INSIDE:

This month, China Update looks at changes from the State Administration of Foreign Exchange (SAFE) affecting outbound investment and overseas institutions’ management of foreign exchange accounts in China, stronger supervision of venture capital enterprises and outbound investment by the National Reform and Development Commission (NDRC), and regulations and guidance related to the Growth Enterprise Market (GEM), as well as several other topics.

Owing to the increase in Chinese outbound investment and acquisitions abroad, SAFE has relaxed controls on Chinese domestic enterprises’ lending abroad. At the same time, SAFE has issued new instructions allowing overseas enterprises to manage their foreign exchange in China through local commercial banks.

In addition to regulating venture capital, the NDRC has strengthened its supervision over outbound investment in light of sharp increases in such investment. Regulations for the GEM indicate that the ‘second board’ will admit domestic enterprises that meet certain revenue, share capital, and profit requirements. Additionally, securities firms seeking to market these offerings to investors received guidance from the China Securities and Regulatory Commission (CSRC).

SAFE Loosens Restrictions on Overseas Lending by Domestic Enterprises ..........................2

China Strengthens Supervision of Venture Capital Enterprises and Their Fundraising Activities.............................4

Shenzhen Stock Exchange Releases Growth Enterprise Market Listing Rules5

China Regulates Investor Appropriateness in the Growth Enterprise Market ........................................6

SAFE Facilitates Management of Overseas Institutions’ Domestic Foreign Exchange Accounts ..........................7

NDRC Strengthens the Administration of Certain Outbound Investment Projects ................................8

SASAC Gives Details on the Issuance of Exchangeable Bonds and Securities by Holders of State-Owned Shares and State-Owned Listed Companies ....................9

China Clarifies Pre-Tax Deduction of the Reserves of Credit Guarantee Institutions for Small and Medium Enterprises ......................................................11

China Issues Judicial Interpretations on the Application of Law in Criminal Prosecutions Involving the Manufacturing or Sale of Counterfeit or Inferior Drugs ....................................11

Deepening Reform of China’s Economic Structure in 2009 ........................................13
SAFE Loosens Restrictions on Overseas Lending by Domestic Enterprises

In the context of the global economic recession and China’s high level of foreign exchange exposure, the State Administration of Foreign Exchange (SAFE) issued the Circular on Relevant Issues Concerning Foreign Exchange Administration of Overseas Lending by Domestic Enterprises (关于境内企业境外放款外汇管理有关问题的通知, the Circular), which came into effect on August 1, 2009. By easing the administration of overseas lending by domestic enterprises, the Circular aims not only to facilitate domestic enterprises’ financing of overseas affiliates, but also to help reduce China’s exposure to foreign exchange risk.

Before the issuance of the Circular, overseas lending was governed by the Circular on Relevant Issues Concerning the Internal Operation and Management of Foreign Exchange Funds of Multinational Companies (关于跨国公司外汇资金内部运营管理有关问题的通知, the Old Circular), which was issued by SAFE and took effect on November 1, 2004.

The Circular expands the scope of enterprises that are permitted to make overseas loans. Under the Old Circular, the only companies permitted to make overseas loans were multinational group companies that had member companies in a foreign country. Specifically, where a multinational group company was controlled by Chinese investors, it had to have at least three member companies that were legally incorporated outside of China in order to qualify for overseas lending. Where a multinational group company was controlled by foreign investors, it had to have at least three member companies that were legally established in China.

Under the Circular, however, any enterprise other than a financial institution can apply to extend a loan to its wholly-owned or partially-owned overseas subsidiary as long as the lender and borrower meet the following conditions:

1. Both the lender and borrower are legally incorporated, and have fully paid in their registered capital;
2. Both the lender and borrower have been in good standing with respect to their operations, and have sound accounting and internal control systems;
3. Neither the lender nor the borrower has been found to violate any foreign exchange regulation in the past three years;
4. All of the lender’s overseas direct investment projects have been approved by competent Chinese government authorities and duly registered with SAFE, and the lender was ranked Class II or higher on its latest annual government-conducted examination for overseas investment (unless it has been less than one year since the establishment of the lender’s overseas subsidiary); and
5. No breach of contract has occurred under the lender’s last overseas loan as approved by the government.
In addition, the Circular increases the sources of funds available to make overseas loans. In extending an overseas loan, a lender can use its own foreign currency funds, purchase foreign currency funds with Renminbi, or draw from the foreign currency fund pool approved by SAFE. Under the Old Circular, only self-owned foreign currency funds could be used for overseas lending.

The Circular also delegates the authority to approve overseas lending to the local SAFE branch where the lender is domiciled. Specifically, to extend a loan to an overseas subsidiary, receive repayment of a principal and accrued interest, or receive payment of a performance bond to secure an overseas loan, a lender must seek approval from the local SAFE branch. However, a lender no longer needs SAFE’s approval in order to open or close a bank account designated for overseas lending (a Designated Account), or transfer funds between its Designated Account and its other foreign exchange accounts in China.

Under the Circular, an enterprise can open a Designated Account with a specialized foreign exchange bank simply by presenting a certificate of approval for overseas lending from its local SAFE branch. Once an enterprise has created a Designated Account, it must use the account as a hub for its overseas lending: the entire loan amount must be transferred from the Designated Account, and all repayment of the principal and accrued interest must flow back through the Designated Account. This provision not only simplifies the procedures and formalities associated with overseas lending, but also provides the Chinese government with an expedient way to monitor the flow of funds across the border.

The Circular offers more flexibility in terms of the maximum loan amount. According to the Circular, the maximum loan amount is calculated based on the balance rather than the cumulative, which means that a lender can optimize its total loan amount by making loans on a revolving basis. The Circular stipulates that the balance of the loans made by the lender should not exceed 30 percent of the lender’s ownership interests in borrower, nor exceed the agreed-upon amount of the Chinese investor’s interests in the borrower for which relevant registration has been completed.

In addition, the Circular extends the valid period of SAFE’s approval for overseas loans. Under the Old Circular, a lender must grant overseas loans within six months following SAFE’s approval; the Circular extends the period to two years. If a lender intends to renew the valid period, it must submit an application for renewal to the local SAFE branch within one month before the expiration of the current valid period. In addition, while the Old Circular provided that the term of overseas loans should not exceed two years, the Circular does not restrict the term of the loans.

The Circular serves to encourage domestic enterprises to grant loans to their overseas subsidiaries. It also reflects the Chinese government’s intention to encourage domestic companies to expand overseas in the midst of the worldwide economic crisis.

(Steven Robinson and James Zhang)
China Strengthens Supervision of Venture Capital Enterprises and Their Fundraising Activities

On July 10, 2009, China’s National Development and Reform Commission (NDRC) issued the Circular on Strengthening Supervision of Venture Capital Enterprises’ Record Filing and Strictly Regulating Their Fundraising Activities (关于加强创业投资企业备案管理、严格规范创业投资企业募行行为的通知, the Circular). The Circular, which aims to facilitate management of venture capital (VC) enterprises and crack down on the illicit fundraising activities of some VC enterprises, demonstrates the Chinese government’s attention to the overheated VC market.

The Circular is a continuation of the Provisional Measures for the Supervision of Venture Capital Enterprises (创业投资企业管理暂行办法, the Measures), which was issued by NDRC and several other government ministries and took effect on March 1, 2006. According to the Measures, VC enterprises that meet certain criteria must keep records with NDRC, which is tasked with monitoring the VC enterprises and their activities. These criteria include having an appropriate business scope, a minimum capital commitment and injection, a maximum number of investors, and certain qualifications for senior management. The Circular emphasizes that filings will be rejected for VC enterprises that fail to meet the abovementioned criteria under the Measures. It further stipulates that if any VC enterprise whose records are already filed with NDRC does not meet these criteria, such enterprise must rectify the problem within 30 working days, or its record filing will be cancelled.

The Circular also emphasizes regulation of VC enterprises’ agency activities in order to attack their illicit fundraising activities in the market. The Circular clarifies that when a VC enterprise is acting as the agent of another entity or individual in the VC business, the following rules apply:

1. the amount of each transaction for a single entity or individual may not be less than RMB10 million;
2. the entrusting party (i.e., the principal) will exercise ownership of the entrusted assets and bear corresponding responsibilities;
3. the VC enterprise may not promise any fixed profit;
4. the VC enterprise may not promote its agency business to general audiences by publishing advertisements (including placing announcements on its website, or leaving pamphlets on counters at commercial banks, or security, trust or investment companies), holding seminars, giving lectures, or using any other means of public communication.

The Circular sets up a disclosure mechanism for the cancellation of a VC enterprise’s record filing with NDRC. For any VC enterprise whose record filing is cancelled, the competent government authority will publish the enterprise’s basic information, along with the names of the relevant parties and the VC enterprise’s senior managers on the official website.

The Circular further provides that the competent government authorities should strengthen supervision over VC enterprises that have filed records with NDRC and their management and related entities through annual inspections. In addition, the authorities should conduct random checks of no less than 10 percent of all filed VC enterprises in each quarter.
The Circular also lays out the chain of command among competent government authorities. According to the Circular, provincial-level supervisory authorities should report to the relevant national authority on a quarterly and annual basis. If any situation arises that would lead to the cancellation of a VC enterprise’s record filing, the provincial-level authorities should notify the national authority within five working days.

The Circular reflects the government’s efforts to ensure the healthy development of the VC market, which is still in its incipient stages in China.

(Roger Peng and Junjie Zhang)

**Shenzhen Stock Exchange Releases Growth Enterprise Market Listing Rules**

On June 5, 2009, the Shenzhen Stock Exchange (SSE) released the Rules Governing the Listing of Securities on the Growth Enterprise Market of the Shenzhen Stock Exchange Listing (深圳证券交易所创业板股票上市规则, the GEM Listing Rules), which took effect on July 1, 2009. The GEM Listing Rules set out, among other things, rules on disclosure, requirements for the directors, supervisors, senior management, controlling shareholders, the persons in actual control and the listing procedures and conditions (including those for an initial offering, issuance of new shares and convertible bonds and restricted shares).

A growth enterprise market (GEM) is also known as a second-board market, which offers small and medium-sized enterprises opportunities to capitalize on their growth if they cannot meet the requirements to be listed on the main board. Under the GEM Listing Rules, enterprises that seek listings on the second board must, at a minimum, meet the following requirements:

1. its shares have been issued to the public;
2. the enterprise’s total share capital is no less than RMB30 million;
3. the publicly issued shares account for more than 25 percent of the enterprise’s total shares (or more than 10 percent if the enterprise’s total share capital exceeds RMB400 million);
4. the enterprise has more than 200 shareholders; and
5. the enterprise has no record of serious violations of law and no false accounting records in the last three years.

The Shenzhen Stock Exchange may place additional requirements on an issuer.

According to the Provisional Measures for the Administration of the Initial Public Offerings and Listing on the Growth Enterprise Market (首次公开发行股票并在创业板上市管理暂行办法), issued by China’s Securities Regulatory Commission (CSRC) and effective as of May 1, 2009, to achieve an initial public offering (IPO) of its stocks on the GEM, an issuer must, among other things, either be profitable in each of the last two years with an accumulative profit of no less than RMB10 million, with a trend of profit growth, or be profitable in the last year with a net profit of no less than RMB5 million and an annual revenue of no less than RMB50 million, and with an annual revenue growth of no less than 30 percent in the last two years.
In contrast, under the IPO and listing rules for the main board in China, an issuer must either have been profitable in each of the last three years with an accumulative profit of no less than RMB30 million, or the issuer’s revenue in the last three years must be no less than RMB300 million. In addition, while the GEM Listing Rules require that the total issued share capital be at least RMB30 million, the minimum share capital required for a main board listing is RMB50 million.

As most growth enterprises are relatively small, immature and unstable, the GEM Listing Rules provide for stricter information disclosure and exit mechanisms than the listing rules for the main boards. Moreover, regulators have issued detailed rules regarding investors and other related service entities involved in GEM listings.

China’s GEM has been more than ten years in the making, and more than 100 Chinese companies submitted GEM-listing applications on the first day CSRC opened its door to those applications. The GEM in China is expected to develop with a focus on enterprises specializing in technical innovations, unconventional services, alternative energies, new materials and other innovative business fields.

(Arthur Mok and Jenny Ni)

China Regulates Investor Appropriateness in the Growth Enterprise Market

On June 30, 2009, the China Securities Regulatory Commission (CSRC) issued the Interim Measures on Investor Appropriateness in the Growth Enterprise Market (创业板市场投资者适当性管理暂行规定, the Interim Measures), which took effect on July 15, 2009. This is the first regulation regarding investor protection in the growth enterprise market since the government launched the growth enterprise market in June 2009. The issuance of the Interim Measures underscores CSRC’s concern that unsophisticated investors will be more vulnerable in the growth enterprise market, thus necessitating the need for a standard to filter investors when they try to enter the growth enterprise market. The Interim Measures are yet another example of CSRC’s paternalistic approach to protecting investors. Nevertheless, CSRC has set forth only guiding principles and ground rules in the Interim Measures and empowered the Shenzhen Stock Exchange (SSE) to issue more detailed measures with respect to the appropriateness standard.

According to the Interim Measures, securities firms are required to check the investor’s identity, assets and income, experience in investing in the stock market, risk preferences and etc., and must also fully disclose the risk inherent in the growth enterprise market before the securities firms bring the investor into the growth enterprise market. If the investor refuses to disclose any of the abovementioned information, the securities firms in question shall not provide services to such investor. Before the investor may engage in any actual trading in the growth enterprise market, the securities firms must have the investor sign the “growth enterprise market risk disclosure letter”, the contents of which will be determined by the Securities Association of China (SAC). In addition to the letter, the securities firms are obliged to provide educational programs regarding the growth enterprise market to investors on a continuing basis in accordance with the requirements set forth by CSRC, SSE and SAC. Anticipating the potential disputes resulting from trading in the growth enterprise market, securities firms are required to
improve relevant dispute resolution mechanisms by appointing an internal department in charge of dealing with complaints from investors regarding trading in the growth enterprise market. In the Interim Measures, CSRC lays out the penalties to the securities firms for any violation of the Interim Measures, ranging from an order to correct the violation, discussion with a supervisory authority the issuance of a warning letter and the disciplining of relevant employees.

(Victor Yu and Ran Li)

SAFE Facilitates Management of Overseas Institutions' Domestic Foreign Exchange Accounts

On July 13, 2009, the State Administration of Foreign Exchange (SAFE) issued a circular on the management of overseas institutions’ domestic foreign exchange accounts (关于境外机构境内外汇账户管理有关问题的通知, the Circular), by which SAFE intends to facilitate trade and investment while mitigating the financial risks associated with overseas institutions’ domestic foreign exchange accounts (Domestic Foreign Exchange Accounts).

Domestic Foreign Exchange Accounts are foreign exchange accounts that overseas institutions keep with domestic banks in China. The Circular defines “overseas institutions” as entities duly registered outside of mainland China, and “domestic banks” as duly licensed Chinese- or foreign-invested banks inside of mainland China. Domestic Foreign Exchange Accounts exclude offshore foreign exchange accounts that overseas institutions open with domestic banks. These offshore accounts are subject to the Measures for the Administration of Offshore Banking Businesses (离岸银行业务管理办法).

To improve efficiency, the Circular provides that domestic banks may directly handle the settlement of certain foreign exchange transactions, unless special regulations are provided by SAFE. Such transactions include the receipt of foreign exchange inside and outside of China through overseas institutions’ Domestic Foreign Exchange Accounts; the transfer of funds between Domestic Foreign Exchange Accounts; the transfer of funds between Domestic Foreign Exchange Accounts and offshore accounts; and overseas payments through Domestic Foreign Exchange Accounts.

The Circular also regulates the management of the Domestic Foreign Exchange Accounts. For example, the Circular stipulates that domestic banks must carefully examine all corporate documents relating to the due establishment of overseas institutions when opening Domestic Foreign Exchange Accounts. After a Domestic Foreign Exchange Account is established, all foreign exchange receipts and disbursements between domestic institutions or individuals and the Domestic Foreign Exchange Account will be managed as cross-border transactions, and domestic banks will examine valid commercial documents and vouchers for each transaction.

The Circular also provides that Domestic Foreign Exchange Accounts may not be used for depositing and withdrawing foreign currency in cash and that the foreign exchange in Domestic Foreign Exchange Accounts may not be settled into renminbi without SAFE’s approval. The fund balance of a Domestic Foreign Exchange Account will be included in the short-term foreign debt of the domestic bank where the Domestic Foreign Exchange Account is opened. Where the fund balance of a Domestic Foreign Exchange Account serves as a pledge for a
domestic institution to obtain loans from a domestic bank, the case will be handled in accordance with relevant regulations on the foreign exchange management of overseas guarantees for domestic loans. Domestic banks also should comply with relevant laws and regulations regarding money laundering, as well as rules on reporting large and suspicious transactions.

In addition, the following accounts are subject to special regulations regarding the settlement of foreign exchange transactions: foreign exchange accounts of qualified foreign institutional investors; special foreign exchange accounts of foreign investors; B-share foreign exchange accounts of overseas institutions; domestic foreign exchange accounts of embassies and consulates of foreign countries (or regions) with diplomatic immunity in China; and representative offices of international organizations in China. If there are no relevant special regulations, the Circular applies.

(Roy Zou and Jay Song)

**NDRC Strengthens the Administration of Certain Outbound Investment Projects**

On June 23, 2009, China’s National Development and Reform Commission (NDRC) issued the Circular on Certain Issues Regarding Improving the Administration of Outbound Investments (关于完善境外投资项目管理有关问题的通知, the Circular) to regulate the rapidly proliferating forms of overseas acquisition and bidding.

The “outbound investment projects” governed by the Circular refer to “outbound acquisition projects” and “outbound bidding projects”. “Outbound acquisition projects” are defined as projects in which the domestic companies acquire all or part of the shares or assets of, or other interest in an overseas enterprise by means of agreements or provision of an offer directly or through their overseas subsidiaries or holding companies. “Outbound bidding projects” are defined as projects in which domestic companies obtain all or any part of the shares or assets of, or other interest in an overseas enterprise by participating in open or closed competitive bidding directly or through their overseas subsidiaries or holding companies.

The Circular only applies to outbound acquisition and bidding projects that are subject to verification and approval by NDRC or the State Council in accordance with the Provisional Administrative Measures on the Government Catalogue of Authorized Investment Projects (政府核准的投资项目目录, the Catalogue). Specifically, only those outbound acquisition and bidding projects in which the total investment made by the domestic party reaches the following thresholds are subject to the requirements contained in the Circular: resource development projects in which a domestic party invests more than US$30 million, and other projects in which a domestic party invests more than US$10 million (collectively, the Qualified Projects). Other outbound investment projects are governed by the Provisional Administrative Measures on the Authorization of Outbound Investment Projects, promulgated by NDRC on October 9, 2004 (境外投资项目核准暂行管理办法, the NDRC Measures).

Similar to the NDRC Measures, the Circular requires that the Chinese party participating in such Qualified Projects submit a written report (the Report) to NDRC prior to commencing material commercial activities. The Report should contain basic information on the investors
involved in the project, a description of the project and the acquisition or bidding target and a
basic plan and timeline for the acquisition or bidding.

One meaningful difference between the NDRC Measures and the Circular is that the latter
provides a clear definition of “material commercial activities,” which makes the reporting
requirement more practicable. According to the Circular, “material commercial activities” with
respect to outbound acquisition projects refers to the execution of a binding agreement, the
issuance of a binding offer or the submission of a formal application to overseas governmental
authorities. With respect to outbound bidding projects, “material commercial activities” means
the submission of a formal bid.

Another noteworthy provision in the Circular is that, if the NDRC determines that there are
“substantial adverse factors” affecting a project, it will make note in its written
acknowledgement of receipt of the Report that the project involves potential risks, and the
project will be subject to strict review during the rest of the authorization process. This
provision has engendered uncertainty and speculation as to NDRC’s standards for “substantial
adverse factors,” the amount of information NDRC will present to the Chinese party if it
determines that “substantial adverse factors” exist, and the extent to which such determination
will affect the project’s ultimate prospects for authorization.

The Circular also outlines the consequences for failing to submit a Report as required. The
consequences include, without limitation, prohibiting domestic financial institutions from
financing the Qualified Project at issue and imposing economic penalties on the project’s
Chinese party.

(Jun Wei and Agnes Liu)

SASAC Gives Details on the Issuance of Exchangeable Bonds and Securities by Holders
of State-Owned Shares and State-Owned Listed Companies

On June 24, 2009, the State-Owned Assets Supervision and Administration Commission of the
State Council (SASAC) issued the Circular on Relevant Issues Regarding Regulation of the
Issuance of Exchangeable Bonds by Holders of State-Owned Shares of Listed Companies and
the Issuance of Securities by State-Owned Listed Companies (关于规范上市公司国有股东发行
可交换公司债券及国有控股上市公司发行证券有关事项的通知, the Circular) The Circular
complements Certain Opinions on Regulating the Activities of State-Owned Shareholders of
Listed Companies (关于规范上市公司国有股东行为的若干意见), issued by SASAC on the
same date, by specifying which documents must be submitted to the competent authorities by
the two categories of issuers, the holders of state-owned shares and state-owned listed
companies. Compared to the Trial Provisions on the Issuance of Exchangeable Bonds by
Shareholders of Listed Companies (上市公司股东发行可交换公司债券试行规定,
Announcement No. 41, also the subject of an article in our November 2008 issue of China
Update), released in October 2008 by the China Securities Regulatory Commission (CSRC),
the Circular deals exclusively with holders of state-owned shares, whereas Announcement No.
41 targets shareholders of all circulating shares.
SASAC first clarifies the meaning of exchangeable bonds and securities. According to the Circular, “exchangeable bonds” refers to one type of corporate bonds that a holder of state-owned shares of a listed company has lawfully issued within a certain period and can be exchanged into shares of the listed company held by this shareholder once certain conditions are met. “Securities issued by a state-owned listed company” refers to shares that the listed company has publicly allocated to original shareholders or publicly offered to potential investors, or convertible bonds privately offered to certain investors.

The Circular also sets forth requirements on the exchange price and coupon rate of exchangeable bonds. Specifically, the exchange price for exchangeable bonds to be issued by a shareholder must not be lower than the highest average stock price of the listed company one transaction day, twenty transaction days, and thirty transaction days prior to the release of the Bond Prospectus. As for the coupon rate of exchangeable bonds, the Circular provides that it should be determined through price inquiry and reference to the loan interest rate, the discount rate of bank bills, the coupon rate of exchangeable bonds issued by other companies in the same industry at the same time, the exchange price for shares of the target company, and the prospects of the listed company.

In addition, the Circular prescribes procedures that a shareholder should follow in issuing exchangeable bonds if the shareholder is a wholly state-owned company. In the case that the shareholder is a wholly state-owned company, the company’s Board of Directors is responsible for planning the issuance, and SASAC will decide whether or not to permit the planned issuance. If the shareholder is a company other than a wholly state-owned company, however, it must submit its issuing plan to SASAC at the provincial or higher level (the Provincial SASAC) for approval no less than twenty days before the shareholders meeting on the subject of the plan is held, but after the plan is reviewed and approved by the company’s Board of Directors. Under normal circumstances, Provincial SASAC will respond to the issuing plan five days before the shareholders meeting is scheduled to take place.

Under the Circular, SASAC lists the documents that the holders of state-owned shares and state-owned listed companies must submit for approval. If the shareholders are state-owned organizations, the submission should be made to SASAC; if the shareholders are regional organizations, the submission should be made through their parent companies to Provincial SASAC. The documents that state-owned issuers should prepare include but are not limited to an issuing plan, a resolution from the Board of Directors, and an interim report on the issuer’s operations. The holders of state-owned shares should vote on the issuing plan, once approved by SASAC, at the shareholders meeting.

The Circular reflects SASAC’s intention to promote bond financing for holders the state-owned shares and state-owned listed companies, and provides specific requirements on the issuing price and coupon rate of exchangeable bonds, as well as a list of documents that potential issuers must submit in preparing for their bond issuance.

(Jun Wei and Keddy Huang)
China Clarifies Pre-Tax Deduction of the Reserves of Credit Guarantee Institutions for Small and Medium Enterprises

On June 1, 2009, China’s Ministry of Finance (MOF) and State Administration of Taxation (SAT) jointly issued the Circular on Issues Regarding the Pre-Enterprise Income Tax Deduction of the Reserves of Credit Guarantee Institutions for Small and Medium Enterprises (关于中小企业信用担保机构有关准备金税前扣除问题的通知, the Circular), which retroactively applies to January 1, 2008 and will be effective through December 31, 2010. In essence, the Circular is a continuation of a former circular of the same title jointly issued by MOF and SAT on December 19, 2007 (the Old Circular). By tracking most provisions of the Old Circular, the Circular clarifies certain issues regarding the pre-tax deduction of reserves set aside by credit guarantee institutions (CGIs) under the PRC Enterprise Income Tax Law, which took effect on January 1, 2008.

This Circular defines a CGI as an entity that mainly provides credit guarantee services to small and medium enterprises. According to the Circular, a CGI may, in a specified tax year, set aside guarantee compensation reserves in an amount not more than 1 percent of the total year-end amount of guarantees, with the reserves being deductible for the purposes of enterprise income tax (EIT).

In addition, the CGI may, in a specific tax year, set aside outstanding guarantee liability reserves in an amount not more than 50 percent of the guarantee fees earned by the CGI in the same year, with the reserves being deductible for EIT purposes. At the same time, the balance of the outstanding guarantee liability reserves up to the end of the previous tax year should be recognized as revenue of the CGI in the current tax year.

When a CGI incurs guarantee compensation losses, the CGI should first use guarantee compensation reserves and general risk reserves to offset the losses, and if such reserves are insufficient to offset the losses, then the CGI may deduct the remaining losses from its taxable income.

(Roy Zou and Kitty Zhang)

China Issues Judicial Interpretations on the Application of Law in Criminal Prosecutions Involving the Manufacturing or Sale of Counterfeit or Inferior Drugs

On May 27, 2009, the Supreme People’s Court and the Supreme People’s Procuratorate of China issued a set of judicial interpretations to govern certain issues concerning the specific application of law in trying criminal cases involving the production or sale of counterfeit or inferior drugs (最高人民法院、最高人民检察院关于办理生产、销售假药、劣药刑事案件具体应用法律若干问题的解释, the Judicial Interpretations). The Judicial Interpretations are effective as of the date of their issuance.

Article 141 and Article 142 of the Criminal Law of the PRC stipulate the criminal liabilities and criminal penalties for the sale or production of counterfeit drugs, and for the sale or production of inferior drugs, respectively. Under Article 141, manufacturing or selling counterfeit drugs leads to increased criminal liabilities and criminal penalties. There are three levels of criminal liabilities and penalties depending on whether the counterfeit drugs “are sufficient to severely harm human health,” or “cause serious harm to human health,” or “result in death or cause
extremely serious harm to human health.” Article 142 penalizes the manufacturing or selling of inferior drugs that “cause serious harm to human health,” or “result in extremely serious consequences.” The Judicial Interpretations clarify the meaning of these terms.

Under the Judicial Interpretations, drugs “sufficient to severely harm human health” as provided in Article 141 of the Criminal Law means drugs which meet any of the following conditions:

1. the counterfeit drugs contain toxic or hazardous substances in violation of national drug standards, or the amount of toxic or hazardous substances contained in the drugs exceed national drug standards;

2. the counterfeit drugs fall into the category of narcotic drugs, psychotropic drugs, toxic drugs for medical use, radioactive drugs, contraceptive drugs, blood products or vaccines;

3. the counterfeit drug are mainly used by pregnant women, women in childbirth or recovering from childbirth, infants, children or patients in critical condition;

4. the counterfeit drugs are administered primarily through injection or as first aid;

5. there is no drug production license or approval code, or the license or code is counterfeit, and the counterfeit drugs belong to the category of prescription drugs; and

6. any other circumstance that may sufficiently endanger to human health.

In addition, the Judicial Interpretations clarify the meaning of “causing serious harm to human health” as provided in Articles 141 and 142 of the Criminal Law. According to the Judicial Interpretations, if the use of any counterfeit drug results in minor injuries or more severe injuries, minor or moderate disabilities, general dysfunction or serious dysfunction due to organ or tissue damage, the counterfeit drugs have caused “serious harm to human health”.

Furthermore, “causing extremely serious harm to human health” under Article 141 of the Criminal Law means that the use of any counterfeit drug results in severe disabilities, serious injuries to three or more persons, moderate disabilities or serious dysfunctions due to organ or tissue damage affecting three or more persons, minor injuries to ten or more persons, minor disabilities or general dysfunctions due to organ or tissue damage of five or more persons or causing the death of any person. These events result “in extremely serious consequences” under Article 142 of the Criminal Law.

The Judicial Interpretations provide that if a medical institution knows or should know a drug is counterfeit or inferior, but still uses or sells the drug and causes recognizable harm as described above, it is criminally liable for selling or using counterfeit or inferior drugs.

Under the Judicial Interpretations, any person who knows or should know that a drug is counterfeit or inferior but still engages in the following actions will be punished as an accomplice in a criminal case:

1. providing funds, loans, accounts, invoices, certificates, or licenses;
(2) providing manufacturing or business premises or equipment, or providing conveniences for transport, storage, safekeeping, and mailing; or

(3) providing production technologies or raw, auxiliary or packaging materials for the manufacturing or sale of fake or inferior drugs.

(Roy Zou and Jessie Xie)

Deepening Reform of China’s Economic Structure in 2009

On May 19, 2009, China’s State Council circulated the Opinions on Deepening Reform of the Economic Structure in 2009 (关于2009年深化经济体制改革工作的意见, the Opinions) drafted by the National Development and Reform Commission (NDRC). The Opinions outline the Chinese government’s plan to continue its policy of reforming and opening its economy to the outside world in the midst of the global financial crisis. At the outset, the Opinions note that 2009 will be the most difficult year since 2000 due to the worldwide economic contraction and accumulated structural damage, and that deep changes are needed to keep China’s economic growth on track.

Despite the aggressive $586 billion stimulus plan that the Chinese government unveiled at the end of 2008, there have been increasing calls for more drastic measures to revive the economy, like those the government took after the Asian financial crisis of 1997-98. The issuance of the Opinions indicates that the Chinese government is ready to move beyond its stimulus plan, and underscores its ambitious long-term agenda to overhaul the domestic economy. The Opinions focus on ten areas, discussed below, in which the major reforms will take place.

1. The government’s role as gatekeeper with respect to investment.

According to the Opinions, the government will continue to streamline its approval processes to provide more efficient channels for investment in the domestic economy. In addition, the government promises to take the following steps to promote investment: reduce the types of investment subject to government approval; revise the foreign investment catalog; pass new regulations on government investment; enhance approval and registration procedures for corporate investment; and use an agent construction model to evaluate not-for-profit government investment projects. When taken together, these steps constitute the most significant relaxation of China’s regulatory regime on investment since it entered WTO in 2001.

2. Private investment in state monopolized industries.

The government encourages private investment in currently state-monopolized industries, such as oil, railroad, electricity, telecommunications and municipal utilities. In the Opinions, the government presents specific reform objectives for individual industries, such as improving investment and financing in the railroad industry, enhancing competition in the telecommunications industry, reorganizing logistics firms in the postal industry, joining networks in the broadcasting and telecommunications industries, reorganizing electricity providers and reforming the electricity system in rural areas, and expanding municipal franchise programs for the provision of gas, heat, sewage and garbage.
3. The toll of economic growth on the environment.

In the Opinions, the Chinese government makes clear that sustained economic development cannot be achieved at the expense of the environment. The government vows to relinquish its control over prices for resources like electricity, water and gas and let the market set prices that reflect their environmental impact. The government will also attempt to lower emissions by encouraging investment in environmentally-friendly products and closing factories that pollute the environment. According to the Opinions, the government will provide credit to the environment industry, expand the scope of emissions trading, and create a reserve fund for sustainable development.

4. Ownership reform, and promotion of the private sector and service industry.

The service industry and private sector have played increasingly important roles in China's economy. According to the Opinions, the government plans to move away from state-owned enterprises in certain industries and fine-tune a supervision system for public investment, so as to leave room for private sector involvement in such industries.

As credit for small and medium enterprises (SMEs) has dwindled in the global financial crisis, the government intends to step in and provide financial assistance by establishing a credit rating agency and risk management system for SMEs. In addition, the government will help SMEs tap into the securities market for financing purposes. The government will also attract private investment to reform the state-owned service sector.

5. Social welfare system.

For years, China’s economic development has outpaced advancement in its social welfare system. As the employment rate began to tumble amid the global financial crisis, the government recognized the need to strengthen employment aid programs to boost the employment rate. In the Opinions, the government focuses on promoting labor unions, negotiating collective contracts and facilitating implementation of the minimum wage law. The government will also upgrade the state pension system and expand its coverage to rural areas. In addition, the government will strictly enforce food safety laws, and provide housing aid in certain cities.

6. Education system.

In the Opinions, Chinese educational institutions are encouraged to cooperate with market players to provide students with both academic training and professional experience. This blending of academic and practical education is one aspect of the government’s long-term education agenda, which also includes perfecting the financial aid and education funding systems, providing students in rural areas with free access to vocational education, and helping children of migrant workers obtain the same education as their urban counterparts.

7. Rural reform.

In the past 30 years, China’s rural areas have experienced less of the social and economic developments that completely transformed its urban centers. In the Opinions, the government addresses this issue, which, it notes, is not conducive to sustainable economic development.
According to the Opinions, the government will advise local governments on how to provide better public services, improve the land use rights system in rural areas to allow for more convenient transfers of land among farmers, expand the social welfare system to rural areas, and grant farmers greater access to cities. In addition, the government will adjust subsidies for agricultural products based on the price of fertilizer and fuel.

8. Tax and budget systems.

According to the Opinions, the Chinese government will grant more financial autonomy to local governments to more efficiently provide public services. The government will also reform the state budget system to curtail superfluous government spending and better fund social welfare programs.

In addition, the government intends to overhaul the value-added and personal income tax systems as a part of a comprehensive tax reform. One aspect of this reform, however, involves the incorporation of property tax into the tax code, which has generated significant public controversy. While property tax is common in other countries, it seems unreasonable in China, where property owners do not actually “own” their property, but rather lease it from the government for a period of 70 years. Given this fact, many argue that the application of property tax seems unfair.


The Opinions contain an ambitious plan to substantially overhaul the domestic financial system. The main components of the plan include assisting financial institutions in rural areas, expanding credit support and guarantees in rural areas, and drawing on private investment to reform the financial industry.

With respect to the securities market, the government plans to pass more effective regulations and promote the growth enterprise market to stabilize securities and protect investors. The government also intends to reform the insurance industry, and provide detailed regulations on private equity firms to facilitate their investments.

10. Foreign investment regulations and international trade.

As 40 percent of China’s gross domestic product comes from trade or trade-related activities, the slowdown of international trade that resulted from the global financial crisis hit China’s economy particularly hard. In response to this crisis, the Chinese government plans to encourage the development of the outsourcing and services industries to reduce China’s dependence on the trade of goods. The government will also establish a comprehensive mechanism to handle international trade disputes, and enhance and expand the free trade agreements to which China is a party. According to the Opinions, the government intends to significantly relax regulations on foreign investment, and encourage domestic firms to invest overseas by providing policy, foreign exchange and credit support.

(Victor Yu and Ran Li)
For more information about the topics discussed in this China Update, please contact one of the Hogan & Hartson attorneys below.

**JUN WEI**
jwei@hhlaw.com  
86.10.6598.8600  
Beijing

**ROGGER PENG**
rongpeng@hhlaw.com  
86.10.6598.8600  
Beijing

**ROY G. ZOU**
rgzou@hhlaw.com  
86.10.6598.8600  
Beijing

**ROBINSON N. STEVEN**
snrobinson@hhlaw.com  
86.21.6122.3800  
Shanghai

**GORDON NG**
gng@hhlaw.com  
852.2151.5858  
Hong Kong

**ARTHUR MOK**
acmok@hhlaw.com  
86.21.6122.3800  
Shanghai

**MAN CHIU LEE**
manlee@hhlaw.com  
852.2151.5858  
Hong Kong

This Update is for informational purposes only and is not intended as basis for decisions in specific situations. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship.

Copyright © 2009 Hogan & Hartson LLP. All rights reserved. Hogan & Hartson LLP is a District of Columbia limited liability partnership with offices across the United States and around the world. Some of the offices outside of the United States are operated through affiliated partnerships, all of which are referred to herein collectively as Hogan & Hartson or the firm.

www.hhlaw.com