Latest Developments in M&A Laws and Regulations in China

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Introduction:

The Ministry of Commerce (MOFCOM) for the People’s Republic of China (the “PRC” or “China”), which provides security reviews for inbound mergers and acquisitions, has implemented new review features that have the potential to alter the foreign investment landscape.

Variable Interest Entities (VIEs), corporate structures utilized in certain M&A transactions to access industries normally restricted to foreign investment, may now fall under the purview of MOFCOM. This would subject VIEs to tighter screening procedures and increase the likelihood that certain transactions will not be completed.

Foreign companies making acquisitions in China will have to reconsider their approach to VIEs as these structures come under greater scrutiny.

This presentation will discuss recent legal developments relevant to companies engaged in M&A transactions in China.
I. Overview: Variable Interest Entities

**What is a Variable Interest Entity (VIE)?**

- A variable interest entity (VIE) is a term used by the United States Financial Accounting Standards Board (FASB) to refer to an entity in which the investor holds a controlling interest that is not based on equity ownership or majority voting rights.

- Potential variable interests include: holding economic interests, voting rights, or obligations to an entity; issuing guarantees on behalf of an entity; transferring assets to an entity; managing the assets of an entity; leasing assets from an entity; and providing financing to an entity.

- In such cases FASB Interpretation 46(R), which interprets Accounting Research Bulletin (ARB) 51, *Consolidated Financial Statements*, permits consolidation of such entity into the financial statements of the enterprise that controls the economic risks and rewards of the entity, regardless of ownership.
I. Overview: Variable Interest Entities

Use of VIE Structure in China

- VIE structures are commonly used by foreign investors in China to obtain a degree of control over, as well as a substantial economic interest in, PRC companies operating in industry sectors where direct foreign ownership is restricted or prohibited.

- VIE structures were first used in the internet sector by companies such as Sina.com and Baidu, but then spread to other restricted-industry sectors, such as advertising, tourism and education, and eventually into non-restricted sectors as well.

- No government approval was believed to be required to establish VIE structures, and they did not appear to be prohibited by PRC law.
I. Overview: Variable Interest Entities

Use of VIE Structure in China, cont’d

- The usual way of structuring a VIE in China was to do the following:
  - Establish an offshore special purpose vehicle (SPV).
  - Have the SPV establish a PRC entity which is deemed to be a wholly foreign owned enterprise (WFOE).
  - Establish a series of contracts between the WFOE and the restricted PRC company that bind them together and ensure that the SPV and the WFOE maintains a measure of control over the restricted PRC company.
  - These control agreements often involve loans secured by registered equity pledges, service contracts providing for delivery of the VIE’s net revenues in exchange for management services, and provisions requiring parent board approval for certain VIE material actions.
I. Overview: Variable Interest Entities

Prevalence of VIE Structure

- According to informal research conducted by China Finance blogger, Fredrik Öqvist (via http://www.chinaaccountingblog.com/weblog/statistics-on-vie-usage.html):
  - 42% of U.S. listed PRC companies use the VIE structure.
  - More than half of NASDAQ listed companies (53%), 29% of NYSE listed companies and 6% of NYSE Amex companies use the structure.
  - The use of the VIE structure increased during 2010, with 47% of 2010 NYSE listings of PRC companies (9 out of 19) having used VIEs, and 65% of 2010 NASDAQ listings (10 out of 16) having used VIEs.
I. Overview: Variable Interest Entities

Prevalence of VIE Structure, cont’d

- Öqvist also conducted research on the usage of VIEs by industry, using Standard Industry Classification (SIC) codes and found the following:
  
  o VIEs are highly concentrated in the Business Services industry, which includes internet companies.
  
  o The use of the VIE structure is most apparent in industries that have restricted foreign investment, such as the internet sector, but its use has spread to include companies in other industries, such as financial services and real estate.
  
  o Most of the listed companies utilizing the VIE structure cited the PRC government prohibition against foreign investment in the sector as the primary reason for utilizing the VIE structure.
  
  o Five companies cited restrictions on PRC companies listing directly abroad as a reason for the use of VIEs, indicating that that some PRC companies are using the VIE structure to circumvent recent rules restricting offshore listings.
II. National Security Review Rule and Implementing Regulations

Background

- On August 8, 2006, six PRC regulatory agencies promulgated the Regulation on Mergers and Acquisitions of Domestic Companies by Foreign Investors (the “2006 M&A Rules”), which became effective on September 8, 2006, and was amended in 2009. The 2006 M&A Rules establish a general legal framework for foreign investors to acquire either equity or assets of a Chinese company in exchange for cash or stock of the foreign acquiror, requiring, among other things, approval by one or more PRC government authorities, and that foreign investors notify PRC authorities if a proposed M&A transaction results in foreign investors gaining control of a PRC company that involves or affects: a key domestic industry; national economic security; or well-known or traditional trademarks or brand names.

- On August 30, 2007, the Standing Committee of the PRC National People's Congress issued the Anti-Monopoly Law of the People’s Republic of China (the “AML”), to be administered by MOFCOM’s Anti-Monopoly Bureau, and it took effect on August 1, 2008. Article 31 of the AML states that “where a foreign investor participates in the concentration of undertakings by merging or acquiring a domestic enterprise or by any other means…, and national security is involved, besides the examination on the concentration of undertakings in accordance with this Law, the examination on national security shall also be conducted according to the relevant provisions of the State.”
II. National Security Review Rule and Implementing Regulations

Overview

• On February 12, 2011, the PRC State Council promulgated a Notice on the Establishment of the National Security Review Mechanism for the M&A of Domestic Enterprises by Foreign Investors (the “NSR”), and on August 25, 2011, MOFCOM, which has primary authority over the NSR process, issued implementing regulations pertaining to the security review of inbound M&A transactions, which became effective on September 1, 2011.

• The NSR and implementing regulations provide MOFCOM with the authority to determine whether or not an acquisition of a domestic enterprise by a foreign enterprise should be subject to national security review by considering both the substance of the acquisition, as well as its actual impact on national defense, national economic stability, social stability, and on the research and development of key technologies related to national security.

• A ministerial-level review committee established under the State Council, led by MOFCOM and the National Development and Reform Commission (NDRC), and comprised of other authorities in charge of the industry to which the transaction is related (the “Committee”), will conduct the security review.
II. National Security Review Rule and Implementing Regulations

Covered Transactions

- The NSR covers the following transactions (with no apparent minimum value thresholds). Therefore, any transaction that falls within one of the identified categories may be subject to review:
  - The purchase by foreign investors of existing equity interest or shares or increased capital of PRC non-foreign-invested enterprises and conversion of such domestic PRC enterprises into foreign-invested enterprises (FIEs);
  - The establishment by foreign investors of FIEs and the purchasing and operating of assets acquired from domestic PRC enterprises through such FIEs;
  - The purchase of equity interests or shares of domestic PRC enterprises through FIEs;
  - The purchase by foreign investors of assets owned by domestic PRC enterprises and the establishment of FIEs to operate such assets; and
  - The purchase by foreign investors of equity interests or shares owned by PRC parties in FIEs or the purchase by foreign investors of the increased capital of FIEs.
II. National Security Review Rule and Implementing Regulations

Covered Industries

- National security review is required for transactions involving PRC companies in the following industries:
  - **Military and Related Enterprises**: This includes military enterprises, as well as enterprises that provide support to, or are otherwise connected to military enterprises.
  - **Military Area Enterprises**: Military enterprises also include enterprises that are located around key and sensitive military facilities (the “Military Area”). Even if a PRC target company is engaged in non-military business, if it is located in a Military Area, the transaction is subject to national security review.
  - **Key Companies**: If a foreign investor may acquire actual control of the PRC target company, and such target company is involved with key agricultural products, key energy or natural resources, key infrastructure and transportation services, key technologies and key equipment manufacturing activities that raise national security concerns, then the transaction is subject to national security review.
II. National Security Review Rule and Implementing Regulations

Covered Industries, cont’d

- For the purposes of the NSR, an acquisition of "actual control" refers to a situation where a foreign investor (including its parent or subsidiary), or several foreign investors:
  - acquire 50 percent or more of the PRC target's equity interests or voting rights;
  - have a significant influence over the PRC target's shareholder meetings or its board of directors, or
  - obtain actual control over the PRC target's business decisions, financial affairs, personnel and/or technology or other matters.

- The NSR does not define "national security" or what "key" means in reference to an industry or sector.

- PRC authorities have broad discretion in determining which transactions are ultimately subject to national security.
II. National Security Review Rule and Implementing Regulations

National Security Review Procedure – Initiation of Committee Review

- MOFCOM may determine, whether a given M&A activity requires national security review.

- Upon its receipt of a notification or application from the transaction parties with respect to a covered transaction, MOFCOM has 5 business days to refer a transaction to the Committee for national security review.

- If MOFCOM decides not to refer the transaction for review (a) other relevant departments or ministries under the PRC State Council, (b) national industrial organizations, (c) enterprises in the same industry as the PRC target and (d) upstream and downstream enterprises of the PRC target company (together, the “Domestic Constituents”), have the right to request that MOFCOM refer the transaction to the Committee for national security review.

- MOFCOM is obligated to forward such Domestic Constituent requests to the Committee without discretion (although no specific timeframe is mandated in such cases).
National Security Review Procedure – Committee Review Procedure

The NSR stipulates a two-step procedure: a preliminary review and a special review.

- Preliminary Review

  - Preliminary Review commences with a written notice from the Committee to the Domestic Constituents within 5 business days after the Committee receives the request from MOFCOM.

  - Domestic Constituents have 20 business days after receiving such written notice to provide comments, if any, to the Committee.

  - If any Domestic Constituent believes that the transaction will affect PRC national security, then the transaction must undergo special review.
II. National Security Review Rule and Implementing Regulations

National Security Review Procedure – Committee Review Procedure, cont’d

- Special Review
  - The Committee will initiate the special review procedure within 5 business days after it receives notice from a Domestic Constituent that in its view the transaction will affect PRC national security.
  - The Committee will then assess the transaction for impact on national security.
  - If an absolute majority of the members of the Committee reach a conclusion regarding the transaction, the Committee will render its decision.
  - If the members of the Committee hold significantly different views on the transaction such that there is no a majority view, or if the special review could not be completed within 60 business days after its initiation, then the transaction will be submitted to the PRC State Council for review.

Prior to a formal submission to the review process, parties have the option of engaging in non-binding preliminary discussions with MOFCOM, subject to a confidentiality obligation imposed on the applicable commerce departments and their personnel. In addition, the parties have the right to modify or withdraw a transaction from review at any time during the review process.
National Security Review Rule and Implementing Regulations

National Security Review Procedure – Committee Findings/Measures

- After completion of its review, the Committee will issue a determination (through MOFCOM) as to whether or not the transaction will affect national security.

- If the Committee concludes that the transaction will affect national security, it will issue a separate order or notice to MOFCOM on what actions should be taken by the foreign investor and the PRC target.

- In such cases the Committee can require MOFCOM to either:
  - terminate the transaction,
  - require the foreign investor to transfer its equity or assets, or
  - take other measures for the purpose of eliminating the adverse effects of the transaction on the national security.
III. Impact of National Security Review on VIEs

Overview

- The implementing regulations of the NSR and other recent developments in China have raised some uncertainty regarding the long-term viability of the VIE structure.
  - Article 9 makes it clear that foreign investors can no longer avoid the scrutiny of PRC government authorities through the VIE structure.
  - Recent regulations and publications indicate that PRC authorities are aware of the widespread use of the VIE structure and are considering the implementation of regulations in connection with VIE structures.
  - In light of the language used in recent publications, many commentators believe that any such regulation is likely to be restrictive.
III. Impact of National Security Review on VIEs

Article 9 of Implementing Regulations

- Article 9 of MOFCOM’s NSR implementing regulations expressly states that foreign investors may not for any reason evade the national security review process, such as by holding equity via trusts and exercising control through contractual arrangements (i.e. VIE structures).

- Any foreign investment can be subject to security review.

- Although there is no express prohibition against the VIE structure, national security review of transactions with VIE structures will subject them to increased scrutiny.

- It is uncertain how MOFCOM’s implementation of the NSR will impact VIEs going forward.
III. Impact of National Security Review on VIEs

Significance of Recent Regulatory Actions and Publications

PRC authorities have acted to discourage or prohibit use of the VIE structure for foreign investment in the PRC telecommunications sector, internet gaming sector, e-commerce and payment services sector and steel sector.

• Telecommunications Sector:

  o In 2006, the PRC Ministry of Information Industries (MII) issued its *Notice Concerning Strengthening the Administration of Foreign-Invested Value-Added Telecommunications Business Operations*, suggesting it would be taking a close look at VIE structures used by internet companies.

  o The use of the VIE structures has continued in this sector, but practitioners are viewing the notice as a warning sign of potential future issues.
III. Impact of National Security Review on VIEs

Significance of Recent Regulatory Actions and Publications, cont’d.

- Internet Gaming Sector:
  - In September 2009, the PRC General Administration of Press and Publication (GAPP), the National Copyright Administration and the National Office of Combating Pornography and Illegal Publications jointly published the *Notice Regarding the Consistent Implementation of the "Stipulations on ‘Three Provisions'" of the State Council Internet Games, etc.*
  - This Notice expressly prohibited the use of technology support or other agreements to give foreign investors control over internet gaming operations and services in China.
  - This was significant in that it signaled the PRC government’s awareness of the proliferation of VIE structures and its ability to regulate them.
III. Impact of National Security Review on VIEs

Significance of Recent Regulatory Actions and Publications, cont’d.

- E-commerce/Payment Services Sector:
  - In August 2010, the management of Alibaba Group Holding Limited, in which foreign entities, Yahoo Inc. and Softbank Corp, owned controlling interests, transferred the assets of its VIE and largest e-commerce business, Alipay, to purely domestic entity, with no contractual arrangements with the foreign entity, because, according to Jack Ma, Alibaba’s founder and CEO, China’s central bank refused to issue required Payment Business Permits to online payment companies that have foreign ownership.
  - The parties disputed whether the transfer was approved or was required to be approved by the Alibaba board or shareholders.
  - It is not clear whether this case is signaling PRC government unhappiness with the level of foreign control over a PRC e-commerce and payment services business, or whether the spinoff was a strategic move by Ma to force the foreign investors, including Yahoo, to sell their interests at a discount.
III. Impact of National Security Review on VIEs

Significance of Recent Regulatory Actions and Publications, cont’d.

- Steel Sector:
  - Buddha Steel, Inc. conducted its operations through a PRC company, Baosheng Steel, which was owned primarily by Buddha Steel’s CEO and his family, but controlled pursuant to the usual VIE agreements and consolidated into Baosheng Steel’s financial statements as a VIE.
  - Buddha Steel was in the process of conducting a $38 million underwritten public offering in the U.S. when, in March 2011, the local government authorities in Hebei Province reportedly advised the PRC operating company that the VIE agreements "contravene current Chinese management policies related to foreign-invested enterprises and are against public policy."
  - As a result, Buddha Steel terminated its commercial agreements with its VIE and the VIE reverted to 100% control by the original PRC owners. This rendered Buddha Steel a shell company with no operations and resulted in a withdrawal of the public offering registration.
III. Impact of National Security Review on VIEs

Significance of Recent Regulatory Actions and Publications, cont’d.

- On July 4, 2011, the Communist Party School paper, Study Times, published an article criticizing the supposed influence of foreign capital within the country’s sensitive IT sector, which has been largely accomplished through the VIE structure.

- In mid-September, 2011, Reuters reported on the existence of an unconfirmed internal China Securities Regulatory Commission (CSRC) report, dated August 17, 2011, describing VIEs as a major threat to China’s national security and asking the PRC State Council to take action against VIEs in the following manner:
  - PRC companies under the VIE structure must receive approval from both MOFCOM and the CSRC to list overseas, but the old rules would still apply to companies that are already listed.
  - The PRC government should encourage PRC internet companies to list on PRC domestic exchanges, and if such listings are not possible, then to list directly in foreign markets.
  - The CSRC should collaborate with the SEC, and other foreign equivalents, regarding the enforcement of such rule. For example, the SEC would cross-check any reports of VIEs in SEC filings with PRC government filings to ensure compliance with the rules.
IV. What These Changes Mean to You

Continued Uncertain Enforceability of VIE Contracts

- The inclusion of VIEs in the NSR implementing regulations in the CSRC report and ensuing debate have highlighted the risks of the VIE structure, and in particular, the uncertainty of enforceability of the contracts between the WFOE and the VIE.

- In order to consolidate a VIE in the controlling company’s financial statements, one has to show that that company not only receives the economic benefits and takes the economic risks of the venture, but also that the VIE is in fact controlled by such company.

- If the contracts, which are put in place to establish this control, are deemed invalid or unenforceable, then consolidation may no longer be justifiable under FASB Interpretation 46(R). In such circumstances, foreign investment in PRC companies with such VIE structures may then be more difficult to secure.
IV. What These Changes Mean to You

Continued Uncertain Enforceability of VIE Contracts, cont’d

- Public companies with VIE structures have included risk factors such as the one below in China Information Technology, Inc.’s last 10-K:

*Uncertainties in the PRC legal system may impede our ability to enforce the commercial agreements that we have entered into with iASPEC or any arbitral award thereunder and any inability to enforce these agreements could materially and adversely affect our business and operation.*

While disputes under the Management Service Agreement and the Option Agreement with iASPEC are subject to binding arbitration before the Shenzhen Branch of the China International Economic and Trade Arbitration Commission, or CIETAC, in accordance with CIETAC Arbitration Rules, the agreements are governed by PRC law and an arbitration award may be challenged in accordance with PRC law. For example, a claim that the enforcement of an award in our favor will be detrimental to the public interest, or that an issue does not fall within the scope of the arbitration would require us to engage in administrative and judicial proceedings to defend an award. China’s legal system is a civil law system based on written statutes and unlike common law systems, it is a system in which decided legal cases have little value as precedent. As a result, China’s administrative and judicial authorities have significant discretion in interpreting and implementing statutory and contractual terms, and it may be more difficult to evaluate the outcome of administrative and judicial proceedings and the level of legal protection available than in more developed legal systems. These uncertainties may impede our ability to enforce the terms of the Management Service Agreement, the Option Agreement and the other contracts that we may enter into with iASPEC. Any inability to enforce the Management Service Agreement and Option Agreement or an award thereunder could materially and adversely affect our business and operation.
IV. What These Changes Mean to You

Continued Uncertain Enforceability of VIE Contracts, cont’d

- The recent case of GigaMedia Ltd., a foreign private issuer with a PRC VIE relationship through T2CN Holding Limited, shows that the enforceability risk is real.
  - Control of the VIE was usurped by its original PRC owner, Wang Ji, after the GigaMedia board voted to replace him as CEO of its PRC operations.
  - GigaMedia reported that Wang had the seals, financial chops and business registration certificates necessary to run its online games business in the PRC, including, to declare dividends and approve service fee payments, conducting banking business and register the resolutions removing Wang from his position.
  - GigaMedia filed lawsuits against Wang in the PRC, Hong Kong, Singapore and the British Virgin Islands, but subsequently disclosed that it was highly unlikely that its VIE contracts would be enforced in court. GigaMedia based this conclusion on the fact that it had failed to register the equity pledge included in the VIE contracts, however, it is unclear whether they would be able to enforce VIE contracts with a restricted company in any event, especially in the current PRC regulatory environment.
  - The company subsequently disclosed that it was considering writing off the entire investment in the entities held by the WFOE since they had lost control of the WFOE and were unable to gain access to any financial information regarding the entities.
IV. What These Changes Mean to You

Scrubtiny of M&A Transactions, including VIE Structures

- Parties engaging in M&A activity with PRC target companies in the covered industries should be prepared to submit such transactions to MOFCOM for NSR review, even if such transaction includes a VIE structure.

- Parties should also expect that MOFCOM will separately subject the transaction to the merger control review process, including the original transaction establishing the VIE structure.

- It is presently uncertain how the merger control review process and the national security review process will correlate, but MOFCOM has said that it intends to combine the procedures for foreign investment approval, anti-monopoly review and national security review of transactions.

- MOFCOM timing for approval under the 2006 M&A Rules is approximately 30 days (depending on the locality) and the approval time for clearance under the NSR is expected to be 95 business days (based on the procedural timing outlined in the rule).

- Potential PRC targets will need to be carefully considered and a coordinated strategy developed to address possible concerns, including, modification of the transaction scope or structure, especially in light of the rights provided to third parties to request or recommend initiation of the national security review process.
IV. What These Changes Mean to You

Scrubtny of M&A Transactions, including VIE Structures, cont’d.

- Any existing VIE structure of a PRC target company should be examined to determine the following:
  - Is the VIE structure necessary for continued participation in a restricted industry, or was it established merely to circumvent the 2006 M&A Rules or other PRC regulatory requirements? If the latter, then terminate the structure and have the WFOE acquire the domestic entity.
  - Is the PRC target company engaged in a military or related industry or located in a Military Area? Is the operating company engaged in one of the key industries identified in the NSR, and the transaction is structured to give a foreign person or entity actual control over the operating company? Then the transaction will be subject to national security review and the parties should consider engaging in non-binding preliminary discussions with MOFCOM before submission of the transaction.
  - Does the VIE operate in the telecommunications sector, internet gaming sector, e-commerce/online payment services sector or steel sector, where PRC authorities have expressed disfavor to the use of VIE structures for foreign investment? If so, the parties should consider preliminary informal discussions of the planned transaction with PRC authorities to ensure that there is support for the transaction.
V. Regulatory Outlook

- The inclusion of VIE structures in the NSR implementing regulations and recent publications criticizing VIEs and foreign investment in certain sectors through VIEs, have added more uncertainty to the validity and enforceability of VIE structures which, in turn, could chill if not shut another avenue of financing options available to PRC companies operating in restricted industries.

- In his article “Cleaning up the VIE Section” in the China Accounting Blog¹, Prof. Paul Gillis, visiting professor of accounting at Peking University's Guanghua School of Management, posits that the solution to the current uncertainty rests in the hands of the PRC regulators, and he makes the following observations for reform:

  o Make it easier for PRC companies to directly list overseas without using an offshore entity. Many companies have chosen the VIE approach as a way to circumvent cumbersome PRC regulations.

¹ Available at: http://www.chinaaccountingblog.com/weblog/cleaning-up-the-vie-sector.html.
V. Regulatory Outlook

- Recognize the reality that there already is significant foreign investment in prohibited sectors, and find another way to regulate this investment as China needs entrepreneurial companies like Baidu.

- Develop rules to make it possible to bring offshore structures back onshore, such as through mergers of the offshore parents of U.S. listed PRC companies into the PRC operating company. This will provide China better regulatory control over these companies and it will provide the shareholders direct ownership of the operations (a good tradeoff for investors).

- Develop a regulatory structure that works for these companies, and which coordinates effectively with their SEC and PCAOB obligations.

- Create more opportunities for U.S. listed PRC operating companies to obtain listing on PRC stock exchanges. Let the markets decide the best place for a PRC company to obtain capital, not regulatory barriers or even worse, the opportunity to avoid regulatory oversight.

- Make it easy for firms to comply with existing PRC laws, and then strictly enforce existing PRC laws on any companies that do not comply.
V. Regulatory Outlook

- While it is clear that MOFCOM wants to ensure that foreign investors do not avoid the NSR, including pursuant to a VIE structure, it does not necessarily mean that they will enforce existing rules in the future to the detriment of foreign investors.

- PRC regulators have confirmed their awareness of the widespread use of the VIE structure to circumvent foreign investment restrictions and have used their discretion in determining whether or not they will discourage or prohibit its use in certain sectors.

- The consensus appears to be that while China could just get tough and force all of the companies using VIE structures to restructure into PRC owned entities, it is unlikely to do so as such conduct would cause a great deal of harm to the companies, their shareholders and the PRC economy.
For more information regarding the new National Security Review Mechanism for M&A transactions in China and its possible impact on VIE structures in particular, please contact one of the following partners in Blank Rome LLP’s Asia Practice Group:

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