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Newsletter

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Insights & Ideas

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Introduction to Beijing QFLP Measures (Authors: James WANG; Kelvin GAO; Vincent SONG and Florine GU)

After the Shanghai Municipal Government became the first in China to implement rules for pilot foreign-invested equity investment enterprises on December 24, 2010 to allow foreign capital to participate in forming private equity funds in China, the Beijing Municipal Government also promulgated the *Interim Measures on Carrying Out the Pilot Program to Utilize Foreign Capital for Equity Investment Funds and Management Enterprises in Beijing* (the "**Beijing QFLP Measures**") on February 28, 2011, which came into effect as of the date of promulgation.

The Beijing QFLP Measures mainly regulate the qualification for foreign-invested equity investment funds and foreign-invested management enterprises established in Beijing to participate in the pilot program as well as the treatment enjoyed by pilot enterprises. Although the basic framework of the Beijing QFLP Measures is similar to that of Shanghai QFLP measures, more specific limitations are provided in the Beijing QFLP Measures, reflecting a more conservative attitude on the part of the Beijing Municipal Government toward introducing foreign capital in China's private equity fund market. Below is the highlight of the Beijing QFLP Measures:

Qualification for pilot enterprises

Pilot enterprises in the Beijing QFLP Measures mean the foreign-invested equity investment funds and foreign-invested fund management enterprises as recognized by Beijing Municipal Finance Services Working Group to carry out the pilot program. Unlike the *Measures on Pilot Program for Foreign-invested Equity Investment Enterprises* in Shanghai (the "**Shanghai QFLP Measures**"), there is no specific provision in the Beijing QFLP Measures specifying the procedures to set up foreign-invested equity investment funds and foreign-invested fund management enterprises in Beijing. Instead, the Beijing QFLP Measures emphasize that pilot enterprises shall take the form of a corporation or a partnership.

Qualification for Pilot Foreign-Invested Fund Management Enterprises According to the Beijing QFLP Measures, foreign-invested fund management enterprises applying to participate in the pilot program shall meet the following requirements: (i) the business scope stipulated in the articles of association or the partnership agreement shall be limited to establishment of equity investment funds, management of the assets of equity investment funds, provision of management services for portfolios of equity investment funds, equity investment consultation, or other activities related to equity investment; (ii) senior management personnel shall have good track record in the areas of equity investment and equity investment management; (iii) it has law/regulation-compliant operation, strict and reasonable investment decision procedures and risk control system; (iv) it has a sound internal finance management system and accounting measures in accordance with applicable finance and accounting rules; and (v) it shall undertake that the equity investment fund raised or managed by it shall primarily invest in the seven strategic new industries preferentially developed in Beijing or equity investment funds whose primary investment focus in the seven strategic new industries.

It is noteworthy that the Beijing QFLP Measures set out the investment industry restrictions for pilot enterprises, which require that pilot equity investment funds shall primarily invest in the seven strategic new industries (i.e., energy saving and environment protection, new-generation information technology, biology, manufacture of high-tech equipment, new energies, new materials and new energy automobiles), while there is no similar restrictions in the Shanghai QFLP Measures.

Qualification for Pilot Foreign-Invested Investment Funds According to the Beijing QFLP Measures, foreign-invested equity investment funds applying to participate in the pilot program shall meet the following requirements: (i) the investment funds shall consist of both RMB funds raised onshore and foreign capital raised offshore, while the capital commitment by foreign investors shall be no more than 50% of the fund size. Further, the size of a single fund shall be no less than RMB500,000,000 (or equivalent amount of foreign currency) and the fund management enterprises shall commit part of the fund's capital; (ii) the primary investment areas stipulated in its articles of association or its partnership agreement shall be the seven preferred strategic new industries in Beijing or equity investment funds whose primary investment focus in the seven strategic new industries; and (iii) other conditions required by the pilot program.

Besides the investment industry restrictions as mentioned above, the Beijing QFLP Measures clearly provide that the capital committed by foreign investors shall be no more than 50% of the fund size. In contrast, there is no upper limit for foreign capital commitment in the Shanghai QFLP Measure, even though it will consider the existence of the onshore investor as one of the key factors when reviewing the application for the pilot program. In addition, the Beijing QFLP Measures set a higher requirement on the minimum fund size (i.e., no less than RMB500,000,000 (or equivalent amount of foreign currency)) than that in the Shanghai QFLP Measures, which require a minimum capital of US$15,000,000. As to the qualification for foreign investors, the Beijing QFLP Measures do not expressly impose such requirement on the self-owned capital or the capital under management as do the Shanghai QFLP Measures.

Special treatment for pilot enterprises

Pursuant to the Beijing QFLP Measures, a pilot foreign invested fund management enterprise is allowed to settle its foreign capital with its custodian bank according to applicable foreign exchange regulations, and further to make capital commitments to the equity investment fund raised by it. The upper limit on foreign capital settlement by pilot fund management enterprises is 5% of the paid-in capital (including the aggregate amount of settled capital) of the equity investment fund. This is generally similar to the Shanghai QFLP Measures. But the Beijing QFLP Measures do not indicate, as stated in the Shanghai QFLP Measures, that the capital contribution by pilot fund management enterprises will not affect the nature of the equity investment fund invested by it.

Pilot foreign-invested equity investment funds can settle foreign exchange with the custodian bank pursuant to applicable PRC laws and regulations, provided, however that, the investment scope of pilot funds shall be consistent with the articles of association or partnership agreement of the fund and the range of industries required in the Beijing QFLP Measures and the approval from the relevant governmental authorities where the investee is located shall be obtained with respect to each investment.

In addition, pilot enterprises shall not invest in the industries where foreign investments are prohibited, secondary securities transactions, financial derivatives transactions, non-self-use real estate investment and shall not use non-self-owned funds to make investments or to provide loans or guarantees to any third party.

Contribution custodian system for foreign-invested equity investment funds

According to Beijing QFLP Measures, pilot enterprises shall entrust a domestic commercial bank as the custodian bank. The responsibilities of the custodian bank include, among others, (i) keeping the account balance information of pilot enterprises for a term of 20 years in order for the inspection by the governmental authorities; (ii) supervising the custodian accounts (including the special foreign exchange account for capital items and special RMB account for capital items) and the use of capital, examining the authenticity of the capital use, reviewing the approval documents of relevant authorities with respect to investment activities, and reporting to Beijing Municipal Bureau of Finance once it becomes aware of suspicious circumstances; and (iii) formulating the capital flow and settlement monthly report for pilot enterprises and submitting it to Beijing Municipal Bureau of Finance with copies to the other relevant authorities.

Legal Updates

1. **MOFCOM Issued Notice on Cross-border RMB Foreign Direct Investment (Authors: Yinshi CAO; Lynn TENG; Amanda HU)**

In order to carry forward the RMB cross-border trade investment, the Ministry of Commerce ("**MOFCOM**") released the *Notice of the Ministry of Commerce on Relevant Matters concerning Cross-border Renminbi Foreign Direct Investment (Draft for Comments)* (the "**Draft Notice**") on its website in August 2011 to solicit public comments. On October 12, 2011, MOFCOM formally promulgated the *Notice of the Ministry of Commerce on Relevant Matters concernning Cross-border Renmibi Foreign Direct Investment (Shang Zi Han [2011] No.889)* (the "**Notice**") which came into effect as of the date of promulgation. The Notice applies to cross-border RMB foreign direct investment ("**FDI**") carried out by foreign investors, as well as investors from Taiwan, Hong Kong and Macao. The majority of offshore RMB is centralized in Hong Kong, Taiwan and Macao with some located in Singapore and regions within close vicinity. The Notice is aimed at supporting and encouraging enterprises from such areas to engage in onshore direct investment with RMB.

In comparison with the previously issued Draft Notice, The Notice stipulates the following differences with respect of the scope of FDI by offshore RMB:

First, the Draft Notice prohibits cross-border RMB FDI from "directly or indirectly investing in securities or financial derivatives or making entrusted loans or settling foreign or domestic debts", whereas the Notice no longer includes the item of "settling foreign or domestic debts". We understand that this change extends the scope of using offshore RMB from investment only to the settlement of debts.

Second, the Notice incorporates Article 11 which states that foreign investors engaging in onshore listed company equity private placement and agreed share transfer with lawfully obtained offshore RMB shall follow relevant procedures to obtain approval from MOFCOM in accordance with the *Administrative Measures on the Strategic Investment in Listed Companies by Foreign Investors* (the "**Administrative Measures**"). This provision not only makes it possible for foreign investors to participate inequity private placement and agreed shares transfer transactions of onshore listed companies with offshore RMB, but also provides a legal ground for lawfully obtained offshore RMB to successfully flow back to the onshore security market, which can be conducted in accordance with the Administrative Measures. However, the Administrative Measures set a comparatively higher standard for the qualification of foreign strategic investors and implements a three year lock-up period, thus, we understand that the abovementioned method may not be good for investment of offshore RMB in the onshore security market until the formal issuance of specific regulations applicable to qualified foreign institutional investors.

The Notice stipulates in detail the qualified sources, the scope of FDI and relevant approval procedures of the offshore RMB used in the cross-border RMB FDI and is as follows:

Qualified sources of offshore RMB

The Notice defines "cross-border RMB FDI" as foreign investors' direct investment in China by lawfully obtained offshore RMB. Lawfully obtained offshore RMB includes two types of funds:

1) RMB obtained by foreign investors through cross-border trade RMB settlement, and RMB earned lawfully onshore and remitted from China as dividends, share transfer proceeds, capital reductions, liquidation proceeds and early returns on investment.

2) RMB obtained by foreign investors through lawful channels offshore, including but not limited to RMB obtained by issuance of offshore RMB bonds or offshore RMB shares.

It is worth mentioning that the Notice specifically indicates that foreign direct investments carried out by foreign investors by RMB which is earned through foreign-invested enterprises but not remitted from China as dividends, share transfer proceeds, capital reduction, liquidation proceeds and early returns on investment are still subject to the currently applicable rules, not the Notice.

Scope of FDI

1) General Principle

The Notice requires cross-border RMB FDI and the re-investment of the invested enterprises to be subject to the general regulatory rules applicable to foreign investments in China, in compliance with the national industrial policies for foreign investment, the security review on foreign mergers and acquisitions and the antimonopoly review. FDI in real estate industry by offshore RMB shall be subject to the approvals and filings rules currently applicable to foreign-invested real estate business.

2) Limitations on the Use

The Notice prohibits cross-border RMB FDI from investing directly or indirectly in negotiable securities or financial derivatives (with the exceptions stipulated in Article 11 of the Notice), or making entrusted loans. As mentioned above, an exception to this limitation is provided under Article 11 of the Notice.

Approval procedures

1) Standard Approval

Pursuant to the Notice, all competent commerce departments at all levels shall be responsible for approving cross-border RMB FDI in accordance with the current regulations applicable to foreign investment and their limits of authority. In addition to the standard application documents required by commercial authorities for a foreign investment project, the following documents specific to cross-border RMB FDI shall also be submitted:

(i) an evidence regarding the source of RMB funds or explanation document;

(ii) an explanation of the intended application of the funds, and

(iii) a "Fact Sheet of Cross-border Renminbi Foreign Direct Investment" (as an appendix of the Notice).

A cross-border RMB FDI with a change in the original capital contribution currency from foreign currency to RMB shall also be reported to commercial authorities for approval. In this case, a resolution by the board of directors or the supreme governing bodies and the amended contract or articles of association (or amendment agreement) shall also be submitted in addition to the documents listed above.

The Notice deleted the requirement of submission of an undertaking letter executed by all investors or legal representatives of the entity that the funds will not be used for any of the prohibited purposes mentioned above. However, we understand, commercial authorities still place strong emphasis on these matters and investors are required to strictly abide by the prohibition regulations stipulated in the Notice.

2) Special Approval

Pursuant to the Notice, local commercial authorities shall record "Fact Sheet of Cross-border Renminbi Foreign Direct Investment" in the foreign investment examination and approval management system. In the event that any of the below circumstances occurs, provincial commercial authorities shall sign and affix their seals on the "Fact-sheet of Cross-border Renminbi Foreign Direct Investment and submit it to MOFCOM for examination.

(i) the investment amount reaches or exceeds RMB300 million;

(ii) the invested industries involves financial guarantees, financial leasing, small loans, auctions and etc;

(iii) the foreign-invested entity is an investment orientated company, a venture capital enterprise or private equity enterprise; and

(iv) the foreign-invested entity is in an industrial sector regulated by the State at a macro-level, including cement, iron and steel, electrolyzed aluminum, shipbuilding and etc.

MOFCOM shall complete the examination or provide opinions on the “Fact-sheet of Cross-border Renminbi Foreign Direct Investment” submitted by provincial commercial authorities within five (5) working days upon the receipt of the same. Once it passes the examination by MOFCOM, the local commercial authorities may issue approval and award a Approval Certificate for Foreign-Invested Enterprise.

We understand that according to the *Circular of the Ministry of Commerce on Issues concerning Foreign Investment Administration (Shang Zi Han [2011] No.72)* promulgated by MOFCOM in 2011, where a foreign investor carries out investment activities in China (including establishment of a new enterprise, increase of capital of an existing enterprise, merger and acquisition of a PRC domestic enterprise, the provision of loans and etc.) with RMB funds obtained through cross-border trade settlements or otherwise lawfully obtained abroad, the provincial commercial authorities shall first submit a reporting letter to (the Department of Foreign Investment Administration of) the MOFCOM and then proceed with the relevant formalities upon the receipt of consent issued by (the Department of Foreign Investment Administration) of the MOFCOM, which shall specify the investment currency and amount. Once the Notice takes effect as it is, except in the circumstances mentioned in Part 3(b), the authority to approve a standard cross-border RMB FDI transaction will be delegated to local commercial authorities.

Miscellaneous

In addition, the People’s Bank of China has recently released the *Administrative Measures for FDI RMB Trade Settlements* (the “**RMB Settlement Administrative Measures**”). Once MOFCOM approves the cross-border RMB FDI in accordance with the Notice, the foreign investor and bank shall proceed with the FDI RMB trade settlement in accordance with the RMB Settlement Administrative Measures. The content and timing of the introduction of the RMB Settlement Administrative Measures are both for the purposes of supporting and protecting the Notice. The legal system of cross-border RMB FDI will be further improved upon the formal introduction of administrative measures and detailed operational rules applicable to qualified foreign institutional investors.

2. PBOC Published Draft Rules on the Deposit and Administration of Clients' Reserve Funds of Payment Services Institutions (Authors: Li ZHANG; Chu Liu)

Following the issuance of the Payment Services Permits, the People's Bank of China ("**PBOC**") has further accelerated the legislation process of the administration regulations and rules on the payment services provided by non-financial institutions (in other terms, the third party payment services institutions). On October 28, 2011, the PBOC published the *Measures for the Administration on Prepaid Card Business of Payment Services Institutions (Exposure Draft)*, while on November 4, 2011, the *Interim Measures for the Deposit and Administration of Clients' Reserve Funds of Payment Services Institutions (Exposure Draft)* (the "**Measures**") are published to solicit public opinions.

The administration authority of the payment services institutions has always been concerned with the safety of the clients' funds obtained by the payment services institutions due to lack of measures to control liquidity risks, credit risks and operational risks of reserve funds that accumulated in the payments made by third parties to payment services institutions. Thus, the publication of the Measures meets the request of the current situation and receives a lot of attention from the payment services industry, particularly after the recent friction of "bank run" between the owner of www.taobao.com and the small and medium sized business owners operating on www.taobao.com.

In comparison with the current effective regulations and rules on the payment services business conducted by non-financial institutions, the Measures highlight and specify the rules in the following aspects.

The measures clarify the ownership of the interests for the first time

As provided in the *Administrative Measures of Payment Services of Non-Financial Institutions* and the *Implementing Rules for the Administrative Measures of Payment Services of Non-Financial Institutions (Exposure Draft)*, the deposited funds of payment services institutions (i.e., the reserve funds) shall belong to the clients which shall not be misappropriated. However, the foregoing *Administrative Measures* and the *Implementing Rules* do not provide rules regarding the ownership of interests derived from such reserve funds.

The Measures specifically provide for the first time as follows: a payment services institution can transfer the interests balance accumulated in the bank account of the reserve funds to its own capital account after accruing the risk reserve funds. In these words, PBOC confirms that the interests accrued on the reserve funds shall belong to the payment services institutions. Moreover, according to the provision of the Measure that the accrued risk reserve funds shall be no less than 10% of the interests accumulated in the bank account of the reserve funds", a payment services institution can obtain up to 90% of the interest proceeds. As quoted by insiders, such provision is the result learning from the provisions of other countries, i.e., the interests generated in the third-party payment services shall belong to the payment services institutions and will not be paid or refunded to the clients. Such provision is significantly commercially favorable to payment services institutions possessing large amounts of reserve funds.

In addition, as provided in the Measures, payment services institutions can deposit reserve funds in the reserve funds banks in the form of current accounts, fixed term deposits, notice deposits, agreement deposits or any other form of deposits approved by PBOC. If a payment services institution deposits its reserve funds in the form of current accounts, such reserve funds shall be deposited in the special reserve funds deposit account. If a payment service institution deposits its reserve funds in other forms other than current accounts, it shall guarantee that there are sufficient reserve funds deposited in the current accounts to meet the requirements for daily payment services. The reserve funds deposited in such other forms in the cooperating banks for reserve funds shall not bear a term more than 3 months, the interests of which can also belong to the payment services institutions.

The measures establishes the system for designation of the reserve funds deposit bank

Aside from the issue regarding the ownership of interests, designation of the banks for the deposit of reserve funds also has a significant impact on the non-financial payment services institutions. The *Administrative Measures of Payment Services of Non-Financial Institutions* have provided that a payment services institution can only designate one commercial bank as its reserve funds deposit bank. Thereafter, only a few large payment services institutions including Alipay have disclosed their designation of reserve funds deposit banks. Most payment services institutions remain silent in this regard.

In practice, payment services institutions usually possess a large amount of reserve funds and are thus always VIP customers for banks. Under the current market conditions, payment services institutions usually will not have the reserve funds deposited in one single bank. Instead, they may select numerous banks to cooperate with. In this regard, although the Measures provide that a payment service institution may only designate one commercial bank as the reserve funds deposit bank, the Measures also state that a payment services institution may also choose commercial banks as cooperating banks for reserve funds deposit to meet the requirements of business operation. Such provision forces payment services institutions to decrease the numbers of deposit accounts while at the same time looses the restriction on the “one single bank designation”, which reduces the difficulty for PBOC to monitor the cash flows of payment services institutions.

It is said that over 40 payment services institutions which have been granted the Payment Services Permit have not designated their own reserve funds deposit banks. Such situation also will be tremendous business opportunities for commercial banks.

The measures specify the relevant requirements on the reserve funds accounts

According to the provisions in the Measures, the special deposit accounts for reserve funds opened in the reserve funds banks by payment services institutions shall be divided into two types based on their respective usage: reserve funds receipt accounts and reserve funds remittance accounts.

The reserve funds receipt account opened by payment services institutions in the reserve funds deposit banks can accept the clients' reserve funds through cash, intra-bank transfer or inter-bank transfer. Such reserve funds receipt accounts may also provide payment services to the clients directly through intra-bank transfer or inter-bank transfer. A payment services institution can only open one reserve funds receipt account in one cooperating bank for reserve funds. The other special reserve fund deposit accounts, other than the reserve funds receipt account, opened by a payment services institution at different branches of the same cooperating bank for reserve funds to satisfy its business operation shall be reserve funds remittance accounts.

The reserve funds remittance accounts shall only be used to accept the clients' reserve funds by payment services institutions through cash or intra-bank transfer. The cooperating banks for reserve funds shall, before the end of each business day, automatically transfer the balance of the reserve funds remittance banks into the reserve funds receipt accounts opened by the payment services institution at such cooperating bank, or into the special reserve funds deposit account opened by the payment services institution at the reserve fund deposit bank. Such provision implies that the reserve funds remittance accounts can only accept reserve funds from the clients, yet such accounts cannot be used to provide payment services. There shall be no balance in such reserve funds remittance accounts at the end of each business day, which reduces the risks that such reserve funds may be embezzled or misappropriated.

In summary, the Measures provide more detailed and comprehensive provisions and rules regarding the basic administration system of reserve funds of payment services institutions. However, since the public opinions which will be submitted on the Measures remain unknown, it is uncertain whether the provisions of the Measures involving the interests allocation among the relevant parties, especially the provision regarding the ownership of interests, will arouse disputes. The payment services institution industry still awaits the formal promulgation of the relevant regulations.

3. Brief of Pilot Program of VAT Reform in Shanghai (Authors: Bing XUE; Jiaxin LIU; Chu LIU)

On November 16, 2011, the Ministry of Finance ("MOF") and the State Administration of Taxation jointly issued the Circular on Printing and Distributing the Pilot Program for the Collection of VAT Instead of Business Tax (Cai Shui [2011] No.110, "Circular No. 110") and the Circular on the Pilot Program for the Collection of VAT Instead of Business Tax in the Transportation and Certain Modern Service Sectors in Shanghai (Cai Shui [2011] No. 111, "Circular No. 111", collectively as "the Reform Rules" together with Circular No. 110) to provide detailed implementation rules for the pilot program of the indirect tax reform ("the Pilot Program"). The Pilot Program will become effective from January 1, 2012 in Shanghai.

The issuance of the Reform Rules indicates the significant kick-off of the turnover tax reform in China. We set out below the key points of the Reform Rules and share our observations to the Pilot Program.

Highlights of the Pilot Program

The Reform Rules set out detailed implementation and transitional rules to give effect to the Pilot Program.

1) The Reform Rules

Circular No. 110 outlines the general principles for the Pilot Program and clarifies the general scope and the step-by-step reform arrangement. Circular No. 111 provides detailed implementation rules for the pilot reform in Shanghai, which is accompanied with three appendices below:

- Appendix 1: Pilot Implementation Measures for the Collection of VAT Instead of Business Tax in the Transportation and Certain Modern Service Sectors;
- Appendix 2: Regulations on Relevant Issues for the Collection of VAT Instead of Business Tax in the Transportation and Certain Modern Service Sectors; and
- Appendix 3: Regulations on the Transitional Policy for the Collection of VAT Instead of Business Tax in the Transportation and Certain Modern Service Sectors.

2) Pilot Industries Scope

We summarize below the pilot industries scope and applicable VAT rates as stated in the Reform Rules.

Industries	Service Sectors	Applicable VAT Rates
Transportation	Road transportation services	11%
	Water transportation services	11%
	Air transportation services	11%
	Pipeline transportation services	11%
Certain Modern Services	Research, development and technical services	6%
	Information technology services	6%
	Cultural and creative services	6%
	Logistics and ancillary services	6%
	Tangible movable property leasing services	17%
	Certification and consulting services	6%

The attachment to Circular No.111, referred to as "Annotations to the VAT Items," sets forth detailed explanations of the scope of each of aforesaid service sectors.

Please kindly note that services sectors that are not covered in the Reform Rules, such as construction, telecommunication and financial and insurance services, may be further included in the pilot scope at a later stage.

3) Pilot Reform in Shanghai

This phase of Pilot Program is set to implement in Shanghai. However, it is still important to look into the potential tax impact on cross-region businesses as listed below.

Location of Services Provider	Where Services Take Place	VAT or Business Tax
Shanghai	Shanghai	VAT
Shanghai	Non-Shanghai area in China	Business Tax, but credit can be claimed against VAT payable
Non-Shanghai area in China	Shanghai	Business Tax
Non-Shanghai area in China	Non-Shanghai area in China	Business Tax

In addition, cross-border services transactions may also involve various tax implications.

4) Other Salient Points in the Pilot Program

(i) Registration as General VAT Taxpayers

Under Circular No.111, the minimum annual VAT related sales income for qualifying as a general VAT taxpayer is RMB 5 million. For businesses with sales income below RMB 5 million, they may still register as general VAT taxpayers if they have sound and complete accounting records in place.

(ii) Extension of Business Tax Related Incentives

As confirmed in the Reform Rules, the currently effective Business Tax incentives, including those with respect to the R&D and technology related activities and qualified offshore outsourcing services will remain in force during the Pilot Program.

Our observations

As the Pilot Program will become effective in Shanghai in the very near future, it is recommended that taxpayers concerned start to thoroughly review their internal tax compliance systems and closely monitor the local tax authorities' interpretations and guidelines on the Pilot Program.

4. MOFCOM Conditionally Approved the Acquisition of Savio by Penelope (Authors: Tracy ZHOU; Haoze LI)

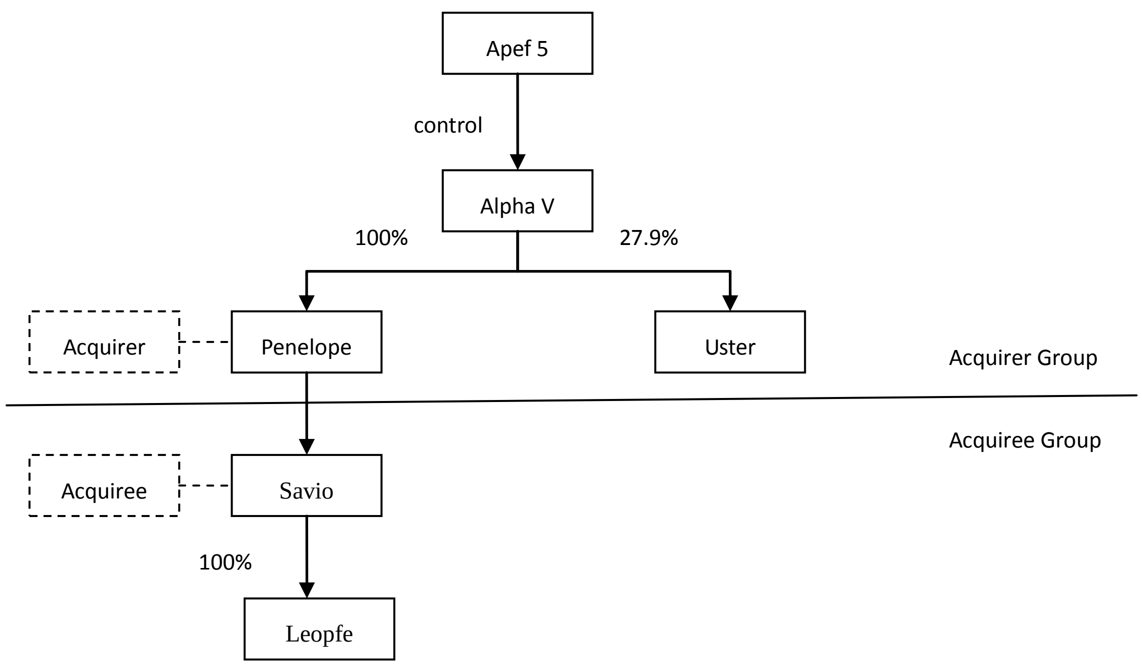
On November 2, 2011, the Ministry of Commerce of the People's Republic of China ("**MOFCOM**") published on its website an announcement to conditionally approve issued Penelope Acquisition of Savio. Set forth below is a brief introduction to details of the involved acquisition and our observations regarding this anti-monopoly review case.

The acquisition

1) Basic Information

According to the announcement, the acquirer, Penelope is a special purpose vehicle established by Alpha Private Equity Fund V ("Alpha V") who holds 27.9% shares of Uster, while Savio is the sole shareholder of Leopfe. Uster and Leopfe are the only two manufacturers of electronic yarn clearers for automatic winders in the world.

The structures of the acquisition are as follows:



2) Review Procedures

On July 14, 2011, MOFCOM received the notification for concentration of business operators submitted by Penelope; on September 5, 2011, MOFCOM began to scrutinize the acquisition after all necessary materials had been supplied; on September 30, 2011, MOFCOM decided to launch further scrutiny procedures; on October 31, MOFCOM finally approved the acquisition subject to equity divestiture by Alpha V (further discussed below). It took three and a half months for MOFCOM to reach a conditional clearance decision from notification.

3) Assessment on Elimination or Restriction of Competition

According to Article 2 of *the Anti-Monopoly Law of the People's Republic of China* ("**Anti-Monopoly Law**"), the monopolistic conducts outside the territory of China which have the effect of eliminating or restricting competition in the domestic market of China shall be governed by the Anti-Monopoly Law. In this Savio/Penelope case, MOFCOM investigates the competing status, supply and demand balance, purchasing model and market access of manufacturing market, and finds out that as the only two manufacturers, Uster and Leopfe occupied 52.3% and 47.7% of global manufacturing market respectively in year 2000 (in Chinese market, the portion was alike). MOFCOM further regards the threshold of manufacturing market is quite high and it is very difficult for a new enterprise to enter into the aforesaid market. As such, MOFCOM determines that Uster and Leopfe may eliminate or restrict the competition of manufacturing market under coordination by Alpha V after the acquisition.

4) Equity Divestiture

Apef 5 (the ultimate controller of Alpha V) undertook to transfer its shares of Uster to an independent third party under supervision by an independent trustee and reports the identity of transferee, transfer amount and transfer date to MOFCOM. Before the aforesaid transfer, Aped 5 shall neither engage in nor influence the management of Uster.

Our observations

There are two breakthroughs in this anti-monopoly review case worth noting: (i) it is the first case published by MOFCOM where a PE fund is involved; (ii) MOFCOM decides that Alpha V was able to control or influence Uster, despite the fact that Alpha V's shareholding in Uster was quite clearly a minority interest. Generally speaking, PE funds are always financial investors which seldom participate in the management of companies they invest into. MOFCOM based its decision by taking into account "Uster's shareholding structure, voting system of shareholder's meeting, attendance record of shareholder's meeting, composition and voting system of board of directors", and concluded that" the possibility that Alpha V may be able to participate in or influence the management of Uster cannot be excluded".

By including Uster into its anti-monopoly review scope, it is likely that MOFCOM has adopted the standards as set forth in the *Measures for the Notification of Concentration of Business Operators* ("**Measures for Notification**"), read as: "the turnover of a single business operator involved in the concentration shall be the sum of the turnovers of the following business operators: i) the single business operator (i.e. Penelope, Savio); ii) other business operators controlled directly or indirectly by the business operator referred to in item i) (i.e. Leopfe); iii) other business operators that directly or indirectly control the business operator referred to in item i) (i.e. Alpha V); iv) other business operators controlled directly or indirectly by the business operators referred to in item (3) (i.e. Uster); v) Other business operators controlled jointly by two or more business operators among the business operators referred to in items i) to iv)."

It seems, in this case, when determining "control", MOFCOM has referred to the definition of "control "in Article 3 of Measures for Notification(Draft for Comments) promulgated on January 20, 2009, read as: "acquiring 50% of other operator's voting shares or assets" or "could appoint one or more members of board of directors and key management officers, decide financial budget, operation and sale, price, material investment or other important management and operation issues by means of acquiring shares or assets or making contracts but without acquiring 50% of other operator's voting shares or assets", although these two criteria have been taken out in the official version of the Measures for Notification.

Important Announcement

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If you have any questions regarding this publication, please contact:

Contact Us

Beijing Office
Tel.: +86-10-8525 5500
Suite 906, Office Tower C1, Oriental Plaza
No. 1 East Chang An Ave.
Beijing 100738, P. R. China

Rong CHEN Attorney at-law
Tel.: +86-10-8525 5541
Email: estella.chen@hankunlaw.com

Shanghai Office
Tel.: +86-21-6080 0909
Suite 5709, Tower 1, Plaza 66, 1266 Nanjing West Road,
Shanghai 200040, P. R. China

Anita SUN Attorney-at-law
Tel.: +86-21-6080 0907
Email: anita.sun@hankunlaw.com

Shenzhen Office
Tel.: +86-755-3680 6500
Suite 4709, Excellence Times Plaza, 4068 Yitian Road, Futian District,
Shenzhen 518048, P. R. China

Jason WANG Attorney at-law
Tel.: +86-755-3680 6518
Email: jason.wang@hankunlaw.com