliance with the laws and regulations on foreign investment, on overseas investment and on foreign debt.

Only after completion of these formalities is the relevant certificate issued.

Payments to special-purpose vehicles may be made from profits, dividends, proceeds on liquidation, equity transfers and capital decreases.

The profits, dividends and foreign exchange incomes from capital modifications must be repatriated within 180 days.

Where offshore special-purpose vehicles undergo material modifications to their capital, such as capital increase or decrease, the domestic residents must, register it with the competent SAFE department within 30 days.

8.5. Qualified Domestic Institutional Investors' (QDIIS') overseas investments

The instauration of an inverse of the QFII measures allows Chinese citizens to invest in overseas financial markets through Qualified Domestic Institutional Investors (QDIIs). On June 18, 2007, the CSRC adopted the Administration of Qualified Domestic Institutional Investors in Foreign Securities Investments Trial Procedures which became effective as of July 5, 2007. On that date, the CSRC also issued its Circular on Issues Concerning the Implementation of Trial Measures for the Administration of Overseas Securities Investments of QDIIs.

For Chinese residents holding foreign currencies, QDIIs provide an alternative to the poorly regarded B-share market. The availability of QDIIs will probably also reduce the attractiveness of illicit channels for foreign exchange.

QDIIs include Chinese management companies, securities companies and other securities institutions, which upon approval of the CSRC, may raise domestic funds for investment in foreign securities portfolios under their management.[155] They must entrust commercial banks within China with custody of their assets, and designate foreign securities service institutions as agents for their trading of securities.[156]

The CSRC and the SAFE are responsible for the surveillance of QDIIs' investments outside China.[157]

8.5.1. Qualifications

In addition to the general requirements of suitable assets, personnel and systems, as well as relevant experience and good governance, the minimum requirements to qualify as a QDII correspond to the following:

- for fund management companies: net assets of no less than RMB 200 million; more than two years experience in the management of securities investment funds; and assets under management at the end of the last quarter of no less than RMB 20 billion or the equivalent in foreign exchange assets;
- for securities companies: net capital of not less than RMB 800 million; a net capital to net assets ratio of no less than 70 percent; at least one year's experience in asset pool management plans; and assets under management at the end of the last quarter of no less than RMB 2 billion or the equivalent in foreign exchange.[158]

Upon receipt of an application, the CSRC either issues a licence for securities investment business outside China or sends a written rejection.[159] The institution makes a separate application to the CSRC for the right to raise funds.[160] Approvals are also sought separately from the SAFE.[161]

8.5.2. Foreign investment consultants

Investment consultants outside the territory of China may advise QDIIs for trading securities and provide portfolio management services, and receive compensation. They must comply with the CSRC's rules.[162]

Such investment consultants are subject to the approval and the surveillance of organs in their countries of origin that must have signed a memorandum of understanding with the CSRC. They must have engaged in investment management for at least five years, and their securities assets under management for the last fiscal year must be no less than USD 10 billion or the equivalent in a foreign currency. They must possess sound governance, internal control systems, as well as normalized business performance, be free of any major sanction by the surveillance organ and not subject to investigation by judicial or surveillance organs during the previous five years.[163]

Foreign branches of Chinese securities companies may act as investment consultants.[164]

QDII's duties are characterized as being "fiduciary" in nature.[165] Investment consultants must always give priority to the interests of the fund holders, their suggestions must be based on reasonable evidence, they must treat all clients in a fair and objective manner, and fully disclose conflicts of interests, and respect the confidentiality of their clients' information.[166] In their contracts with QDIIs, they must accept to pay compensation for losses caused by their mistakes, negligence or failures to perform their duties.[167]

8.5.3. Asset custody

QDIIs appoint Chinese banks that are qualified to provide custodial services for securities investment funds.[168] They may entrust the performance of their services overseas to foreign custodians that, *inter alia*, must be:

- subject to the surveillance of the local government, financial or securities surveillance organ;
- possess at least USD 1 billion in paid-in capital or the equivalent in a foreign currency as of their last fiscal year, or assets in their custody must amount to no less than USD 100 billion or the equivalent in a foreign currency; and
- free of any major sanction by a surveillance organ and investigation by judicial or surveillance organs during the last three years.[169]

Custodians' duties extend to:

- reporting anomalies to the CSRC and the SAFE;
- calculating the net value of the fund or units, in light of the methods prescribed in relevant laws and regulations, as well as those in the fund or asset pool management contracts;
- ensuring that the fund or pool plan has been approved, subscribed or redeemed in accordance with relevant laws and regulations, as well as the fund or asset pool management contracts;
- ensuring that the fund or pool plan proceeds are distributed in accordance with relevant laws and regulations, as well as the fund or asset pool management contracts;
- registering assets in the name of the custodian or the designated agent, in accordance with relevant laws and regulations, as well as the fund or asset pool management contracts; and
- filing monthly reports with the CSRC and the SAFE with respect to their QDII activities.[170]

Where a custodian outside China causes losses by its fault or negligence, its principal custodian in China is liable.[171]

QDII authorization and transaction records must be retained for 20 years.[172]

Custodians must strictly separate their own assets from those managed on behalf of QDIIs.[173]

8.5.4. Raising of capital and information disclosure

Subject to obtaining approval, QDIIs may raise capital by selling fund units to the public.[174] They must obtain approvals for their pool plans, and must implement them as approved.[175] The performances achieved by their other funds are disclosed in the application documentation.[176]

QDIIs and investment consultants must observe the following principles in their relations with overseas institutions:

- trading commissions remain the property of the funds' or pool plans' holders; and
- they are liable for ensuring the implementation of trades on the best terms, the minimization of trading costs, and the use of trading commissions for the benefit of the holders.[177]

QDIIs and investment consultants strictly perform their fiduciary responsibilities.[178]

QDIIs must respect the laws and regulations as prescribed by competent overseas surveillance organs and local stock exchanges.[179]

8.5.5. Quota and capital management

QDIIs must inform the SAFE of their plans to raise funds. The plans must be adapted to market conditions.[180]

Custodians must maintain settlement accounts and securities custody accounts for their funds with the competent securities depository and clearing institution.[181]

They must report the use of their quotas to the SAFE, as well as their outward and inward capital remittances.[182]

According to the CSRC QDII Circular, the counterparties of QDIIs must be rated by credit rating institutions approved by the CSRC. The mark-to-market system is applied to account for their trading. QDIIs may hold:

- cash;
- certificates of deposit;
- commercial bills;
- government bonds; and
- irrevocable letters of credit issued by Chinese-funded commercial banks, or overseas financial institutions rated by credit rating institutions approved by the CSRC.

Funds and collective schemes managed by QDIIs may participate in repurchase transactions and reverse repurchase transactions according to usual market practices. In the participation of funds and collective schemes in securities lending transactions and securities repurchase and reverse repurchase transactions, the total market value of all the lent securities to be returned, or all the sold securities to be repurchased may not exceed 50% of a QDII's total assets. Net asset values of funds and collective schemes are recalculated and disclosed on a weekly basis. For investments in derivatives, net asset values are calculated and disclosed for each working day. Net asset values of funds and collective schemes are disclosed within two working days following the valuation date.

Derivatives and securities with limited circulation are valued in accordance with international accounting standards. The specific calculation methods for net values and subscription and redemption prices of open-end funds and collective schemes must be stated in the contracts and prospectuses. Unless specified otherwise by the CSRC, redemptions are paid within 10 days of acceptance the application.

8.5.6. Supervision and administration

Both the SAFE and the CSRC may intervene in the affairs of QDIIs including through spot inspections.[183]

Each of the following events must be reported within five working days to the CSRC:

- changes of custodians;
- changes of investment consultants; and
- legal actions or any other major events outside China.

If there is a change of custodian, QDIIs must also file a report with the SAFE.[184]

Were a QDII to change its name or be taken over by another institution, it would be then obligated to re-apply within 60 working days for approval as a QDII.[185]

In the event of a violation of the QDII Measures, or of a serious illegal or irregular act, the SCRC may restrict its related activities, the SAFE may limit its international remittances, and both may apply administrative sanctions.[186]

8.6. Financing of foreign projects by Chinese entities

The Temporary Procedures for the Administration of Project Financing Conducted Outside China were promulgated by the NDRC and the SAFE effective as of April 16, 1997 (the Overseas Project Financing Procedures). Their implementation is entrusted jointly to the MOFCOM and the SAFE.[187]

Project financings are defined as montages in which:

- foreign exchange funds are raised outside China for construction projects in China;
- the creditors have no recourse against assets or revenue other than those of the construction project;
- no institutions in China effect any mortgage, pledge of debt payment with assets, rights, interests or revenue other than those of or in the construction project; and
- no institutions in China provide financing guarantees in any form.[188]

The regime is intended to be applied principally to infrastructure projects such as power generating facilities, high-grade highways, bridges, tunnels, urban waterworks, sewage treatment plants, etc., as well as other construction projects requiring large-scale investment and that generate long-term and stable revenues.[189]

To qualify, the principal Chinese investors must have ample economic resources and the ability to perform the contract while the leading foreign investors must in addition have relatively strong international financing capacities and positive track records in project financing.[190]

The principal investors of a project may not become parties to any contract that might create a major risk for, or conflict of interest with, the project.[191]

The performance of project contracts may not change the nature of the project financing. No domestic financial institution may provide a guarantee in any form. Provision of performance bonds by other institutions in China to foreign entities is subject to the approval of the relevant government departments.[192]

The rights of foreign and domestic creditors of projects rank *pari passu*.[193]

Article 7 sets down a framework for pricing of inputs to projects:

- prices must respect Chinese regulations concerning price control and be approved where required by the competent authorities;
- they must be conducive to the generation of expected stable revenues;
- they reasonably reflect the effect of rises in commodity prices and fluctuations in exchange rates;
- they must make full allowance for the price level that the project's locale can sustain; and
- project charges within China may not be denominated in foreign currencies.

Required documentation includes a prospectus and a feasibility study prepared in conjunction with the competent local planning department. After preliminary examination by the authority in charge of the industry, the prospectus and a feasibility study are reviewed by the NDRC. Major projects are ultimately submitted to the State Council for approval.[194] When projects are promoted by local authorities, they must be reviewed by the local SAFE department prior to submission to the SAFE in Beijing for approval.[195]

Once the project financing has been finally approved, a project company is constituted in China to carry out the project. The project financing must then be completed within one year.[196]

Foreign exchange funds raised by project companies must be repatriated in a timely manner and they must be used to import technology, equipment and materials and to pay other approved expenses. The closing balance is retained or settled in accordance with the SAFE's regulations. Such funds may not be retained outside China without the approval of the SAFE.[197]

Project companies may not credit revenue generated in China to foreign bank accounts and their foreign exchange flows must transit through an approved bank.[198]

Where there results a shortfall in foreign exchange to repay the principal of the foreign debt, the project company may, after verification and approval by the local SAFE department, purchase foreign exchange.

Outward remittances of foreign exchange from special accounts for repayment of principal and payment of interest shall be made on schedule in accordance with State regulations and the relevant agreements.[199]

Prior to March 31 of every year, project companies must report to the SAFE their uses of funds, revenues and debt payments, etc. during the preceding year.[200]

Article 17 prohibits foreign exchange banks from repaying the principal and interest project loans unless the required approvals are produced.

9. Conclusion

In the empirical manner typical of the reform and opening-up movement set in motion in 1978, the Chinese authorities have gradually liberalized international financial flows in parts of the territory and for segments of the financial markets.

These policies have facilitated China's achievement of sustained economic development over the course of three decades.

Notes

[1] In 1978, China's foreign trade amounted to only 9.8% of its Gross Domestic Product (GDP). Only a few corporations were authorized to carry on foreign trade and all foreign exchange transactions were conducted through the Bank of China. All foreign exchange receipts had to be sold to the State and all exchange payments abroad were subject to the State Plan. China did not borrow from other countries and it accepted no foreign investment, Min Zhao, *External Liberalization and the Evolution of China's Exchange System: an Empirical Approach*, The World Bank Beijing Office, 2006.

[2] In conformity with international practice, the authorities still examine the payments' supporting documentation. Most recently, the SAFE has undertaken an acceleration of the liberalization with the adoption of The Circular on Adjusting the Policies for Foreign Exchange Administration under Current Accounts, which cancelled the requirement of prior approval for opening foreign exchange accounts for current account operations, and increased the limit on foreign exchange account held on current account, while simplifying payment remittances and relaxing restrictions on exchanges purchase of domestic citizens. This circular was promulgated on April 13, 2006 and entered into effect as of May 1, 2006.

[3] This account includes foreign direct and portfolio investment.

[4] At end 2006, foreign exchange reserves amounted to USD 1,066 billion. The central parity of the RMB against the US dollar stood at 7.8087, China Monetary Policy Report Quarter Four, 2006, p. 9 and 10.

[5] The chapter entitled Foreign Direct Investment presents the regulatory framework governing such operations involving non-listed Chinese enterprises.

[6] Considering that China's foreign direct investment in 2004 accounted for less than 1% of global flows, this projection may seem excessive. On the other hand, the country's share of world trade corresponded to only 0.8% in 1978 and in 2005 that share had grown to 7.7%.

[7] Furthermore, the spread of Chinese investment abroad has revealed its political consequences in Sudan where China has made its largest overseas investment in the oil industry, Peter S. Goodman, *The Washington Post*, China and Sudan: Partners in oil – and warfare?, http://seattletimes.nwsource.com/html/nationworld/2002131515_chinaoil27.html.

[8] Share indices for B shares had dropped by about 70 per cent from 2002 to 2006, *Economic Information Daily*, http://www.china-embassy.org/eng/gyzg/t231215.htm. This anomaly is partly accounted for by the more favorable conditions on which H shares are available as alternatives to B-shares, and is also attributable to the inflation of the prices of A shares engendered by the lack of alternative instruments for the country's mammoth savings, which correspond to some 40% of GDP, Deutsche Bank Research, *China's financial sector: Institutional Framework*, January 9, 2004, p 15.

[9] By the end of 2001, the BOC had issued bonds in the international capital market 27 times, raising funds in excess of USD 5 billion, http://www.bank-of-china.com/en/common/third.jsp?category=1099376194100.

[10] As of 1996, some 24 Chinese company shares were traded on the Hong Kong Stock Exchange (corresponding to market capitalization of about USD 2.3 billion[10]); five Chinese companies were traded on the New York Stock Exchange (corresponding to market capitalization of about USD 1.4 billion[10]), seven on the Australian exchanges and others were in the process of listing in London, Tokyo, Singapore, Australia and even Taiwan.

[11] Indeed by 1996, in 56 of the 58 companies having issued both A and B shares, the latter were trading below the former in some cases at 90% discounts.

[12] Liu Lisheng, *An Overview of China's Markets*, CSRC, 2006, p. 23.

[13] Interbank bonds open to overseas investors http://english.sina.com/business/1/2005/0513/30922.html

[14] MOFCOM statistics quoted in Zhang Xiaopu, *Capital account management and its outlook in China*, Bank for International Settlements, Paper No. 13, 2003, p. 2. By way of contrast, foreign direct investment in China then corresponded to USD 395 billion involving 390,484 FIEs; China's external debt amounted to USD 170.11 billion and USD 58.6 had been raised from overseas listings of Chinese companies, and USD 4.63 billion had been raised through share issues.

[15] Article 7 of the Foreign Exchange Regulations.

[16] Article 20 of the Foreign Exchange Regulations.

[17] Article 22 of the Foreign Exchange Regulations.

[18] Article 23 of the Foreign Exchange Regulations.

[19] Article 24 of the Foreign Exchange Regulations.

[20] Article 26 of the Foreign Exchange Regulations.

[21] Article 27 of the Foreign Exchange Regulations.

[22] Article 28 of the Foreign Exchange Regulations.

[23] Article 29 of the Foreign Exchange Regulations.

[24] Article 31 of the Foreign Exchange Regulations.

[25] Article 34 of the Foreign Exchange Regulations.

[26] Article 39 of the Foreign Exchange Regulations.

[27] Articles 39, 44 and 45 of the Foreign Exchange Regulations.

[28] Article 50 of the Foreign Exchange Regulations.

[29] Article 38 of the Foreign Exchange Regulations.

[30] Supra, note 12, at p. 10.

[31] To prevent excessive leverage among JVs, permissible debt-to-equity ratios were set down in the Interim Provisions of the State Administration of Industry and Commerce Concerning the Ratio Between Registered Capital and Total Amount of Investment of Chinese-Foreign Equity Joint Ventures of March 1987.

[32] Article 2 of the Foreign Debt Rules.

[33] Article 3 of the Foreign Debt Rules.

[34] Article 4 of the Foreign Debt Rules.

[35] Article 10 of the Foreign Security Rules.

[36] Article 14 of the Foreign Security Rules.

[37] Article 17 of the Foreign Security Measures.

[38] Article 4 of the Foreign Security Measures.

[39] Article 8 of the Foreign Security Measures.

[40] Article 3 of the Foreign Security Measures.

[41] Article 9 of the Foreign Security Measures.

[42] Article 13 of the Foreign Security Measures.

[43] Liu Lisheng, *An Overview of China's Financial Markets*, CSRC, 2006, p. 9.

[44] Article 213, the law was adopted at the Sixth Meeting of the Standing Committee of the Ninth NPC on December 29, of the Ninth NPC on December 29, 1998 and promulgated on July 1, 1999, which entered into effect on the same day.

[45] Article 5 of the B Share Regulation.

[46] Article 4 of the B Share Regulation.

[47] The legislative framework created by the municipalities of Shanghai and Shenzhen in 1991 was repealed with the adoption of the B Share Regulation. Procedures of Shanghai Municipality Governing the Control of Special Stocks in Renminbi, which was promulgated by the PBOC and the people's government of Shanghai Municipality on November 22, 1991, and the Interim Procedures of Shenzhen Municipality Governing the Control of Special Stocks in Renminbi, which was promulgated by the people's government of Shenzhen Municipality on December 5, 1991.

[48] Article 4 of the B Share Regulation. Documents released by B share issuers are written in Chinese and in foreign languages as required abroad. If differences in interpretations occur between the versions, the Chinese version prevails, Article 17 of the B Share Regulation.

[49] Article 4 of the B Share Regulation.

[50] Article 22 of the B Share Regulation.

[51] Articles 8 and 9 of the B Share Regulation.

[52] Article 10 of the B Share Regulation.

[53] Article 11 of the B Share Regulation.

[54] Article 15 of the B Share Regulation.

[55] Article 17 of the B Share Regulation.

[56] Article 14 of the B Share Regulation.

[57] Article 18 of the B Share Regulation.

[58] Article 19 of the B Share Regulation.

[59] Article 20 of the B Share Regulation.

[60] Article 23 of the B Share Regulation.

[61] Article 24 of the B Share Regulation.

[62] Article 25 of the B Share Regulation.

[63] Article 26 of the B Share Regulation.

[64] In particular, some, though apparently not all, overseas listed companies paid prior to 2008 Chinese corporate income tax at the rate of 15%, instead of the 55% generally applicable to State enterprises.

[65] Overseas listings of Chinese companies had in fact been accomplished as early 1993 under a legal regime consisting of provisions in the so-called Standard Opinions with respect to Limited Liability Companies and in particular an addendum (H Share Addendum) thereto resulting from an agreement with the Hong Kong Stock Exchange where the first overseas listing occurred.

[66] Indeed, since some, though not all, of these provisions relate specifically to companies listed in Hong Kong, one might even argue that two new classes of shares are created, overseas shares listed in Hong Kong and those listed elsewhere.

[67] Typically, a Chinese company sets up an offshore venture, usually in one of the tax havens, lists it on a foreign stock exchange, and uses it to acquire assets in China.

[68] Articles 85 and 155 of the Company Law that was originally adopted on December 29, 1993 with effect on July 1, 1994 governs all types of limited liability companies, wholly State-owned SOEs and companies limited by shares (except for certain special industries); it was substantially amended on October 27, 2005 with effect from January 1, 2006. Listed companies are subject to the same requirement under article 29 of the Securities Law.

[69] Article 2 of the State Council's Special Provisions of the State Council on Issuance and Listing of Stocks (Including Additional Offering) Abroad by the Joint Stock Limited Companies.

[70] Article 2 of the State Council's Special Provisions of the State Council on Issuance and Listing of Stocks (Including Additional Offering) Abroad by the Joint Stock Limited Companies.

[71] Article 1 of the Circular of the China Securities Regulatory Commission about the Issues Relating to the Applications of Enterprises for Getting Listed Abroad

[72] Article 3 of the CSRC's Circular on the Issues Relating to the Applications of Enterprises for Getting Listed Abroad.

[73] By comparison with the list of decisions subject to vote by a qualified majority under Hong Kong corporate law, this list is relatively short.

[74] The CSRC QFII Circular entered into effect on September 1, 2006.

[75] By virtue of their article 37, the QFII Measures apply to institutional investors from the Hong Kong and Macau SARs and Taiwan.

[76] Clause 5 of the CSRC QFII Circular.

[77] Article 6 of the QFII Measures.

[78] Articles 8 and 9 of the QFII Measures.

[79] Clause 3 of the CSRC QFII Circular.

[80] Article 5 of the QFII Measures.

[81] Article 32 of the QFII Measures.

[82] Article 33 of the QFII Measures.

[83] Article 10 of the QFII Measures.

[84] Article 10 of the QFII Measures.

[85] Article 25 of the QFII Measures.

[86] Article 3 of the QFII Measures.

[87] Clause 5 of the CSRC QFII Circular.

[88] Article 15 of the QFII Measures.

[89] Article 11 of the QFII Measures.

[90] For foreign bank branches, the relevant reference is the paid-in capital of their foreign headquarters.

[91] Article 12 of the QFII Measures.

[92] Article 13 of the QFII Measures.

[93] Article 14 of the QFII Measures.

[94] Article 17 of the QFII Measures.

[95] Article 18 of the QFII Measures.

[96] Article 9 of the CSRC QFII Circular.

[97] Article 10 of the CSRC QFII Circular.

[98] Article 21 of the CSRC QFII Circular.

[99] The Measures for Strategic Investment by Foreign Investors upon Listed Companies adopted by the MOFCOM, CSRC, the State Administration for Taxation (SAT), the SAIC and SAFE on December 31, 2005.

[100] Clauses 10 and 11 of the CSRC QFII Circular.

[101] Articles 24 and 25 of the QFII Measures.

[102] Clause 14 of the CSRC QFII Circular.

[103] Clause 15 of the CSRC QFII Circular.

[104] Article 5 of the QFII Measures.

[105] Article 30 of the Measures.

[106] Article 35 of the QFII Measures.

[107] Article 32 of the QFII Measures.

[108] The measures apply to investors from Hong Kong and Macao SARs and Taiwan, article 27 of the Foreign Strategic Investor Measures.

[109] Article 2 of the Foreign Strategic Investor Measures.

[110] Article 3 of the Foreign Strategic Investor Measures.

[111] Article 5 of the Foreign Strategic Investor Measures.

[112] Article 4 of the Foreign Strategic Investor Measures.

[113] Article 5 of the Foreign Strategic Investor Measures.

[114] Article 6 of the Foreign Strategic Investor Measures.

[115] Article 7 of the Foreign Strategic Investor Measures.

[116] Article 7 of the Foreign Strategic Investor Measures.

[117] Article 16 of the Foreign Strategic Investor Measures.

[118] Should the investor hold no less than 25% of the shares and commit itself to hold them for 10 years, it is identified as a "foreign-invested joint limited company (A-share acquisition and merger no less than 25%)", articles 17, 18 and 19 of the Foreign Strategic Investor Measures.

[119] Article 20 of the Foreign Strategic Investor Measures.

[120] Articles 21 and 22 of the Foreign Strategic Investor Measures.

[121] Article 24 of the Foreign Strategic Investor Measures.

[122] This reform was adopted in the Circular on Issues Relevant to Further Intensifying the Reform of Foreign Exchange Administration on External Investments.

[123] Clause 3 of the 2006 SAFE Circular.

[124] Clause 5 of the 2006 SAFE Circular.

[125] Clause 7 of the 2006 SAFE Circular.

[126] Clause 10 of the 2006 SAFE Circular.

[127] Article 26 of the NDRC Overseas Investment Circular.

[128] This includes enterprises as well as natural persons and other institutions, article 26 of the NDRC Overseas Investment Circular.

[129] Article 3 of the NDRC Overseas Investment Circular.

[130] Article 4 of the NDRC Overseas Investment Circular.

[131] Article 6 of the NDRC Overseas Investment Circular.

[132] Article 7 of the NDRC Overseas Investment Circular.

[133] The period does not include the time required for experts' reports to be filed.

[134] Were an applicant to be involved in a competitive bidding process, the time for the NDLR to respond would be reduced to seven days, articles 12 and 13 of the NDRC Overseas Investment Circular.

[135] Article 15 of the NDRC Overseas Investment Circular

[136] Article 18 of the NDRC Overseas Investment Circular.

[137] Article 20 of the NDRC Overseas Investment Circular.

[138] Article 23 of the NDRC Overseas Investment Circular.

[139] Article 24 of the NDRC Overseas Investment Circular.

[140] Article 5 of the Overseas Investment of Insurance Funds Measures.

[141] Article 31 of the Overseas Investment of Insurance Funds Measures.

[142] Article 2 of the Overseas Investment of Insurance Funds Measures.

[143] Article 38 of the Overseas Investment of Insurance Funds Measures.

[144] Article 7 of the Overseas Investment of Insurance Funds Measures.

[145] Article 8 of the Overseas Investment of Insurance Funds Measures.

[146] Article 14 of the Overseas Investment of Insurance Funds Measures. The implementation of these facilities depends on the issue of specific regulations by the CIRC.

[147] Article 20 of the Overseas Investment of Insurance Funds Measures.

[148] Article 23 of the Overseas Investment of Insurance Funds Measures.

[149] Article 25 of the Overseas Investment of Insurance Funds Measures.

[150] Article 27 of the Overseas Investment of Insurance Funds Measures.

[151] Article 32 of the Overseas Investment of Insurance Funds Measures.

[152] Article 33 of the Overseas Investment of Insurance Funds Measures.

[153] Articles 35 and 36 of the Overseas Investment of Insurance Funds Measures.

[154] In January 24 and April 21 of 2005, SAFE issued two circulars (respectively No. 11 and No. 29) to regulate capital outflow and to curb tax evasion. The new registration and approval procedures for outbound investments and foreign acquisitions of Chinese companies rendered overseas listings difficult to carry out.

[155] Article 2 of the QDII Measures.

[156] Article 3 of the QDII Measures.

[157] Article 4 of the QDII Measures.

[158] Articles 5 and 6 of the QDII Measures.

[159] Article 9 of the QDII Measures.

[160] Articles 10 and 11 of the QDII Measures.

[161] Article 12 of the QDII Measures.

[162] Article 13 of the QDII Measures.

[163] Article 14 of the QDII Measures.
[164] Article 14 of the QDII Measures.
[165] Article 15 of the QDII Measures.
[166] Article 16 of the QDII Measures.
[167] Article 17 of the QDII Measures.
[168] Article 18 of the QDII Measures.
[169] Article 19 of the QDII Measures.
[170] Article 20 of the QDII Measures.
[171] Article 21 of the QDII Measures.
[172] Article 22 of the QDII Measures.
[173] Article 23 of the QDII Measures.
[174] Article 24 of the QDII Measures.
[175] Articles 25, 27 and 28 of the QDII Measures.
[176] Article 26 of the QDII Measures.
[177] Article 30 of the QDII Measures.
[178] Article 29 of the QDII Measures.
[179] Article 31 of the QDII Measures.
[180] Article 33 of the QDII Measures.
[181] Article 35 of the QDII Measures.
[182] Article 37 of the QDII Measures.
[183] Article 38 of the QDII Measures.
[184] Article 39 of the QDII Measures.
[185] Article 40 of the QDII Measures.
[186] Articles 41, 42 and 43 of the QDII Measures.
[187] Article 19 of the Overseas Investment Measures.
[188] Article 1 of the Overseas Project Financing Regulations.
[189] Article 2 of the Overseas Project Financing Regulations.
[190] Article 2 of the Overseas Project Financing Regulations.
[191] Article 4 of the Overseas Project Financing Regulations.
[192] Article 5 of the Overseas Project Financing Regulations.
[193] Article 5 of the Overseas Project Financing Regulations.
[194] Article 8 of the Overseas Project Financing Regulations.
[195] Article 11 of the Overseas Project Financing Regulations.
[196] Article 10 of the Overseas Project Financing Regulations.
[197] Article 13 of the Overseas Project Financing Regulations.
[198] Article 14 of the Overseas Project Financing Regulations.
[199] Article 15 of the Overseas Project Financing Regulations.
[200] Article 16 of the Overseas Project Financing Regulations.