

Investing in China

Finding the right vehicle

Since China acceded to the WTO in 2001, the country's regulatory framework on foreign investment has gradually been liberalised, providing growing opportunities for investors. In the first of a two-part update, Benita Yu and Jiaxing Zhou highlight the options for direct foreign investment in the country.



The current foreign investment framework in the People's Republic of China (the PRC or China) is the result of a series of measures introduced since the late 1970s. In particular, since December 2001, when China became a member of the World Trade Organisation (the WTO), the country has made a concerted effort to implement its WTO commitments to integrate into the world economy. As a result, China's regulatory framework on foreign investment is gradually being liberalised, providing growing opportunities for investors.

Those looking to make the most of investment opportunities in China should first:

- Check whether the proposed investment concerns an industry where foreign investment is encouraged, permitted, restricted or prohibited.
- Understand the main direct investment

structures and investment holding vehicles available to foreign investors.

As an alternative to direct investment, foreign investors may also consider acquiring a suitable existing Chinese company through merger or acquisition. This option will be considered in the second part of this feature.

The industry concerned

Investment catalogue

The first step for a foreign investor is to determine whether the proposed industry is one in which foreign investment is allowed. The relevant governing legislation is the Foreign Investment Industrial Guidance Catalogue (the Catalogue). It applies to foreign investment in both listed and unlisted companies.

The Catalogue was first issued in 1995 and subsequently updated several times, with

the latest update becoming effective on 1 January 2005. It generally implements the commitments of the PRC government on its accession to the WTO.

The Catalogue effectively divides all industries into four categories: encouraged, permitted, restricted and prohibited (*see box, Investment options by industry*). For industries falling within the encouraged and permitted categories, foreign investment can take the form of a joint venture (JV) or a wholly foreign owned enterprise (WFOE). Such entities may also be eligible to receive certain incentives in relation to taxation and customs duty. For industries that fall within the restricted category, foreign investment is normally subject to stringent market entrance requirements and governmental approval at a high level. Foreign investors cannot invest in the prohibited industries.

In addition to the Catalogue, China entered into the Closer Economic Partner-

ship Arrangement (CEPA) with Hong Kong, which became effective in January 2004. Compared with the Catalogue, the CEPA provides easier access for Hong Kong-made products and Hong Kong-based service providers to the PRC market. Similar arrangements have also been put in place between Macau and the PRC.

Investment structures and holding vehicles

Foreign investment can be structured in one of a number of vehicles:

- Representative office.
- WFOE.
- JV.
- Foreign-invested joint stock company with limited liability.
- A special vehicle such as:
 - an investment or holding company;
 - a foreign-funded venture investment enterprise (FFVIE);
 - a research and development (R&D) centre;
 - a procurement centre; or
 - a branch office.

Apart from the representative office and branch office, the above types of vehicle acquire the status of foreign investment enterprises (FIE) if they involve 25% or more foreign investment. Companies with foreign investment falling below 25% are treated as domestic Chinese companies.

While many of the laws governing FIEs and domestic Chinese companies are similar, there are some important distinctions, particularly in certain regulated industries. In addition, to attract foreign investment in China, certain preferential treatment (such as tax holidays) is only available to FIEs. Such treatment is only available as long as the relevant enterprise continues to have a foreign shareholding of at least 25%. In those industries where foreign investment is restricted, foreign investors may be allowed to set up a domestic company with foreign participation of less than 25%.

Representative office

The establishment of a representative of-

fice (RO) is a common first step into the China market. It involves a straightforward process and the costs concerned are considerably lower than other options.

Due to its very nature, an RO's activities are limited to representing the foreign investor in China and acting as a liaison office for product introduction, market research, technology exchange or other indirect business activities. It is prohibited from engaging in direct business activities in China. Generally the business scope of an RO includes the following activities:

- Market surveys and preliminary investigations, providing necessary information to the head office and other parties.
- Liaison with potential Chinese trading partners on behalf of the head office.
- Promotion of the trade name, goodwill and contracts for the head office.
- Other appropriate support services.

The following activities are, in particular, excluded from the scope of an RO:

- Buying and reselling of imported or domestic goods.
- Receiving payment for goods sold or services provided to a Chinese entity or individual.
- Providing services for which the RO, its head office or another foreign company receives payment from a Chinese entity or individual.

Except for certain sectors such as banking, insurance and transportation, which also require approval from the relevant industry regulators, an RO can be established by registration with the competent local bureau of the State Administration for Industry and Commerce (SAIC). (A requirement for approval by the Ministry of Commerce of China (MOFCOM) was removed in June 2004.)

Wholly foreign owned enterprise

A WFOE is a Chinese legal entity established by one or more foreign investors. A JV between more than one foreign investor is still called a WFOE as it is wholly foreign owned. A WFOE takes the corporate form of a Chinese limited liability company and is therefore distinct from its controlling parties.

In the past, foreign investors tended to form a JV to benefit from the support of a Chinese partner. However, WFOEs have become increasingly popular with the gradual liberalisation of China's regulatory framework on foreign investment. They can also help to protect the foreign investor's technological know-how and intellectual property rights.

Foreign investors can establish WFOEs in the encouraged and permitted categories under the Catalogue (*section 1*), as long as there are no special requirements in the Catalogue. In the restricted category, a WFOE cannot be incorporated unless special approval is obtained. The process of establishment of a WFOE involves an application for approval from MOFCOM and registration with SAIC (*see box, WFOE or JV establishment process*). In some special regulated industries, such as banking, property insurance and cargo carriage by road, a licence from the industry regulator is also required.

Joint venture

A JV with a Chinese party is a commonly used vehicle for foreign direct investment in China. Two types of JVs are available to foreign investors:

- **Equity joint venture (EJV).** An EJV takes the corporate form of a limited liability company. It is a corporation with legal personality and therefore distinct and separate from the investing parties. It can own assets, and liability for the transactions it engages in lies with the company itself. The investors' liability is limited to the amount of their total capital contribution. Each investor is entitled to the distribution of profits according to its contribution.

- **Contractual joint venture (CJV).** A CJV can take either of two forms:

- **an unincorporated CJV.** This does not involve the creation of a company, but is effectively a partnership. In this case, the parties cannot be deemed to be independent of the CJV. The partners and the CJV are jointly and severally liable for the CJV's debts and obligations. The contribution provided by the parties is owned by the contributing parties respectively, but is managed centrally by the CJV. The assets accumulated during the CJV's operation are jointly owned by the parties. No party is allowed to extract its contribution or otherwise dispose of its contribution or other assets accumulated during the CJV's operation without the permission of the other party;

Investment options by industry

Those looking to invest in China should first check the latest Foreign Investment Industrial Guidance Catalogue (the Catalogue) to determine whether foreign investment is allowed in the industry concerned. The table below sets out some of the industries in which foreign investment is either encouraged, permitted, restricted or prohibited by the Catalogue.

| | |
|-------------------|---|
| Encouraged | <p>There are 13 classes of industries under the encouraged category, each covering a wide range of specified areas, for example:</p> <ul style="list-style-type: none"> ■ High and new technology development. ■ Air transportation. ■ Development and production of new technology and new breeds of good quality, high-yield agricultural crops. ■ Energy-saving technology development. ■ Environmental pollution treatment and survey. <p>Within this category, the Catalogue prohibits wholly foreign ownership in particular industries, for example, the construction and operation of railways, bridges, tunnels and ferry ports, and requires majority shareholding or relative majority shareholding by the domestic party.</p> |
| Permitted | All industries other than those listed in the other three categories. |
| Restricted | <p>There are 13 classes of restricted industries, each covering various specified areas, for example:</p> <ul style="list-style-type: none"> ■ Foreign trade. ■ Banks, and financial and trust investment companies. ■ Cargo carriage by railway. ■ Construction and operation of high-grade hotels, villas, high-grade office buildings and international exhibition centres. ■ Making and distribution of radio and TV programmes, and movie-making. <p>Within this category, the Catalogue prohibits wholly foreign ownership in particular industries, for example, transportation by water and telecommunications. In some other industries, such as passenger carriage by railway, the Catalogue requires majority shareholding by the domestic party.</p> |
| Prohibited | <p>There are ten classes of prohibited industries, each covering certain specified areas, for example:</p> <ul style="list-style-type: none"> ■ News organisations, publishing, radio and TV broadcast and movie distribution. ■ Postal operations. ■ Power network construction and operation. ■ Air traffic control. ■ Futures trading. |

□ a legal person CJV. This is a hybrid combining the characteristics of both an unincorporated CJV and an EJV. It has the corporate form of a limited liability company, the basic characteristics of which are similar to those of EJVs, but with some additional flexibility, particularly in regard to the distribution of profits. As in the case of EJVs, legal person CJVs are required to allocate post-tax profits to a reserve fund, an enterprise expansion fund and an employee incentive and welfare fund for staff and workers. The board of directors decides on the amount of the profit to be allocated and the proportion in which it is allocated to the three different funds. An unincorporated CJV does not need to allocate any part of its post-tax profits to such funds.

(See also box, *EJVs and CJVs compared.*)

Approval and registration procedure. EJVs and CJVs can be established in the industries that fall within the encouraged and permitted sectors, and in the restricted sector subject to certain foreign participation restrictions.

The process of establishment of a JV is similar to that of an WFOE (*see box, WFOE or JV establishment process*). It involves an approval procedure with MOFCOM and a registration procedure with SAIC. In certain regulated industries, a licence from the industry regulator is also required. The most distinctive difference between incorporating a JV and a WFOE is that considerable negotiations with Chinese partners regarding

the capital contribution and management are inevitably involved in a JV.

Foreign-invested joint stock company with limited liability

A foreign-invested joint stock company with limited liability (JSC) is an important form of foreign direct investment vehicle. It must have at least two investors and, with the latest regulations, its minimum registered capital appears to have been reduced to CNY5 million (about EUR0.5 million or US\$0.6 million).

In a foreign-invested JSC, the capital is divided into equal shares. As with an EJV, the shareholders of the JSC are liable to it to the extent of their respective shareholdings.

WFOE or JV establishment process

Filing of the project proposal and the feasibility study report with the National Development and Reform Commission (NDRC) or its local bureau. (In practice, this filing may not be required).

Filing of the following documents, among others, with the Ministry of Commerce of China (MOFCOM) for the approval of the establishment of a wholly foreign owned enterprise (WFOE) or joint venture (JV):

- The articles of association of the WFOE or JV.
- In the case of a JV, the JV contract and its various annexes.
- Various documents to prove the incorporation, existence and financial standing of investors (for example, passport, certificate of incorporation and bank statement).

To streamline the establishment procedures, many local governments allow a one-stop procedure to examine and approve the project proposal, the feasibility study report, the articles of association and (if applicable) the JV contract.

When the documentation is complete and to the satisfaction of the approval authority, an approval certificate will usually be granted by MOFCOM (or its local bureau) within 90 days.

Within 30 days from the issue of the approval certificate, an application for the granting of a business licence must be filed with SAIC (or its local bureau). Usually the business licence will be granted within 30 days from the date of the application.

The business licence is proof of the legal establishment of the WFOE or JV.

Within 30 days from the granting of a business licence, applications must be filed with the tax office, customs office, SAFE or its local bureau, and banks to obtain various registration certificates.

Under Chinese company law and relevant regulations on the incorporation of a foreign-invested JSC, this vehicle can be established by either:

- **Promotion.** In this case, the promoters subscribe for the entire share capital.
- **Subscription.** In this case, the promoters subscribe for at least 35% of the share capital with the remainder being offered to the public.

In both cases, there must be at least two promoters, at least half of whom must be domiciled in China, and one must be a foreign investor. A promoter can only transfer its shareholding in a JSC one year after the company's registration and with the approval of the original approving authority.

Investment company

An investment company, normally referred to as a holding company (HC), is

essentially an EJV or WFOE which directly invests in Chinese entities, as opposed to undertaking manufacturing or operational activities itself. It must be a limited liability company. It cannot take the form of a CJV.

HCs are subject to more stringent regulations (*Provisions Governing the Establishment of Investment Companies by Foreign Investors 2004*) than EJVs and WFOEs for manufacturing or operational purposes. As a result they are subject to a more complicated approval process, particularly in relation to their incorporation and permitted business scope.

Incorporation. To establish an HC, a foreign investor must be creditworthy and possess sufficient economic resources. It must either:

- Have total assets of at least US\$400 million (about EUR312 million) in the previous

year and have already established in China one or more FIEs in which the foreign investor's paid up capital contribution exceeds US\$10 million (about EUR7.8 million).

- Have established more than ten FIEs in which the foreign investor's paid up capital contribution exceeds US\$30 million (about EUR23.4 million).

The Chinese partner to the HC (where the HC is to be an EJV) must be creditworthy, possess sufficient economic resources and have total assets of not less than CNY100 million (about EUR9.8 million or US\$12.5 million).

The registered capital of the proposed HC must not be less than US\$30 million (about EUR23 million). If a foreign investor satisfies the above incorporation conditions it can set up the HC through one of its wholly-owned subsidiaries, which gives the

EJVs and CJVs compared

Equity joint ventures (EJVs) have become the more popular form of Sino-foreign JVs and are generally preferred by Chinese parties. The Chinese government appears to prefer EJVs over contractual joint ventures (CJVs) as the EJVs are subject to more definitive regulatory requirements.

CJVs, by contrast, are potentially a more flexible structure and can often be tailored to suit the parties' requirements. Some of the advantages of CJVs over EJVs relate to:

- **Non-cash capital contribution.** The parties' non-cash capital contribution (other than land) to an EJV (the value of which is determined by the parties and which contribution itself is verified by qualified Chinese accountants) must be reflected in the registered capital (which determines the parties' shareholding rights). The value of land use right contributed by the parties must be appraised by qualified asset appraisal firms in China. In the case of a CJV, however, the parties' non-cash capital contribution can be reflected more flexibly when ascribing shareholding rights, such as the profit distribution arrangements in the CJV.

- **Profit distribution.** The profits of an EJV must be distributed in accordance with the parties' registered capital contribution. This is not the case for CJVs, however, which can distribute profits based on the agreement reached by the parties, as set out in the CJV contract.

In addition, a CJV can distribute its profits to the parties not only in cash but also by way of its products and other assets. This is not the case for EJVs, which can only distribute profits in cash.

A CJV therefore allows for a more flexible profit-sharing scheme than an EJV, although, in practice, the agreement reached by the parties must be reasonable and fair to the Chinese party (in the opinion of the Chinese approval authorities). It may be very difficult to obtain approval for a CJV contract if the profit distribution arrangements appear to be unfair to the Chinese party.

- **Recovery of investment.** Unlike an EJV, the foreign party to a CJV can enjoy priority in recovering its investment (that is, its contribution to the registered capital) before the expiry of the term of the joint venture, but only if the JV contract states that:

- ownership of all the fixed assets of the CJV will revert to the Chinese party on expiry or termination of the JV term;

- the foreign party agrees to be jointly and severally liable with the Chinese party to the CJV for the debts and obligations of the CJV to the extent that it enjoys priority in recovering its investment;

- the contribution or conditions agreed under the contract have been made or fulfilled in full; and

- the CJV is in good financial condition and does not have any accumulated losses.

If the foreign partner wishes to recover its contribution to the registered capital from the pre-tax income of the CJV, it must seek an approval from the competent Chinese finance and tax authorities at the provincial or higher level.

investor flexibility in relation to its internal investment and taxation structures. In this case, however, the foreign investor must give the approval authority an undertaking to the effect that:

- The foreign investor will ensure that its wholly-owned subsidiary will make a capital contribution into the HC and the HC will make a capital contribution to the invested companies within the PRC.

- The foreign investor and the wholly-owned subsidiary will make necessary technology transfers to the HC.

Business scope. An HC must also have its business scope approved. This approval, however, does not automatically lead to the approval of the projects in which the HC proposes to invest. Each of these projects must be individually approved.

An HC can:

- Invest in those industries permitted by the law for foreign investment.

- Provide services to the invested enterprises (subject to a unanimous resolution of the board of directors of the invested enterprises) including:

- providing assistance in purchasing equipment and raw materials, selling products and providing after sales service;

- balancing foreign exchange between its invested enterprises with the consent and under the supervision of the relevant foreign exchange control department;

- providing services relating to technical assistance, employee training and internal corporate administration; and

- providing assistance in raising loans and providing guarantees.

- Set up an R&D centre in China.

- Provide consulting services to its investors.

- Provide outsourcing services to its

parent company, affiliated companies and foreign companies.

- Import and export commodities or technology subject to the Filing and Registration Rules on Foreign Trade Operators 2004.

- Engage in domestic sales of imported or domestically procured commodities by wholesale or on a commissioned agency basis.

- Engage in retail and franchise activities subject to MOFCOM's Regulations on Foreign Investment into the Commercial Sector 2004.

- Provide financial support to its invested enterprises with the approval of the China Banking Regulatory Commission (CBRC).

- Set up a leasing company with the approval of MOFCOM.

HCs and their invested enterprises are independent legal entities. An HC cannot perform tax consolidation for, or unify

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the financial management of, its invested enterprises.

If an HC satisfies certain requirements, it can be upgraded to the status of regional headquarters with the approval of MOFCOM. The financial requirements include either:

- Having a paid-up registered capital of not less than US\$100 million (about EUR78.3 million).
- Having a paid-up registered capital of not less than US\$50 million (about EUR39 million), total assets in the previous year of not less than CNY300 million (about EUR29.4 million or US\$37.5 million) and a gross profit margin of not less than CNY100 million (about EUR9.8 million or US\$12.5 million).

In addition to the activities of an HC, the regional headquarters can:

- Import and wholesale (but not retail) products of a multinational corporation and its affiliated companies.
- Import raw materials and spare parts used to provide maintenance services for the products of its invested enterprises and the multinational corporation.
- Provide outsourcing services to domestic or foreign companies.
- Engage in logistics and distribution services in accordance with the relevant regulations.

- With the approval of the CBRC, establish financing companies to provide relevant financial services to investment companies and its invested enterprises.

- With the approval of MOFCOM, contract for overseas projects and engage in overseas investment and operational and financial leasing businesses.

- Entrust other domestic enterprises with the production and/or processing of its products or the products of its parent company, and the sale of such products inside and outside China.

- Engage in other business activities with the approval of the relevant authorities.

Foreign-funded venture investment enterprise

FFVIEs are regulated by the Management Rules on Foreign Funded Venture Investment Enterprises, which became effective on 1 March 2003. This legislation, among other things, governs the vehicle's incorporation, business scope and management structure.

Incorporation. An FFVIE can take the form of a legal person such as an EJV, legal person CJV or a WFOE. In this case, the minimum subscribed capital is US\$5 million (about EUR3.9 million). Unlike an HC, an FFVIE can also take the form of a non-legal person such as an unincorporated CJV, in which case the minimum subscribed capital is US\$10 million (about EUR7.8 million).

To establish an FFVIE, there should be two to 50 investors. At least one of these (the requisite investor), or its affiliated entity, must:

- Have venture investment as its main line of business.
- Have cumulative capital under its management of not less than US\$100 million (about EUR78.3 million) in the last three years before its application, of which at least US\$50 million (about EUR39.1 million) has been used for venture investment. If the requisite investor is a Chinese investor, it must have cumulative capital under its management of not less than CNY100 million (about EUR9.8 million or US\$12.5 million) in the three years before the application, of which at least CNY50 million (about EUR4.9 million or US\$6.3 million) has been used for the venture.

- Have at least three professional management employees, each with not less than three years' experience in the venture investment business.

- Not have been prohibited by the judicial authorities or other relevant regulatory authorities of its own country from engaging in venture investment or investment and consultancy activities, or penalised for reasons such as fraud.

- In the case of a non-legal person FFVIE, have subscribed to not less than 1% of the total subscription by all investors, contributed not less than 1% of the total paid-up capital and must bear joint and several liability with the non-legal person FFVIE; or, in the case of a legal person FFVIE, have subscribed to not less than 30% of the total subscription by all investors and contributed not less than 30% of the total paid-up capital.

For the purposes of the above, the term "affiliated entity" means an entity controlled by that investor, or an entity that controls that investor, or another entity that is under the common control of an entity as that investor. The term "control" means the controlling party owning more than 50% of the voting rights of the controlled party.

A requisite investor cannot withdraw from an FFVIE during the vehicle's existence, unless:

- It has obtained the consent of other investors whose capital contribution accounts for more than 50% of the total capital.

- Its equity interests are transferred to a new investor that fulfils the requirements of a requisite investor.

- MOFCOM approves the withdrawal.

The subscribed capital of other investors in the FFVIE must not be less than US\$1 million (about EUR783,000).

Business scope. An FFVIE can:

- Use all of its own funds to make equity investments, including setting up new enterprises, investing in existing enterprises, accepting the transfer of equity interests from shareholders of existing enterprises, and other forms of investment permitted by the law.

- Provide venture investment consulting services.

- Provide management consulting services to its invested enterprises.

- Engage in other business activities approved by the relevant approval authority.

The capital of an FFVIE must be used mainly for equity investments in its invested enterprises.

Management structure. An FFVIE in the form of a legal person must set up a board of directors, while an FFVIE in the form of a non-legal person must set up joint management committees to operate the FFVIE. The board of directors or the joint management committee can set up a management body responsible for the daily operation of the FFVIE. The board of directors or the joint management committee can also entrust the management of the FFVIE to a venture investment management enterprise, which can be a domestic entity or an FIE.

R&D centre

An R&D centre is an entity that engages in research and development and in experimental development (including pilot testing) in natural science and related fields. In April 2000, the Chinese government issued the Circular on Questions Relating to Foreign Investors Investing in and Establishing Research and Development Centres to encourage the development of high technology by way of foreign investment.

An R&D centre can take the form of an EJV, CJV or WFOE. It can also be estab-

lished as an independent division or a branch within an FIE or HC.

An R&D centre must have:

- A defined research and development subject.

- Specific research and development projects.

- Fixed premises as well as the necessary apparatus, equipment and other conditions required for scientific research. The R&D centre's investment in research and development must not be less than US\$2 million (about EUR1.6 million).

- Dedicated management and scientific research employees. Not less than 80% of the R&D centre's employees directly engaged in research and development must hold the equivalent of an undergraduate degree or higher qualification.

An R&D centre's scope of business can include basic research and development, product application research, high-technology research and public welfare research. On the other hand, it cannot:

- Undertake activities in industries that are classified as prohibited by the Catalogue (*see box, Investment options by industry*).

- Engage in technology trading other than that involving the technological achievements of its own research and development or engage in production activities other than pilot testing.

- Operate as a training centre.

An R&D centre may enjoy certain preferential treatment in relation to the payment of customs duty, business tax and enterprise income tax.

Procurement centre

China is becoming increasingly important to multinational companies as a source for the procurement of goods. In November 2003, MOFCOM together with certain other government authorities issued the Administration of Establishment of Foreign-invested Export Procurement Centres Procedures to encourage the establishment of export procurement centres.

A foreign-invested export procurement centre (procurement centre) means an FIE established in China to engage in export procurement business. A procurement cen-

tre must be a limited liability company. It can take the form of a JV or WFOE. To establish a procurement centre, foreign investors must have a multinational marketing network and the capacity for export procurement. The registered capital of a procurement centre must not be less than CNY30 million (about EUR2.9 million or US\$3.8 million).

A procurement centre can:

- Procure domestic goods for export, and export-related warehousing, information consultancy and technical services.

- Import raw and auxiliary materials that are to be re-exported after processing by other businesses upon commission.

- Import samples required for procurement for export. The quantity and value of imported samples must comply with the relevant customs regulations concerning the import of samples.

Branch office

Chinese company law allows foreign companies to set up branch offices to engage in production and business activities. The branch office of a foreign company is not a Chinese legal person, nor does it enjoy limited liability, which means that the relevant foreign company is accountable for any debts or liabilities incurred by its Chinese branches.

In effect, however, branch offices can only operate in those sectors where specific legislation has been enacted to allow for their approval, such as banking and insurance. In these two sectors, approvals can be obtained from the CBRC and the China Insurance Regulatory Commission respectively. In those industries where no specific legislation has been enacted, it would seem that foreign investors must use other appropriate vehicles.

Branch offices can conduct direct business in China. The requirements for establishing a branch office are the same as those for the establishment of a WFOE or a JV (*see above*).

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