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The Chinese Government And its Relevance to Foreign Multinationals

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Who We Are

Founded in China by Americans over a quarter century ago, ChinaVest is a leading merchant bank with offices in Shanghai, Beijing, Hong Kong and San Francisco. We have operated in China longer than almost any other firm, concurrently developing keen market intelligence and essential relationships with both the business community and with the government. In a country with a deeply embedded culture, we truly understand the nuances of doing business in China.

From our location in a remodeled 102 year-old building on the Shanghai Bund, we have seen China grow into an energetic, thriving, and modern country. Through the years, we have been a catalyst for many of these changes. In the past quarter century, we have worked with, or been a financial advisor to, some of the world's largest corporations. In addition, ChinaVest has managed and invested almost half a billion dollars in more than 60 companies in greater China with exits on the Hong Kong Stock Exchange, Taipei Stock Market, and NASDAQ, as well as 20 strategic sales.

We provide this summary on the Chinese government for the benefit of our global clients interested in doing business in China. We believe that if any organization is serious about investing in China, it is crucial to understand the complicated interplay between central government, local/provincial governments, and the business community.

Overview

In today's China, government MEANS business. Historically, China modeled its "command and control" economy in the image and likeness of the Soviet Union. The transformation to a market economy over the past twenty-five years has been dramatic and, at times, painful and disruptive. Today's government plays the role of both chief planner, regulator, and owner of large parts of the residual of this communist system. While the percentage of China's GDP attributed to the private sector is roughly the same as many counties in Western Europe (at over 60%), Beijing's economic control over the economy is much larger and more powerful.

This report outlines the structure and scope of activity of China's most important government bodies. We also discuss how those activities affect foreign companies and their ability to do business in China. At the end of the report, we summarize the information and offer key principles to follow when formulating or expanding a China strategy.

Historical Context

The China of the fifties and sixties is best described as a "vertical" economy, where each industry was controlled from top down--from the State Council, to various economic ministries, to State-owned Enterprises (SOEs). Throughout this period, Chinese SOEs enjoyed monopolistic status. In the late 1970s, however, China began to undertake economic reform measures under the direction of Deng Xiaoping. The changes began with the creation of Special Economic Zones adjacent to Hong Kong, permitting a sort of "laboratory of capitalism." These economic zones were soon reproduced throughout the

nation, in a controlled manner, creating an explosion of entrepreneurial activity. This activity was initially led by the overseas Chinese business communities from Hong Kong, Taiwan, Singapore and the West Coast of North America.

Most of our readers comprehend the social and political ramifications of Tiananmen Square in 1989. What most don't know, however, is that events such as Tiananmen actually led China's leadership to accelerate economic reform. In the early 1990's, laws were created to protect foreign investment, and soon thereafter, the stock exchanges of Shanghai and Shenzhen were launched. In the mid 1990's the growth of entrepreneurial activity in China continued, while Hong Kong fearfully braced for its inevitable annexation to China by exporting billions of dollars out of the territory. When Hong Kong reverted to Chinese control in 1997, China did not, as some feared, turn its new asset into a communist state. Instead, it created the concept of "one country, two systems" which was used to describe the hyper-capitalistic world of Hong Kong successfully co-existing with China. Rather than expropriate property and make Hong Kong "more like China," Beijing saw the territory as an asset from which it could learn. China continues to learn from Hong Kong and much of this knowledge has helped provide economic development to cities such as Shanghai.

In the mind of the Chinese government, the 1997 Asian financial crisis helped validate China's dual economic path (i.e. control from the top and entrepreneurship from the bottom). China's resolute rejection of open currency conversion averted the economic disasters which befell many other Asian nations during that turbulent period. As a result, from the late 1990's to date, China has been able to continue to take bolder moves in development, focusing on infrastructure, expansion of foreign direct investment and a continued buildup of its foreign exchange.

The next important, almost cataclysmic economic reform event in China took place with China's accession into the World Trade Organization (WTO) in 2001. While this event might be viewed as insignificant by Western nations, for China, it meant having a legitimate place at the table amongst the world's most economically powerful nations. However, for China's government, this event had its share of consequences. The first was the effective destruction of one of the principal tenants of the communist system—the separation of ownership from regulation and management. WTO, in effect, forced China to create a regulatory system. For the first time in its history, China was forced to disband the old "command and control" economic system and replace it with a series of regulatory agencies. Beijing's was thus forced into "macro" rather than "micro-managing" the economy. New agencies were created, such as the National Development and Reform Commission (NDRC), the China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission (CIRC), and many others. Through these agencies China began to manage its economy through laws and regulations as opposed to administrative edict. Though the process has NOT been completed, and tensions continue to exist throughout the *entire* apparatus of central government, this new economic system is well underway and its consequences are far-reaching. Regulatory agencies today do not chose to reward or punish specific industries or companies as they did in the past. Instead they set rules, monitor results and let the marketplace determine outcomes.

It would be misleading to suggest that this new system has been entirely implemented and is fully functional. There are countless examples of favoritism, inconsistency, and corruption within these new agencies. This system is still in its infancy and all foreign companies require a considerable amount of patience and effort in order to navigate their way through it. It is fair to say, though, that today, "change" is the centerpiece of government and commerce.

The pivotal theme related to understanding the Chinese government can best be described with one question—"who owns China?" We believe this will be the overarching issue for years and decades to come, and the answers to this question will be made by National Government, by Provincial Governors and Mayors, by State-Owned Enterprises, by the

newly reformed State Banks and by the countless millions of entrepreneurs who have created this economic juggernaut, an inertial force unparalleled in modern history. It will also be answered by the many foreign companies of the United States, Europe, Japan, and others with a vested interest in doing business in China.

Conclusion

There are three main themes that underpin the regulatory environment for a foreign company that wants to do business in China.

1. The first theme is the contradictory nature of the political and regulatory bodies. Similar to the United States, China is an enormous country with often conflicting layers of government. At times, Beijing's agenda may not coincide with that of a local Mayor or provincial Governor. This concept is not strikingly different from the Federalist system in the U.S. and its attendant conflicts between Washington and individual states. Additionally, many national agencies have overlapping jurisdiction, which may be confusing. It is therefore crucial for a foreign company to identify the various agencies that could affect the transaction early in the process. The first agency on this list will inevitably be China's Ministry of Commerce (MOFCOM). We provide more detail on MOFCOM in subsequent pages of this document.
2. The second pivotal theme is that China no longer needs capital. As of this publication China has approximately US\$5 trillion in total savings and US\$1.4 trillion in reserves. Additionally, roughly US\$13 billion worth of private equity money was raised specifically to invest China last year. Meanwhile, China's surging stock markets have added to the liquidity bubble. This means that China no longer needs foreign capital. If anything, China will have to export capital in coming years. This issue is important for foreign multinationals, as it indirectly affects the regulatory process. For strategic buyers it even has a silver lining—namely that foreign multinational firms, unlike LBO funds, are viewed favorably by Beijing when they provide "more than just money." Regulators are much more disposed to grant approval for those transactions involving a strategic buyer who provides "more than just capital" (i.e. best practices, technological innovation, management expertise, etc.).
3. The final theme relates to the fact that foreigners need to exercise patience when dealing with regulators. The regulatory system governing foreign investment in China is still generally approval-based, as opposed to procedure-based. This means there isn't a set of comprehensive procedures a foreign company can follow to guarantee that it can conduct business in the country. Instead, foreign companies (and in many cases domestic companies) must receive approval from regulators. Regulators follow a "general" set of guidelines, but those guidelines are constantly evolving alongside China's dynamic business and economic environment.

To conduct any type of business in China, a foreign company will almost always have to get the Ministry of Commerce's (MOFCOM) seal of approval. A foreign company may find itself dealing with (a) MOFCOM's central office in Beijing, (b) MOFCOM's provincial or local branches, or, potentially, (c) with both. A foreign company will also have to gain approval from the relevant industry regulator (e.g. CBRC for the banking industry, CIRC for the insurance industry, etc.). The industry regulator can reside at the central government level, the provincial level, or the local level, and often at all three levels simultaneously. If a foreign company wishes to invest in state-owned assets, it needs to negotiate with and get approvals from SASAC (defined below).

Communication with the relevant bodies is of paramount importance. In China's transitory regulatory environment, market conditions and the government's development goals are constantly changing. Therefore, only through constant communication will foreign enterprises gain a better understanding of the government's intentions. China is a

pragmatic country and often, the government is keen to work together to find a solution that benefits both China and the foreign company.

In the following appendix we provide a detailed snapshot of the Chinese government as it currently exists. Clearly, time will bring changes to this structure but we believe that we provide a fairly clear and comprehensive picture of the Chinese government apparatus as it pertains to doing business in this country. For those foreign companies with appropriate levels of foresight and determination, the rewards to doing business in China are huge. A word of caution—with inadequate preparation and commitment, the results can be q very disappointing. The Chinese word for crisis, Wei Ji (危机), is made up of two characters: danger (危) and opportunity (机). This is an excellent concept to keep in mind when considering doing business in China.

Appendix A: Government Ministries and Organizations

High Level Decision Makers

As in all governments, there are institutions and individuals that provide high-level policy. Below, we describe the key state organs and policymakers.



National People's Congress (NPC)

Chairman: Wu Bangguo

The National Peoples' Congress is the highest branch of government in China and is responsible for enacting laws, policies, and regulations (the "legislative branch"). The NPC is composed of a permanent "standing committee," with members that are elected for 5-year terms who represent provinces within China. Twice a year, the NPC gets together to enact and revise laws, elect members of government, and examine and approve issues for national economic and social development. The NPC elects the president of China who in turn appoints many high ranking positions within the government.



The Presidency

President: Hu Jintao

Vice President: Zeng Qinghong

The President is elected by the NPC for five-year terms. The President serves as the head of state and CPC (communist) party leader (although by law these titles can be held by separate individuals). The President also serves as leader of the NPC as well as the "supreme representative of China" both internally and externally. The President has the power to promulgate statutes and holds "supreme" diplomatic and ceremonial rights. However, China's concept of having a Head of State is one of "collective leadership," subordinating the presidency to the NPC. The President also elects the "Premier" of the State Council (to be approved by the NPC), who in turn elects ministers for the State Council (also to be approved by the NPC).



The State Council

Premier: Wen Jiabao

The State Council is the highest body in the Executive Branch and is often referred to as "China's Cabinet." The State Council is responsible for executing China's laws in a manner that conforms to the nation's overarching goals. The NPC enacts the policies and principles and the State Council carries them out. The State Council deals with such affairs as: China's internal politics, diplomacy, national defense, finance, economy, culture and education.

The State Council is comprised of a Premier, Vice-Premiers, State Councilors, and Ministers in charge of various ministries and commissions. The Premier of the State Council is nominated by the President and reviewed by the NPC. Other members of the State Council are nominated by the Premier, reviewed by the NPC or its Standing Committee, and appointed by the President. In the State Council, each office has a term limit of five years, and incumbents cannot be reappointed after two successive terms. Wen Jiabao, the "Economic Tsar" of China, holds one of the most powerful and influential positions in the country.

Within the State Council are various ministries, commissions, institutions, and organizations that are responsible for administering the economic and social policies of China. Below, we detail some of those departments, and discuss why they may be important to foreign investors.



***The Supreme People's Court
President: Xiao Yang***

The Supreme People's Court is the highest judicial branch in China and reports to the NPC and its Standing Committee. It independently exercises the highest judicial rights, without any interpretation by administrative organs. It is charged with three main responsibilities: trying cases that have the greatest influence on China, supervising the work of local courts, and providing judicial explanation of law.



***Supreme People's Procuratorate
Procurator-General: Jia Chunwang***

The Supreme People's Procuratorate is the state branch for legal supervision. It is mainly responsible for supervising regional and special procuratorates to perform legal supervision by law and protecting the unified and proper enforcement of State laws. Their purpose is to safeguard the unity of the country, maintain public order, protect socialist property, and protect citizens' rights.



Communist Party of China (CPC)

With over 70 million members, the CPC is the world's largest political party and the real source of government power in China. It is the CPC that postulates laws and determines which officials will be admitted to the NPC, presidency, military, etc. New laws and policies are created by the party and are subsequently passed by the NPC through the state's legal procedures. The CPC was founded in Shanghai in 1921. However it was not until 1949 that the party became the primary political power of China. It was the CPC who decided in 1978 to move towards a "socialist market economy," famously stated by Deng Xiaoping as, "socialism with Chinese characteristics." This was the beginning of the tectonic movement that has shaped the modern political/economic landscape of China over the past 25 years. The CPC is essentially China's only political party, however it can be noted that the CPC operates in a "one party, two factions" system. The Shanghai faction (mainly officials from prosperous provinces) and the youth league faction (officials from rural, interior China) are two main divisions. Organizationally, the CPC is run by the Politburo which is composed of a 9 person standing committee along with 24 other delegates.

MINISTRIES, COMMISSIONS & INSTITUTIONS

Below is a guide to some of the ministries & commissions, institutions, organizations, and other government bodies under the State Council. Many of them directly and indirectly affect foreign investment and business operations in China.

Ministry of Commerce (MOFCOM)

Duties: MOFCOM is the lead approval agency for all M&A transactions in China. MOFCOM exists at both a national level and a provincial level. Its basic functions include:

- Formulating development strategies, guidelines, and policies for domestic & foreign trade, as well as international economic cooperation.
- Drafting laws and regulations governing domestic and foreign trade, economic cooperation, and foreign investment.
- Conducting research into and formulating policies for regulating market operations.
- Breaking up monopolies & regional blockages.
- Setting up and improving an integrated, open, competitive and orderly market system.

Any foreign enterprise that wishes to acquire a stake in a Chinese company must get approval from MOFCOM. In September 2006, MOFCOM (along with numerous other government bodies) released new rules governing M&A activity by foreign companies. The rules grant MOFCOM the authority to allow (or disallow) acquisition of a Chinese company. MOFCOM generally evaluates potential investments on a few basic criteria:

- The industry—what is the industry, and what level of industry control would the foreign player gain through investment/acquisition? At all levels, the government encourages investment in some sectors and has a more cautious attitude toward foreign investment in others. MOFCOM therefore considers the “status of the industry” when making approval decisions.
- Will the foreign company gain control of “famous Chinese brands or trademarks?” If so, MOFCOM may disallow or require a change in the structure of the investment.
- MOFCOM will also examine whether the investment could threaten China’s economic security or national security. If MOFCOM, at its sole discretion, believes it could, it will not approve the investment.

The process delineated above can be referred to as MOFCOM’s “anti-trust examination.” MOFCOM will perform the anti-trust examination on all potential foreign investments. Recently, MOFCOM enacted a series of new anti-monopoly laws. These laws are not perfect, but they now provide more clarity into what constitutes a monopoly. These new laws also do not discriminate between foreign or domestic Chinese companies in terms of what constitutes monopolistic business practices.

The M&A approval process is run by MOFCOM at either the central government level or at the relevant provincial or local level, depending on the location and scope of the potential foreign investment. Whether at a national or local level, foreign companies that wish to make investments in China should begin informing

MOFCOM of their intentions from an early stage. MOFCOM is willing to work with, and help guide, foreign enterprises in order to maximize their chances of gaining approval. If chances of gaining approval for particular acquisitions are slim, MOFCOM will let the foreign company know early, before significant time, money and resources are spent.

Peoples Bank of China (PBOC)

Duties: As China's central bank, the PBOC is analogous to the Federal Reserve Bank in the United States. PBOC formulates and implements monetary policy, works to prevent and alleviate financial risks, and attempts to safeguard financial stability. Its specific functions include:

- Issuing RMB currency and administering its circulation.
- Regulating the inter-bank lending market and the inter-bank bond market.
- Administering foreign exchange and regulating the inter-bank foreign exchange market.
- Regulating the gold market.
- Holding and managing official foreign exchange and gold reserves.
- Managing the State Treasury.
- Conducting financial statistics, surveys, analysis and forecasts.
- Participating in international financial activities in the capacity of the central bank.

PBOC essentially acts like any major country's central bank. It uses interest rates to control inflation, issues government bonds, etc. Although it does not have a direct role in approving foreign investment, all other government bodies must conform their strategies to work within PBOC's general economic framework.

The PBOC has been organized as a mirror image of the US Federal Reserve with the notable exception that it is a "purely" governmental organization. Similar to the Federal Reserve, the PBOC is currently establishing 12 regional banks. Interestingly, China is mirroring the U.S. Fed model to the point where PBOC has even brought in members of the U.S. Treasury department as strategic advisors who have been working with China for many years to develop and refine the role of the PBOC.

National Development and Reform Commission (NDRC)

Duties: NDRC is China's top economic planning body. Its role is to formulate and implement strategies of national economic and social development, maintain economic balance, and guide the restructuring of the overall economic system. It is also responsible for:

- Studying important issues concerning national economic security.
- Summarizing and analyzing fiscal and financial problems.
- Participating in the formulation of fiscal and monetary policies.
- Formulating and implementing industrial and price policies.
- Setting and adjusting the prices of important commodities that are regulated by the state, as well as setting and adjusting important tariffs and fees.
- Controlling and monitoring the total size of China's foreign debts.
- Studying major issues concerning the restructuring of economic systems and opening up to the outside world.

The NDRC is what used to be known as the "State Council." In the pre-reform era, the State Council was, in effect, the owner of the State Owned Enterprises. It could formerly best be described as the "owner of the owners." Because of this

legacy, the NDRC still retains a large amount of regulatory power that seemingly overlaps with MOFCOM. An example of this overlap is the power that NDRC has over approving sales of certain assets. NDRC usually focuses its approvals on investments in physical assets (e.g. setting up a new factory, building a major infrastructure project, expanding a port, etc). NDRC handles approval for such projects for both domestic and foreign firms. NDRC also must approve the establishment of those Sino-foreign joint ventures that plan to invest in physical asset projects. The commission must grant approval since major physical asset investments have a significant effect on the economy. Like MOFCOM, NDRC has local representative branches, so it will have a keen understanding of how potential investments fit with local needs.

Ministry of Finance (MOF)

Duties: As advisors on the government's financial matters and monitoring of financial cycles, the Ministry of Finance has been set up as a replica of the U.S. Treasury Department. The MOF role used to include those of the CBRC and CIRC, but with China's entrance into the WTO, and a subsequent addition of new regulatory agencies, MOF has reduced its responsibilities. Today, MOF is primarily responsible for formulating and implementing strategies, policies & guidelines regarding public finance and taxation. It is also responsible for overseeing accounting practices, social security expenditures, and drafting the central government's annual budget.

Ministry of Labor and Social Security (MLSS)

Duties: The Ministry of Labor and Social Security is in charge of the administration of national labor and social security undertakings, including labor force management, labor relationship readjustments, and various other items within the "social insurance" sector.

Ministry of Land and Resources (MLR)

Duties: The Ministry of Land and Resources monitors the appropriate use of land. It is responsible for the planning, administration, protection and rational utilization of such natural resources as forests, minerals, and marine resources. This ministry is especially relevant to industries such as mining and forestry. Key to a successful market economy, as seen in the United States, is the ability to effectively control land ownership titles. Argued in De Soto's, *The Mystery of Capital*, the distinguishable mark of poor nations versus wealthy nations is the ability to turn "dead" capital into "liquid capital." Creating value in real estate or the stock market through the establishment of laws and titles is a key ingredient for creating wealth in a nation. The MLR is responsible for establishing land ownership in China in compliance with China's economic reform.

Ministry of Water Resources (MWR)

Duties: The Ministry of Water Resources is in charge of drafting legislation for water-related policies, controlling water conservation and formulating demand management policies. This ministry is relevant to any foreign companies interested in working with municipal water businesses. MWR has the task of dealing with one of China's major environmental/social problems: its water supply. Contrary to what many believe, China does not have a shortage of water, but rather its water is located in all the wrong places. The southern, less populated regions have a vast majority of the nation's water supply, while the most populated areas have severe shortages. MWR is responsible for huge public works projects. Such projects include the Three Gorges Dam (the largest dam in the world) and the South-to-North water diversion project, a massive canal/aqueduct expected to be completed in 2050, which will be the largest water project of its kind ever created.

Ministry of Foreign Affairs (MFA)

Duties: The Ministry of Foreign Affairs oversees Chinese embassies, Chinese general consulates, Chinese missions to international organizations and representatives of offices abroad. There is a strong sense of admiration and knowledge of Western cultures within upper levels in the Chinese government, especially amongst China's up-and-coming younger leaders. The Asia Foundation, a US-based non-profit organization, has developed a "young diplomats program" in which every year, eight to ten of China's most promising diplomats are sent to Washington D.C. to study politics at schools such as Georgetown. In fact, most leaders (and future leaders) within the Chinese government have studied in Western universities and are therefore more accepting of Western ideas.

Ministry of Information Industry (MII)

Duties: The Ministry of Information Industry formulates legislation and strategy in China's electronics, IT, software, telecommunications, broadcasting, and other technology and information-related industries. This includes:

- Formulating laws governing the manufacturing of all electronics, communications, and IT products, as well as the laws governing software production.
- Handling and managing telecommunications services, including licenses for telecom operators.
- Establishing technical standards for radio and TV transmission networks.
- Managing all communications resources and infrastructure, such as website domain names, telecommunications network numbers, satellites, etc.
- Facilitating R&D in the above industries.
- Compiling and releasing relevant industry statistics.

MII will play a role if a foreign company seeks to enter or invest in any of the aforementioned sectors (especially internet, and telecom companies). Due to their importance in the flow of information, foreign activity in these sectors is highly restricted. If looking to purchase a stake in a Chinese company, a foreign enterprise may experience some difficulty acquiring a control position.

Ministry of Communications (MOC)

Contrary to its name, the Ministry of Communications is responsible for all highway and waterway transportation in China. This includes regulating logistics (except for rail & air) such as international shipping ports, mail (including FEDEX & UPS), and truck lines. Similar to other large continental economies such as the United States, China's intricate and sophisticated highway systems are integral to a healthy economy. MOC is at the epicenter, responsible for developing similar highway infrastructure projects in China. MOC also plays a key role in the port industry. Over the past few years China has emerged as an international shipping center with 8 of the top 20 largest cargo/container ports in the world and Shanghai predicted to become the world's largest port by 2008.

The M's vs. the C's:

Many people wonder what the difference is between a Chinese ministry and a commission. In many ways, the two represent the difference between the China of today, and the China of yesterday. In broad, general terms, Ministries are government agencies left over from the days of a closed market. They were designed to operate under the old system of state ownership, where SOE's totally controlled the market. China's entrance into the WTO in 2001 marked the beginning of the "commission era" in China. Interestingly, many of the commissions are actually organized as virtually exact models of similar agencies within the U.S. government, such as the Peoples' Bank of China (U.S. Federal Reserve), Administration of Customs (U.S. Customs), and CSRC (the U.S. Securities and Exchange Commission).

A simple way to distinguish between the two branches is to remember that *commissions*, in American baseball parlance, are going to "call the balls and strikes" whereas *ministries* "pick the winners and losers." In other words, commissions are not trying to control outcomes, but rather provide a healthy legal/stable environment in which the market can perform. Ministries on the other hand, take more of an authoritative role, in which the decisions are picked on individual (and sometimes arbitrary) basis. The difference is highlighted by MOFCOM & NDRC. Foreign investment requires approval from both MOFCOM & NDRC (according to the 2006 M&A laws). However, each organization has different approval requirements. MOFCOM (ministry) takes a "micro" approach to approval and bases judgments on an individual basis, where there are no definite guidelines. Sometimes getting shut out of a deal seems indiscriminate and un-transparent. NDRC (commission), on the other hand, takes a "macro" approach to investment and has established a series of rules and regulations that serve as a guide to its approval of investments. The contrast between these two governing bodies makes China's regulatory system for foreign investment quite unique

China Banking Regulatory Commission (CBRC)

Duties: The China Banking Regulatory Commission formulates supervisory rules and regulations governing banking institutions. They authorize the establishment, changes, termination and business scope of banking institutions; publish statistics and reports of the overall banking industry; provide administration of the supervisory boards of the major state-owned banking institutions; combat financial crimes; and strive to enhance the international competitiveness of the Chinese banking sector.

CBRC will regulate any investment by both domestic and foreign enterprises into the banking sector. As a focused regulator of one industry, it concentrates its specific goals when considering whether or not to allow an investment. For instance, the Carlyle Group recently attempted to purchase a 7.99% stake in a small Chinese bank. Since the stake was small and the bank was relatively small, it did not trigger "anti-trust" issues with MOFCOM. However, because CBRC prefers foreign strategic investors to private equity funds, it blocked Carlyle's bid.

China Securities Regulatory Commission (CSRC)

Duties: Modeled after the U.S. Securities and Exchange Commission, the China Securities Regulatory Commission directly regulates businesses such as brokerage houses, mutual fund management firms, investment banks, and trust companies. The Commission's purpose is to:

- Study and formulate policies and develop plans regarding securities and futures markets.
- Draft relevant laws and regulations on securities and futures markets.
- Supervise these markets and exercise vertical power of authority over regional and provincial supervisory institutions of the market.

Furthermore, CSRC oversees the issuance, trading, custody and settlement of equity shares, convertible bonds, and securities investment funds, in addition to approving the listing of corporate bonds and supervising the trading activities of listed government and corporate bonds.

CSRC regulates any potential investment or business activity in the aforementioned sectors. To conduct business in these areas, foreign companies must partner with a domestic firm and foreign companies cannot hold more than 49% of the venture. CSRC also regulates IPOs by China-based companies that list on domestic exchanges.

China Insurance Regulatory Commission (CIRC)

Duties: The China Insurance Regulatory Commission conducts administration, supervision and regulation of the Chinese insurance market. It ensures the stable operation of the insurance industry as well as compliance with relevant rules and regulations.

CIRC regulates all investments in the insurance industry. CIRC does approve some foreign insurance companies to establish wholly-owned mainland insurance ventures. It also approves joint venture insurance arrangements with Chinese companies.

State Electricity Regulatory Commission (SERC)

Duties: The State Electricity Regulatory Commission is empowered by the State Council to perform administrative and regulatory duties with regards to the national electric power sector. The SERC is not in charge of power sources, but instead is in charge of controlling the power grid. They are responsible for determining the allocation of power (volume, distribution) to all cities across China, which involves intricate planning (as much as 10 to 20 years in advance).

National Council for Social Security Fund (NCSSF)

Duties: China's social security system is a strategic reserve fund which is accumulated by the central government to support future social security expenditures. The social security fund aims to be a financial solution to the problem of a large aging population.

ORGANIZATIONS

General Administration of Customs (GAC)

Duties: Modeled after the US Federal Customs Bureau, the General Administration of Customs is responsible for supervising and managing all inward and outward means of transportation, goods and articles, collection of customs duties, taxes & related charges, combating smuggling, compiling customs statistics, and handling other customs matters.

State Administration of Taxation (SAT)

Duties: The State Administration of Taxation organizes reforms of the tax administration system and supervises the implementation of tax laws, regulations,

and policies. It drafts tax laws and regulations; formulates detailed implementation rules for tax laws and regulations, and puts forward suggestions on tax policies.

As the body responsible for corporate taxation, foreign companies doing business in China will have to deal with SAT. At its March 2007 meeting, NPC promulgated the *Uniform Enterprise Income Tax Law*, which made the tax rate equal for both domestic and foreign-invested enterprises. The Chinese government has traditionally taxed foreign enterprises at only 15-17%, while domestic enterprises paid 33%. Now the two both pay 25%, although foreign enterprises that were already established as of March can enjoy a grace period before paying the 25% rate. The *Uniform Enterprise Income Tax Law* also introduced taxes for assets that Chinese and foreign-invested enterprises have moved offshore (many domestic and foreign enterprises move their assets outside of China for tax and other reasons). Any foreign company should speak with their China legal team to discuss their specific tax ramifications.

State Food and Drug Administration (SFDA)

Duties: SFDA is responsible for the comprehensive supervision of the safety management of food, health food, and cosmetics. It is also the country's drug regulator (this administration is analogous to the FDA in the United States).

National Bureau of Statistics (NBS)

Duties: The main function of NBS is to organize and implement national statistical surveys for economic and social development. They collect, process, and provide statistical data for the country or a specific region. Oftentimes the NBS's statistics, such as economic growth, are often revised. Because an extremely large portion of China's economy is transacted in cash, it is difficult for the NBS to provide meaningful and accurate statistics in this area.

State Administration for Industry and Commerce (SAIC)

Duties: SAIC is in charge of market supervision/regulation and related law enforcement through administrative means. Its main duties include drafting and promulgating guidelines, policies, laws, rules, and regulations concerning industry and commerce in China. Functions include:

- The handling and administration of the registration of all kinds of enterprises (including foreign-invested enterprises), organizations and individuals that are engaged in business activities (also includes representative offices of foreign companies).
- Examining and ratifying the registration of business names; reviewing, approving and issuing business licenses and carrying out regulations.
- Supervising market competition; investigating into illegal trade practices including monopoly, unfair competition, smuggling, selling of smuggled goods, pyramid selling and disguised pyramid selling.
- Investigating and penalizing illegal acts such as distribution of fake and/or substandard goods.
- Regulating the operation of brokers and brokerage agencies.
- Taking charge of trademark registration and administration, protecting exclusive right of trademark, investigating and penalizing trademark infringements and reinforcing recognition and protection of well-known trademarks.

SAIC will not have a direct role in approving foreign business ventures, however, as a major law-making, supervisory, and planning body, its opinions and desires will be reflected in decisions by other bodies.

State Intellectual Property Office (SIPO)

Duties: SIPO is the main body responsible for drafting Chinese patent laws and implementation of regulations. SIPO handles applications for new intellectual property patents and guides in settlements for patents disputes and investigations. SIPO is also responsible for study in all foreign related intellectual property policies and the development of international intellectual property. Contrary to world perception, China does have IP laws that are quite sophisticated. The IP problem in China has a lot more to do with enforcement rather than the absence of laws.

Xinhua News Agency (NCNA)

Duties: One of the largest news agencies in the world, Xinhua News has over 100 bureaus worldwide collecting and distributing information in seven different languages. Not only is NCNA China's largest news source, but it also publishes newspapers & magazines throughout Asia, the Middle East, South America, & Africa. NCNA is under direct control of PRC and is one of only two news agencies in all of China.

State Administration of Radio, Film and Television (SARFT)

Duties: The primary role of SARFT is to approve all radio, film and television content in China. CCTV, China's national cable network is operated by SARFT along with national radio and satellite networks. Although many in China receive foreign satellite programs (as well as counterfeit DVD's), both activities are actually illegal under PRC law, (as all unapproved foreign viewing content). In short, all foreign content, especially foreign films and television, must be approved by SARFT. SARFT has banned foreign investment into its radio and cable networks and has even placed restrictions on domestic investments. Although to the Western eye it may look like the "censorship bureau" they do in fact provide quality programming with some semblance to the U.S. FCC.

ADMINISTRATIONS & BUREAUS UNDER THE M&C

State Administration of Foreign Exchange (SAFE)

Duties: SAFE is responsible for the management and control of all foreign exchange. Its duties include drafting rules & regulations governing foreign exchange markets, overseeing market conduct and operations, promoting future development of the foreign exchange market, and analyzing and forecasting supply/demand positions in foreign exchange.

All foreign businesses operating in China will have to deal with SAFE. This government body regulates the flow of money moving out from inside China's borders. This will have implications for a foreign company wishing to set up an offshore structure. SAFE also requires offshore entities (discussed briefly in State Administration of Taxation section) to repatriate certain assets to China. Foreign companies should consult with their China legal team to understand SAFE's role in regulating their potential investment. That role can vary significantly on a case to case basis.

State Tobacco Monopoly Administration (China National Tobacco Corporation)

Duties: The State Tobacco Monopoly Administration is responsible for the centralized management of properties, products, supply, distribution, and domestic/foreign trade for the country's tobacco industry. In China today, it is estimated that over 30% of the male population smokes.

State Administration of Foreign Expert's Affair (SAFEA)

Duties: SAFEA designs the development strategy for the introduction of foreign intellectual resources into China. SAFEA is responsible for the administration concerning experts from abroad in the fields of economics, technology, management, education, science, culture, and healthcare. Their jurisdiction also includes experts working in foreign invested ventures, those working under import contracts and also key construction projects. This organization is also in charge of sending Chinese technical and managerial professionals from various Chinese government departments and enterprises to train overseas.

SPECIAL ORGANIZATIONS

Commission of State-owned Assets Supervision and Administration Commission of the State Council (SASAC)

Duties: The SASAC guides and pushes forward the reform and restructuring of state-owned enterprises. SASAC supervises the preservation and growth of the value of state-owned assets for enterprises under its supervision, and enhances the management of state-owned assets. It appoints and removes top executives of enterprises in accordance with the requirements of the socialist market economy system and the modern enterprise system. In addition, it administers strategic adjustments to the structure and layout of the state economy. Like many other ministries, SASAC's branches exist at the central, provincial, and local levels.

When foreign companies invest in state-owned enterprises (SOEs) or other state-owned assets, SASAC is closely involved. It often directly owns and administers an SOE's state-owned shares. In addition to the other relevant government bodies mentioned above, SASAC will have to approve the purchase of state-owned shares.

The first half of 2007 witnessed a significant development in the realm of acquiring state-owned assets. SASAC declared that companies (both foreign and domestic) cannot acquire state-owned assets for less than 10% "below market value." It enacted this policy in response to years of foreign investors scooping up state-owned shares and other assets for well below market value (often using asset value as a valuation benchmark). The rule leaves little room for negotiations, and has killed numerous deals already. The surge in China's stock markets in 2006 and 2007 led to the overvaluation of many Chinese companies. Without the ability to discount sales prices too far below those astronomical valuations, the execution of some deals is virtually impossible.

ADDITIONAL DEPARTMENTS OF THE STATE COUNCIL:

The following is a list of other Ministries & Commissions, Organizations, Institutions, and Administrations & Bureaus not included in this report.

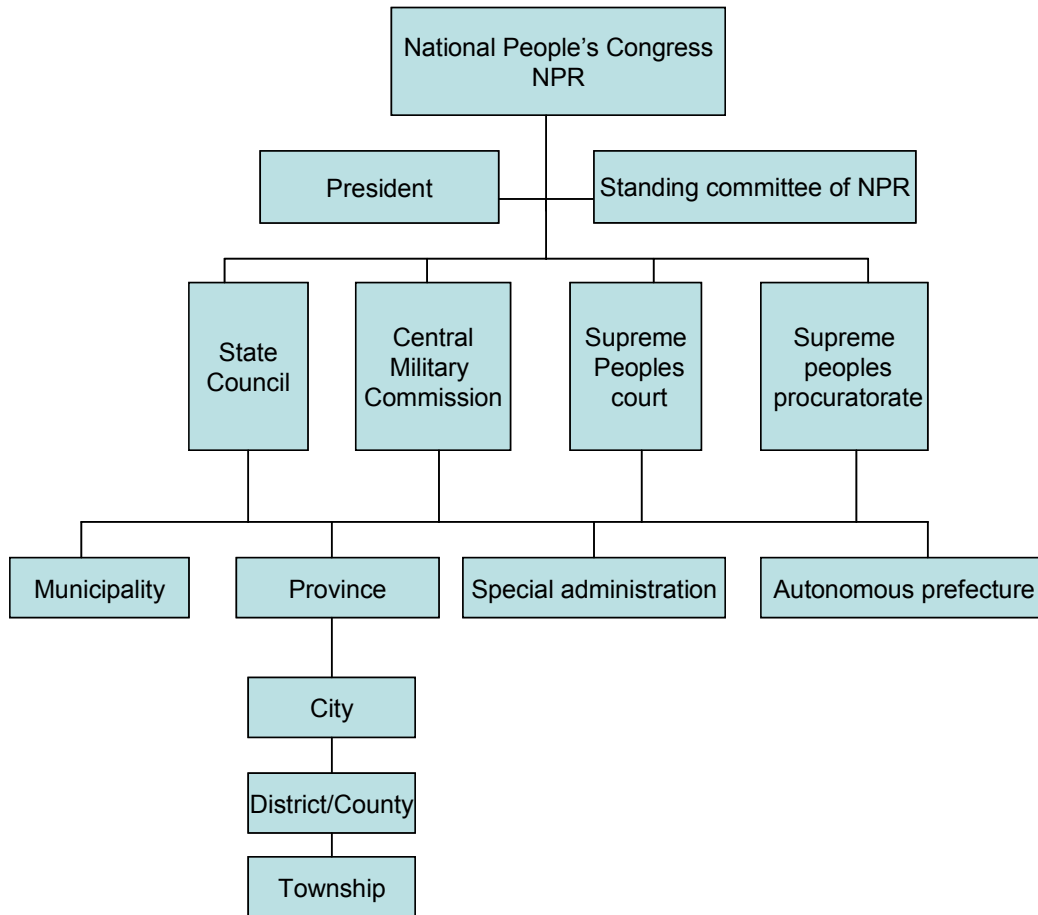
Ministries & Commissions:, Ministry of National Defense, Ministry of Education, Ministry of Science and Technology, State Commission of Science, Technology and Industry for National Defense, State Ethnic Affairs Commission, Ministry of Public Security, Ministry of State Security, Ministry of Supervision, Ministry of Civil Affairs, Ministry of Justice, Ministry of Personnel, Ministry of Construction, Ministry of Railways, Ministry of Information Industry, Ministry of Agriculture, Ministry of Culture, Ministry of Health, State Population and Family Planning Commission, National Audit Office

Organizations: General Administration of Customs, General Administration of Quality Supervision, Inspection and Quarantine, State Environmental Protection Administration, General Administration of Civil Aviation, General Administration of Press and Publication (National Copyright Administration), General Administration of Sport, State Forestry Administration, State Food and Drug Administration, State Administration of Work Safety, National Tourism Administration, State Administration for Religious Affairs, Counsellors' Office of the State Council, Government Offices Administration of the State Council.

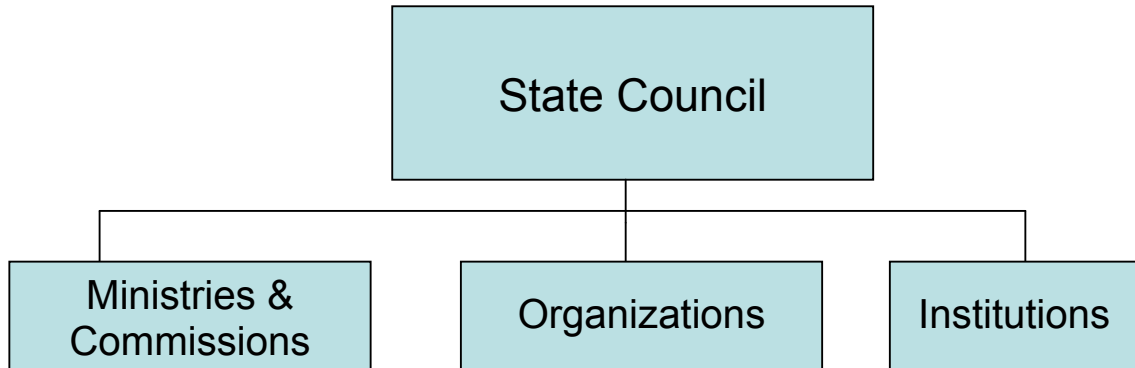
Institutions: Chinese Academy of Sciences, Chinese Academy of Social Sciences, Chinese Academy of Engineering, Development Research Center, National School of Administration, China Earthquake Administration, China Meteorological Administration, National Natural Science Foundation

Administrations & Bureaus: State Bureau for Letters and Calls, State Administration of Grain, State Oceanic Administration, State Bureau of Surveying & Mapping, State Post Bureau, State Bureau of Cultural Relics, State Administration of Traditional Chinese Medicine, State Archives Administration,

Appendix B: State Structure for the Peoples' Republic of China



Appendix C: Structure of the State Council



- Ministry of Commerce (MOFCOM)
- Peoples Bank of China (PBC)
- Ministry of Foreign Affairs
- State Administration of Foreign Exchange (SAFE)
- Ministry of Finance (MOF)
- Ministry of Labor and Social Security
- Ministry of Land and Resource
- Ministry of Water Resources
- State Administration of Foreign Exchange (SAFE)
- State Administration of Foreign Expert's Affairs (SAFEA)
- State Tobacco Monopoly Administration (China National Tobacco Corporation)

- General Administration of Customs
- State Administration of Taxation (SAT)
- State Administration for Industry and Commerce (SAIC)
- State Food and Drug Administration
- State Intellectual Property Office
- National Bureau of Statistics (NBS)
- Commission of State-owned Assets Supervision and Administration Commission of the State Council (SASAC)

- China Banking Regulatory Commission (CBRC)
- China Securities Regulatory Commission (CSRC)
- China Insurance Regulatory Commission (CIRC)
- State Electricity Regulatory Commission (SERC)
- National Council for Social Security Fund (NCSF)

Note: not all government agencies are included in the above chart