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In the 2001 China Law Year-in-Review we used the term "historic" to describe 2001's legal developments.[1] In 2002, the People's Republic of China (China or PRC) continued a fast pace of legal development, following a theme of liberalizing foreign access to several sectors of China's economy. The liberalization has been dictated by China's desire to implement and honor the commitments it made in connection with its accession to the World Trade Organization (WTO).

The PRC government issued new Foreign Investment Guidelines increasing the number of permitted and encouraged projects while decreasing the number of prohibited or restricted projects. For the first time, the Chinese government promulgated merger and acquisition regulations and liberalized foreign access to China's securities markets. Technology import regulations were first-time regulations. The PRC also liberalized access to the construction and banking sectors. For the first time, the Chinese government issued government procurement regulations.

The year 2002 also was a significant year for legal development in the Hong Kong Special Administrative Region (Hong Kong or HKSAR). A heated debate emerged on legislation implementing Hong Kong's commitments under article 23 of the Basic Law. In addition, the HKSAR issued the Securities and Futures Ordinance, fundamentally changing regulation of financial services.

This article highlights selected 2002 legal developments in China and Hong Kong.

I. People's Republic of China

A. Revised Foreign Investment Guidelines

China acceded to the WTO and the government issued regulations liberalizing access to several of China's economic sectors consistent with its WTO commitments. On February 11, 2002, the State Council issued the *Regulation on Guiding Foreign Investment Direction* (2002 Provisions), and on March 21, 2002, the State Development and Planning Commission (SDPC), the State Economic and Trade Commission (SETC), and the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) jointly issued the revised *Catalogue for Guiding Foreign Investment in Industry* (New Catalogue).[2] The 2002 Provisions and the

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1. Michael E. Burke, *China Law*, 35 Int'l Law. 815 (2002).

2. Perkins Coie, *Catalogue for Guiding Foreign Investment in Industry* (Mar. 21, 2002), *available at* www.perkinscoie.com/resource/intldocs/catalogue.htm.

New Catalogue were effective as of April 1, 2002. As with past catalogues, the New Catalogue divides projects into classes, including "prohibited," "restricted," and "encouraged."[3] Projects not in any of the foregoing three categories are deemed "permitted."[4]

The 2002 Provisions state that the New Catalogue may impose other restrictions on foreign investors, such as defining the structure of a foreign invested enterprise (FIE).[5] Such structuring restrictions are imposed usually on "restricted" projects.[6]

The 2002 Provisions provide a number of incentives for foreign investors. "Permitted" projects exporting all of their products will be deemed "encouraged" projects.[7] "Restricted" projects exporting more than 70 percent of their total sales will be deemed "permitted" projects upon regulatory approval.[8]

The 2002 Provisions and the New Catalogue contain preferential policies for investment in China's central and western areas. Such policies are consistent with 2000's *Guiding Foreign Investment in the Dominant Industries of the Central and Western Regions Catalogue.* "Permitted" and "restricted" projects in China's western region are eligible for a 15 percent income tax rate for three years after the end of other applicable tax holidays.[9] In addition, such projects are exempted from duties and value-added tax (VAT) on imported equipment.[10]

B. Regulation of Foreign Invested and Chinese Enterprises

1. *New Takeover and Disclosure Procedures*

On September 28, 2002, the China Securities Regulatory Commission (CSRC) published the *Administration of the Takeover of Listed Companies Procedures* (Takeover Procedures). Related thereto, the CSRC, on the same date, issued the *Administration of Disclosure of Information on the Change of Shareholdings in Listed Companies Procedures* (Disclosure Procedures). Both regulations became effective on December 1, 2002. The Takeover Procedures are the first regulation of public company takeovers in the PRC's history. The Disclosure Procedures require public disclosure of certain shareholding activities. The new regulations cover any purchase of listed company shares with the intent of gaining control and other specified transactions.

The Disclosure Procedures impose disclosure obligations on defined persons, including share controllers (such as proxy shareholders) and shareholders in listed Chinese companies. The procedures require these defined persons to submit a *Report of Shareholding Changes Among the Shareholders of Listed Companies* to the CSRC and the stock exchange in response to specified events. Such a defined person is to notify the issuer and make a public announcement. If the transaction will result in a controlling stake (30 percent), the purchaser is to submit an acquisition report to the CSRC pursuant to the Takeover Procedures.

Defined persons are to file the above-mentioned report when: (1) their holdings cross (either up or down) the 5 percent threshold (holder-initiated transactions of such shares

3. *Id.*
4. *Id.*
5. *Id.*
6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*

may be restricted) or (2) for existing 5 percent holders, when their holdings vary by 5 percent of the company's total shares (with resale prohibitions provided in the Disclosure Provisions). The defined person is prohibited from transacting in the company's issued shares within two or three working days after the required public announcement, respectively. In either event, the defined person is to make a public announcement regarding the transaction within two working days of transaction consummation. Such announcement is to be made within three working days for transfers involving state-owned shares. If a covered person's share varies by 1 percent of the company's total shares by virtue of transactions on a stock market, such defined person is to publicly announce such transaction.

The Takeover Procedures offer significant guidance as to mergers and acquisitions and the conduct of a private sale. In the private sale takeover context, the purchaser is to submit a report to the CSRC within two days of the execution of a takeover agreement. The purchaser then must provide a specified notice about the proposed transaction to the target and the public. When the target's board receives this notice, it is to provide an opinion on takeover; the target's independent directors are to give separate opinions, which are to be made public. In the discharge of these duties, the target's board may retain an independent financial adviser. However, an independent financial advisor is required by the Takeover Procedures for management buyouts. A takeover agreement for the transfer of state-owned shares or those shares requiring government approval is effective only upon relevant approval.

The Takeover Procedures allow publicly traded shares to be transferred in a private sale, subject to certain conditions. A securities company must handle the transfer and settlement procedures. The securities company is to apply to the stock exchange and clearinghouse for the suspension of trading in the shares to be transferred. The transferor shall make a public announcement of the transfer agreement on the day after the transfer application has been submitted to the relevant stock exchange. The stock exchange is to review the application and issue a decision within three working days of receipt of the application. Upon stock exchange approval, the securities company must apply to the clearinghouse for the transfer of shares. The transferee is to announce the transfer within two working days after the transfer is complete. After the shares have been transferred, the securities company is to apply to the stock exchange for the release of the share custody. The transferee is to announce the release within two working days after the release.

Upon completion of these steps, the public trading of such shares can resume. The new procedures allow a shareholder to sell shares in a listed company by public solicitation (through a securities company), provided the CSRC and the relevant stock exchange have approved such soliciting. This type of transaction seems limited to non-listed shares in a listed company.

Related to the Takeover Procedures, on November 4, 2002, the CSRC and the Ministry of Finance (MOF) jointly issued a notice allowing the transfer of Chinese non-listed shares to foreign investors. Any transfer of state-owned shares is to be approved by the MOF. Full payment of the purchase price is required before such transfer can be legally registered. Non-listed shares acquired by foreign investors may not be resold within twelve months after the transfer. Foreign investors may not acquire a Chinese listed company through the purchase of shares on China's stock exchanges.

Consistent with the Securities Law, the Takeover Procedures require a party to make a general offer to all the shareholders of a target company should such party intend to hold or control more than 30 percent of the outstanding shares of the target company. A person

controls a listed company if the person: (1) is the single largest shareholder, (2) exercises or controls more voting rights than the largest shareholder of the company, (3) holds or controls more than 30 percent of the shares or voting rights in the company, (4) holds the right to appoint more than half of the board members by exercising voting rights, and (5) falls under other circumstances determined by the CSRC.

A purchaser may apply to the CSRC for a waiver of the "general offer" requirement. Pursuant to the Takeover Procedures, such waiver is appropriate for: (1) certain intra-company or related-party transactions; (2) corporate rescues; (3) situations where the 30 percent threshold is crossed by virtue of a stock split, capital reductions, inheritance, administrative order, or enforcement of a court order; (4) a shareholder holding more than 50 percent of the shares in a listed company intends to increase his or her holding, and the result of such increase will not cause the shares held by such shareholder to exceed 75 percent of the outstanding shares of such company; (5) underwriters or banks holding more than 30 percent of shares in the ordinary course of their business; and (6) other CSRC-defined circumstances.

An acquiring party that originally held less than 30 percent of the shares in the target company may increase its stake by making a tender offer. The shares to be purchased pursuant to such tender offer may not exceed 5 percent of the outstanding shares, and the result of the tender offer shall not cause the acquirer's shares to exceed the 30 percent threshold.

At the outset of a tender offer the acquirer is to notify the target and make a public announcement (Tender Offer Report) describing the proposed offer. If the CSRC does not object to the Tender Offer Report within fifteen days of receipt, the acquirer may make the offering documents public. If the CSRC does object to the Tender Offer Report, the acquirer must amend the tender offer to the CSRC's approval. The acquirer must provide a legal counsel opinion as to the truthfulness, correctness, and completeness of the Tender Offer Report. In addition, a financial adviser must provide an opinion as to the acquirer's financials.

The target's board is to retain a financial adviser to assess the targets financial condition and opine as to the offer's fairness. In the management buyout context, independent directors (instead of the board) are to retain a financial adviser to undertake the above-mentioned tasks. The target's board is to prepare a Response Report describing the board's recommendation to the shareholders. The Response Report and related opinions are to be submitted to the CSRC and made public. If the acquirer intends to fund the transaction with cash, 20 percent of the transaction value must be placed in a bank account designated by the securities clearinghouse as a performance bond. If the transaction is to be funded by transferable securities, such securities shall be held in custody by the securities clearinghouse.

A tender offer's term may be thirty to sixty days, unless there are competing tender offers in place. Once made, a tender offer may not be withdrawn during its term. A tender offer may be revised only upon the CSRC's permission. If the potential purchaser abandons its tender offer prior to consummation, it may not attempt another tender offer as to the same stock for one year from the date of withdrawal.

The Takeover Procedures regulate the per-share price at which a tender offer may be consummated. The minimum offer price for a target's listed shares is the greater of (1) the highest acquisition price paid within six months of purchasing the target company's securities; or (2) the amount equaling 90 percent of the average daily weighted trading prices

of such listed shares in the past thirty trading days prior to the date of the announcement of the existence of a tender offer. For non-listed shares, per the Takeover Procedures, the offer price is not to be lower than the higher of (1) the highest price paid by the acquirer within six months of the announcement of the existence of the offer, or (2) the most recent audited book value per share of the target company.

Interestingly, the Takeover Procedures prohibit targets from undertaking certain anti-takeover provisions. In an effort to derail the takeover, a target's board may not: (1) issue new shares, (2) issue convertible bonds, (3) redeem the company's shares, (4) amend the company's articles of association, or (5) sell all or substantially all of the target's assets.

2. *Supreme People's Court Bankruptcy Provisions*

On September 1, 2002, the Supreme People's Court (SPC) issued the *Several Issues on Trial of Enterprise Bankruptcy Cases Provisions* (Bankruptcy Provisions), creating a single set of rules governing private and public bankruptcies. The Bankruptcy Provisions specify that a debtor's application is to include a list of assets, employment statistics, and outplacement plans for affected employees. A creditor is to provide only information related to the debtor's ability to pay its debts. A debtor may challenge a creditor's application under the Bankruptcy Provisions.

People's Courts may reject a debtor's bankruptcy application if the debtor has concealed or disposed of assets during the application's pendency. A creditor's application could be rejected if motivated by a desire to harm the debtor's business or reputation. This rejection power remains with the People's Courts even after it has approved a bankruptcy application. The Bankruptcy Provisions presume that a debtor is unable to pay its debts when the debtor has continually failed to pay such debts. What length of time constitutes "continual" is unclear.

The Bankruptcy Provisions specify certain bankruptcy assets, which are items that may be sold in order to satisfy the debtor's obligations. Goods subject to mortgages, liens, and pledges are not bankruptcy assets. Secured creditors must obtain a People's Court's approval prior to enforcing their security rights, except when the security holder waives his right to be paid in priority. The liquidation committee may recover the bankrupt enterprise's assets located outside the PRC.

An enterprise management committee operates the debtor enterprise during the pendency of the bankruptcy application. The enterprise management committee may include debtor's management, shareholders, and creditor representatives and ends upon the establishment of a liquidation committee. A court is to establish a liquidation committee within fifteen days of declaring an enterprise bankrupt. A liquidation committee may include government representatives from the State Administration of Industry and Commerce (SAIC), the State Administration of Taxation, and the Labor Department, and the debtor's directors. The liquidation committee may employ such professionals (accountants and lawyers, among others) as the committee deems necessary.

Creditors must provide proof of the debt, including information about any security interest securing such debt, to the court, or, if established, the liquidation committee. Guarantors who bear joint and several liability with the debtor may also file their indemnity claims against the debtor in anticipation of the creditor's claim against the guarantor arising under the guarantee. Also, a creditor's meeting will take place with only those creditors who have filed claims as provided in the Bankruptcy Provisions. A People's Court should convene the first creditors meeting and must appoint officers for the committee. The

committee may act by simple majority (computed by value of debt held), except for a draft settlement between creditors and debtor, which must be approved by two-thirds of creditors (measured by value of debt held). If two creditors' meetings fail to create an asset distribution plan, the People's Court may decide upon a plan. A majority of unsecured debtors (measured by value of debt held) may appeal the ruling of the People's Court.

The new provisions allow for set-off, although such right is neither mandatory nor automatic. Upon acceptance of a bankruptcy application, the People's Court informs the bankrupt enterprise's bankers that no setting-off of liabilities owed to the bank is permitted, except as authorized by the court. Creditors may apply to the liquidation committee to exercise a right of set-off, provided such right has been confirmed and accrued prior to the bankruptcy declaration. Setting-off the rights of a creditor acquired by assignment is not permitted.

The Bankruptcy Provisions provide for the following distribution: first, wages due to staff and workers and employment insurance premiums owed by the bankrupt enterprise; second, taxes; and third, other creditors' claims, such as unsecured claims. If an employment contract is terminated as a result of the bankruptcy, the termination compensation will be put in the first priority, as will any amounts provided by employees to the bankrupt enterprise. During liquidation, employees' daily and medical expenses may be paid in priority out of bankruptcy assets.

The new provisions allow for reorganizations, except that such right is limited to State-Owned Enterprises (SOE). Only the government department supervising the SOE may make a restructuring application within three months of a People's Court accepting the bankruptcy application. In the absence of a supervisory department, the debtor SOE's shareholders may seek reorganization.

3. *State-Owned Enterprise Reform*

On November 8, 2002, the government issued the *Use of Foreign Investment to Restructure State-Owned Enterprises Tentative Procedures* (SOE Tentative Procedures), effective as of January 1, 2003. The SOE Tentative Procedures clarify the regulatory framework for the conversion of an SOE into a foreign invested enterprise (FIE), and allow such restructuring to be accomplished by way of equity or asset transfers. SOEs in "prohibited" industries are excluded from such restructuring, and the post-restructuring FIE must comply with any Catalogue requirement demanding a Chinese party to hold a "controlling" or "relative controlling" interest in the enterprise.

The SOE Tentative Procedures specify five forms of conversion acquisitions by foreign investors: (1) the acquisition of all of the state interest in the enterprise, (2) the acquisition of all or part of the state shareholdings, (3) the debt transfer by domestic creditors, (4) the acquisition of all or substantially all of a SOE's assets, and (5) the issuance of new shares or increase of capital by the SOE. Foreign (including Hong Kong, Macao, and Taiwan) companies, enterprises, economic organizations, and individuals may participate in an SOE restructuring.

The new regulations do not require a minimum asset value level for the foreign investor, but do require foreign investors to contribute capital, "advanced technology," and "business management expertise" to the SOEs. Furthermore, the foreign investor must have a solid commercial reputation and strong financial standing. For approval purposes, the new regulations require information as to the Chinese market share held by foreign investors in the target SOE's market. The foreign investor must produce a comprehensive restructuring

plan for the target SOE prior to commencement of approval procedures. The SOE Tentative Procedures provide that any SOE proposing to undergo restructuring involving foreign investors must receive necessary approvals from the government.

The SOE Tentative Procedures provide a multi-stage approval procedure for restructuring a SOE into a FIE. First, the restructuring application and related documentation (including the feasibility study, basic information about the parties, audited accounts of the foreign investor for the prior three years, reorganization plans, and plans for employee arrangements) are to be reviewed and approved by a relevant MOF branch. Second, the relevant MOF branch reviews and approves the acquisition agreement between the SOE and the foreign investor. If the first two steps are approved, the restructuring may commence and the resulting FIE itself must seek approval and a business registration.

The target SOE must consult with labor representatives on the restructuring plan. If a foreign party is to control the restructured entity, the SOE should develop a plan for employee arrangements prior to restructuring. The restructuring plan is to be reviewed and approved by the SOE's labor unions. Employees who are kept on by the new FIE are to enter into new employment contracts with their new employer.

The SOE Tentative Procedures do not address issues relating to MOFTEC's existing procedures for FIE approval. Nor do they specify the percentage of SOE shares open to foreign investment, or the minimum total investment or minimum registered capital requirements for the post-restructuring FIE.

Non-listed SOEs are to use public tendering to select foreign investors and to determine the acquisition price. The entire acquisition price must be fully paid within three months of the date on which the newly established FIE's business license is issued. Until such time as the foreign investors have paid off the acquisition price in full, the Chinese party will supervise the enterprise's business operation.

C. Regulation of Financial Services

1. *Securities: QFII Procedures*

On November 5, 2002, the CSRC and the People's Bank of China (PBOC) jointly issued the *Administration of Securities Investments in China by Qualified Foreign Institutional Investors Tentative Procedures* (QFII Tentative Procedures), effective as of December 1, 2002. The QFII Tentative Procedures allow certain foreign institutional investors to apply to become Qualifying Foreign Institutional Investors (QFIIs). The QFII Tentative Procedures create the first framework for foreign investors to access China's A-share and bond markets and, with some restrictions, to repatriate profits and principal. QFIIs must be companies, not individuals; individuals would only be able to access the A-share and bond markets through vehicles offered by the QFII. QFIIs are subject to the New Catalogue and, therefore, may not invest in "prohibited" projects.

QFIIs may be fund management institutions, insurance companies, securities companies, other types of asset management institutions, or (as yet undefined) "other" institutions. Potential QFIIs are to be financially stable, enjoy good credit, and satisfy the asset size test and other CSRC requirements. QFIIs must have appropriate risk control and monitoring standards, staff licensed in the QFII's home jurisdiction, and a sound corporate governance structure. QFIIs are to comply with any further requirements issued by the CSRC and are required to have an account at a commercial bank within China. Those commercial banks are to be the custodians of QFII assets. Certain branches of foreign commercial banks with

more than three years of operating experience in the PRC may be custodians of QFII assets. A securities company within China is to execute the QFII's securities trading.

Financial institutions desiring to become a QFII are to submit a standard application form and a specified list of documents to the CSRC. The form imposes joint and several liability on the board of directors for deliberate misrepresentations on the form. The CSRC must approve or reject a QFII application within fifteen working days of receipt. Upon approval, the CSRC notifies the applicant and issues a securities business investment permit. Upon receipt of the permit the applicant has to apply through its PRC custodian for State Administration of Foreign Exchange (SAFE) approval of its intended investment level. SAFE has fifteen working days to act upon an application. Upon SAFE approval, the QFII applicant will be issued a notification of its investment limit and a foreign exchange registration certificate. Upon receipt of the foreign exchange certificate, the QFII may open a special purpose RMB account with its custodian. The RMB account will fund purchases and other related costs as well as holding proceeds. QFIIs are to be fully invested, in the amount approved by SAFE, within ninety days of receipt of the CSRC approval certificate.

QFIIs may invest in RMB-denominated financial instruments, including A-shares, treasury bonds, convertible and corporate bonds, and any other instrument approved by the CSRC. QFIIs may only remit proceeds offshore pursuant to relevant guidelines. QFIIs may only apply to SAFE to purchase foreign exchange one year after their principal is fully paid. Thereafter, each remittance is capped at 20 percent of the total principal and must be made at three-month intervals. The recipient of the offshore remittance of principal or profits must be the QFII itself.

Complementing the QFII Tentative Procedures, the SAFE issued *Administration of Foreign Exchange for Securities Investments in the PRC by QFIIs Tentative Provisions*, effective December 1, 2002. The minimum QFII investment is to be U.S.$50 million with a U.S.$800 million cap. A single QFII cannot hold more that 10 percent of the aggregate A-shares in a single listed company. The aggregate limit of all QFII investments in a single listed company may not exceed 20 percent of the total A-shares. If QFII holdings exceed such limits, the stock exchange is to issue a sell down notice. Pursuant to that notice, QFIIs are to sell A-shares in a quantity to comply with the aforementioned limits. QFIIs have five trading days to comply with the sell-down notice, with excess shares sold on a last-in first-out basis.

PBOC promulgated the *Issues Relevant to the Application by Commercial Banks for Engaging in the Custody Business of Domestic Securities Investments by Qualified Foreign Institutional Investors Circular* (PBOC QFII Circular). The circular sets forth the requirements and procedures for commercial banks to undertake a custodian business for domestic securities investments by QFIIs. The circular divides applicant banks into domestic and foreign-funded categories.

PBOC's head office oversees all applications filed by domestic banks. The PBOC QFII Circular requires domestic banks to file an application for carrying-out such business, a feasibility study report, and other specified documents. Only one branch of a foreign-invested bank may engage in custodial services. If the foreign-invested bank is a wholly foreign-owned entity (WFOE) or a joint venture, only the head office may engage in custodial services. Foreign-invested banks must submit their application and related materials in triplicate to the local PBOC branch. If the head bank authorizes a signatory, who happens to be the chairperson of the board or the president, then the relevant application may be signed by that person and power of attorney is not required. If the signatory does not hold

such a position, power of attorney is necessary and must be notarized as specified in the PBOC QFII Circular. Upon PBOC approval, applicants must apply to the CSRC for the custodianship under the QFII Tentative Procedures.

2. *Securities: Foreign Investment in Fund Management Companies*

On June 1, 2002, the CSRC issued the *Establishment of Fund Management Companies with Foreign Equity Participation Rules* (Establishment Rules), effective as of July 1, 2002. The Establishment Rules create the first framework for foreign investment in China's investment funds sector. Foreign ownership in a foreign invested-fund management company (FI-FMC) is restricted to 33 percent, rising to 49 percent by December 11, 2004. Subject to such restriction, foreign investors may be the FI-FMC's controlling shareholders.

The Establishment Rules require the foreign investor in an FI-FMC to be a financial institution licensed in its home jurisdiction. The prospective investor must have a clean disciplinary record and paid-in capital of at least RMB 300 million. The FI-FMC itself is to have paid-in capital of RMB 10 million. FI-FMCs may be formed by joint promotion or through a QFII's acquisition of fund management company shares. In the QFII context, the Chinese partner is required to be a trust, an investment company, or a securities company. The CSRC may impose additional conditions on FI-FMC formation.

The Establishment Rules state that CSRC approval is the only requirement to establish a FI-FMC. The regulations do not specify a role for MOFTEC approval. CSRC approval is needed to establish an FI-FMC and each FI-FMC fund and to transfer fund shares. Fund managers are to obtain CSRC approval, with the law and accounting firms assisting the applicant in completing an FI-FMC application. FI-FMC funds are to have an 80:20 portfolio split between corporate securities and government bonds. Relevant CSRC regulations prohibit fund directors from directly or indirectly trading stocks. Foreign investors in a FI-FMC must be cognizant that, as of this writing (January 2003), China does not have a permanent investment funds law.

3. *Securities: Joint Venture Securities Companies*

On June 1, 2002, the CSRC promulgated the *Establishment of Securities Companies with Foreign Equity Participation Rules* (Securities JV Rules), effective July 1, 2002. The Securities JV Rules set forth the procedures for establishing Sino-foreign joint venture securities companies. Sino-foreign joint venture securities companies may: (1) underwrite A-Shares, B-Shares (within certain limitations), government bonds, and corporate bonds; (2) broker B-Shares; (3) deal in government and corporate bonds as a broker and for their own accounts; and (4) engage in other CSRC-approved activities.

The rules require that the foreign party in the venture: (1) be a licensed securities firm, (2) have operated for ten years, (3) have no disciplinary record, (4) have appropriate risk control and internal control processes, and (5) be in compliance with any other CSRC required conditions. At least one of the venture's Chinese shareholder(s) is to be a domestically funded securities company. The venture's minimum registered capital is to exceed RMB 500 million. Foreign investors may not hold more than 33 percent of the venture's equity, while a single Chinese securities company is to hold at least 33 percent of the venture's equity. Chinese securities companies must seek CSRC approval if its holdings exceed 5 percent of the venture's capital, as provided in the *Administration of Securities Houses Procedures* issued by the CSRC and effective as of March 1, 2002.

The Securities JV Rules require the venture's senior management to meet certain qualifications. The CSRC must review and approve a joint venture application. If approved, the

joint venture must then obtain a CSRC Permit for the Operation of Securities Business. CSRC rules prohibit a joint venture securities company from trading A-shares, whether for itself or on behalf of its client. In addition, joint venture securities companies do not seem to be able to offer asset management services or domestic private placement financing services.

4. *Banking: FFI Regulations*

On December 30, 2001, the State Council issued the *Administration of Foreign-Funded Financial Institutions Regulations* (FFI Regulations); while the *Implementing Measures for the Regulations on Management of Foreign-Invested Financial Institutions* (Implementing Rules) were issued by the PBOC on January 30, 2002. Both the FFI Regulations and Implementing Rules went into affect as of February 1, 2002. The FFI Regulations implement some of China's WTO commitments in the financial services sector and seek to strengthen bank regulation to be more consistent with the Basle Accord.

The FFI Regulations allow FFIs to commence operations in the PRC, provided they satisfy prudential requirements. FFIs may set up in any PRC city within China. The new regulations remove client restrictions on FFIs' foreign currency business within China and remove quantitative restrictions on the foreign currency business of FFIs as a condition to RMB market access. The new regulations provide that the Chinese party to an equity joint venture bank or equity joint venture finance company does not need to be a financial institution. However, the registered capital of wholly foreign-owned banks, equity joint venture banks, wholly foreign-owned finance companies, and equity joint venture finance companies must be based on actual capital contributed.

The total foreign currency deposits received by the FFI in the PRC may not exceed 70 percent of total domestic foreign currency assets. As defined in the FFI Regulations, total domestic foreign currency assets is equal to the total foreign exchange assets less: foreign exchange assets of overseas affiliated institutions; overseas foreign exchange loans; offshore interbank foreign exchange deposits; offshore interbank foreign exchange loans; and offshore foreign exchange investments. The PBOC will examine the ratio monthly.

FFIs are to satisfy prudential conditions, such as by creating an effective (1) corporate governance structure, (2) risk management system, (3) internal control system, (4) information management system, (5) operating status with no record of any material violation or breach, and (6) anti-money laundering measures.

The FFI Regulations provide for methods of assessing currency risk. For a WFOE bank, an equity joint venture bank, a WFOE finance company, or an equity joint venture finance company, the ratio of RMB assets to RMB risk-weighted assets must not be less than 8 percent. For a foreign bank branch, the ratio of its RMB working capital plus reserve funds to RMB risk-weighted assets must not be less than 8 percent.

The regulations tighten large exposure limits, which may not exceed 25 percent of the FIE's capital. In addition, the ratio of current assets to the balance of current liabilities must be greater than 25 percent. Current assets are defined as cash, gold, deposits with the PBOC, deposits with other banks, interbank loans with maturities not exceeding one month, net credit balances in accounts with associated overseas banks and affiliated institutions, discounted and other purchased bills with maturities not exceeding one month, other account receivables and loans with maturities not exceeding one month, negotiable bonds with one month maturities, and any other assets that can be realized within one month. In each case, these current assets are adjusted for estimated non-recoverable items.

FFIs in the form of wholly foreign-owned banks, foreign bank branches, and joint venture banks may (1) accept public deposits with no limit on foreign currency deposits; (2) issue short-term, mid-term, and long-term loans; (3) handle acceptances and discounts on negotiable instruments; (4) buy and sell government bonds, financial bonds, and other foreign currency securities other than stocks; (5) provide letter of credit services and guarantees; (6) conduct domestic and overseas settlements; (7) buy and sell foreign exchange on its own behalf or as an agent; (8) conduct foreign exchange businesses; (9) engage in interbank loans; (10) conduct bank card businesses; (11) provide safety deposit box services; (12) provide credit investigation and consulting services; and (13) conduct other business operations as permitted by the PBOC.

FFIs in the form of wholly foreign-owned finance companies and joint venture finance companies may (1) accept deposits, each of which shall be no less than RMB 1 million or the equivalent, in a freely convertible foreign currency for a term not less than three months; (2) issue short-term, mid-term, and long-term loans; (3) handle acceptances and discounts on negotiable instruments; (4) buy and sell government bonds, financial bonds, and other foreign currency securities other than stocks; (5) provide guarantees; (6) buy and sell foreign exchange on its own behalf or as an agent; (7) engage in interbank loans; (8) provide credit investigation and consulting services; (9) provide foreign exchange trust services; and (10) conduct other business operations as permitted by the PBOC. FFI finance companies may not engage in the bank card business, but may, unlike FFI banks, provide foreign exchange trust services.

PBOC, through relevant regulation, determines the geographic scope and client base of an FFI's RMB business. The FFI Regulations provide that FFI RMB business applicants are to have operated in the PRC for three years, with profitability for the most recent two years. PBOC continues to manage RMB interest rates for loans under $3 million. FFIs may, however, independently set foreign exchange interest rates for loans exceeding $3 million. PBOC rates apply to smaller loans. Furthermore, interbank capital flows are subject only to periodic reporting rather than direct PBOC control.

Deposit-taking FFIs are to place a deposit reserve with the local PBOC branch. As stated in the FFI Regulations, the reserve ratio is to be set (and may be adjusted) by the PBOC. FFIs are subject to the following additional prudential requirements, as provided in the FFI Regulations: (1) a foreign bank must place 30 percent of its branch's working capital in interest bearing assets as designated by the PBOC; (2) the capital adequacy ratio for wholly foreign-owned or equity joint venture banks and finance companies must exceed 8 percent; (3) fixed assets of wholly foreign-owned or equity joint venture banks or finance companies may not exceed 40 percent of equity capital; and (4) the maintenance of an appropriate bad loan reserve.

FFIs are subject to PBOC reporting requirements for: (1) any serious financial or operational problems; (2) major adjustments to its operating strategy; (3) important board resolutions; (4) any change in shareholders of less than 10 percent of the total capital or shares of a FFI; (5) any change to the articles of association, registered capital, and registered address of the head office of a FFI; (6) reorganization of the head office of a FFI and changes in its chairman or president; (7) any serious problems (financial or operational) of the head office of a foreign bank branch or a foreign joint venture party; and (8) major changes in the laws and regulations for the location of the head office of a foreign bank branch or a foreign joint venture party. The local PBOC branch is to be notified seven working days prior to an FFI's suspension of business.

The PBOC may suspend, ban, or close any FFI that has not been approved by the PBOC or that conducts any illegal or unauthorized financial business. In such circumstances, the FFI involved may also be subject to criminal liability, and the PBOC may confiscate any illicit gain. A FFI may also be subject to criminal liability if it operates beyond the business scope. If a FFI operates its business in violation of supervision and management sections of the regulations, the PBOC may issue a warning, confiscate any illicit gains, and impose a fine of one to three times the amount of such gains. If a FFI refuses or hinders legitimate supervision or inspection, or submits false documentation or information, the PBOC may issue a warning and issue a fine of RMB 100,000 to RMB 500,000. If a FFI fails to submit its financial statements and other documents or information on time, the PBOC may issue a warning and order the FFI to comply, within a specified period, and may impose a fine of RMB 10,000 to RMB 100,000. In the case of serious violations of FFI Regulations, the PBOC may suspend or revoke the business license of a FFI, and any senior management personnel involved may be disqualified from working in China.

D. Technology Import Regulations

On December 10, 2001, the State Council issued the *Regulations of the People's Republic of China on the Administration of Technology Import and Export* (New Technology Import and Export Regulations), effective as of January 1, 2002. The New Technology Import and Export Regulations apply to the transfer of technology from foreign companies to Chinese companies and outbound technology transfers. Transfer, as defined in the new regulations, includes transfers of patent rights, the right to apply for a patent, know-how, technology through technical services or other means, and a license to implement a patent.

The new regulations divide technologies into "prohibited," "restricted," and "permitted" categories. Prohibited or restricted technologies, as defined in the *Foreign Trade Law*, may be barred from import or subject to MOFTEC approval or registration. The *Foreign Trade Law* prohibits the import of: (1) technology that could endanger State security or public interest; (2) technology that could endanger life or health; (3) ecologically-damaging technology; or (4) technology whose import is prohibited by an international agreement to which China is a contracting party. The *Foreign Trade Law* restricts imports of: (1) technology threatening State security or public interest; (2) technology that could harm the development of a domestic industry; (3) technology that could harm China's international financial status and international payment balance; or (4) technology whose import is restricted by an international agreement to which China is a contracting party.

These regulations call for a two-step approval process to import a restricted technology. The first step is an application with MOFTEC and SETC. If the application is approved, MOFTEC will issue a non-binding letter of intent to grant a technology import permit. After the technology import contract is executed, the importer is to file another application for the issuance of the technology import permit. If approved, MOFTEC verifies the technology import contract and issues the technology import permit. The technology import contract will become effective on the date the technology import permit is issued.

Under the new regulations, an import contract for non-prohibited and/or non-restricted technology becomes effective upon execution. The contract is still subject to MOFTEC registration, but issuance of the registration certificate is not a condition precedent for the contract's effectiveness. Pursuant to the *Measures of the People's Republic of China on the Administration of Registration of Technology Import and Export Contracts* (MOFTEC Registration Measures), issued by MOFTEC on December 30, 2001, when a technology import

contract becomes effective, the importer is to register the contract online (with the China International Electronic Commerce Network) and submit a hard copy registration, including a duplicate copy of the contract. Most submissions should be directed to local-level MOFTEC branches.

The New Technology Import and Export Regulations now permit technology license terms for a longer period than ten years. The licensor will be allowed to prohibit the use of any technology provided after the expiration of the term of the contract or upon the early termination of the contract. The new regulations circumscribe the use of restrictive clauses in the contract. Clauses that require the licensee to purchase unnecessary technology, raw materials, products, equipment, or services are prohibited. Also, clauses that require royalties for patented technology beyond the patent's term are invalid. Licensees may not be restricted from improving licensed technology or using such improvements. Licensees may not be restricted from acquiring technology similar to, or in competition with, the licensed technology. Furthermore, a licensee may not be unreasonably restricted in the production volumes, types, or sales price of its products.

E. Construction

On September 27, 2002, MOFTEC and the Ministry of Construction (MOC) jointly issued the *Administration of Foreign-invested Construction Enterprises Provisions* (Foreign Construction Provisions), effective as of December 1, 2002. In acceding to the WTO, China agreed to gradually eliminate restrictions on foreign investment in the construction sector. Under the new regulations, WFOE construction companies will be allowed to operate by December 1, 2002, two years ahead of China's WTO commitment. Prior to these new regulations, foreign construction companies were able to engage in contracted construction work only on a project-by-project basis.

The *Construction Law* of 1998 divides companies engaging in construction activities into four categories: (1) construction companies; (2) design companies; (3) surveying companies; and (4) construction management companies. These entities are subject to registration, licensing, and tiered grading systems. The new rules create a new grading system for construction FIEs, with the application and approval procedures varying according to the grade. Construction FIEs approved prior to December 1, 2002, must reapply for gradation under the new system.

New Construction FIEs are subject to MOC and MOFTEC approval. An application to establish a construction FIE first must be submitted to MOFTEC, who will forward the application to MOC. Both MOFTEC and MOC determine whether to approve the application. If approved, the construction FIE registers with SAIC to obtain a business license. Upon obtaining the business license, the FIE will then apply to the MOC for construction qualification certificates. The Foreign Construction Provisions state that this process may take 190 days.

The Foreign Construction Provisions eliminate the higher registered capital requirements imposed on joint venture construction companies. Thus a joint venture construction FIE shall have less than 75 percent foreign equity ownership, and a Chinese party's capital contribution to a joint venture must be greater than 25 percent of the construction FIE's registered capital.

Foreign construction companies already holding a qualification certificate may convert into a construction FIE. Classification of such FIE will be based on the foreign construction company's performance records. Such conversion should be completed by October 1, 2003,

the date on which the project-by-project qualification certificates regime ends. After that date, foreign construction companies will not be able to undertake contracted projects on a project-by-project basis but must form a subsidiary, such as a construction FIE.

The new provisions limit the scope of work that a construction WFOE may undertake to: (1) wholly foreign investment and/or grant financed projects; (2) projects financed by international financial institution loans awarded through international tendering; (3) Sino-foreign projects with foreign investment greater than 50 percent or certain types of joint projects with less than 50 percent foreign capital; and (4) Chinese-invested projects jointly undertaken by Chinese and foreign construction enterprises with the approval of a provincial government.

F. Internet

1. *Domain Name Registration and Dispute Resolution*

On September 30, 2002, the Ministry of Information Industry (MII) issued the *Administration of China Internet Domain Names Procedures* (Domain Name Procedures), while the China Internet Network Information Center (CNNIC) issued both the *Resolution of Domain Name Disputes Procedures* (Dispute Resolution Procedures) and *Policies for Resolution of Domain Name Disputes Procedural Rules* (Procedural Rules).

The Domain Name Procedures create a first-in-time regime for domain names—the first domain name applicant has priority over other applicants. No domain name reservations are allowed, except for reservations for certain words related to the original application. The following are exceptions to the first-in-time rule: (1) if the domain name infringes on an existing name, logo, or mark; (2) if the applicant does not have any rights underlying the domain name or portion thereof; and (3) if the applicant registers or uses the domain name in bad faith. Holders of well-known trademarks recognized by the Trademark Office have priority in applying for second-level .cn domain names. Pursuant to existing regulations, a court may cancel a domain name registration if (1) the domain name is identical or substantially similar to a well-known mark; or (2) if the domain name is unused after registration and there is no intent to use the domain name in the future.

The regulations also create a new regime for Chinese-character and .cn domain names, including third-level .cn English domain names, second-level .cn English domain names, and Chinese character top-level domains (TLDs). In addition, foreign businesses will be able to register .cn domain names, as the new regulations end all location requirements.

The Domain Name Procedures prohibit certain items from being part of a domain name, including activities: (1) opposing the PRC Constitution or national security; (2) exposing state secrets; (3) defaming another person; and (4) depicting pornography, violence, or gambling.

Domain name disputes may be heard through the China International Economic and Trade Arbitration Commission or the Hong Kong International Arbitration Center under these new regulations. Parties are free, upon agreement, to submit their dispute to an arbitral body of their choice. Parties may file suit in a People's Court having the jurisdiction over the district in which CNNIC is located (for domestic disputes) or in the First Intermediate People's Court of Beijing Municipality (for foreign disputes).

Under the new regulations, CNNIC will not provide registration services but will remain the official administrator and Registry operator of the .cn ccTLD and Chinese-character domains. In its regulatory role, CNNIC drafted new measures to regulate domain name

registration service providers. Chinese Domain Name registrations can only be obtained through CNNIC-accredited registrars, such as NeuStar, the exclusive gateway for registrars outside of China.

2. *Beijing's E-Commerce Regulations*

The Beijing Municipal Administration for Industry and Commerce (BAIC) issued the *Supervision and Administration of Electronic Commerce Tentative Procedures* (EC Tentative Procedures), effective as of August 1, 2002. The EC Tentative Procedures apply to all business-to-business (B2B) and business-to-consumer (B2C) activities. The new procedures define e-commerce as any trading of a commodity and distribution of trade information between two parties in a commercial transaction via the Internet. An operator is defined as the owner of the Web site or the contractor who uses the Web site to engage in online transactions. Under the new provisions, business-oriented Web sites in Beijing must hold an Internet Information Services and Value-Added Telecommunication Business Permit from the Beijing Municipal Telecommunications Administration and must be registered with the BAIC in order to conduct business activities.

The EC Tentative Procedures require online merchants to sell items at the price agreed to online. The new procedures create a confirmation process, ending with a confirmation notice from seller to buyer stating the quantity of the goods, payment, after-tax price, delivery charges, and returns information. Online purchasers may rescind their purchase within twelve hours of receipt of the confirmation notice, or within another agreed-upon timeline. With certain exceptions, purchasers may return goods within seven days of receipt. The exceptions to the return rule include custom-made items, perishable items, and software.

Online merchants are to keep transaction records for two years, subject to BAIC inspection. Sellers are to have a secure platform and the means to operate the site and fulfill each transaction. Online merchants are not allowed to use their site for illegal activity, hacking, or the use of false e-mail addresses.

H. Government Procurement

On June 29, 2002, the National People's Congress promulgated the *Government Procurement Law* (GPL) effective as of January 1, 2003. The GPL is an attempt at creating a comprehensive regulation of government procurement in the PRC. The GPL's issuance coincides with the release of an official "Action Plan" to guide development activities in connection with the Games of the XXIX Olympiad, to be held in Beijing in 2008.

The GPL applies to procurement by state organs, public institutions, and social organizations at all levels; however, state-owned enterprises are not subject to the GPL. The GPL covers the procurement: (1) of goods, including materials fuels, equipment, and products; (2) of construction projects, including the new construction, renovation, expansion, demolition, or repair and maintenance of a building or structure; and (3) of services, defined as all objects of procurement other than goods and construction projects.

The GPL applies to government funded transactions that exceed limits specified by the State Council and lower-level People's Governments. Military, national security, state secrets, and emergency procurement are not subject to the GPL. Once the quantitative limit is exceeded, the GPL provides specific procurement options, including: public tender, bid invitation, competitive negotiation, single-source procurement, and quotation inquiry. The

GPL states that public tender is to be used exclusively unless circumstances prevent an effective public tender. The GPL does not define public tender or bid-invitation and does not specify any public tender or bid-invitation processes. There is an assumption that the PRC's *Bidding Law* fills the gaps in the GPL.

The law requires each level of government, at the municipal level or above, to establish an independent procurement agency to administer procurement of all items included in the *Centralized Procurement Catalogue*. Regulated entities purchasing other supplies may engage such an agency, purchase the supplies directly, or appoint another qualified agency. Potential government suppliers (including FIEs) must meet certain conditions, such as having a good professional reputation and an appropriate accounting system. However, the GPL does not provide for procedures to evaluate suppliers' qualifications. A group of suppliers may engage in government procurement if each supplier meets GPL-specified requirements.

The GPL requires procurement of domestic goods, services, or construction engineering. Limited exceptions to this requirement include circumstances where supplies are unavailable or difficult to find in the PRC. The GPL does not define domestic goods, services, or construction engineering. Prior regulations defined foreign goods as imported goods and goods manufactured or processed in China with a domestic value added of less than 50 percent. Such test may be applied under the GPL.

Except for limited circumstances, a procurement contract may not be modified or discontinued after execution. Under the GPL, a procurement contract may be terminated on vaguely defined grounds, such as for state or public interest. It seems that a People's Court will have jurisdiction on disputes related to procurement contract termination.

As stated in the GPL, the local MOF branches are the supervisory authorities for government procurement activities. The supervisory authority may order corrective action where the procuring entity fails to entrust a centralized procurement agency or fails to publicize procurement criteria and results. In addition to the foregoing, the GPL provides a three-step system for an aggrieved bidder: (1) an inquiry to the procuring entity; (2) a complaint about the procuring entity's response; and (3) an administrative review or administrative lawsuit on the subject. The GPL provides that procuring entities may be subject to administrative, civil, or criminal punishment.

The State Council has issued a plan for central government bodies to implement the requirements in the GPL. Central government bodies in Beijing are to implement the government procurement system in 2003, followed by lower level government bodies in 2004; the system is to be fully implemented by all government entities by 2005.

II. Hong Kong

A. Article 23

The most contentious legal development in Hong Kong in 2002 was not enactment of an ordinance, subsidiary legislation, or a judicial decision. On September 24, 2002, the Hong Kong Special Administrative Region (HKSAR) Government issued the Government's Consultation Document on Proposals to Implement Article 23 of the Basic Law (Document), sparking an intense debate on Hong Kong's civil liberties. Article 23 of the HKSAR's Basic Law requires the HKSAR to "enact laws on its own to prohibit any act of

treason, secession, sedition, and subversion against the Central People's Government."[11] In the Document, the HKSAR Government (Government) proposes the creation of new criminal offenses and the modification of existing offenses to comply with the Government's obligations in the Basic Law.[12]

1. *Creating New Offenses; Revising Existing Offenses*

The Document introduces two new concepts, secession and subversion. The former concept is defined as waging war, using force or threat of force, or using "other serious unlawful means"[13] to incite a part of the PRC to withdraw or resist the Chinese Government. The latter concept is defined as "intimidating the Chinese Government, overthrowing the Chinese Government or disestablishing the basic system of the state."[14] In the Document, the Government proposes to narrow the definition of sedition to incitement of treason, secession or subversion or incitement to "cause violence or public disorder which seriously endangers the stability of the state or the HKSAR."[15]

In addition, the Document proposes enactment of laws prohibiting "theft of state secrets." The Document proposes to amend aspects of the Official Secrets Ordinance (Cap 521). These modifications would extend the definition of "protected information" to include "information relating to relations between the Central Authorities of the PRC and the HKSAR." Another proposed amendment would create a new offence for making an

11. HK Basic Law, art. 23, *available at* http://www.info.gov.hk/basic_law/fulltext/index.htm (last visited Oct. 9, 2003).

12. *See* Proposals to Implement Article 23 of the Basic Law, *Safeguarding National Security Protecting Human Rights*, *at* http://www.basiclaw23.gov.hk/english/index.htm (last visited May 10, 2003).

13. *Id.*

14. *Id.*

15. Commentators note that this narrowing of the definition of sedition falls short of the standards stipulated in the Johannesburg Principles on National Security, Freedom of Expression, and Access to Information referred to in the Document. University of Minnesota: Human Rights Library, *The Johannesburg Principles on National Security, Freedom of Expression and Access to Information*, *available at* http://www1/umn.edu/humanrts/instree/johannesburg.html (last visited May 13, 2003). The Johannesburg Principles provide that an expression may only be punished as a threat to national security if a government can demonstrate: (1) that the expression was intended to incite imminent violence; (2) that the expression was very likely to incite such violence; and (3) that there was a direct and immediate connection between the expression and the likelihood or occurrence of such violence. The Chinese Government's proposed definition relies on the concept of 'incitement' as defined in the HKSAR's common law. This common law understanding does not take into account the Johannesburg Principles' 'likelihood' of the acts being incited actually occurring. Instead, "incitement" seems to be broadly interpreted and appears to include possessing, importing, or selling publications likely to incite others to commit specified offenses.

16. *See* Article 23, *Official Secrets Bill papers*, *available at* http://www.article23.org.hk/english/research/research1.htm (last visited May 12, 2003). Under the Official Secrets Ordinance, whether a piece of information is "protected" depends on the simultaneous application of two tests: (1) whether the nature of the information falls within any of the four specified categories: (a) security and intelligence; (b) defense; (c) international relations; and (d) the commission of offences and criminal investigations; and (2) whether the information has come into the defendant's possession by virtue of his position as a public servant or government contractor, or, whether the information has been disclosed to the defendant by a public servant or government contractor.

17. The Document does not define "unauthorized access." In the "unauthorized access" context, the Document uses an example of a person obtaining protected information through computer hacking. However, this illustration does not make its way into the Document's formal legislative proposals as an enumerated example of "unauthorized access."

unauthorized and damaging disclosure of protected information[16] obtained, directly or indirectly, by unauthorized access[17] to it.

As detailed in the Document, the Government proposes to amend the Societies Ordinance. The Document would augment the Government's powers to refuse to register, cancel the registration of, or prohibit the operation of any organization on the ground of national security. Under the proposed changes, the Government may ban an organization that (1) has the objective of engaging in treason, secession, subversion, or espionage; (2) has committed or is attempting to commit any such offence; or (3) is affiliated with an organization in mainland China that has been proscribed for reasons of national security. As intended, this amendment would make it unlawful for organizations to make use of Hong Kong's free and open environment as a base against national security and territorial integrity.

It seems that the Government would defer to Beijing in determining whether an organization endangers the PRC's national security and, therefore, should be banned in the HKSAR. Further, it will be an offence to support the activities of a banned organization, and organizations with connections to a banned organization may themselves be declared an "unlawful society."[18]

The Document proposes to expand police powers to investigate those activities to be proscribed by the Government pursuant to article 23. The police would be given the power to enter and search premises without a warrant, and to require banks to disclose financial information in specified situations.

2. *January 28, 2003 Press Release*

On January 28, 2003, the Secretary for Security issued a press release in response to the over 97,000 comments the Government had received on the article 23 issue.[19] Pursuant to these comments, the HKSAR stated that it would further clarify certain items in the Document.

3. *September 5, 2003 Announcement*

On September 5, 2003, Tung Chee Hwa, Chief Executive of the HKSAR, announced that the Government would withdraw the National Security (Legislative Provisions) Bill from the current legislative schedule. The Government's Security Bureau is to establish a special working group to review this legislation.[20]

B. Securities and Futures Ordinance

On March 13, 2002, the HKSAR's Legislative Council passed the Securities and Futures Ordinance (Cap 571) (SFO) to replace ten existing ordinances[21] and create a new regulatory

18. The concept of "affiliation" is not defined in the Document. Also, it is unclear whether a banned organization refers to those banned in Hong Kong or to organizations inside the PRC.

19. Press Release, Hong Kong Economic and Trade Office (Canada), *HKSARG Further Clarifies Legislative Proposals to Implement BL 23* (Jan. 28, 2003), *available at* http://www.hketo.ca/news/pages/Jan-28-2003_BL23.html.

20. Government Security Bureau, *at* http://www.info.gov.hk/gia/general/200309/05/0905155.htm.

21. The ordinances are the Securities and Futures Commission Ordinance (Cap. 24); the Commodities Trading Ordinance (Cap. 250); the Securities Ordinance (Cap. 333); the Protection of Investors Ordinance (Cap. 335); the Stock Exchanges Unification Ordinance (Cap. 361); the Securities (Insider Dealing) Ordinance (Cap. 395); the Securities (Disclosure of Interests) Ordinance (Cap. 396); the Securities and Futures (Clearing Houses) Ordinance (Cap. 420); the Leveraged Foreign Exchange Trading Ordinance (Cap. 451); and the Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555).

framework for Hong Kong's financial markets. Under the SFO, the Securities and Futures Commission (SFC) has a revised regulatory objective: to assist the Financial Secretary in maintaining Hong Kong's financial stability through effective regulation of the securities and futures industry. Among other changes, the SFO creates a single licensing regime for the securities industry, strengthens the SFC's investigation and disciplinary powers, and improves the disclosure regime for securities interests. The SFO was expected to become operational in early 2003, as the SFC has to finalize subsidiary legislation and regulations.

1. *Single Licensing Regime*

The SFO replaces the multiple licensing regulations in the Securities Ordinance, Commodities Trading Ordinance, and Leveraged Foreign Exchange Ordinance with a single, unified licensing process. Persons and organizations must be licensed with the SFC if they (1) deal in securities; (2) deal in futures contracts; (3) engage in leveraged foreign exchange trading; (4) advise on securities; (5) advise on futures contracts; (6) advise on corporate finance; (7) provide automated trading services; (8) engage in securities margin financing; or (9) engage in asset management.

Pursuant to the SFO, two additional activities require SFC licensing: "[a]dvising on corporate finance"[22] and "providing automated trading services."[23] The former activity includes providing advice on (1) the Hong Kong Listing Rules or the SFC Takeovers Code; (2) the process of making Hong Kong public offers; or (3) corporate restructuring for a Hong Kong listed company involving its securities. The latter activity covers (1) providing electronic facilities wherein offers to transact in securities or futures contracts are regularly made or accepted; or (2) where such transactions may be cleared, settled, or guaranteed.[24] These concepts will be fleshed out as the SFC engages in the rulemaking process created by the SFO.

Unlike the former Securities Ordinance, under the SFO, only companies may be licensed.[25] License applicants still must satisfy the SFC that they are fit and proper and can comply with financial resources requirements. Under the SFO, individuals within a licensed company must be registered with the SFC as licensed representatives. Further, if a non-Hong Kong securities firm actively markets SFO-regulated activities to the public in Hong Kong, it will have to register with the SFC. Existing registered persons have until March 2004 to migrate to the new licensing regime.

Applicants may submit a single application to be licensed in all the above mentioned regulated activities, except for securities margin financing. Securities margin financing license applicants are restricted from engaging in activities not incidental to securities margin financing. Pursuant to the SFO, engaging in any regulated activity without a license is a

22. Securities and Futures Ordinance, Schedule 5, *available at* http://www.justice.gov.hk/home.htm (last visited on Oct. 10, 2003).

23. Securities and Futures Ordinance, § 95, *available at* http://www.justice.gov.hk/home.htm (last visited on Oct. 10, 2003).

24. Under the SFO, providers of automated trading services will have to be licensed by one of two separate regimes. In addition to the main licensing regime for traditional broker/dealer functions, separate licensing requirements exist for automated trading services. Thus, online brokers may be licensed under the traditional broker/dealer regime, while electronic exchanges and automated trading systems will seek licensure under the automated trading services regime.

25. The Securities Ordinance allowed individuals, partnerships, and companies to be licensed as securities dealers or investment advisers.

criminal offense punishable by a maximum fine of HK$5 million and seven years incarceration. Continued unlicensed activity can result in an added fine of HK$100,000 for each additional day of proscribed activity.

2. *Effect on Hong Kong Banks with Securities Activities*

Prior to the SFO's enactment, the SFC granted exempt status to banks conducting securities business because banks were already subject to regulation by the Hong Kong Monetary Authority (HKMA) under the Banking Ordinance (BO). Such banks could conduct certain securities activities without being licensed or regulated by the SFC. This exemption will survive the SFO's implementation with a new requirement: banks must register with the SFC, and the SFC must act on the advice of the HKMA in deciding whether or not to grant exempt status. Concurrently, the HKMA will make new efforts to strengthen regulation of the securities arm of exempt banks.

Despite these changes, the HKMA will remain the front-line regulator for exempted banks. The SFO vests HKMA with inspection powers for the supervision of the securities arm of exempt banks. The SFO does not require exempt banks to follow the SFC's requirements on audit and information reporting. Further, exempt banks will be excluded from SFO's disciplinary processes. The new regulatory framework for exempt banks will be the subject of a revised Memorandum of Understanding to be drafted by the SFC and HKMA.

3. *Market Misconduct*

The SFO makes important changes to Hong Kong's construction of market misconduct. There are five types of market misconduct: (1) false trading in securities or futures contracts; (2) price rigging in securities or futures contracts; (3) stock market manipulation (securities only); (4) disclosure of information about prohibited transactions in securities or futures contracts; and (5) disclosure of false or misleading information about securities or futures contracts, inducing transactions in those products. Further, the SFO applies extraterritorially to conduct within Hong Kong affecting foreign markets and to conduct outside Hong Kong affecting Hong Kong markets. The SFO preserves the following existing short-selling rules: (1) uncovered short selling of securities is a criminal offence; and (2) covered short selling can only be effected in limited circumstances.

Every officer of a Hong Kong-listed company is responsible for ensuring that the company has anti-market misconduct preventions in place.[26] A responsible officer of a licensed company will be held accountable for the misconduct of their subordinates. In such circumstances, officers may be punished by the Market Misconduct Tribunal and fined by the SFC.

4. *Disciplinary Powers*

The SFO creates an alternative civil route to the existing criminal procedures for dealing with certain forms of market misconduct. The SFO will retask the existing Insider Dealing Tribunal, and expand it into a Market Misconduct Tribunal (MMT) to handle insider trading and market misconduct matters. The MMT will use the civil standard of proof and civil procedures. The MMT will be chaired by a judge, who is assisted by two members.

26. "Officer" is defined as including any director, company secretary, or 'any other person involved in the management of the corporation.'

The Chief Executive, with the recommendation of the Chief Justice, will appoint the Chairman of the MMT and select the two other members. The Financial Secretary will be able to initiate proceedings before the MMT. The MMT may impose civil sanctions including: (1) a disgorgement order; (2) a disqualification order preventing a person from becoming a director or other officer of any listed corporation for up to five years; and/or (3) a cease and desist order.

Under the SFO, the SFC may (1) reprimand individuals or corporations under its supervision; (2) revoke or suspend a license (or any part of a license); (3) revoke or suspend individuals and a particular officer's designation as a "responsible officer" in a corporation; and (4) ban a person from applying for a bank license and/or from applying to act as an executive officer of a registered institution. Further, in the civil context, the SFC may impose fines of up to the greater of HK$10,000,000 or triple the profit gained (or loss avoided) as a result of the misconduct.[27] The SFC is required to publish guidelines on how it proposes to exercise its powers to fine prior to its use of such powers.

Such fines may be imposed upon individuals or entities under the supervision of the SFC or the HKMA, as well as other regulated persons.[28] Further, such fines are contingent upon a finding that the regulated person: (1) breached any provision of the SFO or Parts II and XII of the Companies Ordinance (Cap 32); (2) breached any terms or conditions of a license or registration; or (3) committed an act or omission that, in the SFC's view, is likely to harm the investing public. SFC fines are to be paid within thirty days of imposition.

In addition to its existing disciplinary powers, the SFO empowers the SFC to initiate criminal prosecutions for breaches of SFC regulations. Under the SFO, the maximum penalty for criminal offences of market misconduct is a fine of $10 million and ten years imprisonment. The SFO has also extended some of the civil sanctions described above to penalize criminal actions.

The SFO creates an express statutory cause of action for market misconduct, allowing victims to recover losses that result from market misconduct. Further, the SFO allows the court, hearing a private action, to admit the MMT's findings and criminal convictions as evidence of market misconduct. However, the plaintiff retains the burden to prove that the MMT findings or criminal convictions are probative and relevant to his civil proceedings.

5. *New Defenses and Safe Harbor*

The SFO creates a few limited defenses. First is a limited defense for a director of a listed corporation who is aware of a false statement but opposes its issuance. The SFO provides that conduits for disseminating information, such as printers, publishers, live broadcasters, and hyperlinks shall not be legally liable for market misconduct for unknowingly reporting or reprinting false information. In addition, the SFO creates a new defense to insider trading charges. This defense would enable a person to enter into a transaction despite knowing material, nonpublic information. Pursuant to the SFO, the SFC has created a safe harbor for limited price stabilization actions taken in connection with securities offerings.

27. The SFC is not restricted from imposing numerous separate fines on an individual or corporation held accountable for multiple acts of misconduct. Each fine can reach the maximum amount statutorily allowed. Further, there is no cap on the aggregate fine which may be imposed on a number of individuals found to be jointly or severally liable for an act of misconduct committed by any one or other of their number.

28. A "regulated person" is (1) a licensed person, (2) a responsible officer of a licensed corporation, or (3) a person involved in the management of the business of the licensed corporation.

III. Conclusion

As described above, 2002 was a significant, and busy, year for legal developments in the PRC and Hong Kong. China's revised foreign investment guidelines generally expanded the number of "encouraged" projects, and reduced the number of "prohibited" projects. For the first time, China enacted regulations on mergers and acquisitions, and bankruptcy. The PRC provided additional exit avenues for foreign investors and liberalized foreign access to its securities and banking sectors. In addition, China amended the procedures for technology transfer contracts. The development of Internet regulation in China continued. The PRC attempted to regulate certain purchases by government entities for the first time with the GPL.

Hong Kong began the process of defining the intersection of civil liberties and its obligations under article 23 of the Basic Law. The new SFO fundamentally alters financial services regulation in the PRC, providing the SFC with new rights and responsibilities.

Indeed, 2002 was a very busy year. But if one trend has emerged in China's legal development over the past few years, it is to expect the unexpected. Legal development will continue at a fast pace in 2003. New regulations will be issued and old regulations will be amended. The year 2003 may be as important as 2002 for legal development in China and the HKSAR.