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CONTENTS

A dynamic spirit

Tencent's legal director of investments and acquisitions Yan Li discusses with *China Law & Practice* the importance of keeping up with anti-monopoly, data privacy and industry-specific laws as well as why Shenzhen is the ideal place for entrepreneurship

What is your role at Tencent and what is the structure of your legal team?

I head the legal M&A team, which provides legal support related to acquisitions, investments and exits – basically all the M&A work worldwide. Our team has seven lawyers, including those in Shenzhen, Shanghai and the US.

What is a typical day like for you at Tencent? What are the biggest challenges of your job?

I can't say that there is a typical day but at any given moment we may have more than dozens of active deals. The company has deals constantly coming in and going out, so I need to work through a lot of emails which takes up a lot of my time. I will get more closely involved for particularly complex issues of deals that require hands-on management. Larger strategic deals can get more intense.

What are the biggest recent legal developments that have affected your work?

Of all our investments worldwide, the majority is still in the China market. The development of PRC laws and regulations is therefore important to us. We follow them closely, for example, studying the Anti-monopoly Law is crucial as we need to know how the merger control and review process works. We also keep a watch on other developments, such as the recent SAFE regulations that affect our cross-border investments. We also remain up to date with the general rules and regulations of our industry, specifically internet and new media such as online streaming of TV and movies. The developments in data privacy laws are always on our radar too.

What are some specific challenges to M&A? What has the company's M&A experience been like and how do you see the M&A landscape changing?

There are a multitude of challenges – in general, the internet industry in China is one of the more healthy and competitive industries where private entrepreneurship and creative ideas keep it really dynamic. There are many smart people and new companies that pop up as well as new ideas and inventions that get put into practice. It's absolutely necessary to monitor the industry closely. As we grow in size, we do more and more deals. The number of deals we do alone is a challenging factor for us. But we have handled that successfully so far. There are always legal developments, though sometimes the laws and regulations could be more clear cut and allow private companies like us to do more deals. On the international front, we deal with lots of companies entering new markets all over the world and encounter new jurisdictions with regulations different to what we are accustomed to. Internet companies tend to have a universal footprint since the internet is a global community, compared with traditional industries.

We have witnessed crazy growth. Our legal team was much smaller when I first joined three years ago. We weren't doing as many deals as we are doing now and the deals are increasing in size and being publicised in the press. And this trend is not exclusive to Tencent, as we see that, in general, Chinese companies are becoming more active in M&A worldwide.

What are some recent regional regulations that have affected Tencent's operation or investments?

The Qianhai special economic zone in Shenzhen has a number of encouraging policies. It is where we and other partners have set up one of the first private banks approved in China, for example. We are also looking at lots of other opportunities there and designing multiple projects to take advantage of that area. Qianhai's policies are attractive to us.

What are the benefits of having the company's headquarters in Shenzhen as opposed to elsewhere in China?

Shenzhen has an advantage in that it is very entrepreneurial. There are many internet companies and smart people. It is very close to the manufacturing base as well as to Hong Kong. It is the ideal location for entrepreneurship as there is much talent in software and hardware engineering. It is where our company grew up.

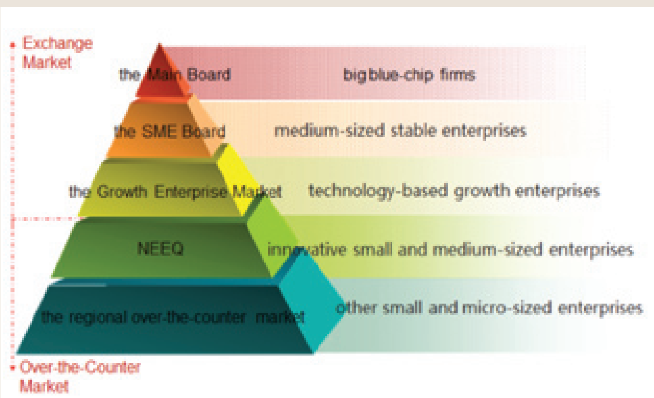
The city is extremely service oriented and provides a contrast to Shanghai and Beijing. The feel of the city is more entrepreneurial than commercial and you can feel this energy in the air. It's really China's modern city.

A new investment system

The development of multi-level capital markets provides new opportunities for venture capital and private equity investment. The benefits are amplified in Guangdong, where the various equity exchanges boost the development of tech companies

In January 2013, the China Securities Regulatory Commission (CSRC) decided to accelerate the development of the multi-level capital markets in which means of fund-raising complement each other to satisfy the financing demands of various sizes and types of enterprises. The CSRC aims to gradually reform the national capital market system to a four-level pyramid ecosystem, which include the main board (including the SME board), the growth enterprise board, the NEEQ (national level over-the-counter market) and the REEM (regional over-the-counter market). Each level of the capital market system will provide different listing criteria for different types of enterprises, such as financial indicators, information disclosure and modes of transaction and supervision, to preliminarily realise a new structure involving diversified entities, multiple sources of funds, various methods of investment and the marketisation of project construction. More importantly, a healthy multi-level capital market will refine the economic structure, raise investment returns and promote coordinated development and overall social advancement.

On December 14 2013, the State Council released the *Opinions on Issues Relating to the National Equities Exchange and Quotations*. The CSRC then issued the *Measures for the Supervision and Administration of Unlisted Public Companies* and seven other related rules. As a result, the NEEQ, which implements a promoter brokerage system, had been established in December 2013. Any Chinese joint-stock enterprise, which has continuously operated in compliance with the regulations for more than two years, can be listed in the NEEQ upon the recommendation of promoter brokerages. Companies whose shares are quoted in the NEEQ are non-listed public companies and the number of shareholders may exceed 200. In addition, the NEEQ will implement a system for managing the appropriateness of investors. Investors participating in share transfers should possess experience in securities investment, risk identification and bearing capacity.



By mid-August 2014, more than 1,000 joint-stock companies have been listed in the NEEQ. The number of listed companies in the NEEQ is expected to exceed the total number of that in main board and growth enterprise board in the next year.

The rise of Guangdong

Guangdong province is on the South China Sea coast of China. Since 1989, Guangdong has topped the total GDP rankings among all provincial-level divisions. It is home to the production facilities and offices of a wide-ranging set of multinational and Chinese corporations and also hosts the largest Import and Export Fair in China called the Canton Fair in Guangzhou, the capital city of Guangdong province. With the support of a good economic environment, Guangdong has recently focused on developing the financial industry and expanding the levels of the capital markets. According to the *Opinions on Issues Relating to the reform of Financial Industry and Improve the Financial Market System* released by the General Offices of the Guangdong People's Government in June 2014, Guangdong will closely connect with Hong Kong and Macau and become one of the international financial centres in the Asia-Pacific region.

Various assets and equity exchange centers will be set up in Guangdong, such as an emission rights trading centre, intellectual property trading centre and cultural property trading centre

The increasingly sophisticated economy in Guangdong calls for a more accommodating and multi-level financial system. Also, the Guangdong government is following the instructions in the Opinions released by State Council in December 2013. Guangdong has developed the provincial level unified property rights exchange centre and several financial centres such as the Regional Financial Center of Shenzhen, Shenzhen Qianhai, Zhuhai Hengqin, the Guangdong High Tech Service Zone for Financial Institutions and the Guangzhou Nansha Financial Service Zone. The Guangdong High Tech Service Zone for Financial Institutions is a good example of financial centres as it is built to attract large global financial institutions, financial service outsourcing enterprises and new industries to set up headquarters, branches or service centres in the Zone. Also, various assets and equity exchange centers will be set up in Guangdong, such as an emission rights trading centre, intellectual property trading centre and cultural property trading centre.

Reforming Guangdong's multi-level capital markets

In constructing multi-level capital markets in Guangdong, there are the main board, the SME board and the growth enterprise market with the Shenzhen Stock Exchange and the REEM with different financial service zones in Guangdong. The REEM expands the share transfer system, which provides a necessary platform for the transfer and distribution of shares of unlisted public companies under unified supervision. The REEM provides a new platform for small and micro-sized unlisted companies to increase their financial value and raise capital. For example, it is easier for small and micro-sized companies to attract venture capital investment and complete fair transactions in such an open market. Considering the size and maturity of the companies in the REEM, it usually does not have strict rules regarding the government approval procedure, registration and exchange fee and compulsory disclosure requirements. Moreover, unlisted companies, which do not have the form of corporation such as partnerships, and limited liability companies can also trade in the Guangdong REEM. The REEM is helpful for developing the unlisted companies into larger-sized companies and preparing them to enter a higher-level market. It is also a new and effective market for those accredited investors looking for targets and investment.

As one of the benchmarks of the REEM and important to the construction of the regional financial centre in Guangdong, the Guangzhou Equity Exchange (GEE) officially opened in August 2012. In the GEE market, the listed companies can raise funds utilising their equity shares as well as by way of loans facilities. By mid-August 2014, over 780 enterprises have listed in the GEE and raised over Rmb2.65 billion worth of funds. At the same time, a series of favourable policies and convenient measures have been adopted for subsidies for enterprises' listing expenses. Through a government subsidy, enterprises will not increase the cost of financing after entering the GEE market. The GEE will influence economic development in the peripheral areas of the Pearl River Delta and the Pan-Pearl River Delta region so as to facilitate the formation of a new pattern of regional economic development characterised by mutual and complementary advantages.

Another striking example of the REEM is Qianhai Equity Exchange (QHEE) which aims to solve the financing problems of small and micro-sized enterprises. Operating in May last year, the QHEE was regarded as the second Shenzhen Stock Exchange. With

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an average of nearly 10 enterprises listing every day, it has become one of the most active regional over-the-counter markets. By mid-August 2014, over 3,800 enterprises have listed in the QHEE, according to figures compiled by its official website. The figure also shows the enterprises in Guangdong province accounted for 77% of the listed enterprises. The QHEE is expected to be the first exchange platform between small and medium-sized enterprises and foreign investors if relevant policies also open up to foreign capital and companies.

Meanwhile, as the third regional equity exchange, the Guangdong Equity Exchange (GDOTC) officially opened in July 2013. It mainly provides professional financial services to high-tech and innovative enterprises as well as small and medium-sized enterprises. In the GDOTC market, there are more than 800 enterprises registered and about 27 enterprises listed.

On August 21 2014, the CSRC issued the *Provisional Measures for the Supervision and Administration of Private Equity Investment Funds* (Provisional Measures). According to the Provisional Measures, the standard of qualified investors involved in private equity investment funds has been established and the rules of raising funds and operating private equity investment funds have been specified. These measures not only ensure relatively free space but also regulate management for all kinds of private equity investment funds.

A new investment system emerges

Through the strengthening of reform and further opening up of the capital markets, a new type of investment system takes shape in which investment is led by the market. Enterprises have autonomy in decision-making, financing methods are diversified, and efficient macro-economic adjustment and control will eventually be established. According to the statistics of the Office of Financial Affairs of the Guangdong Provincial People's government, there were 23 fund management companies and over 610 venture capital/private equity funds in the capital markets by the end of May 2014. The majority of the companies listed on the NEEQ are start-up technology companies. More and more venture capital/private equity funds have begun to hunt for investment targets in the NEEQ and REEM markets. The market-maker system has been introduced to help the listed companies and investors in reaching a win-win result in the NEEQ by the end of August. It is expected that the fast development of the NEEQ and REEM systems will bring great opportunities to venture capital/private equity funds and start-up tech companies in the coming years.

Aron Hu and Leo Li, Zhong Lun Law Firm, Guangzhou

Getting the most out of property purchase contracts

Foreigners who purchase houses in China often run into disputes and are unable to enforce their contracts. They are advised to understand how the Chinese courts deal with these issues and put in the right clauses

According to the *Opinions on Regulating the Access to and Administration of Foreign Investment in the Real Estate Market* (Opinions), a foreign institution or individual that wishes to purchase a house in China must comply with the following regulations, which have been in effect since July 11 2006:

- A branch or representative office, established in China by an overseas institution (except for an enterprise that has been approved to engage in real estate operation) or a foreign individual that has worked or studied in China for more than one year may purchase a commercial house according to his actual needs of self-use or self-accommodation, but may not for other reasons. An overseas institution without any branch or representative office in China or a foreign individual that has not yet worked or studied for more than one year in China may not purchase a commercial house. A Hong Kong, Macau or Taiwan resident or an overseas Chinese may purchase a commercial house of a certain area for self-accommodation within China in line with his needs.
- Overseas institutions and individuals that meet the relevant provisions must adopt a real-name system for purchasing commercial houses for self-use or self-accommodation, and, upon effective certification (an overseas institution must hold the certification issued by the relevant departments on the establishment of a China-based branch, while a foreign individual must hold the certification for his work and study in China issued by the Chinese party), they may register for rights to land use and/or house property with the administrative departments of land and real estate. The administrative department in charge of the registration of property rights will, in strict accordance with the principles of self-use and self-accommodation, handle the registration of the overseas institution and individual, and will not register for any house that fails to meet the relevant conditions.

Validity of the purchase contract

According to the Opinions, a foreign buyer cannot purchase a house in China if it does not satisfy the right conditions. However, in practice, due to reasons such as the rapidly-appreciating value of property, there are foreign buyers signing to purchase houses in China from time to time. They often resort to the Chinese courts after disputing with the other party of the purchase contracts.

The Chinese courts' understanding and application are different from those of the administrations. Even if a foreign buyer's contract to purchase a house in China does not comply with the Opinions, the Chinese courts may still deem them as valid due to the following reasons:

- Article 52.5 of the *PRC Contract Law* (implemented on October 1 1999) provides that a contract that violates mandatory provisions of laws and administrative regulations is invalid.
- Pursuant to the *PRC Legislation Law*, while the law is formulated by the National People's Congress and its Standing Committee, the administrative rules and regulations are formulated by the State Council.
- Article 4 of the *Interpretation on Several Issues Concerning the Application of the «PRC Contract Law» (1)* by the Supreme People's Court (SPC) provides that after the implementation of the Contract Law, the courts shall confirm a contract as invalid based on the laws formulated by the National People's Congress and its Standing Committee, and the administrative rules and regulations formulated by the State Council, rather than on regional laws and administrative rules.
- The Opinions belong to an administrative normative document created by ministries and commissions directly under the State Council, and its effect is even below the administrative rules.
- Therefore, according to the Contract Law and the *Interpretation on Several Issues Concerning the Application of the «PRC Contract Law» (1)*, the court will not apply the Opinions to avoid the contract of a foreign buyer's house purchase in China.

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Partner

Kent Woo graduated from the School of Law at Sun Yat-sen University with a major in International Law. He later also received a master's degree in International Business Law from the University of Manchester. Before joining Guangda, he worked as a legal consultant for a large London-headquartered British law firm in Guangzhou and then as the general legal counsel for a major US IT company in Beijing.

Kent has considerable experience in corporate, IP and commercial transactions in China, with a particular expertise in foreign investments into China. His clients are mainly major multinational corporations from Europe, the US, Japan and Hong Kong. His advice often involves creating client-specific strategies for entry into the China market and drafting and negotiating corporate documentation in all aspects, ranging from those related to the setting up and operation of foreign invested companies to the acquisition of major state-owned enterprises and compliance. As an experienced lawyer well-versed in international legal issues, he speaks fluent English and Chinese.

In addition to his client work, Kent has contributed to a number of publications including Asia Law & Practice and Sweet & Maxwell on foreign investment into China.

This has become the common approach of the Chinese courts. For example, the SPC's verdict of the 2012 Civil Appeal No. 1268 states that the Opinions do not affect the validity of the related house-purchase contract and the reason raised by the involved party does not support the invalidity claim.

The SPC is increasingly respecting party autonomy. Even when laws and administrative regulations have mandatory provisions, the SPC will further divide them into regulatory and validated mandatory provisions and will not avoid contracts purely based on the regulatory mandatory provisions.

Cancelling the contracts

Although the courts deem the foreign buyer's house-purchase contract as valid, the contract cannot be enforced and the property of the house cannot be transferred to the foreign buyer due to the Opinions. As a result, the courts will generally decide to cancel the contract.

However, courts in different regions have different approaches to cancelling a contract. Most courts decide that only the purchase price paid together with certain interests are returned to the foreign buyer. Some courts decide that the added value also belongs to the foreign buyer.

For example, the Guangzhou Intermediate People's Court awarded the added value of a purchased house to a foreign buyer in a recent case. In that case, Mr C (a natural person from America) entrusted Mr Z (a natural person from China) to purchase a house in Guangzhou. Later, Mr C provided Mr Z with a purchase price of over Rmb1.5 million. In 2012, the property was registered under the name of Mr Z and the market value of the house rose to Rmb3 million. Mr C sued Mr Z for returning the house property or the market price of the house. After the trial, the court deemed that there were policy barriers regarding Mr Z's return of the house to Mr C and transfer of the title to the house under the assistance of Mr C. Thus, the property was only able to be registered under the name of Mr Z. As Mr Z did not provide opposing evidence concerning the value of the house, Mr C's claim for Mr Z's return of over Rmb3 million of the estimated market value was deemed reasonable and lawful, and was therefore upheld by the court.

> **A foreign buyer who signs a contract to purchase a house in China should add a specified clause in the contract to secure his returns**

Given the situation above, we suggest that a foreign buyer who signs a contract to purchase a house in China should add a specified clause in the contract to secure his returns. The clause would provide that if the contract must be cancelled because it cannot be performed according to the related Chinese provisions, the foreign buyer has the right to own the added-value income in addition to the returned purchase price.

Liability for breaching a contract

A foreign buyer needs to consider another factor when signing a house-purchase contract. Related contracts generally specify a similar clause such as "*the foreign buyer is aware of the related policies regarding the limitations of house purchasing, and the foreign buyer undertakes that if the purchase contract cannot be recorded, registered or transferred due to the unconformity of the related house with the provisions of Chinese laws, regulations and policies, the foreign buyer shall bear all the risks and liabilities arising therefrom*." In other words, the foreign buyer alleges that, as an overseas subject, it is not familiar with the policies of China, and thus shall not assume the corresponding liabilities (which usually refers to the liability of late payment) for a breach of contract. The Chinese courts will probably not uphold this allegation. In contrast, the courts will require the foreign buyer to assume the corresponding liabilities for a breach of contract, and the foreign buyer must assume the heavy liabilities for this breach because it usually cannot pay due to the administrative policies on foreign exchange. We suggest the foreign buyer to revise the above-mentioned clause in the house-purchase contract to "the foreign buyer shall not be liable if the late payment or cancellation of the contract is attributable to the related provisions of China".

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Navigating the dangers of mergers

The merger process in China can be long and painful. This is primarily due to the lack of detailed implementing rules and un-reconciled discrepancies among governmental authorities

China has entered a critical stage of economic restructuring after 30 years of steady growth. Many industries have suffered from overcapacity, slowing growth, falling profits and soaring costs, and are facing challenges of optimising and upgrading their industrial structure.

More and more foreign investors strive to eliminate outdated capacity and build new competitive edges through the restructuring of their China businesses and operations. They naturally come up with the idea of corporate restructuring by the way of merger, which, through reducing the numbers of corporate entities, may facilitate the reduction of management costs, enhancement of operation efficiency, optimisation of resource utilisation and, most importantly, achievement of tax benefits through utilising losses of the merged companies. Moreover, the tax liabilities arising from ordinary assets transfer are normally not applicable to mergers. Nevertheless, the aforesaid benefits could be substantially compromised by the merger process, which is very complicated and time-consuming in reality. The business may even be interrupted if the merger is not properly planned and executed.

Chapter 9 of the *PRC Company Law* provides for two types of mergers, namely a consolidation merger (新设合并), under which two or more companies will be dissolved and consolidated into one newly established company, and an absorption merger (吸收合并), under which one or more companies (the dissolving company) will be dissolved and absorbed into an existing company (the surviving company), which will absorb the former and survive the merger.

Complicated and time-consuming process

An absorption merger is supposed to be simple and straightforward (compared with an ordinary assets transfer) because the assets and liabilities of the dissolving company conceptually would be automatically succeeded and assumed by the surviving company. However, according to Article 179 of the Company Law, as well as the *Merger and Division of Foreign Investment Enterprises Provisions* (关于外商投资企业合并与分立的规定) jointly issued by the State Administration for Industry and Commerce (SAIC) and the predecessor to the Ministry of Commerce in 2001, the dissolving company is required to undergo de-registration with the authorised local Administration for Industry and Commerce (AIC), which leads to a number of complications.

Firstly, as a result of the AIC de-registration, the de-registrations with tax authorities will need to be completed beforehand, according to the *Implementing Rules for the PRC Law on the Administration of the Levy and Collection of Taxes* (税收征收管理法实施细则) promulgated by the State Council in 2002 and amended in 2012. Due to the lack of special procedures of tax de-registration for the merger, in practice, the dissolving company would have to go through essentially the same procedures as those for the normal dissolution and liquidation of a company, a complicated and lengthy process that could take over a year.

During the process, the tax authorities may scrutinise the historical tax filings of the dissolving company, initiate a tax audit and impose penalties for any irregularities or non-compliance spotted.

Furthermore, many tax authorities will not process the tax de-registration unless and until the dissolving company ceases to generate revenue or incur liabilities, which comes from the customary practice and requirement for normal dissolution and liquidation (where there will be no business generating revenues or incurring liabilities during the course of tax de-registration). Meanwhile, for mergers, the practice will force the dissolving company to cease its business and operations and transfer all its business, employees and necessary operating assets to the surviving company prior to tax de-registration, which essentially requires the completion of the assets and business transfer prior to the merger and, consequently, dilutes the tax benefit (as ideally the merger will not trigger tax liabilities which arise from an ordinary assets transfer) and further complicates and prolongs the merger process.

Secondly, in order to ensure the continuity of the surviving company's business and operation, in many cases the company will need to set up a branch to take over essentially the same or similar operation at the premises of the dissolving company. If the business and operation of the dissolving company are subject to the possession of any extraordinary or special governmental approval, license or permit, the surviving company will also need to spend a substantial amount of time and resources to re-apply for such approval, license or permit, because none of these are directly transferrable (except for

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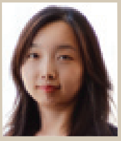
Luo Ke has advised equity and assets acquisitions by multinational companies or overseas listed companies in a broad spectrum of industries including healthcare, pharmaceutical, agricultural cultivation, consumer products, retail, real estate, logistic, telecom and manufacturing.

Luo Ke has substantial experience in foreign direct investment and has advised a large number of multinational companies and domestic Chinese companies in establishing, restructuring or dissolving their joint ventures or wholly owned subsidiaries in China in various industries. He also frequently advised on labour and employment matters, including compliance with labour laws, employees stock options plans, overall transfer or massive lay-off of employees.

Luo Ke is now a mediator of the Mediation Center of the South China International Economic and Trade Arbitration Commission, specialising in M&A, FDI, private equity investment and financing.

Luo Ke obtained a LLB degree from University of International Business and Economics in 1997. He had practiced in Guangzhou for four years before he joined Fangda Partners.

Zhang Yuhan



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a few governmental authorities such as the Ministry of Construction, which formulated a simplified application procedure for mergers).

As a result of the above, in reality it may take a surprising two or three years to complete the entire merger process. It is rather complicated, costly and hard to manage, and could unnecessarily divert the time and resources of the management.

Conflicting resolutions

The government has tried to simplify and facilitate the merger process. For instance, the State Council issued the *Opinion on Promoting the Merger and Re-organisation of Enterprises* (关于促进企业兼并重组的意见) and the *Opinions on Further Optimising the Market Environment for Enterprise Mergers and Restructuring* (进一步优化企业兼并重组市场环境的意见) in 2010 and 2014 respectively. In response, the SAIC issued the *Opinions on Duly Registering Company Mergers and Divisions so as to Support Enterprise Consolidation and Re-organisation* (关于做好公司合并分立登记支持企业兼并重组的意见) in 2011 and some other rules. Nevertheless, none of them worked out as intended due to the absence of adequate endorsement or corresponding rules from other government authorities such as the tax authorities.

For instance, the aforesaid SAIC rules permit the direct transfer of the branches of the dissolving company to the surviving company through the direct change of AIC registration, without going through AIC de-registration of the branches, but this may not be so feasible in practice. We have seen many cases in which tax authorities tend to ignore these SAIC rules and require the completion of tax de-registration of the branches concurrently with or prior to the tax de-registration of the dissolving company. Due to the lack of special tax de-registration procedures for mergers, the SAIC alone is unable to reconcile the discrepancies between its rules and the procedural requirement of the tax authorities.

Like other corporate restructuring subject to approvals and registrations, governmental support and endorsement could help expedite and smoothen the merger process, but the government appears to be less helpful with mergers compared with other corporate restructuring, due to the lack of coordination among the different authorities at both the legislation and execution levels.

What companies need to do

Companies in China should be careful with restructuring by way of merger, particularly those with extensive operations and a large number of corporate entities (including branches) and that are subject to regulation by many governmental authorities. In order to minimise the interruption to business and expedite the process, they must well-prepare a detailed merger plan that is reviewed from legal, financial, tax, business and compliance perspectives. They are also recommended to have pre-consultations with relevant local governments (regarding the re-application of operating licenses and permits by the surviving company, and most importantly, the tax de-registration procedure). Nevertheless, there will still remain uncertainties, difficulties and even risks associated with the merger process. Therefore, to justify the needs for mergers in China, it must be ensured that the benefits would substantially outweigh these risks.

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