# LEGAL REGULATIONS OF INWARD INVESTMENT IN THE UK AND CHINA

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## ABSTRACT

Inward investment is vital to the economic life of both the United Kingdom and the People's Republic of China. By injecting capital from overseas, it generates exports, creates jobs, and brings advanced technology and new management styles. Legal regulations and government policies in this regard are always geared to reflect a balance between encouraging foreign business activities and maintaining certain degrees of control upon them.

Based on expertise and experience that history shows, the United Kingdom offers an environment under which foreign investors can benefit from a rather complete legal framework. China today is also an attractive place for overseas capital, as its virtually limitless market is now becoming increasingly open to the world.

This thesis is designed to examine the structure and performance of respective legal regulations concerning inward investment in the United Kingdom and China. With a view of gaining enlightenment from each other's experience, the thesis identifies and compares the following aspects which are of close relevance to inward investment issues, including basic structure of investment market, adoption of investment vehicles, roles of financial markets, real

estate investment, taxation of investment behaviour, and settlement of disputes by arbitration. It is proposed that the analysis, materials and conclusions of this research may orientate foreign investors to get a deeper understanding about the UK investment market, and equally enable them to target their Chinese business in a more effective way.

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# CHAPTER 1

## BASIC STRUCTURE OF INVESTMENT MARKET

Inward investment behaviour produces profit as well as risk. The volume of foreign capital flowing to each country is largely subject to the effectiveness of the country's legal and economic framework that governs its current investment market. In consideration of the fact that such a regime is almost invariably established on the basis of actively accommodating towards foreign capital while at the same time preserving certain control upon it, the factors that work to shape the basic structure of inward investment market is identified as comprising two principal facets: a) a legal framework for protecting and regulating commercial activities of foreign investors; b) a business environment embracing both investment inducements as well as impediments.

This chapter examines the above two aspects in the UK and China. It contains a general introduction and analysis about the basic legal and economic structure of inward investment market in each of these two countries today.

PART I (UK PART):

Generally speaking, there is no obvious disparity in the legal treatment of foreign and domestic businesses in the UK. The law contains no category that is specifically divided as concerning inward investment, and governing principles must therefore be identified according to different circumstances from various legal regulations. Moreover, as the UK has acceded to the new European Union which is established on the basis of the European Community (EC), the relevant EC law also applies domestically.

The government takes a very liberal and open stance towards foreign capital, and places emphasis on its role in providing a pleasing business environment where confidence of investors can develop. The highlight of today's favourable elements lies principally in the facilities provided by financial services. In the meantime, unfavourable elements also exist and can mostly be reflected by the economy's overall underperformance, and in particular by the weakening of manufacturing industry.

## 1.1 OVERVIEW OF LEGAL FRAMEWORK

### 1.1.1 Impact of state policy upon legal treatment

Recognising the many benefits brought to the nation's

economy, the UK government implements a basic policy of encouraging investment from overseas. To this end, it offers foreign investors the same incentives as their local counterparts on the one hand, while applying all the legal regulations for carrying out commercial activities to both of them alike on the other. Adoption of this national treatment policy decides that unless the law or state policy otherwise indicates there is basically no incongruity in the legal treatment of foreign and indigenous businesses.

As there is essentially no independent division in the law which specifically deals with foreign investment matters, adoption of the relating legal regulations must therefore take a piece-meal approach by resorting to the basis reflected from various categories of the law in the context of different circumstances and requirements.

### 1.1.2 Legal impact from the European Union

The largest external legal impact in the UK comes from the European Union. Founded on the European Community (EC), the Union is committed to a regional economic integration policy based on the concept of an internal common market, i.e. an area without internal frontiers where goods, services and capital can move without hindrance, so as to realise its final goal towards establishment of a

political, economic and monetary union in Europe [1].

Being a member of the new European Union, the UK must perform its obligation to implement the EC law, which is directly applicable in the national legal order with the nature of supremacy [2]. Foreign investors are thus regulated under the legal framework of the relating law both in the UK and in the European Union. However, as many overseas businessmen investing in the UK not only consider the domestic market but contemplate a penetration into the European Continent as well, this unique legal and economic structure definitely presents them an easier access to the single European marketplace from which more business opportunities may be identified.

## 1.2 CURRENT BUSINESS ENVIRONMENT

### 1.2.1 Favourable factors

(1) General advantages

The UK is a rather ideal place for foreign capital as current business environment contains a number of inducements which are directed at stimulating creation of wealth and ensuring a fair level of protection for investors' interests.

Firstly, excepting certain strategic industries [3], there is essentially no constraint imposed by the government on any particular field in which foreign investment is not allowed to be involved. Secondly, infrastructure problems are generally solved, and foreign investors can benefit from a modern and efficient system of energy, transportation and telecommunications. Thirdly, exchange control has been removed. There is no restriction on investment from overseas and repatriation of profits, dividends or capital. Fourthly, compared with other major European nations, the UK is a low tax country. Business entities pay one of the lowest corporate taxes in the EU and also enjoy a number of tax relief treatments [4]. Fifthly, there is a range of industrial assistance available to foreign investors who invest in those areas in greatest need i.e. the so-called Assisted Areas, mainly comprising Regional Selective Assistance in the form of capital grants, and also some European investment incentives e.g. European Coal and Steel Community Loans and European Investment Bank Loans. And finally, as another selective support for inward investment, some Enterprise Zones have been designated and established by the government for the purpose of encouraging private sector activity in the zones by removing certain tax burdens and by relaxing or speeding up certain statutory and administrative controls [5].

(2) Special advantages represented by financial services

A distinctive superiority reflected from the current business environment lies in the facilities offered by the UK's financial markets, in particular by the City of London as one of the world's leading financial centres. The financial markets have a long-established reputation for their high degree of professionalism and maintenance of excellent standards of services and business conduct.

First, in the banking sector, foreign investors may have easy access to the credit market for raising finance, and to the retail market for any other general services. A highly modernised transaction network is now operating on the markets with involvement of a large number of various domestic and foreign banks, along with many other financial institutions of similar nature, among which competition is fierce.

Second, the UK is a major international centre for insurance and reinsurance business. Lloyd's as a world-famous incorporated society of underwriters based in London regulates its underwriting members that are organised into syndicates supplying a variety of insurance coverages on a basis of unlimited personal liability [6]. Today, Lloyd's is home to what is probably the world's greatest concentration of underwriting expertise [7]. And customers

may have a wide range of selection for services provided by domestic as well as foreign insurance institutions.

Third, the London Stock Exchange is one of the world's leading places for equity trading and plays a key part in maintaining London's role as a famous international financial centre. Foreign participants can greatly benefit from a highly developed primary market in which they can raise money through issue of shares, or offer funds and receive equities, and also from an active secondary market where they can more widely market and trade those financial assets among various investors.

Fourth, LIFFE, the London International Financial Futures and Options Exchange, is Europe's leading exchange and the third largest one in the world [8]. Trading on LIFFE is devoted to financial futures and options which are denominated in most of the world's major currencies. LIFFE provides for investors an environment where effective risk management of their funds can be accomplished, and profit speculation may be achieved.

Fifth, investors can also avail themselves of the UK's two major commodity markets: the London Metal Exchange where trading of standard quantities of metal can be made, and the London Commodity Exchange which is the world's primary centre for the trading of soft commodity futures and

options contracts. As settlements on the markets are mostly effected by payment of price difference under matched contracts with physical delivery rarely made, similar to LIFFE, the principal attraction of these two Exchanges lies in their financial nature, most notably risk management of fund and profit speculation.

### 1.2.2 Unfavourable factors

Unfavourable factors which may lower the momentum of overseas capital inflows come in the main from the negative impact made by the unsatisfactory performance of the economy as a whole, and especially by the dwindling competitiveness in world markets of UK-based manufacturing industry.

On the one hand, there is little doubt that by virtue of the long-term trend in productive capacity the UK's contemporary economy is in some form of general decline and is also not doing well at the moment [9]. The disappointing economic performance has brought about a shrinkage in demand on domestic markets in which consumption and purchasing powers are accordingly affected to a great extent. This becomes an obstacle which restricts foreign investors from tapping the potential of the existing consumer markets.

On the other hand, it is clear that the traditional international competitiveness can hardly be maintained by manufacturing industry today. Low expansion and slow renovation have left modern and technologically intensive industries disproportionally underdeveloped, while in the wake of increased competition particularly from third world nations many traditional industries are undergoing serious deterioration [10]. As a lot of foreign capital is targeted at manufacturing industry, enterprises based on present industrial foundations can scarcely be expected to comfortably occupy a place in the international competition, and it is especially true in the case of export-oriented businesses. Improvement of this situation will depend on the availability of the sector's overall structual change, which is a gradual process and requires in the first instance a large amount of investment in new facilities and technologies.

There is no single reason that can be highlighted as being responsible for the economic underperformance as well as the weakening of manufacturing industry. Correcting these problems will be subject to many complex and interlinked elements, some of which may not be purely of economic nature. Thus, it will be wrong to anticipate that the government can remove or even reduce the impact shaped by these unfavourable factors in a brief space of time.

PART II (CHINA PART):

Inward investment law is a special branch in its own right of China's legal framework as a whole. Two different groups of legal regulations govern investment from overseas and domestic sources respectively, and foreign investors can generally receive more favourable treatment than their local counterparts. Whilst the government takes a very active attitude as regards attracting capital from overseas, it also pursues an orientation policy by steering foreign investment towards the projects it particularly encourages, and away from those it restrains or prohibits.

In the current business environment, principal inducements lie within various tax incentive packages, which along with many other benefits emphasise on whether the project concerned is export-oriented or based on high technology, or whether it is located in any of several specifically designated geographical areas. In the meantime, the existence of unfavourable elements, including in particular the financial markets' immaturity and the legal regulatory framework's overall incompleteness, may undermine foreign investors' willingness to invest and to some extent counterbalance the positive role played by those incentive measures.

**1.3 OVERVIEW OF LEGAL FRAMEWORK**

### 1.3.1 Government attitude

The government welcomes inward investment by adopting a long-term policy of attracting it. Foreign businesses and individuals may invest in China and carry out various forms of cooperation with their local counterparts.

This attitude is basically rooted in the following two factors. First, an open-door policy that has been implemented since the late 1970s has altered the economic system from one based on self-isolation to one of actively pursuing economic growth by participating in international market and particularly by harnessing inward investment. Second, in early 1992, the country's constitution was amended to delete references to the old system of planned economy, which operated for more than forty years, enshrining a new goal of establishing a socialist market system [11]. This fundamental change has greatly accelerated the whole opening up process, and also to a large extent ensured the continuity and consistency of the government's stance towards encouraging capital inflows from overseas.

### 1.3.2 Perspective of legal treatment

China does not for the time being grant full national

effectively utilise inward investment by directing it towards specified industrial fields and geographical areas where development is in greatest need, and also to protect the interests of some fledgling domestic industries by keeping out outside competitors or at least reducing possible influences exerted by them.

Foreign capital is prohibited from flowing into key strategic industries [12], upon which the state will maintain its absolute control.

Because of the existence of a virtually limitless consumer market, service sectors, especially financial services, hold a special appeal to many foreign investors. However, they are now being listed as principal restrained fields where inward investment is restricted but may under certain circumstances be allowed to enter [13]. The general trend is that the government is gradually relaxing constraints in these regards, and whether foreign elements can be involved or not in a restrained field may become a quite negotiable matter in practice. To protect inexperienced domestic businesses in similar fields from being overwhelmed by their overseas counterparts, what the government usually does today is to confine admission of foreign elements into certain restrained investment fields to only a few big cities on the trial basis, and sometimes exclude them from taking a 100% stake in the concerned investment project by

treatment to foreign investors. The prevailing regime is based on the fact that there is a distinct disparity in the legal treatment of investment from foreign and Chinese sources. Foreign investors are treated differently from and in many cases more favourably than their local counterparts.

Several foreign investment laws in connection with various subjects have been enacted and are specifically tailored as measures for attracting foreign capital as well as entrenching state control upon it. Moreover, the conduct of inward investment is subject to a host of laws of general application, some of which may apply to both indigenous and overseas businesses, and also to some regional rules which are only tenable in specific local jurisdictions.

**1.3.3 Differentiated investment fields**

The government's positive attitude towards inward investment does not mean that foreign capital can liberally flow into any investment field. On the contrary, a series of orientation policies represented by the interim rules promulgated in June 1995 have been worked out to indicate the government's clear-cut stand as regards any particular field in which foreign involvement is encouraged, restrained or prohibited. This inclination serves to more

effectively utilise inward investment by directing it towards specified industrial fields and geographical areas where development is in greatest need, and also to protect the interests of some fledgling domestic industries by keeping out outside competitors or at least reducing possible influences exerted by them.

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keeping their share capital proportion under a certain limit.

Guidelines have been designed to steer inward investment towards the following major industrial fields and geographical areas: a) infrastructure sectors; b) high-tech industries; and c) China's central and western regions [14]. Great importance is attached to infrastructure sectors, as their poor facilities, especially in energy and transportation, have more and more become the bottleneck impeding the whole economy's healthy development at present [15]. The government equally sets great store by the performance of high-tech industries [16], which may bring about huge added values, and their development will play a vital part in switching China from today's labour intensive country to a technologically intensive market. So far as China's central and western regions are concerned, their economy on the whole lags behind that in other parts of the country [17]. Although abounding in natural resources, the central and western regions are severely short of funds for exploration and development.

## 1.4 CURRENT BUSINESS ENVIRONMENT

### 1.4.1 Favourable factors

In ongoing attempts to secure more inward investment, China

is now adopting an incentive system, which principally relies on tax preferences, along with other inducements in connection with foreign exchange facilities, import and export control, and business management requirements, etc., with emphasis placed on investment project's nature and its location as the bases for such preferences.

(1) Project-oriented inducements

Special preferences are given to businesses with foreign involvement that are denoted as export-oriented or advanced technology enterprises [18]. In order to receive export-oriented or advanced technology status, enterprises must establish export figures and the base of the technology in use. By granting incentives in this way, the state strengthens its capacity to steer foreign capital towards the investment fields which it particularly encourages.

(2) Location-oriented preferences

The emphasis on geographical location is more evident in the designation of a number of special investment areas where a more separate administrative tutelage and relaxed business control are available. The establishement of these special areas is predicated on their role as windows of China's open-door policy.

The evolution of these special investment areas has experienced four main stages.

The first stage started in 1980 with the establishment of four Special Economic Zones (SEZs) [19], which are geographically near Hong Kong, Macao and Taiwan. Preferential treatments offered to businesses established in SEZs which are wholly or partially funded by overseas capital are mainly pertinent to taxation, foreign exchange, land usage right, profit repatriation, and import and export control, etc.

The second stage covered the period from 1984 to 1988, during which a large number of coastal cities were opened to foreign investors with almost the same preferential policies as those applied in SEZs [20]. This expansion of special investment areas was based on the practical experiences accumulated from SEZs.

The third stage was represented by designating Hainan Island, an offshore island that is geographically separated from the mainland, the status of special economic region at the highest local administrative level (the provincial level) in 1988 [21]. Preferential policies applied in the Island are more generous than those for SEZs and coastal cities.

The fourth stage commenced in 1990 with building up "Pudong", an offshore part of China's largest city Shanghai, into a "New Area" [22]. In addition to incentives similar to those already available in SEZs, coastal cities and Hainan Island, a distinctive feature in Pudong New Area is that many restrained investment projects are permitted to be carried out in this special jurisdiction, including those in the fields of service industries, especially in financial markets.

### 1.4.2 Unfavourable factors

Whilst investment incentives can play an effective role as a catalyst for attracting foreign capital, unfavourable factors that exist in current business environment are highlighted as well by a number of obvious obstacles which may form a vital indicator of dilemmas to foreign investors.

First, the problem of serious inadequacy in infrastructure facilities, most notably in energy, transportation and telecommunications that are crucial to contemporary economic life, is now plaguing many cities in China. Improvement can hardly be expected in the short term and this will in turn greatly affect the initiatives of foreign investors. Second, a system of import/export licensing is operational, and any business set up in China will be

subject to the state control upon purchasing needed items from abroad as well as marketing products overseas. Third, highly qualified labour forces are in seriously short supply, and foreign investors may find it difficult to obtain suitable technical and managerial personnel from local sources. However, the most troublesome impediments come from the immature financial markets and more importantly from China's incomplete legal regulatory framework as a whole, both of which may to some extents give discounts to the effectiveness of those impetus measures taken for attracting foreign capital.

(1) Immature financial markets

China's immature financial markets can be characterised by the following three aspects.

First, the whole markets are still in the process of transition from a planned economy to a market economy. Lack of adequate laws and regulations that are in line with international norms results in many of their commercial functions not truly being corresponding with those in developed economy. Financial institutions have not yet been completely divorced from the state's central planning and unified administration, and therefore are still not enterprises with independent management responsible for their own loss and profit. Under such circumstances,

operational efficiency can scarcely be fully guaranteed.

Second, any business carried on in China will be subject to foreign exchange control under which repatriation of profits, dividends or capital is not entirely liberal.

Third, there is a high degree of monopoly among financial institutions with rather weak competition and low liquidity on the markets. In the banking sector, there are only five major specialised banks, whose respective activities used to be sharply demarcated, and which are now in the course of gradually changing into commercial banks engaged in general overlapping banking activities [23]. It is still difficult for foreign banks to extensively edge into domestic markets. Only upon satisfaction of many strict criteria and securement of special permission from the government can they be allowed to establish their presence in certain big cities, or in some special investment areas e.g. Special Economic Zones and Pudong New Area, and carry out trial operations which are confined to a very limited range of business [24]. The insurance market is now basically monopolised by domestic companies with only a few foreign concerns involved in some coastal cities [25].

Fourth, given the planning tradition and incomplete commercial nature of domestic banks, they may still have to obey some mandatory loans with different policy priorities

laid out by the government. And these interventions will compromise their proposed independent operations and directly affect foreign investors' financing demands from the markets.

And fifth, the securities market is still developing at an embryonic stage. China has not enacted its securities law so far, and therefore viewed from the angle of either raising finance or carrying on investment business, the securities market at the present time is by no means an appropriate place for foreign participation.

(2) An incomplete legal regulatory framework

The legal regulatory framework towards inward investment is one of the weakest areas in China's economic regime. A sound market system with corresponding regulations guaranteed is the major concern of foreign investors. Incompleteness of the legal framework and inconsistency of regulatory performance will have a negative effect on their willingness to invest and may discourage them from actively participating in China's investment market.

Although great efforts have been made, current legislation is far from adequate. There are many inward investment issues which the prevailing regulations fail to cover. Moreover, lack of precision and transparency is another

noteworthy problem. Many laws and regulations only provide a very general and sometimes a rather vague guideline, and in practice implementation of these legal principles may additionally require to be assisted by further elaboration of the relevant government departments which are given substantial discretion to interpret.

Inconsistency of regulatory performance occurs in various local jurisdictions and is reflected by lack of uniformity and consistency in the application of state laws. This behaviour is usually the product of some arbitrary local policies which are formulated by local governments and tailored for their regional development goals. As local measures may contradict national regulations in the course of execution, if the central government feels that they are poised to damage the entirety and consistency of state policies, it is likely that they will have to be revoked. In this circumstance, foreign investors already starting to pursue benefits under those local rules, may have a risk of being finally sacrificed.

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## CHAPTER 2

## ADOPTION OF INVESTMENT VEHICLES

The subject of inward investment is a vast and intricate one. What matters above all else is to choose and set up a suitable vehicle as a medium for access to the host country's investment market.

For foreign investors carrying on business in the United Kingdom, the most common entities are subsidiary companies or branches of foreign corporations. A company incorporated as a foreign corporation's subsidiary is a legal person separate from its parent and subject to the relating statutory provisions in the same way as all other domestic businesses. It can take the form of either a private or a public company, assuming its liability is limited by shares. A branch is an extension of a company incorporated overseas, and bears no distinct legal personality. The foreign corporation undertakes overall responsibility for activities of its UK branch.

Vehicles available to foreign investors in China normally take one of three forms: an equity joint venture, a co-operative joint venture (also referred to as a contractual joint venture), or a wholly foreign-owned enterprise. Each of them is by nature an independent legal person, whilst a

co-operative joint venture can be established with no such personality status. Three independent sets of foreign investment law are specifically designed to govern these vehicles respectively.

This chapter is devoted to exploring a number of important issues as regards formation of the above-mentioned investment vehicles, and its primary focus is on the ways in which these vehicles are organised to do business in British and Chinese investment markets.

PART I (UK PART):

A UK subsidiary company has a legal independence that is commercially indispensable. It is an entity whose existence, rights and duties are separate from the foreign parent corporation, and there is a clear indisputable line which sets the company's assets and liabilities, and business activities, apart from those of its owners. This facilitates dealings with outsiders and streamlines internal management. Foreign investors will have to decide whether the subsidiary company is to be a private or a public one, each of them fulfilling different economic purposes and subject to various statutory requirements as regards company registration, capital structure, objects clause, internal management, and disclosure of information. In a general sense, it will be much more onerous to incorporate a public company than a private one, but the genius of the former lies in its entitlement to offer shares to the public for raising fund whilst the latter is not allowed to do so.

A foreign company may set up its UK branch without difficulty although it must register as well. One major advantage of having such a branch as opposed to a UK subsidiary company is that its establishment and operation requires fewer legal formalities. However, as the branch is not separate from the foreign parent but merely becomes

a place of business in the UK with no independent personality, the main drawback of this vehicle is the requirement to disclose a lot of information about the parent corporation overseas.

## 2.1 ESTABLISHMENT OF A UK SUBSIDIARY COMPANY

A UK subsidiary company can be formed by registration under the Companies Act 1985 as amended by the Companies Act 1989 for a company incorporated in Great Britain. Section 1(1) of the 1985 Act allows two or more people to form an incorporated company for any lawful purpose.

A UK subsidiary company has several advantages: firstly, a subsidiary company has an independent artificial status, with the debts claimable only against itself but not the foreign corporation, no matter whether the subsidiary is actually directly controlled by its immediate parent undertaking or not; secondly, also because of this separate legal personality, a subsidiary company is able to enter into contracts on its behalf, and entitled to possession of property in its own name as well. Its rights and obligations that are distinct from the shareholders or owners are not subject to any alteration in the ownership; and thirdly, with a view of financing the business, a subsidiary company is likely to have facilities for raising large amounts of share capital in the event of its huge

membership.

However, some foreign investors may find that the principal disadvantage associated with the subsidiary company lies in its inability of preserving the privacy of business affairs, since many important documents will have to be filed at the Companies Registry and may thus become available for public inspection.

### 2.1.1 Company registration requirements

(1) Registration of a subsidiary as a private company

A private company is the residual class of companies without any special requirements [1], as section 1(3) of the 1985 Act merely defines it as one which is not a public company. The prevailing registration system enables foreign investors to set up its UK subsidiary as a private company by a simple procedure of registration with the Registrar of Companies.

For forming a private company, the following documents must be forwarded to the Registrar: a) memorandum of association which sets out the fundamental basis of the company's constitution including its name, objects, share capital and that the liability of its members is limited; b) articles of association which contains regulations for internal

management of the company; c) a statement of the first director(s) and company secretary, and address of the intended registered office; and d) a statutory declaration as to compliance with the requirements of the Companies Acts [2].

After receiving the above documents, the Registrar will examine them to see that they have been properly completed and the statutory requirements have been complied with. When satisfied, the Registrar will issue a certificate of incorporation. A private company comes into existence at this point and can commence trading immediately.

(2) Registration of a subsidiary as a public company

In the case of foreign investors who consider setting up a vehicle through which they can obtain the capital the subsidiary needs by offering shares to the public, they should opt for a public company. In this instance, registration will be subject to more strict statutory requirements than those for a private company, and normally involves two principal stages.

First, the applicant must be able to offer shares to the public for subscription. And as such an offer is unlikely to be a success without a ready market, the offer usually has to be combined with an application for listing on the

Stock Exchange, which is a complex and expensive process, and must comply with the rules of the Stock Exchange as well as those laid down in the financial services legislation.

Only upon the successful securing of the required share capital through a public offer can the applicant enter the second stage. At this stage, the applicant must in addition to the documents required for a private company also file the following information with the Registrar, comprehending: a) it has stated that it is a public limited company both in its memorandum and in its name; b) it has issued at least £50,000 nominal value of shares, and each share alloted has been paid up to at least one quarter of its nominal value plus any premium [3].

Under section 117(1), a company registered as a public company shall not do business or exercise any borrowing powers until the Registrar has issued it with a certificate of incorporation upon satisfaction that all the necessary statutory requirements for registration of a public company have been met by the applicant.

### 2.1.2 Capital structure requirements

(1) Initial share capital requirements

With a private company, the problem of initial share capital is not conspicuous as this will be contributed mainly by the founders. With a public company, share capital will be largely obtained from outside investors whom the company invites to subscribe for shares in the enterprise. In either form, before commencing trading, a company must first of all acquire the necessary share capital to which its creditors, if any, can look for security of payments of their debts.

A share capital is the ultimate fund for paying liabilities to creditors, and according to section 2(5)(a) there must be stated in the memorandum of association the amount of share capital with which the company proposes to be registered and its division into shares of a fixed amount. This capital, called the nominal capital or the authorised capital, is important only in that it represents the aggregate amount of shares which the company may issue [4]. There is no restriction on the maximum level of authorised share capital. There is also no requirement set for a private company regarding the authorised share capital minimum. However, in the case of a public company, by sections 11 and 118(1), the authorised minimum share capital is £50,000 which in practical term is not a high figure and the company may have a considerably larger share capital than the minimum if it thinks necessary.

As the authorised capital represents the face value of the total number of shares which the company is authorised to issue only, it does not necessarily mean that the company needs to issue all its capital at once. The actual or issued capital will depend on how many shares are issued [5]. The concept of the issued capital is of little importance to a private company as there is no statutory minimum requirement for it in this regard. As to a public company, according to section 117(2), it must issue and allot shares to the nominal value of not less than the authorised minimum, i.e. £50,000 of issued capital. Section 101(1) further requires a public company to have at least one quarter of the norminal value of a share and all the premium on it fully paid up.

(2) Requirements for increase or reduction of share capital

It is likely to change the amount of share capital according to circumstances, and in practice there is less difficulty in doing this with a private company than with a public one, as the former is of little relevance to offering shares to the public.

An increase is usually encouraged. This involves increasing the authorised share capital, if all that has been issued, and finding people to take up new shares. Section 121(2)(a) allows a company upon authorisation by

the articles to exercise the power of increasing its share capital by passing a resolution in general meeting. It should be noted that within fifteen days after passing of the resolution, a notice of the amount of the increase must be filed with the Registrar (section 123(1)).

Due to the fact that a share capital sets the limit of fund for paying liabilities which will not exceed the amount unpaid on the shares taken by shareholders (section 1(2)(a)), a reduction is potentially dangerous, especially in the case of a public company, and share capital in normal circumstances cannot be reduced except under an order of confirmation made by the court. Section 135 provides that subject to the confirmation by the court, a company may, if authorised by its articles, by special resolution reduce the share capital and alter the memorandum of association by reducing the amount of its share capital and of its shares. The resolution for reducing share capital takes effect only on registration of the court's order of confirmation at the Registrar (section 138(2)). When the capital yardstick is reduced, according to section 135(2)(c), it may be accompanied by a repayment to the shareholders of the capital which is in excess of the company's want, and then both the capital yardstick and the assets of the company will be diminished to a corresponding extent, this sanction requirement serves the objective of safeguarding the interests of persons who

transact with the company so that the fund available for satisfying their claims shall not be abruptly lessened. Moreover, in the event of a public company, restriction is imposed upon it from reducing capital below authorised minimum. By section 139, if the reduction results in that the nominal value of a public company's allotted share capital falls below the authorised minimum, the court's confirmation order thus made will not be registrable at the Registrar and so does not become tenable until the company re-registers as a private one.

(3) Transfer of shares

There is no statutory restriction on transfer of shares.

In the case of a public company, shares must be free from restriction on the right of transfer if a Stock Exchange quotation is to be obtained since the purpose of such public listing is to make securities become more marketable.

A private company may in practice include in the articles a pre-emptive clause providing that no shares shall be transferred to any person who is not a member of the company so long as a member of the company can be found to purchase them. However, use of this pre-emptive clause is completely at the discretion of the company and it is not

a compulsory requirement imposed by statute.

(4) Restriction on distribution

Under section 263(2), a distribution is defined as any payment of a company's assets to its members. At this point, the existence of limited liability should be taken into account. The share capital of a company as a guaranteed fund for creditors must be maintained at least to such an extent that the paid-up capital will not be reduced. A company's resources therefore will not be distributed in any way which may prejudice the interests of unsecured creditors.

By section 263(1), a company may only make a dividend out of profits available for that purpose. And this is explained by section 263(3) as the total of accumulated realised profits less accumulated realised loss.

A public company is subject to further restrictions. According to section 264(1), a public company may only make a distribution at the time when the amount of its net assets is not less than the aggregate of its called-up capital plus undistributed reserves, and it must make sure that such a distribution does not reduce the amount of those assets to less than that aggregate. Also, a public company is restricted from including any uncalled share

capital as an asset in any account relevant for the purpose of distribution (section 264(4)).

### 2.1.3 Objects clauses requirements

Prior to amendment made by the 1989 Act, the objects clause contained in the memorandum of association of a company normally included every possible field remotely needed to be dealt with in the course of trade, and it may sometimes run to several pages for fear of being accused of ultra vires.

Insertion of section 3A into the 1985 Act by the 1989 Act enables a company to become a general commercial entity. By section 3A, a general commercial company is to carry on any trade or business, and do all such things as are incidental or conducive to the carrying on of these activities.

This new provision completely lifts the constraints levied upon the company's business scope, resulting in not only diminution of the previous redundancy in clauses but avoidance of the accusation for acting against ultra vires doctrine as well. Under this context, a company can freely be engaged in whatever commercial activity it thinks appropriate.

#### 2.1.4 Internal management requirements

(1) Requirements for company directors

The day-to-day management of the company should be entrusted to the board of directors who are responsible to shareholders for the overall management of the company in the context of the powers and obligations set out in the articles. Unless otherwise specified, there are no qualifications for becoming a director, nor is there any statutory requirement that a director must be a shareholder of the company. Foreign persons are not restricted from being directors and directors of a company incorporated in the UK are not required to be resident in the country.

Section 282 of the 1985 Act requires a private company to have at least one director and a public company to have at least two. Apart from this section, the actual number of directors can be regulated by the articles.

(2) Requirements for company secretary

Under section 283, every company must also have a company secretary, but the sole director cannot also be secretary. That is to say, in a public company, one of the directors may be secretary, while in a private company the same person cannot be both sole director and company secretary.

Section 744 defines the company secretary as an officer of the company. In practice, the secretary acts as the main administrative officer responsible for ascertaining the compliance of the company with legal requirements placed upon it by statute.

There is no requirement for the secretary of a private company to hold a particular qualification. However, the secretary of a public company especially in the event that the company is listed on the Stock Exchange must be highly qualified for the position either by profession or by experience. Section 286 requires the directors of a public company to secure that the secretary is a person who appears to them to have the requisite knowledge and experience to be a secretary, and he must have been a public company secretary for at least three out of the five years before his present appointment, or be a barrister, advocate or solicitor called or admitted in any part of the UK, or a member of one of the professional accountancy bodies or of the Institute of Chartered Secretaries and Administators, or be someone who because of his position or qualifications appears to the director to be capable of discharging the duties of a public company secretary.

(3) Requirements for registered office

By section 287(1), it is the duty of every company to have

a registered office to which all communications and notices may be addressed. And according to section 10(1), the information about the office shall be included in the memorandum and filed with the Registrar. However, there is no compulsory requirement that the company carry out actual business in the registered office. In practice, the common way is to use the office of the company's accountant or solicitor as the registered office. Hence, such an office is more of a nominal nature, and the same address can be shared by many entities purely for the purpose of registration.

(4) Requirements for general meetings and resolutions

General meetings are meetings of shareholders, affording them an opportunity of measuring protection of their investment in the company. Section 241(1) provides that the directors of a company shall in respect of each financial year lay before the company in general meeting the company's annual accounts, the directors' report and the auditor's report. Also, the articles of a company may include such provisions that certain important issues must be decided by a resolution in general meeting.

In terms of theory, under section 366, every company must hold an annual general meeting every year with an interval of not more than fifteen months. And in accordance with

section 368, an extraordinary general meeting other than an annual one may be requisitioned by the holders of at least one tenth of the paid-up capital with voting rights at a general meeting. However, the 1989 Act relaxes some administrative rules at this point as regards a private company. An elective regime is introduced by new insertion of section 379A into the 1985 Act under which a private company may elect to dispense with certain formalities, including annual general meetings, and the laying of accounts and reports before general meetings.

There are several kinds of resolution that can be made in general meetings. In the absence of a contrary provision in the memorandum or the articles, the company in general meetings acts by ordinary resolution, which, albeit not defined in the Act, is a resolution passed by a simple majority of the votes of the members entitled to vote [6]. Sometimes, however, an extraordinary resolution or a special resolution is required under certain circumstances in the context of the memorandum or the articles. Section 378(1) defines an extraordinary resolution or a special one as a resolution passed by at least a three-fourths' majority of the members entitled to vote. Again, private companies in this respect are entitled to some de-regulation measures introduced by the 1989 Act, which has inserted a new section 381A into the 1985 Act, providing that with a private company the passing of resolutions at

a general meeting can simply be achieved in writing and by correspondence, rather than at a formally convened meeting, with the resolutions being signed by or on behalf of all members entitled to vote.

### 2.1.5 Disclosure requirements

Every company is committed to make information about its capital structure, financial position, internal management and commercial activities available to its members of the company, the Registrar, and in the case of a public company listed on the Stock Exchange to the general public. However, disclosure requirements may vary according to different companies in term of their types and sizes.

(1) Annual return requirement

Section 363(1) provides that it is every company's duty to deliver an annual return to the Registrar. This annual return should include particulars about the company, the director(s) and secretary, the registered office address, the shareholders and share capital (section 364, and section 364A inserted by the 1989 Act). The purpose of this requirement is to keep the Registrar informed of any likely alteration in the company's current situation.

(2) Annual accounts requirement

section 226(1) imposes on the directors of every company the duty to prepare for each financial year of the company a balance sheet and a profit and loss account.

Under section 234, the directors must also prepare a report for each financial year, containing a fair review of the company's business development and a recommendation of dividend payments and reserves arrangements. Moreover, by section 235, an auditor's report must accompany the annual accounts, stating whether in the auditor's opinion the annual accounts have been properly prepared in accordance with the Companies Acts and whether they give a true and fair view.

Generally speaking, a company's directors must lay before the company in general meeting in respect of each financial year copies of its accounts, and reports of directors and auditors, under section 241(1). Section 242(1) also requires that they shall in respect of each financial year deliver to the Registrar the same accounts documents.

As a private company, it may dispense with laying of the above accounts and reports before general meeting (section 379A(1)(b)). However, it still has to comply with the requirement of filing these documents with the Registrar.

(3) Group accounts requirement

A subsidiary company may also encounter the problem of group accounts. Section 227 imposes a like duty on directors of a company, which is a parent company, to prepare a consolidated balance sheet and profit and loss account of itself and its subsidiary undertakings (i.e. group accounts).

For the purpose of determining whether group accounts should be prepared, a parent undertaking is essentially defined by section 258(2) in relation to a subsidiary, if a) it holds a majority of the voting rights in the subsidiary; or b) it is a member of the subsidiary and has power to appoint or remove a majority of the subsidiary's board of directors; or c) it can exert a dominant influence over the subsidiary (e.g. by virtue of provisions contained in the subsidiary's memorandum or articles, or a control contract); or d) it is a member of the subsidiary and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in the subsidiary.

If the concerned subsidiary company itself happens to be a parent undertaking in conformity with these criteria with one or more subsidiaries, it will have to prepare group accounts. However, under this circumstance, if the subsidiary company has the immediate parent undertaking which is established under the law of a EU member state,

according to section 228(1), it can be given exemption from meeting group accounts requirement in either of the following instances: a) it is a wholly-owned subsidiary of that parent undertaking; b) in the event of the parent undertaking holding more than 50% of the shares in it, notice requesting the preparation of group accounts has not been served on it by shareholders holding in aggregate more than half of the remaining shares or 5% of the total shares (such notices must be served not later than six months after the end of the financial year before that to which it relates).

(4) Concessions from the accounts requirement

Using a size criterion to determine the extent of disclosure in the accounts is confirmed by section 246, under which small and medium-sized companies can avail themselves of concessions whereby they need only file modified accounts. Modified accounts (also called abbreviated accounts) are shortened versions of the full accounts [7].

To qualify as small or medium-sized in any financial year, a company must first of all not be a public one (section 246(3)(a)).

By section 247(3), the qualifying criteria are that the

company should meet at least two of three conditions concerning annual turnover, balance sheet totals and the average number of employees. At present, in the case of a small company, the annual turnover must not be more than £2.8 million net, with the balance sheet not totalling more than £1.4 million net and the average number of persons employed not exceeding 50 [8]. And in the case of a medium-sized company, the annual turnover must not be more than £11.2 million net, the balance sheet must not total more than £5.6 million net, and the average number of employees should not exceed 250 [9].

(5) Disclosure for listing purpose

Having a public company listed on the Stock Exchange will unavoidably incur release of a great deal of details in connection with the company's internal operation.

Listing of shares on the Stock Exchange is governed by Part IV of the Financial Services Act 1986. Section 144(1) regulates that no securities may be admitted to listing unless the listing rules and other requirements of the Stock Exchange are complied with. By section 144(2), one of the requirements of the listing rules is that the Stock Exchange will require as a condition of admission to listing that the company in question publish listing particulars comprising the prescribed information. The

content of the listing particulars is generally specified by section 146(1) as to the assets and liabilities, financial position, profits and losses, and prospect of the issuer of the securities, and the rights attaching to those securities as an investor and his professional advisers would reasonably require in order to make an informed assessment.

**2.2 ESTABLISHMENT OF A UK BRANCH**

Establishment of a branch as opposed to a subsidiary company is subject to less tedious formalities and hence an easier route for a foreign company to have a presence in the UK.

Foreign investors may find that there are some advantages of operating through a branch: first, a branch is an extended place of business in the UK and ultimately controlled by its overseas parent company, therefore there is no need for the branch itself to satisfy any initial share capital requirement; second, although the branch is not a separate legal person from its foreign parent undertaking, it exists in the capacity of a place of business which has the apperance of permanency, and is physically equipped to negotiate business; third, it can have its own management to deal with ordinary operation affairs, albeit key decision-making function is exercised

overseas.

It should equally not be ignored that operating through a branch may also bring about some side effects. The biggest drawback lies in the fact that the foreign parent company in question does not enjoy limited liability and is responsible in full for all the obligations of its branch so that an unsuccessful undertaking especially in a high-risk business conducted by the branch may have very serious repercussions on its foreign parent. Also, important particulars of the foreign company will have to be released for the purpose of branch registration and operation, and this may allow the public including competitors to study the financial situation of the enterprise and possibly gain a competitive edge. Moreover, the branch itself does not possess facilities for raising large amounts of money.

The EC Eleventh Company Law Directive concerning registration and disclosure requirements in respect of branches of overseas companies (i.e. Directive 89/666/EEC) has been inserted in Schedule 21A of the 1985 Act, and came into force in the UK from 1 January 1993, according to article 16 of the Directive.

Regarding requirements for branch registration and disclosure of corporate and accounting information, there is a distinction between branches of EU companies and

branches of non-EU companies.

### 2.2.1 Registration requirements

According to para. 1(1) of Schedule 21A, within one month of establishing the branch, the foreign company must lodge information with the Registrar about the company itself as well as the branch.

In all cases, the company must deliver the following documents: a) a certified copy (with a duly certified English translation, if necessary) of the company's constitutional documents, e.g. the company's charter, statutes, memorandum and articles, etc.; b) the name of the company, its legal form and details of its registration in its home country; c) the names and details of directors and the company secretary; and d) a list of the names and addresses of all persons authorised to represent the company as permanent representatives for the business of the branch (para. 2(1) and 3 of Schedule 21A).

Companies from outside the EU setting up a branch are subject to more requirements, and the following details must additionally be delivered to the Registrar: a) the law under which the company is incorporated; b) the period for which the company is required by the law under which it is incorporated to prepare accounts, together with the period

allowed for the preparation and public disclosure of accounts for such a period; and c) the company's address of its principal place of business in its country of incorporation, its objects, and amount of its issued share capital (para. 2(2) of Schedule 21A).

### 2.2.2 Disclosure requirements for accounting documents

According to para. 1(2) and 6(1)(a) of Schedule 21A, the company shall send a copy of accounting documents to the Registrar, covering the whole company's activities, not just the activities of the branch in the UK.

The accounting documents required to be submitted to the Registrar depend on what is required by the company's state of incorporation. If the home state requires disclosure of accounts, then all the accounting documents including any consolidated accounts plus reports of directors and auditors must be filed (para. 1(2) of Schedule 21A, and para. 2 of Schedule 21D). If the disclosure is not required, then the company may only send copies of accounts and is not required to deliver reports of directors and auditors [10].

PART II (CHINA PART):

As to adoption of investment vehicles, there are three basic options for foreign investors in China: equity joint ventures, co-operative joint ventures (also called contractual joint ventures) and wholly foreign-owned enterprises, all of which are referred to as foreign investment enterprises. Each vehicle has its own governing law, whilst the law on equity joint ventures is the earliest legislation in the field of inward investment and represents the conceptual base upon which two other alternative structures have been built.

An equity joint venture is formed by having foreign capital partnered with that of a Chinese enterprise. It exists in the capacity of a limited liability company in which the Chinese and foreign parties each take an equity share, and they share profits as well as losses in proportion to their respective capital contributions on which each side bases its limited liability to be assumed. The managerial control of an equity joint venture is subject to majority ownership.

A co-operative joint venture entails a business structure somewhat akin to that of an equity joint venture, but with greater operational flexibility as well as legal uncertainty. It may not necessarily be registered as a

limited liability company with separate legal personality. In any event, each party undertakes to perform its own task completely in accordance with provisions in a joint venture contract mutually agreed in advance. Profits and losses may not be shared in the context of proportional capital contributions, nor does management control necessarily require majority ownership.

A wholly foreign-owned enterprise is a limited liability company normally established as a wholly owned subsidiary of a foreign corporation. Comparatively speaking, it is a rather simple form of investment vehicle through which foreign investors provide all the capital, and are responsible for their own profits as well as losses. Hence, they are entitled to determine the company's internal management structure. However, this vehicle may not be available to every foreign investment project, since some projects are not permitted to be solely conducted by foreign investors without Chinese participation.

None of these three vehicles can be established as a general commercial business entity. Instead, they must be based on one or more concrete project(s) fixed beforehand, which in most circumstances and particularly in the case of a wholly foreign-owned enterprise should be of productive nature involving either the adoption of advanced technology and equipment or the export of all or most of its products.

Also, these three vehicles are subject to supervision of the same regulatory authorities, which most notably include the Ministry of Foreign Trade and Economic Co-operation (MOFTEC, formerly the Ministry of Foreign Economic Relations and Trade) which approves foreign investment projects, and the State Administration of Industry and Commerce (SAIC) which is responsible for vehicle registration and overseeing business operation of foreign investment enterprises.

In reality, foreign investors' decisions on opting for any of the three investment vehicles will largely depend on four principal issues: a) the vehicle's legal basis; b) the degree of difficulty in obtaining approval of intended investment project; c) the requirements for capitalisation; and d) the control of internal management.

## 2.3 OVERVIEW OF LEGAL BASIS

The statutory framework governing equity joint ventures has not been built up at one stroke but has tended to evolve in a piece-meal manner. The relevant regulations are mainly set forth in the Law on Joint Ventures Using Chinese and Foreign Investment of 1979 (the 1979 Law), along with the 1983 Implementation Rules. There are additionally separate regulations that are applicable to various special areas of equity joint ventures, e.g. in the field of capital

contribution. The 1979 Law is China's earliest foreign investment law [11], and in many ways considered as a path-finding piece of legislation which paves the way for the development of other foreign investment structures. On the basis of a number of general statutory threads embodied in the 1979 Law, the 1983 Implementation Rules comprise detailed stipulations spelling out the principal features of equity joint ventures. When viewed as a whole, the law concerning equity joint ventures provides a fairly systematic regulatory framework and is at present the most developed of all foreign investment laws of China. In comparison with other two investment vehicles, relatively comprehensive legal norms governing equity joint ventures provide greater certainty and assurance to foreign investors.

The basic framework for governing co-operative joint ventures is reflected from the Law on Co-operative Joint Ventures of 1988 (the 1988 Law), which in general is a very broad piece of legislation that leaves many questions unclarified. It is possibly due to the complex and diverse nature of the co-operative joint venture practice that implementation rules have not been promulgated yet, thus some foreign investors especially giant multinational consortia are deterred from this vehicle for fear of the lack of sufficiently developed regulations. However, the absence of legislation does not prevent co-operative joint

ventures from attracting foreign capital particularly from small or medium-sized investors who believe that the greater flexibility offered by this business entity outweighs its potential disadvantages.

The Law on Wholly Foreign-Owned Enterprises of 1986 (the 1986 Law), together with the 1990 Implementation Rules, govern the establishment and operation of enterprises wholly owned by foreign interests. The enactment of this legislation marks a new phase in China's open-door policy and presents more opportunities for foreign companies contemplating investments in China. Prior to 1986, the establishment of wholly foreign-owned enterprises was restricted for the most part to the Special Economic Zones [12]. The 1986 Law and the 1990 Implementation Rules now provide a formal legal framework for regulating activities of wholly foreign-owned enterprises on a country-wide basis.

### 2.3.1 Legal status

The legal status of an investment vehicle can be highlighted from two aspects: a) whether it exists in the form of a legal person assuming limited liability; and b) how long the vehicle is allowed to be maintained.

According to article 27 of the General Principles of Civil

Law of 1986 and article 7 of the 1988 Administration Rules Regarding Enterprise Registration as Legal Person, the following prerequisites must be satisfied for a business to possess the required juridical status: a) a lawful establishment; b) the necessary assets or funds; c) a name and place of business; and d) the capacity to assume civil liabilities independently. This legal person status allows a business entity to conduct various business transactions in its own name and enjoy limited liability. An equity joint venture, a co-operative joint venture and a wholly foreign-owned enterprise can all have legal personality with limited liability, whilst a co-operative joint venture may at its discretion be established without such artificial status.

Both co-operative joint ventures and wholly foreign-owned enterprises may determine the period of operation without being subject to any limitation on the length of time. However, equity joint ventures are not so free in this respect and cannot maintain the term as long as they like.

(1) Equity joint ventures

Both article 4 of the 1979 Law and article 19 of the 1983 Implementation Rules provide that an equity joint venture shall take the form of a limited liability company incorporated and registered in China, and that the

liability of the parties shall be limited to the amount of the capital contribution subscribed by each side and the parties shall share the profits, risks and losses in proportion to their respective contributions to the registered capital.

Under the current regulatory framework, an equity joint venture cannot be maintained as long as it likes. Whilst article 12 of the 1979 Law provides that the period of operation is to be determined by the parties to the joint venture, article 100 of the 1983 Implementation Rules further supplements that the term shall normally be from ten to thirty years, and projects with large investments, long construction periods, and low profits may operate for over thirty years. However, the State Council, the highest administrative body of China, made some concessions in this regard by issuing an order in 1986 which modified the above provisions. The order expressly provides that projects in the category of large investments, long construction periods and low profits may operate for fifty years, and upon special approval of the State Council may even last for more than fifty years [13]. The order also gives the same treatment to projects to which the foreign party contributes advanced or key technology through which highly sophisticated products can be produced and to projects which bring about products that are competitive in the international markets [14]. Both the legislation and the

State Council's order go no further than provide the above general principles and the actual criteria for falling into the special category can be quite negotiable in practice. However, one thing is certain: because the emphasis of national economic development may vary in different periods of time, the government is not keen on letting any Chinese enterprise become indefinitely bound by a foreign investment project, unless the project concerned is obviously in line with the state's investment orientation policy, e.g. relating to tapping infrastructure facilities, and of export-oriented and technologically advanced nature.

(2) Co-operative joint ventures

A co-operative joint venture is a kind of contractual business entity participated by investors from both overseas and China. The legal relationship between foreign and local investors is established entirely on the basis of a contract on which all the terms are negotiated and confirmed in advance. In establishing a co-operative joint venture, the Chinese and foreign parties shall under article 2 of the 1988 Law prescribe in their joint venture contract such matters as the investment or co-operative conditions, including the distribution of earnings or products, and the sharing of risks and losses, etc. In this context, the parties do not necessarily need to share the profits, risks and losses in proportion to their

respective capital contributions. A co-operative joint venture may or may not exist in the form of a company with limited liability with the decision left to the discretion of the two sides. Even in the case of a co-operative joint venture which has obtained the status of a legal person, the parties can still determine the mode of sharing profits, risks and losses as they choose, rather than in proportion to specific value of capital contributed. Under this circumstance, a co-operative joint venture as an investment vehicle offers foreign investors greater freedom to organise their venture as they see fit, thus the flexibility of the co-operative joint venture can be well combined with the protection offered through limited liability.

Article 25 of the 1988 Law allows a co-operative joint venture to decide the business duration completely on its own. One of the many areas in which the flexibility of co-operative joint ventures is reflected lies in the fact that there is no statutory limitation upon the length of time for the term of its business operation.

(3) Wholly foreign-owned enterprises

By article 2 of the 1986 Law, a wholly foreign-owned enterprise is an enterprise established within China (not including any branch organisation), with the entire capital

contributed by foreign investors. Article 19 of the 1990 Implementation Rules provides that a wholly foreign-owned enterprise exists in the form of a limited liability company and the liability assumed by the foreign investor in the enterprise in this connection is limited to the capital contributed. In practice, a wholly foreign-owned enterprise is an independent Chinese juridical person normally existing in the form of an overseas company's subsidiary. In normal circumstances, the state will not nationalise or expropriate wholly foreign-owned enterprises. However, the 1986 Law does not completely exclude such possibility, and provides under article 5 that in exceptional circumstances the state based on the need of social and public interests may expropriate wholly foreign-owned enterprises under legal procedures and give commensurate compensation.

Similar to the case of a co-operative joint venture, the law contains no restriction on how long a wholly foreign-owned enterprise may operate, and article 20 of the 1986 Law leaves the issue in connection with the term of business to the enterprise itself to decide.

**2.3.2 Nature of investment project**

(1) Basic requirements for project nature

It should be noted that any investment vehicle in China must be established on the basis of one or more proposed project(s) normally with a productive nature. As a general policy, the desirability of encouraging projects which adopt advanced technology or are export-oriented is emphasised in the legislation.

Article 4 of the 1983 Implementation Rules regulates that an equity joint venture must meet one or more of the following four criteria: a) it must use advanced technology and equipment, and management methods to enable them to increase the variety of products, raise the products' quality as well as quantity, and conserve energy and materials; b) it must be of benefit to the technical development of the enterprise concerned so as to enable it to achieve quick and apparent results and large returns for small investment; c) it must be able to expand the export of products and increase foreign exchange income; and d) it must be able to train technical and managerial personnel. These criteria appear fairly generous, and foreign investment projects of productive nature may easily meet one of them.

As to co-operative joint ventures, the 1988 Law does not provide any criterion for the project's nature, but merely sets forth a vague stipulation under article 4, indicating that the state encourages the establishment of productive

co-operative joint ventures that are export-oriented or technologically advanced.

So far as wholly foreign-owned enterprises are concerned, article 3 of the 1986 Law requires that such enterprises must adopt advanced technology and equipment or export all or most of their products.

(2) Available concessions

Although any investment vehicle of a general commercial nature is still not allowed, the policy has started to become flexible in connection with setting up investment holding companies that either are wholly owned by foreign interests or take the form of joint ventures. Establishment of an investment holding company is subject to the precondition that foreign investors must have already had investment enterprises in China.

MOFTEC issued a provisional rule in April 1995, requiring that any proposed investment holding company satisfy the following stringent criteria: a) foreign investors must be in possession of minimum assets of US$400 million in the previous year before applying for establishment of the investment holding company; b) foreign investors must have already set up investment enterprises in China with paid-up capital of over US$10 million in aggregate and at least

three approved projects, or with paid-up capital totalling more than US$30 million and over ten investment enterprises engaged in manufacturing or infrastructure industries; c) the registered capital of the proposed holding company should not be lower than US$30 million; and d) in the event of the holding company which takes the form of a joint venture, the registered capital of the Chinese enterprise concerned must not be below Chinese RMB100 million [15].

Establishment of foreign investment holding companies in China is still carried out on a trial-and-error basis, and a lot of implementation details are not able to be identified from the existing provisional rule. However, this is already an enormous leap in the process of expanding the scope of investment projects to include those which are not purely of a productive nature.

### 2.4 APPROVAL OF INVESTMENT PROJECTS

In China, securement of approval for foreign investment projects from MOFTEC or other appropriate authorities, and formation of foreign investment enterprises are as a matter of fact synonymous. Once the approval is obtained, registration of foreign investment enterprises with SAIC will become little more than a pure formality.

The approval procedures are to a large extent a reflection

of internal Chinese administrative practices, and entail a significant degree of state control. These procedures are implemented with the aim of monitoring and supervising foreign investment projects so that only those which are in conformity with the state policy will be given consideration. The procedures additionally serve the function of allowing the government authorities to assess at an early stage the various proposals of competitors for the same project, and only the most promising one will be permitted to proceed from the initial stage to the next one.

**2.4.1 Two approval regimes**

There are two approval regimes at present operating at the local and central government level respectively. Precisely which level of approval is sufficient for different types of project has been the source of much confusion for foreign investors. The reason for this uncertainty lies in the fact that there has been no national legislation which comprehensively spells out the approval procedures for investment projects.

The basic criteria that are considered in determining the identity of proper approval authority are the total amount of investment involved in the project and whether the project will require restructuring of the state's overall

economic plan and budget. Whilst MOFTEC in the capacity of the central government's agent maintains ultimate control over local government authorities for approval of foreign investment projects, in order to simplify the likely onerous procedures, it has delegated part of its approval powers to the local authorities.

As a general rule, any project with a total investment of less than US$30 million needs only to be approved by the local government authorities, provided that such approval is filed with MOFTEC later on and the project does not require an allocation of raw materials by the state and also the nation-wide balance of fuel and power distribution, transportation capacity and export quotas will not be affected [16]. Any project that cannot meet the above criteria must be directly approved by MOFTEC.

### 2.4.2 Formation of an equity joint venture

Formation of an equity joint venture may become a rather long process and usually involves two approval stages. At the first stage, an initial approval from the Chinese party's superior must be obtained. At the second stage, the parties should deliver their application to the local approval authority or directly to MOFTEC for official sanction.

(1) Initial approval from the Chinese party's superior

By article 1 of the 1979 Law, foreign companies, enterprises, and other economic organisations or individuals may seek Chinese companies, enterprises or other economic organisations (but not individuals) in establishing joint ventures. As all capable Chinese economic organisations are virtually owned and run by the state, each of them will invariably have its superior unit to whom it is responsible.

Under article 9(1) of the 1983 Implementation Rules, the Chinese party to a proposed joint venture shall submit a project proposal and a preliminary feasibility study report relating to the project in question to its superior for approval in the first instance. These documents usually contain information in connection with the purpose of the joint venture, the scope and scale of the proposed operation, the total amount of investment, forms of capitalisation, the financial situation of the parties concerned especially of the foreign party, the technology to be used, the supplies of raw materials, energy and equipment, the infrastructure facilities of the place where the proposed project will be located, and analysis of market and economic prospects, etc.

They are often accompanied by a letter of intent signed by

the parties concerned. The letter of intent contains little more than a brief summary of the parties' business contact to date, showing their intention to pursue the establishment of the joint venture and listing all the major issues which have already been agreed between them. In any case, this letter of intent is not legally binding but merely a supporting document for the project proposal and preliminary feasibility study report. Any party withdrawing after signing the letter of intent is at no risk of committing any legal offences.

Only in the event that the Chinese party's superior unit agrees to its subordinate's working plan and also receives confirmation from the local approval authority or MOFTEC for such an initial approval will the parties of the proposed joint venture be able to enter the second stage of applying for official sanction.

(2) Official sanction

After the project proposal and preliminary feasibility study report are approved, an official application can be forwarded with the following materials to the local approval authority or MOFTEC for final approval via the Chinese partner: a) the completed application form; b) the official feasibility study report; c) the proposed joint venture agreement, contract and articles of association

signed by the parties; d) the list of names recommended as board members; and e) the comments from the Chinese partner's superior as well as the local government of the place in which the joint venture will be located on the availability of setting up such investment project (article 9(2) of the 1983 Implementation Rules).

Neither the 1979 Law nor the 1983 Implementation Rules contain specific provisions on the contents of the official feasibility study report. In practice, the official report is normally based on all the principal terms as amended according to circumstances of the preliminary feasibility study report and the project proposal submitted at the first stage. In the case that the preliminary report is wholly accepted at the first submission, the official feasibility study report will be merely a reproduction of the preliminary one.

The joint venture contract is generally viewed as the constitutional document which provides for the establishment of the joint venture by the parties, and the articles of association as the company's code of internal governance. The agreement is often thought of as a kind of intermediary step between the letter of intent and the contract. And under article 13 of the 1983 Implementation Rules, the parties may dispense with the signing of the agreement.

According to article 3 of the 1979 law, MOFTEC (or the local approval authority) will decide to approve or disapprove the application within three months after receiving the above-mentioned documents. By article 11 of the 1983 Implementation Rules, within one month upon receipt of the official approval from MOFTEC, the joint venture should register with the local branch of SAIC which will issue a business licence, and the date shown on the licence will be the joint venture's formation date. At this point, the equity joint venture can start trading immediately.

### 2.4.3 Formation of a co-operative joint venture

To form a co-operative joint venture, the parties have to undergo the same approval procedures as those required for an equity joint venture [17]. The identical two-stage approval process will have to be experienced and the same documents required at each stage must be prepared as well.

However, the promise of quicker decisions on applications to establish co-operative joint ventures is a significant feature of the 1988 Law. According to article 5, decisions must be rendered within forty-five days, which is half the time allotted to applications in the case of equity joint ventures.

Within thirty days of receipt of the official approval, the joint venture's representative must register with SAIC, which will issue a business licence for the venture, and the date shown on the licence is the formation date (article 6). Because of the co-operative joint venture's unique feature, in the case that it is established as a limited liability company, it is the business entity itself that is registered and issued with a business licence, whilst in the event of a joint venture without legal personality, the venture normally registers as a project in the names of the concerned parties. Once the business licence is granted, the co-operative joint venture can carry on business right away.

### 2.4.4 Formation of a wholly foreign-owned enterprise

A wholly foreign-owned enterprise is established by following the two-stage procedures which are slightly different from those applied to an equity joint venture or a co-operative joint venture. As the enterprise is completely owned by foreign interests, there will be no involvement of any Chinese participation. At both stages, foreign investors need only to deal with the relevant local government that is in charge of the area where the proposed enterprise is geographically located, and sometimes MOFTEC if the project is a huge one.

(1) Initial approval from the local government

At the first stage, foreign investors intending to establish a wholly foreign-owned enterprise have to prepare an investment proposal and submit it to the local government for initial approval.

Article 10 of the 1990 Implementation Rules requires that the proposal include the object of the company, the scope of business, the scale of production, the equipment and technical know-how to be applied, the intended proportion between products for domestic markets and those for export use, land usage requirements, and demand for allocation of basic public facilities (e.g. water, electricity, coal and gas, etc.) by the state.

In addition, under article 9, foreign investors should also take into account whether the future business activities are to be connected with applying for any export/import licences or quotas. If so, they shall consult MOFTEC for making early arrangements.

The local government will notify investors of their decision within thirty days after the proposal is received (article 10).

(2) Official approval at the second stage

Once the investment proposal is approved, in the context of article 11, the official application must be forwarded to the local approval authority or directly to MOFTEC with the following documents: a) the completed application form; b) the feasibility study report; c) the company's memorandum and articles; d) the name(s) of the company's legal representative or board members; e) the foreign investors' credit certificate; f) the comments on the investment proposal from the local government; and g) the list for planned importation of needed materials.

Out of the above documents, the credit certificate deserves special attention. In normal circumstances, according to article 3 of an explanation note relative to the 1990 Implementation Rules, which was issued by MOFTEC in 1991, the credit certificate should prove two things: first, if investors are in the capacity of juridical persons in home countries, the credit certificate in question shall include the Registrar's certificate, proof of composition of board members or legal representatives, and balance sheets in the past three years; second, if investors are in the capacity of natural persons, the credit certificate shall embrace investors' personal details, including a proof of their present assets.

The local approval authority or MOFTEC under article 12 of the 1990 Implementation Rules will give notification of

final approval or rejection within ninety days after receiving the above-mentioned documents.

Within one month of receipt of the official approval, the proposed enterprise is required under article 13 to register with SAIC for obtaining a business licence, which will enable the enterprise to commence work straight away.

### 2.5 REQUIREMENTS FOR CAPITALISATION

#### 2.5.1 Form of capital contribution

Capital contribution in a foreign investment enterprise can be in cash or in kind. The latter is defined as including buildings, factory premises, machinery, production materials, industrial property rights, special technical know-how, and land usage rights (article 25 of the 1983 Implementation Rules, article 8 of the 1988 Law, and article 26 of the 1990 Implementation Rules).

(1) Attraction and restriction of non-cash contribution

Non-cash capital contribution appeals to many foreign investors as they may use some idle machinery or industrial property rights as investment capital with their overall cash capital turnover being unaffected. The Chinese participants in an equity joint venture or a co-operative

joint venture might also be interested in this approach, since they may offer buildings, factory premises and land usage rights which are already in their possession as their capital contribution.

In the case of an equity joint venture or a co-operative joint venture, there is no statutory restriction upon the ratio between the capital contributed in kind and the whole registered capital, that is to say, theoretically the whole registered capital can be in kind, albeit practically this seldom happens, as MOFTEC or the local approval authority will be very reluctant to let an investment project proceed where there is no cash capital injected into the project.

However, for a wholly foreign-owned enterprise, article 28 of the 1990 Implementation Rules requires that the enterprise should not have its capital contribution which takes the form of industrial property rights and special technical know-how exceed 20% of the registered capital's total volume.

(2) Appraisal of non-cash capital contribution

Non-cash capital contribution is valued by local inspection authorities. The appraisal is mostly aimed at foreign investors to prevent them from deliberately overestimating their contribution by jacking up the price.

Since the contracting parties in a co-operative joint venture are allowed to determine the ownership or the distribution of earnings or products of the joint venture as they choose, there is no need for the parties to agree on a precise valuation of their contributions to the venture.

An equity joint venture or a wholly-owned enterprise is much more strictly treated in this regard than a co-operative joint venture. In the event of foreign investors using machineries or other items as capital contribution, these items must meet the following three conditions: a) they are indispensable to production; b) they cannot be produced by domestic manufacturers; or, even though domestic products are available, the prices are too high, or the technical function and/or delivery time cannot be guaranteed; and c) their prices shall not be higher than the current international market prices for similar items (article 27 of the 1983 Implementation Rules and article 27 of the 1990 Implementation Rules). Also, foreign industrial property rights or special technical know-how as capital contribution must meet one of the following conditions: a) they can enable the company to manufacture new products which are in urgent need, or suitable for export; b) they will lead to marked improvements in the function, quantity and quality of existing products; and c) they must be able to cut down the costs of raw materials,

fuel and power to a large extent (article 28 of the 1983 Implementation Rules and article 28 of the 1990 Implementation Rules). Further, in order to ensure the quality of these industrial property rights or special technical know-how, foreign investors are required to produce the pertinent documents, including copies of the patent certificate and trademark registration, and to show their effectiveness, special technical nature and practical value in regard of the methods and basis by which and on which the stated value of contribution is assessed (article 29 of the 1983 Implementation Rules and article 28 of the 1990 Implementation Rules).

(3) Restriction on capital contribution arrangement

Both equity joint ventures and co-operative joint ventures are subject to restriction on capital contribution arrangement and must make sure that such contribution either in cash or in kind must be the parties' own properties.

The 1988 Directive on Capital Contribution which was jointly issued by MOFTEC and SAIC emphasises in this regard by requiring under article 2 that the parties to an equity joint venture must be able to certify that any cash or non-cash contribution is their own property, and in the case of non-cash contribution there is no any lien attached upon

it. Moreover, article 3 excludes any investor from contributing by loans, leased equipment and other properties obtained in the name of the joint venture, or properties of other person(s), and also restricts any investor from using the assets and interests of the joint venture or those of other investors as guarantee for its own capital contribution.

There is a general restriction imposed by the 1988 Law on financing for a co-operative joint venture's capital contribution. Article 17 provides that with respect to funds borrowed by the Chinese and foreign co-operative venturers to be used for investment or co-operation criteria, and the guaranties thereof, each side shall resolve these issues on its own. Although the meaning of the provision taken literally is not quite explicit, it can be construed that it appears to be designed to prevent the joint venture and in particular the Chinese party from financing the foreign party's capital contribution by arranging the venture or the Chinese side itself to guarantee repayment of funds borrowed by the foreign party for such contribution.

The law does not give any restriction on capital contribution arrangement in connection with a wholly foreign-owned enterprise, as the enterprise has no Chinese partner to resort to for guarantee of capital contribution

funds borrowed, thus in this instance no Chinese interest is put in danger.

### 2.5.2 Registered capital as core for capitalisation

The central concept embodied in capitalisation of a foreign investment enterprise is registered capital, which is the total amount of the capital that ought to be paid up by the parties to an equity or co-operative joint venture, or by the foreign investor in a wholly foreign-owned enterprise. The amount of registered capital must be registered with SAIC at the time when the business is formally established, but may not be fully paid up even after the business licence is obtained. That is to say, a foreign investment enterprise may proceed trading for some time without having registered capital fully contributed in the first place.

By article 4 of the 1979 Law, in an equity joint venture, the foreign party should hold not less than 25% of the total registered capital. The Law does not provide a ceiling, leaving open the possibility that the foreign party may hold up to 99%, whilst in practice such a high percentage seldom appeals to foreign investors, because one of their considerations for adopting an equity joint venture as the investment vehicle is to share risks with their Chinese partners. Unlike the 1979 Law, the 1988 Law imposes no such requirement on the foreign side in a co-

operative joint venture as to the minimum percentage of registered capital to be shouldered.

(1) Registered capital and total investment volume

Registered capital should be distinguished from the concept of total investment volume which includes the business's external borrowings. The amount of registered capital should be proportional to the total investment volume. And in this regard, the Provisional Regulations about the Ratio between Registered Capital and Total Investment Volume made by SAIC in 1987 (the 1987 Provisional Regulations) applies to all foreign investment enterprises (article 6).

By article 3, prevailing rules are classfied into the following four categories: a) if the total investment volume is not more than US$3 million (including US$3 million), the registered capital should be at least 70% of the total investment volume; b) if the total investment volume is more than US$3 million but not exceeding US$10 million, the registered capital should be at least 50% of the total investment volume, and in the case of the total investment amount less than US$4.2 million, the registered capital should not be below US$2.1 million; c) if the total investment volume is more than US$10 million but not exceeding US$30 million (including US$30 million), the registered capital should be at least 40% of the total

investment capital, and in the case of the total investment volume lower than US$12.5 million, the registered capital should not be lower than US$5 million; and d) if the total investment volume is above US$30 million, the registered capital should be at least 1/3 (one third) of the total investment capital, and in the case of the total investment volume less than US$36 million, the registered capital should not be lower than US$12 million.

(2) Deadline for full payment of registered capital

Whereas registered capital can be fully paid up either once and for all or by instalments, the timing of payment is very important. In the latter case, the deadline for a full payment must be carefully observed.

The 1988 Directive on Capital Contribution includes a number of guidelines for foreign investment enterprises to comply with deadline requirements [18].

In the context of article 4, if the registered capital is planned to be fully paid up once and for all, the payment must be effected within six months after the business licence is issued; in the case of payment by instalments, the proportion required between the first payment and the total investment volume shall not be lower than 15%, and the first payment must be completed within three months

after the business licence is granted. If the foreign investment project is required to have its registered capital fully paid up once and for all but fails to do so after the deadline, it will be deemed to be automatically dissolved (article 5). And in the event of payment by instalments, if any subsequent payment after the first fails to be completed within three months after its deadline, a one-month grace period will be given within which if payment is still not completed, MOFTEC will consider withdrawing its approval for the investment project (article 6), albeit in practice the above rules may not be implemented so rigidly.

In regard of the deadline for the balance of the minimum 15% after the initial payment, MOFTEC together with SAIC issued a supplementary notice in 1995 (the 1995 Notice) under which a three-year ceiling is set forth for effecting the whole payment but at the same time leaving the possibility of giving concessions to investment projects of extremely huge volume. The main issues are defined as follows: a) as to the registered capital of not more than US$500,000 (including US$500,000), the balance must be paid up within one year after obtaining the business licence; b) if the registered capital is over US$500,000 but not more than US$1 million (including US$1 million), the balance must be paid up within one and a half years after the business licence is given; c) if the registered capital is

over US$1 million but does not exceed US$3 million (including US$3 million), the balance must be paid up within two years after the licence is granted; d) in the case of the registered capital which is over US$3 million but not more than US$10 million, the balance must be paid up within three years after the licence is acquired; and e) as to the registered capital of over US$10 million, the deadline can be negotiable [19].

In the past, the business licence could be granted to the enterprise for it to commence trading before the registered capital is fully paid up. The 1995 Notice in this regard authorises SAIC as registration authority to decide at its discretion whether to delay the registration and issuance of the business licence until the registered capital is fully paid up [20], thus tightening the control upon registered capital payment.

(3) Alteration of registered capital

In any event, there is little difficulty with increases of registered capital. But any such increase shall be conducted subject to the required ratio between registered capital and total investment volume discussed above (article 5 of the 1987 Provisional Regulations).

Both equity joint ventures and wholly foreign-owned

enterprises were not permitted in the past to reduce the amount of their registered capital during the term of contract (article 22 of the 1983 Implementation Rules, and article 22 of the 1990 Implementation Rules). But the 1995 Notice relaxes the constraint by allowing them to scale down the proposed production and reduce their registered capital as well as total investment volume on account of justified reasons. However, the Notice does not define what reasons can be counted as justified.

As to co-operative joint ventures, there is no statutory prohibition on reduction of registered capital during the contract period. Moreover, the parties have the right to provide for the foreign side to recover its investment contribution during the contract term. Under article 22 of the 1988 Law, if upon expiration of the joint venture's operation period all the fixed assets of the venture as agreed upon by both sides in the contract beforehand are to belong to the Chinese party, both parties may prescribe the ways for the foreign party to enjoy a priority in recovering its investment during the term of operation, and in such circumstance the Chinese and foreign parties shall be jointly liable for the venture's debts. This provision ensures that the Chinese party will not be left holding the bag in the event that the foreign side recovers early and leaves the joint venture with too many debts for its remaining assets. In practice, if investment is recovered

early, the foreign side will normally have to provide a guarantee or goods as security for its obligation to return the recovered investment if needed to shoulder a fair share of the whole venture's debts.

(4) Transfer of registered capital

The 1983 Implementation Rules contain restrictions pertaining to transfer of registered capital of an equity joint venture. Article 23 provides that a transfer of all or part of registered capital contributed by one party is not valid without the consent of the other party and the sanction of the original approval authority. Moreover, the article also states that if one party intends to effect any such transfer, the other party will be granted a pre-emptive right to purchase the interest offered to the third party, and no transfer to a third party can be made on terms more favourable than those for any such transfer to the other joint venture party.

In the case of a co-operative joint venture, the 1988 Law only provides a broad stipulation of a similar pre-emptive nature. By article 10, if the Chinese or foreign party wishes to make an assignment of all or part of its rights and obligations prescribed in the joint venture contract, it must obtain the consent of the other party or parties, and report to the approval authority for sanction.

A wholly foreign-owned enterprise is not subject to any restriction in this regard.

### 2.5.3 Distribution of profits

The system of distributing the profits of an equity joint venture is fixed by article 7 of the 1979 Law: a distribution is based on the post-tax profits setting aside a reserve fund, an employee bonus and welfare fund and an enterprise expansion fund, whilst the remaining profits may be divided between the parties by virtue of their respective capital contribution. However, distributions are not mandatory. According to article 88 of the 1983 Implementation Rules, current profits may be retained for distribution in later years, and where losses incurred in previous years have not been recovered, the profits will have to compensate the losses before any distribution can be made.

As to a co-operative joint venture or a wholly foreign-owned enterprise, the existing legislation does not particularly stipulate any requirement for distribution mode, thus enabling the parties concerned in this connection to have more autonomy in handling their profits.

## 2.6 CONTROL OF INTERNAL MANAGEMENT

In an equity joint venture or a co-operative joint venture, the internal management control may ultimately fall into the hands of either the Chinese party or the foreign side, depending on various circumstances. A wholly foreign-owned enterprise can enjoy autonomy in this respect and is entitled to prohibit any interference by organisations other than its own in the enterprise's management affairs.

### 2.6.1 Management in an equity joint venture

Under normal circumstances, a two-tiered system of internal management is operational in every equity joint venture company, and adjustments to the control relationships between the board of directors and the general manager are often made to protect the managerial authority of both the Chinese and foreign investors.

(1) The first-tier management

The board of directors is at the first tier. The 1983 Implementation Rules provides that the board constitutes the highest organ of authority and decides all major issues of the joint venture (article 33). Members of the board of directors are appointed by the parties to the joint venture and hold office for a term of four years which is renewable upon further appointment (article 34). The number of directors should not be lower than three, and the seats on

the board are allocated between the parties in accordance with the ratio of capital contributed by each side (article 34), thus leaving open the possibility that any party holding a majority of registered capital could control the board. Whilst article 34 requires that the position of chairman of the board be held by a Chinese appointee, in practice, it is now possible for a foreign appointee to act as chairman as well.

The board must hold meetings at least once a year and a quorum of more than two-thirds of the directors present is required before a meeting can be convened (article 35). Upon the proposal of more than one-third of the directors, the chairman may convene provisional meetings (article 35).

The board of directors executes the decision-making function. Article 36 specifically provides that certain matters must be decided by the board on the basis of unanimity, including modification of articles, termination or dissolution of the joint venture, increase or transfer of the registered capital, and merger of the joint venture with other business organisations, etc.

(2) The second-tier management

The second-tier comprises the joint venture's management staff usually led by a general manager and several deputy

general managers. They are responsible for daily managerial work (article 38). The 1983 Implementation Rules are silent on how the general manager and deputy general managers should be appointed, but merely stating that they can be either Chinese or foreign nationals, whereas the chairman and directors may also be simultaneously appointed as general manager or deputy general managers (article 40).

What has evolved in reality is that if the chairman of the board comes from the Chinese side, a foreign appointee will take office as general manager, and vice versa. The function of this rotation structure is to balance the power allocation between the two sides so that the scope for independent decision-making by any party would be limited.

### 2.6.2 Management in a co-operative joint venture

A co-operative joint venture can be an independent legal person like an equity joint venture, with its highest authority lying in a board of directors led by a chairman. But it may also operate without such personality, with the top authority residing in a joint management team led by a director.

In the former case, a co-operative joint venture normally adopts a management system that closely resembles that of

an equity joint venture company.

However, in the latter case, investors may have greater freedom to organise their ventures as they see fit, and the management structure can be a good deal more flexible. Most ventures of this type are governed by a joint venture management committee or similar organisation consisting of representatives from each party. Because no independent corporate entity exists, a major practical problem often confronted by the parties relates to the absence of a legal entity that is capable of contracting on behalf of both parties. As a result of these strictures, one side is usually named as the contracting party with powers of attorney granted by the other side authorising it to act on behalf of the venture in the interests of both parties pursuant to the joint venture contract.

### 2.6.3 Management in a wholly foreign-owned enterprise

Management in a wholly foreign-owned enterprise bears a major advantage of much greater independence. There is no statutory requirement for the enterprise to take any specific managerial structure. Without Chinese participation in the decision-making, this flexibility is of vital significance, as it ensures direct control, leadership, and effective co-ordination by the parent corporation overseas, especially in the case of

multinaltional operations.

However, with no direct support from a Chinese partner, it might not be easy for foreign investors to make sound judgements in daily management activities particularly in an environment which is likely to be drastically varied from that in their home countries.

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# CHAPTER 3

## ROLES OF FINANCIAL MARKETS

Whilst financial markets fulfil many economic functions, in consideration of inward investment, their roles basically ought to be twofold: first, they should facilitate the raising of capital by foreign investors who resort to external finance to sustain business; second, they should provide a place where foreign institutions can establish their corresponding presence in financial markets. In the former case, the markets should have an efficient mechanism enabling borrowers to issue claims which can then be taken up by those with funds to lend, since whether there is an existence of a mature capital market is one of the essential factors influencing foreign investors' business plans. In the latter case, direct participation in the markets as financial intermediaries may become a very important route for foreign investors to make a forture: they may not only carry on traditional business e.g. depositing-taking and lending, but take advantage of a variety of services by becoming financial conglomerates with comprehensive business range as well.

However, great differences may exist pertaining to the roles played by financial markets in various host

countries.

As regards foreign investors in the UK, three principal facets have assumed fundamental importance: a) they can seek sources for external fund raising by utilising the UK's highly developed financing facilities; b) they can as banks or financial institutions of similar nature establish and carry on banking business in the UK; and c) they can gain access to conducting investment transactions in financial markets under a self-regulatory framework.

China's financial markets are in a state of low internationalisation and inadequate commercialisation. In an environment where transition from original planned economy is still under way, foreign investors normally face three major problems: a) exchange control is still operational for the time being, imposing a lot of restrictions upon foreign investment enterprises; b) external financing for foreign investment projects is possible but generally difficult; and c) the government exercises strict constraints upon foreign participations into the current markets as banks or financial institutions of similar nature.

This chapter examines the above primary roles each played by the UK and Chinese financial markets in foreign investment operations.

PART I (UK PART):

Foreign investors who wish to raise finance in the UK have a number of options to do so. While traditional credit facilities are generally available by means of bank loans or bond issues, to raise more medium- and long-term capital of a large size, it is generally advantageous to have shares listed on the International Stock Exchange which plays the central part in the UK's capital markets.

Foreign banks or financial institutions of similar nature can establish their long-term business presence in the UK. But all banking activities are strictly under the supervision of the Bank of England, which acts as the country's central bank through the powers granted to it in the context of the Banking Act 1987 (the BA 1987). The major part of the Act applies generally to both foreign and UK institutions, whilst there are some differences depending to a large extent on how the foreign bank conducts business: such a bank may act through a UK-incorporated subsidiary, a branch or merely a representative office.

Due to existence of a number of highly developed and efficiently operated financial markets, it is likely that foreign companies would greatly benefit if they are able to carry on certain investment businesses in the UK. The

entire investment sector is now administered under the Financial Services Act 1986 (the FSA 1986). Central to this framework is a system of self regulation, which relies heavily on market practitioners who can formulate rules that are acceptable to both market players as well as regulators. The Securities and Investments Board (SIB) as the primary regulator has the appearance of a state agency assuming an overall regulatory responsibility, whereas the front-line delivery of regulation is made through a cluster of autonomous self-regulatory bodies which are recognised and supervised by the SIB. Foreign companies intending to carry on investment business need to apply for authorisation under this two-tier regulatory regime, which in turn is intended to ensure that investment business can only be conducted by those who are fit and proper to do so.

## 3.1 SOURCES OF EXTERNAL FINANCE

### 3.1.1 Traditional credit facilities

Traditional credit facilities are represented by financing investment projects by means of various loans or issuance of bonds.

Loans may be advanced either by a single bank or where the sum involved is a huge one by a syndicate of banks. Short-term credit may be used to cover overdrafts or to obtain

cash advances or bankers' acceptances, and these facilities are typically repayable on demand and may require a fixed or floating charge over the borrower's assets. Medium- and long-term loans are also available, especially for the large, strong borrowers, and they normally have a draw-down period, a grace period and a repayment period. In any case, lending institutions expect to be satisfied by the business plan, cash flows and earning performance of the project as a source of funds from which the loan will be repaid. In practice, lenders will invariably require certain forms of security or guarantees for the loan provided.

Foreign investors, especially top-quality companies, may issue bonds as medium- to long-term debt instruments usually at a fixed rate of interest. The structure of a typical bond issue involves in addition to the issuer three siginificant groups: a) the managers who are responsible for managing the issue and preparing the relevant documentation; b) the selling group who place the bonds with outside investors; and c) the underwriters who are large financial institutions agreeing to purchase any part of the issue not sold by the selling group. Compared with conventional loans arrangements, bond issues are likely to bring about several benefits, including more favourable interest rates, a certain publicity to be achieved which may in turn facilitate subsequent access to the market,

while at the same time the issuers do not deplete the availability of resorting to the existing banking sources. However, public bond issues might be more expensive and onerous than directly applying for loans.

### 3.1.2 Listing on the Stock Exchange

The objective of raising finance can be well fulfilled by having shares listed on the Stock Exchange.

A full listing may afford a foreign company many advantages: first, an offer of equity shares to the public is an appropriate way of raising new funds since the prestige attached to a full listing may well make it easier for a company to raise finance from other sources; second, a floated company may have its shares become more marketable, therefore realising part of investment on floation and at subsequent times by selling further shares through the market; and third, there is a considerable degree of high reputation and publicity in connection with a full listing, and this may lead to better trade terms and wider markets for the company's products and services.

However, there are corresponding disadvantages as well: first, having a company listed on the Stock Exchange both in terms of administrative work as well as loss of privacy is a complicated and costly process; second, as in normal

circumstances a minimum percentage of the issued equity share capital must be in public hands, there is certain degree of external involvement which can incur pressure from outside shareholders for paying dividends and sometimes exposure to risk of a take-over bid, and the higher the proportion of the equity in public hands is, the more obvious this drawback appears to be.

As the London International Stock Exchange is a recognised exchange for the purpose of the FSA 1986, the official listing of securities on it is generally dealt with as a separate subject in the Act. Part IV reflects three EEC directives (namely, Council Directives 79/279/EEC, 80/390/EEC and 82/121/EEC respectively), in view of harmonising and coordinating various aspects for the admission of securities to official stock exchange listing throughout the European Union. These lay down minimum requirements for having shares listed in the Exchange. Moreover, as article 9 of Council Directive 79/279/EEC also requires each member state to designate a competent authority to decide on the admission of securities to official listing on a stock exchange operating within its own territory, by section 142(6) of the FSA 1986, the Council of the International Stock Exchange is appointed as the competent authority in the UK and has the power to make listing regulations and rules which are set forth in "Admission of Securities to Listing", usually referred to

as the Stock Exchange's "Yellow Book". All applications for an initial listing must be submitted to the Stock Exchange for approval. In fact, the FSA 1986 only provides a broad framework, and the bulk of detailed rules are contained in the "Yellow Book" which in practice has statutory force as well.

(1) Key considerations of suitability for listing

A foreign company intending to apply for a full listing must in the first place have a clear understanding of its own suitability for going public. The requirements that a company has to meet in order to satisfy the Stock Exchange's criteria for listing can be classified into three main aspects: a) market capitalisation; b) shares in public hands; and c) trading record.

In theoretical terms, an application for listing will not normally be considered unless the expected market value of the shares for which a listing is sought is at least £700,000 [1]. In practice, the Stock Exchange maintains a complete discretion to adjust the minimum figure, and a market capitalisation exceeding £700,000 by a large margin is likely to be required for ensuring prospective outside investors that the company to be listed is a high quality one.

There is a further requirement that at least 25% of its shares must be in public hands [2], so that the nature of the public company can be guaranteed by maintaining a reasonable level of external involvement. However, outside participation is essentially not welcomed by the company to be floated, since in this case a certain degree of business control will definitely fall into other people's hands. In practice, a percentage of lower than 25% may not be totally unacceptable if the market will operate properly with a lower percentage in view of the large number of shares of the same class and the extent of their distribution to the public. Thus, this minimum 25% requirement can become a quite negotiable matter.

A company should normally have a trading record of at least three years and must present audited accounts for the latest three years [3], hence ensuring that only mature companies will qualify for admission to listing.

(2) Methods of going public

The flotation of a company on the Stock Exchange is customarily represented by a sponsor which may be a merchant bank and/or a stockbroker. The sponsor's role is crucial for linking the company with the Stock Exchange. In broad terms, the sponsor advises the company on all aspects of applying for a full listing, from assessing the

company's initial suitability to the pricing and timing of the issue itself. Whilst it is reasonable for the company's directors to be responsible for the accuracy of the information provided for the listing purpose, the Stock Exchange in practice attaches particular importance to the role played by the sponsor in satisfying itself that the company is suitable for a full listing.

The actual methods of flotation in connection with foreign companies seeking listing for the first time may normally comprise two major kinds: a) offer for sale; and b) selective placing. The choice of the more appropriate method depends on factors, such as the costs as well as the company's view of prospective shareholders' profile which is acceptable to it.

Offer for sale is usually conducted by the company distributing the securities that are intended to be offered to the public to an issuing house, which may or may not be the sponsor itself, in the first instance. The issuing house then invites subscriptions from institutional as well as individual investors. An offer for sale can be made by way of bearing a fixed price or arranging a tender. The purpose of a sale by tender is to ensure that any excess over the minimum tender price is made available to the company, and this is in contrast to a fixed-price issue where if the issue price is pitched too low, short-term

speculators will easily stand to make huge profits. In theory, a tender offer provides a basis for a more accurate market valuation of the company's shares, and if the issue is small and a large over-subscription is anticipated, this method will be especially worth trying as the cost incurred by the risk of failure in this instance would be minimal. But in practice, however, it has not always been the case and the company may find it difficult to decide whether to opt for a straightforward offer for sale or an offer for sale by tender. Tender offers are mostly utilised where there is no comparable company already listed to use as a reference for deciding the company's value, and the uncertainty and complexity embodied in the actual process can discourage private and small investors. In either case, before an issue of shares is made to the public, it is usual to insure the success of the issue by having it underwritten. An underwriter does not guarantee that the public will take up the shares, but agrees to subscribe for them himself on the happening of the public's failure to fully purchase. The issuing house would often be the main underwriter and may find others to sub-underwrite part of the issue.

In a selective placing, new shares are offered to the public selectively by the sponsor selling the shares to its own client base and finding purchasers with whom the shares are then placed. A selective placing has two main

advantages: first, it is cheaper to carry out, because the advertising costs are lower and the administrative work involved in handling applications is less as the placing is merely conducted within the limited scope of the sponsor's existing clients; second, due to the placing's nature, it is not necessary to have the issue underwritten so that there may not be any underwriting expenditure incurred. The major disadvantage of a selective placing is that investors are deprived of an equal opportunity to acquire the securities, as the sponsor places securities with their own clients. Thus, the Stock Exchange imposes strict restrictions in this regard, and only permits the entire issue to be placed in the case of an initial public offer of £15 million or less [4].

(3) The listing particulars

One of the most important and time consuming tasks in the whole process of having shares listed is the preparation of listing particulars which comprise the "prospectus" required by the Stock Exchange. The listing particulars serve two purposes: first, they include all information which the Stock Exchange requires to be made public to investors on which they are able to base investment decisions; second, and of great importance to the company when shares are being marketed, they describe the company, its business and prospects which are designed to promote

investment in the company's shares.

Section 146 of the FSA 1986 imposes a general duty of disclosure required for listing particulars: they must release all the information with respect to the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the securities, and the rights attaching to those securities as an investor and his professional advisers would reasonably require in order to make an informed assessment.

However, the more detailed requirements in connection with listing particulars are set out in the "Yellow Book", covering the following seven aspects: a) information on the persons responsible for listing particulars, the auditors and other advisers, including a declaration by the directors accepting responsibility for the information contained in the listing particulars, and a statement that the annual accounts for the last three financial years have been audited; b) information on the shares for which application is being made, indicating the nature and amount of the issue and the fixed dates (if any) on which entitlement to dividends arises, and giving a summary of the rights attaching to the shares; c) general information about the issuer and its capital, including the legislation under which the issuer operates and the legal form which it has adopted under that legislation, the date and country of

incorporation, a summary of the principal contents of each material contract entered in the last two years, the names of persons exercising control over the company and the names of any persons known to the issuer interested in 3% or more of the issuer's capital, details of the share capital of the company and any shares under option, and a summary of the provisions of the memorandum and articles of association regarding changes in the capital and rights of the various classes of shares; d) information on the company or group's activities, including a description of principal activities, information on any legal or arbitration proceedings, an analysis of sales by geographical area and category of activity, details of land, buildings and principal establishments, and information in respect of development policy, employees and material investments in other companies; e) information on the issuer's assets and liabilities, financial position and profits and losses, including consolidated information on the results and financial position for each of the last three completed financial years, a statement by the issuer as to the adequacy of working capital, and details of the issuer's indebtnesses; f) information on the company's management, including directors' details, their services and remuneration, and their interests in the company's securities; and g) information on the recent developments and prospects of the company or group [5].

(4) Flexible treatment is afforded to companies incorporated abroad

Whilst the rules of the "Yellow Book" generally apply to companies incorporated in the UK and abroad alike, the Stock Exchange is more flexible in certain aspects with companies incorporated overseas, and may consider some derogations from the normal requirement for listing particulars proposed by such companies. These foreign companies may not need to prepare UK listing particulars if they have issued a document approved by the competent authority of another EU member state which qualifies for mutual recognition of listing particulars under the rules introduced by Council Directive 90/211/EEC in respect of the mutual recognition of public-offer prospectus as stock-exchange listing particulars.

There are three main conditions contained in the "Yellow Book" which have to be fulfilled by a company to qualify for listing by mutual recognition: firstly, the company must have its registered office in another member state, or, if not, either it must be listed on an overseas stock exchange or the London International Stock Exchange must be satisfied that it can properly be regarded as a company of international standing and repute; secondly, the company must have, either contemporaneously with or within three months prior to its application to the Stock Exchange, had

the qualifying document approved by the competent authority in another member state as a prospectus drawn up according to the Public Offers Directive at the time of a public offer in that member state; and thirdly, the qualifying document must contain additional information specific to the UK market, including a description of the tax treatment of UK resident holders of the securities, names and addresses of the registrars and paying agents for the securities in the UK and a statement of how notices of meetings will be given to UK resident holders of the securities [6].

### 3.2 ESTABLILSHMENT OF PRESENCE BY FOREIGN BANKS

Foreign banks may take advantage of the UK's active money markets, foreign exchange market and financial futures and options market to carry out both international and domestic banking business, particularly Eurocurrency finance and foreign exchange transactions. Banking activity needs to be supervised to safeguard the interests of depositors, protect bank counterparts and ensure order in the markets by certainty and efficiency. The Bank of England acts as the general supervisory and regulatory body of deposit-taking institutions. The Bank's supervision principally involves examination of an institution's adequacy in respect of its financial resources and an assessment of the fitness and propriety of its decision-making team.

Furthermore, as part of the developments in Europe with a view of leading to a single European market, the EC's Second Banking Co-ordination Directive enables credit institutions incorporated in a EU member state to enjoy mutual recognition throughout the whole European Union by virtue of a single authorisation obtained in a member country [7]. Thus a non-EU bank may take advantage of freedoms under this single banking licence scheme by establishing itself in the UK. Nonetheless, this scheme is carried out under a test of reciprocity treatment. In the context of article 7 of the Second Banking Directive, a broad view will be taken of the kind of treatment that EU credit institutions receive in the given non-EU country by judging whether EU institutions are given reciprocal treatment, and if not, credit institutions from such state will be denied establishment of their presence in any EU country including the UK.

Foreign banks may have a presence in the UK in one of three ways: as a distinct UK subsidiary, as a branch of the foreign bank, or simply as the bank's representative office. These three types of institution are entitled to different rights. Only the first two are permitted to transact in the UK, while a representative office is merely allowed to promote the interests of the parent institution overseas.

### 3.2.1 UK subsidiary

A UK subsidiary of a foreign bank is incorporated in the UK as a local business entity with separate legal status. Such subsidiary has to comply in full with the usual minimum criteria of the BA 1987 regarding carrying on a deposit-taking business. Setting up a subsidiary is not easy, but once established it will possess complete banking functions which are very close to those of British banks.

By section 3(1), no person shall in the UK accept a deposit in the course of carrying on a deposit-taking business, unless that person is an institution authorised by the Bank of England. To become an authorised institution, a foreign bank must apply to the Bank of England, which must be satisfied before granting authorisation that the certain minimum criteria specified in Schedule 3 have been properly fulfilled. The most important of these criteria are reflected from the Bank's system of prudential supervision which comprises three major limbs: a) capital adequacy and liquidity control; b) control of the bank's controller(s); and c) risk protection control.

(1) Capital adequacy and liquidity control

Capital adequacy and liquidity control has the objective of improving financial stability which can be enhanced through

the supervision of the strength of financial institutions' capital and liquidity positions.

In relation to capital adequacy, the Bank adopted the proposals put forward by the Basle Committee representating the "Group of Ten" countries in 1988, and the Committee's recommendations providing for banks to hold a minimum of 8% of capital against their weighted counter-party risks were imposed on the UK banks [8]. However, this 8% of capital is a minimum sum and in reality for most banks the actual figure might be much higher. Additionally, by para. 6(1) and 6(2) of Schedule 3, each bank must have a minimum paid up capital and reserves of £1 million, which in practical terms may not be so difficult to satisfy.

Concerning liquidity control, while para. 4(4) of Schedule 3 provides that a banking institution should maintain adequate liquidity having regard to the relationship between its liquid assets and its actual and contingent liabilities, the Bank of England does not use liquidity ratios which should be adhered to by all banks as a standard, but instead indicates that liquidity management is the responsibility of each bank's management with the Bank seeing that individual bank liquidity needs are met [9]. In practice, the guideline ratio for the time being is 12% [10].

(2) Control of the bank's controller(s)

Section 21 prohibits any person from becoming a controller of an authorised institution incorporated in the UK unless he has given notice to the Bank and the Bank does not object. Section 105(3) defines a controller in relation to an institution essentially as any person in the capacity of managing director, or chief executive, or anyone who is entitled to exercise or control the exercise of 15% or more of the voting power at any general meeting of the institution or of another institution of which the former institution in question is a subsidiary. The primary purpose of this control is to protect the UK banking sector from aggressive foreign or other undesirable take-overs, and from the influence and control of individuals whose interests may be harmful to those of depositors.

(3) Risk protection control

Risk protection control, based on providing better consumer protection, is carried out by reporting any large risk exposure and contributing to the deposit protection fund.

Section 38(1) requires an authorised institution to make a report to the Bank of England whenever it enters into a transaction or transactions with a single customer with risk exposure of over 10% of its available capital

resources, or proposes to enter into such transactions with risk exposure of over 25% of those resources.

In order to give protection to depositors against loss, the BA 1987 continues under section 50(1) the Deposit Protection Fund which was established by section 21 of the Act of 1979. According to sections 53-55, each institution is required to make an initial contribution to the Fund at the time of its authorisation and make further or special contributions subsequently so as to restore the amount standing to the credit of the Fund to a minimum of £5 million and a maximum of £6 million if the Fund is reduced beyond the limit of £3 million. Payments may be made out of the Fund upon the occurence of certain specified events which amount basically to the insolvency of an authorised institution, and are limited to a maximum of three-quarters of the depositors' protected deposits maintained at not over £20,000 (sections 58 and 60).

### 3.2.2 Branch and representative office

It is easier for a foreign bank to set up a branch in the UK which is equally able to carry on banking transactions. However, a branch does not have a separate juridical status, and when considering whether it meets the minimum criteria for authorisation, it will be the whole institution which is to be considered and not just the

branch itself, and also the parent bank will be responsible for all obligations committed by the branch. Thus the branch assets alone do not need to meet the minimum capital adequacy and liquidity requirements. Also, it can be construed from section 38(1) that reporting large exposures may not be required for a branch whose principal place of business is outside the United Kingdom.

The simplest way for a foreign bank to establish business presence in the UK is to form a representative office. A representative office is not permitted to conduct a deposit-taking business. Its sole function is to assist and promote the activity of the institution based abroad. Since it does not carry on deposit-taking business, there will be no necessity for it to be authorised under the BA 1987. It is likely that the Bank of England might prefer an overseas bank to establish a representative office which merely does promotion work, thus protecting the interests of domestic banking sector by controlling foreign direct participation in the business as subsidiaries or branches. To foreign banks, especially those which are not quite familiar with the UK's financial operation system, it might be a good idea to set up a representative office in the first place, which is used as a stepping-stone for expanding its activities and becoming a branch or having a subsidiary incorporated later on.

## 3.3 REGULATIONS OF CARRYING ON INVESTMENT BUSINESS

Due to existence of the UK's mature and well-developed investment industries, it is worthwhile for foreign companies to tap into the various financial markets by carrying on investment business from the angle that they act as brokers, agents, advisers or market-makers. The FSA 1986 is intended as a system of regulation relating to the entire investment sector, from large financial institutions to small investment advisers.

### 3.3.1 Concept of investment business

The FSA 1986, rather than devising an all-embracing definition, introduces a comprehensive list of investments which might become the subject matter of carrying on investment business.

According to section 1(1), an investment means any asset, right or interest falling within a statutory list inserted in Part I of Schedule 1, which widely comprises: a) all types of securities and interests in securities, such as shares, bonds, notes, debentures, certificates of deposit, government and public securities, depositary receipts, warrants, options, and units in collective investment schemes; b) currency and other financial options, options on metals and options on commodity futures; c) delivery-

based futures (but not where the contract is made for purely commercial purposes other than a recognised investment exchange); d) contracts for differences, including index-based futures contracts; and e) most long-term insurance contracts.

By Part II of Schedule 1, the regulatory framework in general terms covers all types of investment business conducted in the UK, embracing: a) dealing in investments; b) arranging deals in investments; c) managing investments; d) advising on investments; and e) operating a collective investment scheme. Moreover, under section 1(3), a person carries on investment business in the UK if he carries on investment business from a permanent place of business maintained by him in the UK or engages in investment activity which constitutes carrying on a business in the UK.

The statutory definition of various activities constituting carrying on of investment business is very detailed and complicated. Nevertheless, this precise definition of investment business essentially serves three important purposes. Firstly, the FSA 1986 only applies to investment business carried on in the UK, excluding the activities wholly conducted overseas. The test is whether the revelant activities are from a permanent place of business maintained in the UK or amount to the carrying on of a

business there from abroad. As a general proposition, foreign companies having UK clientele can be counted as carrying on a UK business. Secondly, the definition is used to determine whether there is a real business involving investment activity. In practical terms, this purpose is of great significance. It may help to ascertain whether a particular transaction is an investment activity governed by the FSA 1986 so that in the event of a transaction which is excepted from the statutory list, the company concerned will not be amenable to any disciplinary jurisdiction or statutory liability under the FSA. Thirdly, if the preponderance of a company's activities are excepted from the statutory list of investment business, certain particular transactions in which it engages that are statutory investment activities may not be subject to the provisions of the FSA, unless the transactions are sufficiently numerous and/or continuous to constitute a business with a recurring source of profit. The purpose of this test is to avoid having essentially non-investment business entities from being unnecessarily regulated.

### 3.3.2 Attractions of major investment markets

As the objectives of different investors may vary, the kinds of investment which they choose to meet their varying objectives will differ correspondingly. The most attractive benefit of carrying on investment business in

the UK lies in the fact that within the financial markets, there is a wide range of trading arrangements, which are made to locate investors with whom to carry on transactions. The principal characteristics of investment markets in the UK can be highlighted by performance of three major investment exchanges - the London Stock Exchange, LIFFE, and the commodity markets.

(1) The London Stock Exchange

The London International Stock Exchange is one of the world's best known markets for the trading of equities. It brings together those wanting to raise finance with those who wish to invest. In general, the Exchange offers markets for buying and selling of four major types of securities: a) British domestic equities; b) foreign equities; c) UK gilts; and d) bonds or fixed interest stocks. It has set up a highly developed trading system for market participants to transact efficiently.

So far as foreign companies conducting investment transactions are concerned, the secondary market existing on the Stock Exchange as the place where securities are traded is of the closest significance to them. The active secondary market maintained by the Stock Exchange provides foreign companies numerous opportunities for realising their investment aims.

Since the substantial change of the Exchange's rules in 1986 (i.e. the "Big Bang"), the separation of members into brokers and jobbers has been ceased [11]. All business entities can now become brokers able to represent clients in the markets or principals buying and selling securities on their own account, and are also permitted to register as market makers [12].

(2) LIFFE

Created by the merger of the London International Financial Futures Exchange and the London Traded Options Market in 1992, LIFFE (i.e. the London International Financial Futures and Options Exchange) is now one of the world's leading exchanges devoted to financial futures and options [13].

With unprecedented volatility in the financial markets at the present time, new opportunities and their associated risks exist simultaneously. Not only must financial assets be prudently and vigilantly protected against potential market adversities, but opportunities afforded for enhanced performance are expected to be quickly recognised and selectively pursued. The result is an environment in which financial futures and options markets have become a necessity for investors and traders. The principal benefit of financial futures and options markets lies in the

effective risk protection against adverse movement of financial instruments' values in question. At the same time, LIFFE transactions can be employed to implement a range of aggressive and speculative strategies. It provides risk management and trading chances in fixed income, treasury and equity products with instruments which encompass both short and long end of the yield spectrum and are denominated in a total of seven major world currencies [14].

(3) The commodity markets

The commodity markets in the UK are composed of the London Metal Exchange and the London Commodity Exchange.

The London Metal Exchange's function is to provide an efficient and orderly market on which transactions take place in non-ferrous metals. The Exchange's members may act on behalf of their customers to purchase or sell standard quantities of metals. Bargains are made either for immediate settlement or for delivery in three months' time, and member businesses may additionally issue or deal in options to buy or sell standard quantities of metal for delivery in three months' time [15]. The Exchange is a useful place for hedging and speculating, and primarily concerned with variations in the price of the metals but not their physical supply.

The London Commodity Exchange is Europe's primary centre for the trading of soft commodity futures and options contracts [16]. Like the Metal Exchange, the Commodity Exchange is a financial market concerned with price movement and fulfils the same functions as the Metal Exchange in respect of hedging and speculating. Contracted commitments by its members are usually closed out by entering into counteracting forward contracts or by paying differences between the contract price and the ruling market price at the time of settlement, with very few physical delivery.

### 3.3.3 A two-tier regulatory system

(1) The SIB as the leading regulator

In 1981 the government commissioned Professor L.C.B. Gower to enquire into the operation and effectiveness of the existing law governing investor protection, and based on the Gower's report, the government published its own proposals for new legislation [17]. The common feature of the Gower proposals and the government's proposals was their conclusion that the most effective, practical and economical way to regulate investment markets and activities would be to combine regulation by the representative organisations whose members are engaged in various branches of investment business, with a supervisory

function and a residual degree of regulation by a government appointed body acting as an agent of the state [18]. This notion thus formed the basis of the FSA 1986 and also the SIB's role as the leading regulator.

A self-regulatory system is now applied under the auspices of the SIB in the capacity of a government designated agency responsible for authorising a series of self-regulatory bodies and overseeing their business operations.

The role of the SIB can virtually be classified as standard setter and as supervisor of regulators.

Whilst the FSA 1986 provides the legal basis for the SIB to be empowered to make rules concerning the conduct of business under section 114, the primary role of the SIB in practice is to formulate and develop policies which set standards of investor protection and market integrity. This does not mean that the SIB needs to write more rules in sophisticated technical terms, but means that it spells out where the goal posts are. So that on the one hand, it provides a benchmark of equivalence to judge the rules of the second-tier regulators, and on the other hand, it ensures that investors can know what is expected of business entities engaged in investment activities with whom they deal and equally such business entities can know what is expected of them.

The SIB's role as supervisor of regulators is crucial to the achievement of the objective of cost-effective investor protection. Under the two-tier system, the self-regulatory bodies are the front line regulators with the job of carrying out day-to-day regulation. They are thereby responsible for the quality of the relationship between the members and the public and between their members dealing with each other. However, these self-regulating bodies have to obtain recognition of the SIB in the first instance. Thus, the SIB's duty as supervisor of regulators is fulfilled by carrying out recognition or withdrawal of such recognition so as to guarantee that standards set for regulating recognised bodies are properly delivered.

(2) SROs as the second-tier regulators

The second-tier regulators which are of closest relevance to foreign companies are self-regulatory organisations (SROs). Under the SIB's supervision, they are responsible for the regulation and authorisation of their members, and also have to devise rules that are at least as stringent as those of the SIB itself. Although the SIB undertakes regular supervision of them to ensure that they do their jobs properly, the system of the second-tier regulation runs parallel with that of the direct regulation by the SIB.

By section 8(1) of the FSA 1986, SROs play the role of regulating the carrying on of investment business of any kind by enforcing rules binding on their members, who carry on business of that kind. Although the SIB retains ultimate control, members of SROs are regulated by the rules and constitutions of SROs themselves, and not directly by the SIB. In practice, most foreign investment companies need to obtain their authority to carry on investment business through SRO membership. And a conglomerate conducting a wide range of investment business is likely to face the prospect of joining more than one SRO.

There are currently four SROs recognised by the SIB: Securities and Futures Authority (SFA), Investment Management Regulatory Organisation (IMRO), Financial Intermediaries, Managers and Brokers Regulatory Organisation (FIMBRA), and Life Assurance and Unit Trust Regulatory Organisation (LAUTRO).

SFA is a SRO responsible for regulating business entities that are securities, and derivatives dealers and advisers, and their members are active on the London International Stock Exchange, LIFFE, and the London Metal Exchange, etc. [19].

IMRO principally regulates fund managers and advisers

undertaking management of investments, and trusteeship of collective investment schemes, and its members are mainly from merchant banks, investment trusts, pension fund managers, unit trust managers and insurance companies [20].

FIMBRA oversees investment advices and services offered by independent investment intermediaries in life assurance, unit trust, pensions and personal equity plans, and normally divides its members into the following three categories, depending on whether they handle clients' money and the type of investment business they do: a) members may do any investment business regulated by FIMBRA, and are entitled to handle clients' money and assets; b) members may be involved in any business regulated by FIMBRA except dealing as principal with clients, and are entitled to handle clients' money and assets; c) members may be engaged in the same areas of business as those in category b), but they may not handle clients' money and assets [21].

LAUTRO has its business scope confined to the marketing of life assurance, unit trust products and other collective investment schemes, and mainly consists of insurance companies, friendly societies, unit trusts, and other operators of collective investment schemes [22].

Duplication of regulation over a company or a group of companies which has to join more than one SRO is obviously

a potential problem, and many foreign companies are concerned about the overlapping requirements of different SROs that they have to join simultaneously due to the wide range of activities which they want to carry out. To solve this problem, close co-operation between SROs is essential and any single SRO ought to be willing to share information with all other counterparts. Also, the SROs' responsibilities pertinent to financial surveillance of the member concerned should be clearly allocated by virtue of expertise to a specifically designated SRO, which becomes responsible for the member's business as leading regulator in its own field. Moreover, mergers between certain SROs equipped with similar and overlapping functions are necessary to be conducted as well.

### 3.3.4 Routes to become authorised

Foreign companies proposing to carry on investment business in the UK need to apply for authorisation. The FSA 1986 by section 3 prohibits carrying on of investment business without authorisation. There are three main routes to become authorised: a) they may apply directly to the SIB; b) they may become authorised by getting approval from a SRO in most circumstances; and c) they may become automatically authorised as EU-based companies.

In the first two events, foreign companies must be aware

that incorporation of a subsidiary in the UK through which operation is carried out is an important pre-condition to be fulfilled. Difficulties in monitoring the capital adequacy of a foreign company operating on a worldwide basis as a single entity may lead the SIB or SROs to reject its application for conducting investment activities in the UK via a branch, unless exceptionally the home country can be in agreement with the UK authority ensuring the imposition of the necessary supervision with which the UK authority can be satisfied.

(1) Direct authorisation by the SIB

They may apply for direct authorisation by the SIB. The application should include the information as to the investment business proposed to carry on, the services provided and any other information required by the SIB (section 26(2)). The SIB upon receipt of application for authorisation will first of all consider from the information furnished whether the applicant is a fit and proper person to carry on the investment business (section 27(2)). The fitness and propriety are essentially determined by the applicant's financial capability which has to be proved to the satisfaction of the SIB by fulfilling the financial resources rules set forth by it. However, the provisions in the FSA 1986 do not reveal any exact amount as to the adequate level of financial

resources required. The SIB makes rules imposing different financial resources requirements under different circumstances (section 49(2)). In addition, the SIB will also consider other factors in making its decision to grant or refuse an application. For example, the information about the controllers of a company (i.e. directors or shareholders who control 15% or more of the voting powers at the general meeting, or another body corporate of which the company in question is a subsidiary), the proposed employees, and the appointed representatives in question, might additionally be asked for (sections 27(3)(a) and 207(5)(a)).

Direct application to the SIB is often based on two reasons. First, in the case of the company having no permanent place of business in the UK, the SROs might be very reluctant to grant authorisation to it, thus there could be no other alternative but directly applying to the SIB. Second, the intended investment business might fall within the scope of several SROs and it will be more convenient if authorisation could be acquired once for all from a single source. However, direct authorisation is not easy, nor is it encouraged by the SIB.

(2) Authorisation by a SRO

The role that SROs are playing is of the utmost importance

to the self-regulating legal structure. Most foreign companies obtain their authority to carry on business through membership of and participation in SROs so as to meet the diverse investment demands to their own advantages.

Members of a SRO shall be fit and proper persons to carry on investment business of the kind with which the SRO is concerned, and in order to prove their fitness and properness, they should satisfy the financial resources requirement and other factors same as those discussed above in connection with authorisation by the SIB (para. 1(1) and 1(3), Schedule 2). Each SRO has rules regarding its own business scope prohibiting its members from carrying on a kind of investment business which it does not itself regulate (section 10(3)). The applicant shall ensure that correspondence does exist between its planned investment business and categories of the investment scope of the SRO. To avoid conflicts arisen from the inconsistence between the desired activities and the rules of the SRO, the company intending to participate in a number of separate investment activities shall join more than one SRO.

(3) Automatic authorisation to EU-based companies

A foreign company becomes automatically authorised to carry on investment business in the UK if it has established a

business entity in a EU member state other than the UK, and under the law of that state, has been recognised as a national, and authorised to carry on investment business in that country (section 31(1)). A foreign company may firstly set up a permanent business place in a EU member state, where it is likely that they may be subject to looser administrative control than in the UK, and then carry on the UK investment business indirectly from their EU base. This method could be used to avoid or at least to minimise the cumbersome procedures for obtaining authorisation in Britain.

To become automatically authorised, a EU-based company must ensure that the law of the member state where their investment business entities are established affords protection to investors in Britain at least equivalent to that provided by the provisions contained in the FSA 1986 (section 31(3)(a)). Additionally, the provisions of the law under which they are authorised to carry on investment business shall satisfy the conditions laid down by the regulations of the Council of Ministers for the European Communities for the coordination or approximation of the laws, regulations or administrative provisions of member states relating to the carrying on of investment activities (section 31(3)(b)).

### 3.3.5 Measures for investor protection

The FSA 1986 is intended to provide substantial investor protection with the aim of ensuring healthy, internationally competitive investment markets in which all investors can have confidence. The rules and regulations with which each regulator under the two-tier system has to comply are maintained and enforced by the SIB and the relevant SROs. They principally cover the areas relative to the conduct of investment business by authorised entities which must guarantee that adequate protection can be secured by investors.

The current two-tier regulatory system provides regulators a substantial armoury of supervision sanctions concerning the way for foreign investment companies to seek business, the regulation of insider dealing, and the treatment of investors' complaints and compensation.

(1) The way to seek business

The marketing of investments is tightly controlled by the FSA 1986. Misleading advertisements, statements, claims and unsolicited calls to sell investments are generally prohibited.

Pursuant to section 57(1), investment advertisements must only be placed by authorised businesses. And in the context of section 48(2)(e), these businesses while issuing

advertisements must observe the rules made by the SIB regulating the form and content of investment advertisements. Since investment advertisements are where investors are very probably at greatest risk, certain warnings about matters such as the volatility or marketability of the investments advertised shall be given to prospective investors in advance. Unsolicited calls to sell investments are normally banned even by authorised businesses (section 56(1)). The main exceptions to this are calls relating to life assurance and unit trusts, where such a cold-call results in a sale the customer normally has a 14-day "cooling-off period" (i.e. a period in which the rescinding or the withdrawing of offers to enter into investment agreements are available according to section 51(1)) during which he can reconsider the transaction and withdraw if he wishes [23].

To seek business, authorised entities must release appropriate information to prospective investors. Information about charges, fees and commissions claimed after doing business with clients is to be provided (section 48(2)(g)). If an authorised business itself has a material interest in a transaction, conflicts of interest may arise in the course of marketing of investments. In such a position, the authorised business must timeously disclose the nature of the interest conflicted to investors (section 48(2)(h)). Some changes have been made to

disclosure rules recently. The most important change is the separation of information into a) key features (vital information to be given at the time when the product is recommended); b) important information (to be provided no later than the start of any cooling-off period); and c) usual information (available on request) [24]. These new amendments will mainly affect how intermediaries who advise on and sell packaged products are to disclose to potential investors their status and the details of the products offered.

(2) Insider dealing

Insider dealing, as the practice of using confidential or price-sensitive information for personal gain, was rendered as a criminal offence firstly under Part V of the Companies Act 1980. The Companies Securities (Insider Dealing) Act 1985 re-enacted the earlier legislation with relatively minor amendments [25].

Under sections 1 and 2 of the Insider Dealing Act 1985, insider dealing is specifically defined as dealing which is when an individual knowingly transacts in a security whilst in possession of unpublished price sensitive information relating to that security, and summarises the following 12 categories of offences as insider dealings: a) primary insider dealing in the securities of the insider's own

company; b) primary insider dealing in the securities of a company with which the insider's company has or is about to enter into a transaction; c) secondary insider dealing in the securities of the informant's company; d) secondary insider dealing in the securities of a company with which his informant's company has or is about to enter into a transaction; e) dealing in a capacity other than an offeror; f) secondary insider dealing by other than the offeror; g) counselling or procuring a person to engage in insider dealing; h) communicating inside information for the purpose of insider dealing; i) primary insider dealing by a public servant; j) secondary insider dealing on the basis of inside information obtained through a public servant; k) counselling or procuring a person to deal on the basis of inside information obtained as or through a public servant; l) communicating inside information obtained as or through a public servant for the purpose of insider dealing.

The regulation of insider dealing is in the hands of the DTI (Department of Trade and Industry), and the self-regulatory authorities such as the Stock Exchange and the Panel on Take-overs and Mergers. Inspectors of the DTI have wide investigative powers if insider dealing is suspected. And the self-regulatory authorities assist the DTI in respect of ensuring duly release of information and regulating the conduct of their members. Insider dealers

may face severe punishment. By section 8 of the Companies Securities (Insider Dealing) Act 1985, an individual convicted on indictment of any of the above-mentioned twelve offences is liable to a term of imprisonment not exceeding two years and/or an unspecified fine.

(3) Investors' complaints and compensation

Authorised investment businesses are required to fully investigate and handle all customer complaints. The proper fulfilment of such obligation is under the supervision of SROs and the SIB, which have intervention powers that can be used in the interests of investor protection. The SIB is required to make proper arrangements for the investigation of complaints in respect of authorised businesses to be carried out in appropriate cases independently of the SIB and those authorised businesses (para. 4(2), Schedule 7, the FSA 1986). The SIB may take further actions including prohibiting the employment of unfit persons, and applying for an injunction or restitution order to restrict the business of the authorised entities. SROs may also discipline their members. However, if the authorised businesses in question express disagreement with the investors' complaints as well as the disciplinary measures taken by the SIB or SROs, they may appeal to the Financial Services Tribunal for judgement. The Tribunal is an independent body which

functions to prevent the possible abuse of power by the SIB against the authorised businesses. The Tribunal has the authority to investigate a case referred to it, and will compel attendance of communities or persons in question as well as production of any documentary evidence (section 98(1), para. 5(1) of Schedule 6). It shall be the duty of the Secretary of State for Trade and Industry to decide on the matter forthwith in accordance with the Tribunal's opinions (section 98(1)).

According to section 54(1), the SIB may make rules establishing a scheme for compensation of investors who are owed money or other assets by an authorised business which has become insolvent, either deliberately through fraud or from poor trading. This provision permits creation of a centralised compensation scheme, known as "the Investors' Compensation Scheme", applying to all members of participating SROs and all directly authorised businesses, under which affected investors have chance to be paid up to £48,000 at present [26].

PART II (CHINA PART):

While China's transition to a market economy has been characterised by a "gradual" or "evolutionary" approach to economic reform, the reform in the financial system is very slow. In spite of the fact that efforts have been made to produce rules for increasing the transparency of the regulatory regime, the lack of a complete and elaborate legal framework in financial markets results in the existence of a lot of legal vacua, and many practices are merely conducted at the trial-and-error stage. Concerning the roles played by China's financial markets upon the operation of inward investment, the negative elements seem to play a larger part under current circumstance.

The biggest hurdle for foreign investors to overcome is the foreign exchange control system, which exerts a determinant impact on almost every foreign investment transaction carried out in China. Under the prevailing system, two-way flows of foreign exchange are subject to close surveillance and restrictive control, whereas Chinese currency is not freely convertible. Moreover, as to foreign investment enterprises in China, the system stresses the importance of maintaining balance of their foreign exchange receipts and expenditures at all times, so that resolution of problems emerging in connection with exchange shortages will largely fall to be the responsibilities of the enterprises in

question.

Since China's securities market is still developing and is at an embryonic stage outwith proper legal guidelines, in the absence of the securities law and the relevant financial services legislation, and is therefore not a suitable place for fund-raising at the present time, foreign investment enterprises seeking external finance from market sources should principally rely on applying for loans from Chinese banks. Whilst bank loans are available, the borrowers will have to satisfy a series of stringent criteria to qualify for a loan, and as the government tightens the credit constraints presently in force for fear of worsening the existing high inflation, raising finance from Chinese bank sources is in practice not easy.

Foreign investors as financial institutions may under strict control establish their business presence in China. With the exception of a limited range of banking activities in foreign exchange, they are prohibited from offering other financial services, and are particularly not allowed to be engaged in any form of business relating to Chinese currency. Whilst some foreign financial institutions establish operations simply to satisfy the needs of their own clientele who are doing business in China, most of them cast their eyes on China's virtually limitless consumer market for future financial opportunities. As the overall

reforms progress, it is foreseeable that China will definitely widen foreign investors' access to its financial markets; thus maintaining an establishment in China at the present time has become vital to foreign financial institutions in their efforts to preserve a competitive edge and succeed in business in the near future.

### 3.4 FOREIGN EXCHANGE CONTROL SYSTEM

Every inward investment project must comply with China's foreign exchange control system. The contours of this system basically cover two areas: a) the administration and control of foreign exchange; and b) the ways by which a foreign investment project may achieve and maintain a balance of foreign exchange receipts and expenditures, which plays a key part in alleviating pressures imposed by any foreign exchange shortage.

#### 3.4.1 Administration and control of foreign exchange

The basic law governing foreign exchange control is the Regulations 1996 on Administration of Foreign Exchange (i.e. the 1996 Regulations), which have taken effect as of 1 April 1996 replacing the 1980 Interim Regulations in this regard and the relating implementation rules. In the context of article 2, the administration authority of foreign exchange is vested in the State Administration of

Exchange Control and its local offices. Directly under the leadership of the People's Bank of China, which is China's central bank, the State Administration of Exchange Control and its local offices are given sole authorities over formation and implementation of policies and regulations of the exchange control system, confirmation and declaration of official exchange rates, and supervision of all business activities in China concerning foreign exchange transactions [27].

In reality, the principal administration and control of exchange relate to four aspects: a) the foreign exchange rate; b) the foreign exchange accounts; c) the disclosure of foreign exchange position; and d) the transfer of foreign exchange abroad.

(1) The foreign exchange rate

The Chinese currency, RMB, is independent from any currency bloc. It is not freely convertible, nor is it pegged to any foreign currency. The exchange rate is formulated, adjusted and declared by the State Administration of Exchange Control every day on the basis of the latest information from international financial markets as well as taking into account the need to satisfy the special requirements of the prevailing national economic policies. All foreign exchange transactions within the Chinese border

must be carried out in the context of the official exchange rates.

Whilst this compulsory application of exchange rates fixed by the state is purely a product of the planned economy, as China's economy is still in a state of transition from the old planned regime to the proposed market system, it is indispensable for the time being to maintain an adequate degree of government intervention so as to ensure a proper balance of payments, and prevent any likely risks from adverse fluctuations of exchange rates. As the financial reform must be carried out in conjunction with the restructuring of other economic sectors, and the nature of financial markets determines whether any tightening or loosening of control may have a rippling effect on the whole national economy, the government in this regard consistently takes a very cautious attitude. Notwithstanding the fact that a convertible Chinese RMB with the exchange rates floating in accordance with international markets will emerge at some point, realisation of this objective is not a thing which can be accomplished overnight.

(2) The foreign exchange accounts

Foreign investors may keep foreign exchange accounts both in China and abroad.

In the light of articles 9 and 19 of the 1996 Regulations, foreign investment enterprises may open their foreign exchange accounts in China with any bank approved by the central bank (i.e. the People's Bank of China) or by the State Administration of Exchange Control.

Foreign investment enterprises may also open and maintain foreign exchange accounts outside China. To do this, they must apply to the State Administration of Exchange Control for its approval in the first instance. In order to place any account opened abroad under effective surveillance, in 1989, the State Administration of Exchange Control promulgated the Rules Regarding Setting-up of Overseas Accounts by Foreign Investment Enterprises (i.e. the 1989 Rules). Under article 3 of the 1989 Rules, the applicant must certify that all registered capitals are fully paid up, elaborate the reasons for opening such overseas accounts, and also indicate the methods of regulation and supervision of these accounts. Moreover, according to article 7, the State Administration of Exchange Control will impose limitations upon the accounts' scope of incomes and expenditures, deposit ceiling and validity period. The purpose of doing this is to restrain any illegal transfer of domestic profits by taking advantage of maintaining accounts overseas.

(3) The disclosure of foreign exchange position

Foreign exchange accounts are subject to constant supervision of the State Administration of Exchange Control. Foreign investment enterprises have to provide information about their business activities in connection with foreign exchange to and have their foreign exchange incomes and expenditures inspected by the State Administration for Exchange Control, if required.

In the context of article 5 of the 1996 Regulations, foreign investment enterprises must report periodically to the State Administration of Exchange Control on the state of their foreign exchange reserves. Such periodical report in practice normally includes an annual balance sheet, a statement of profit and loss and a statement of foreign exchange receipts and expenditures along with the audit report provided by an accountant registered in China.

(4) The foreign exchange transfer

To transfer foreign exchange overseas might be subject to the consent of the State Administration of Exchange Control.

Such approval is particularly required for a foreign investment enterprise to allocate capital to its establishments overseas [28].

However, the 1996 Regulations relax the previous constraints pertaining to transferring foreign exchange income. Foreign investors may now freely repatriate the profits and dividends in the form of conventible currencies without the need of applying to the State Administration of Exchange Control for approval as required in the past, providing that in doing so they are able to show the resolution of the board of directors authorising the distribution of profits, the evidence indicating that tax is paid, and the contract that clarifies the method of profit distribution [29].

### 3.4.2 Foreign Exchange Balance

Like the situation in most developing countries that exercise exchange control, how to achieve balance between foreign exchange revenues and expenditures is always posed as a problem which foreign investors in China have to encounter. Although in principle foreign investment enterprises should guarantee adequate exchange earnings to pay all their foreign exchange expenditures, imbalance between exchange incomes and expenses can hardly be avoided in reality. Many enterprises are faced with deficits for having imported more than they have exported. In addition to their inability to export more, some of them are reluctant to expand exports for fear of incurring competition against their similar products abroad, and

place their hopes on the vast domestic markets for digesting what they have produced in China. Therefore, how to maintain balance between exchange incomes and expenditures is a matter of great concern not only to foreign investors but to the government as well.

The steps taken by the government to resolve the issue can be reflected from the following two legal documents: the State Council promulgated the Provisions on Questions of Balancing Foreign Exchange Receipts and Expenditures of Sino-Foreign Joint Ventures in 1986 (the 1986 Provisions); and in 1987, MOFTEC formulated the Procedures Concerning Purchasing of Domestic Products by Foreign Investment Enterprises for Exports to Resolve Problems of Balance of Foreign Exchange Receipts and Expenditures (the 1987 Procedures). The 1986 Provisions apply only to equity joint ventures and co-operative joint ventures (articles 1 and 11), whereas the 1987 Procedures have broader application and cover wholly foreign-owned enterprises as well (article 1).

Whilst the basic theory that foreign investment enterprises should export to generate sufficient exchange for maintaining a balance of foreign exchange receipts and expenditures remains unchanged, the real significance under these two documents lies in the allowed exceptions to this general principle. The rules in the context of the 1986

Provisions and the 1987 Procedures provide various options for a foreign investment enterprise to achieve a foreign exchange balance, and these alternatives can be classified into four broad categories: a) an arrangement can be made allowing the enterprise to market its products in domestic markets; b) the enterprise can reinvest earnings in Chinese currency in other domestic enterprises in China that generate foreign exchange; c) an internal adjustment of the excess exchange can be made by the foreign investor among the funded enterprises set up in China; and d) the enterprise can buy Chinese domestic products for export. However, a wholly foreign-owned enterprise can only have one option (the last one of the above four), i.e. to purchase domestic goods for export, as the 1986 Provisions which introduce the other three alternatives do not cover it.

(1) Domestic sale

Domestic sale refers to an arrangement that allows a foreign investment enterprise to sell its products in Chinese domestic markets for receiving foreign exchange. The relating rules answer two major questions: a) what products can be sold in domestic markets; and b) how foreign investors are ensured that the sale's income can be safely converted into foreign exchange.

With respect to the first question, articles 4 and 5 of the 1986 Provisions qualify two kinds of product: a) products that China urgently needs - in cases where the foreign party to a joint venture provides highly sophisticated products produced with advanced or key technology, or products of superior quality that are internationally competitive, if such products are urgently needed in China, after the products have been appraised and found by the relevant authorities to be up to the required standard, preferential treatment with respect to the proportion of domestic sales and the period of domestic sales can be given; b) products that China needs to import over a long term or urgently needs to import - these products produced by foreign investment enterprises if they are of the same technical standards as those to be imported are used as import substitutes. In practice, domestic sale in the form of import substitutes has more profound significance: it is not only a way for reducing imbalance of foreign exchange accounts, but an important step taken to realise one of the basic aims for absorbing foreign investment, i.e. to gradually substitute domestically produced goods for imported commodities. However, in general terms, there are some disadvantages in connection with domestic sales. First, a part of domestic markets are to be lost to foreign investment enterprises, and local customers will have to pay from the state's limited foreign exchange reserves. Second, a price problem may occur: whereas import

substitutes are basically priced by virtue of international market prices, if they are priced too high, domestic customers may turn to international markets for purchasing; and if they are priced too low, the problem of foreign exchange deficit will still not be properly resolved.

Concerning the second question, the responsibility for guaranteeing that the income of domestic sales is obtained in foreign exchange is vested in the government departments, most notably MOFTEC (or its designated local authorities) which are empowered to approve the establishment of the joint venture, and the State Administration of Exchange Control which commands the whole country's foreign exchange balance position [30]. Under article 3 of the 1986 Provisions, the above government departments may adjust the foreign exchange receipts and expenditures of all joint ventures in China. When a joint venture that has foreign exchange surplus sells its foreign exchange for Chinese currency, the governemnt authorities will set aside the foreign exchange receipts for later resale to other joint ventures that need foreign exchange. The funds so received are the major sources available for the authorities to remedy foreign exchange shortages of joint ventures within their own jurisdictions. This approach is used to maintain overall foreign exchange balance among joint venture projects on the countrywide basis.

(2) Reinvestment of Chinese currency

Another alternative to resolve a foreign exchange imbalance is to allow the foreign investor to reinvest its earnings in Chinese currency from a joint venture in other domestic enterprises that would generate foreign exchange.

Article 10 of the 1986 Provisions provides that a foreign investor in a joint venture which is unable to maintain its foreign exchange balance may invest its Chinese currency profits in other enterprises in China, and in the case of such a reinvestment leading to an increase in the foreign exchange earnings of the enterprise invested, the foreign investor may receive its profits in foreign exchange from the enterprise in which it has invested and is also entitled to refund of part of the tax paid for the invested profits.

(3) Inter-enterprise transfer of excess foreign exchange

If a foreign investor has been involved in and funded more than one enterprise in China, it is possible to pool foreign exchange reserves to offset one entity's deficit with the surplus of another.

This method of adjusting the excess foreign exchange earnings of one joint venture with the foreign exchange

deficit of another is reflected by article 9 of the 1986 Provisions, which provides that foreign investors who have established two or more joint ventures in China may adjust foreign exchange receipts and expenditures among those joint ventures, but such adjustment among affiliated joint ventures must be approved by the State Administration of Exchange Control and must be agreed upon by the Chinese parties in these joint ventures. This provision has the effect of encouraging foreign investors to diversify their investments in more than one project. But, in practice, because of different considerations for each party's own interests, it often proves not so easy to acquire the agreement of the Chinese party to the joint venture having excess foreign exchange; thus this inter-enterprise transfer approach may not work well in every event.

(4) Purchasing domestic products for export

Article 1 of the 1987 Procedures generally allows foreign investment enterprises to purchase products from the domestic markets and then take advantage of their overseas outlets to export these products for acquiring foreign exchange.

However, this practice is subject to a number of restrictions. Firstly, this method cannot be used on a regular basis. The enterprise in question must only have

temporary foreign exchange difficulties and may use this option just for a certain period of time (article 2). Secondly, this approach cannot be used without limitation, and under article 4 it can only be used to the extent that the enterprise will receive adequate exchange for its business operations in the given year, or for repatriating abroad part of its profits, or for liquidating the assets when the project concerned is dissolved. And thirdly, according to article 2, domestic products to be purchased for export do not include those that are uniformly managed and operated by the state. That is to say, if the products to be purchased are subject to export quotas or licences and uniformly administered by the state, the enterprise will have to obtain approval from MOFTEC, which is in charge of export control, in the first instance.

### 3.5 BORROWINGS FROM BANKS

The prevailing law does not forbid foreign investment enterprises to borrow funds from Chinese banks for satisfying the financing requirements of the enterprise over and above the funds offered by way of the investors' capital contribution. However, applying for bank loans is not easy and must be subject to fulfilment of a number of stringent criteria. Such restriction is based on two main reasons: first, the basic goal of encouraging inward investment is to attract capital inflows from overseas

rather than lending China's limited funds to foreign investors; second, the circle of softening the credit control with the consequent credit expansion may obstruct the work of rationalising China's economic mechanism and result in the worsening of the current high inflation. Thus, the government is forced to become very careful in this regard particularly towards money supply volume as well as investment scale. The overall credit constraint is tightened at present.

In reality, borrowings by foreign investment enterprises are principally from the Bank of China, which is specifically designated by the government to provide credit facilities to foreign investors [31]. The Bank of China as the most important Chinese bank involved in international banking and finance formulated a set of rules in 1987, known as Measures for Providing Loans to Foreign Investment Enterprises (the 1987 Loan Measures), for governing foreign investors who intend to raise finance from it. Borrowings from other Chinese banks follow more or less the same pattern.

### 3.5.1 Normal loans

Article 5 of the 1987 Loan Measures authorises the Bank of China to provide two different types of loan to foreign investment enterprises: a) the fixed asset loans that

normally exist in the forms of middle or short-term loans, buyers' credits, or consortium loans, for the purpose of purchasing fixed assets; b) the working capital loans that are usually short-term revolving funds for deficits arising in the process of production or circulation of goods by the enterprises in question.

Such loans may be extended in either a foreign currency or Chinese RMB (article 6), but they should usually be repaid in the same currency in which they are advanced. The term of a fixed asset loan basically does not exceed seven years, but there is the possibility of extending the term to more than seven years upon the special approval from the Bank of China (article 9), whilst the 1987 Loan Measures do not explicitly specify under what circumstances the special approval can be obtained, thus leaving a lot of room for further negotiation in reality. In accordance with article 10, the longest term of a working capital loan will not exceed twelve months. In either event, the interest rates may not necessarily be imposed in the context of those prescribed by the Bank of China. By article 11, the interest rates may either be those prescribed by the Bank of China, or be decided by borrowers and lenders on the basis of the interest rates reflected from international markets, while in the latter case such interest rates are usually calculated in terms of LIBOR plus certain spreads.

Article 7 provides a number of requirements that must be fulfilled by a prospective borrower before its loan application can be approved: firstly, the enterprise in question must have obtained its business licence for operation, and also established foreign exchange accounts in appropriate banks; secondly, its registered capital has been fully paid up and examined; and thirdly, the most important requirement is concerned with security, i.e. the borrower must provide a guarantee acceptable to the Bank of China, providing that the source of funds for repayment of the loan as well as any interest accrued has been fully ensured.

There is no legislation prohibiting either overseas or Chinese domestic organisations from providing guarantees for foreign exchange loans to foreign investment enterprises in China. However, provision of guarantees by Chinese domestic organisations are subject to strict control. The People's Bank of China in 1987 issued the Interim Rules Concerning Guaranty for Foreign Exchange Loans Provided by Domestic Entities, which regulate under articles 4 and 5 that such guaranty can not be applied to the part of registered capital of the borrower's enterprise, and the maximum value ensured must not be over twenty times the value of foreign exchange currently retained by the guarantor organisation.

### 3.5.2 Chinese currency loans with foreign exchange mortgage

Foreign investment enterprises are entitled to Chinese RMB loans from the Bank of China and other approved financial institutions on condition that they in turn provide acceptable foreign exchange as security. The People's Bank of China specifically promulgated the Interim Rules in 1986 governing this special kind of RMB loan. A major attraction of this credit is that no interest is to be charged on either the Chinese currency loan or the relating foreign exchange mortgaged (article 10).

Application for each mortgaged loan must be filed to the State Administration of Exchange Control, which after checking the sources and values of mortgaged foreign exchange will entrust the relevant banks to carry out the actual issuance of such credits (article 6). The loans are permitted to be used as working capital as well as for investing in fixed assets, with the longest term not exceeding five years in either event (articles 2 and 3).

## 3.6 FOREIGN FINANCIAL INSTITUTIONS

The emergence of foreign participation in financial markets as institutions engaged in banking business results from a growing foreign investment interest. The importance of maintaining a presence in China is emphasised on the basis

that such presence enables foreign financial institutions to monitor closely the Chinese domestic markets in which the laws in connection with financial policies towards banking, monetary supply and foreign exchange control are quite changeable. In these circumstances, a continued presence is necessary for foreign financial institutions to stay abreast of the most recent legal developments, and particularly as competition invariably increases with more foreign financial institutions entering the markets, those institutions with no establishment in China may find it more and more difficult to penetrate the markets in contrast to their counterparts who have already maintained a base in China for some time.

### 3.6.1 Development of foreign financial business

The origin of foreign financial institutions in China after the open-door policy was launched lay in satisfying the requirements of the Special Economic Zones for attracting more foreign funds in the mid-1980s. The only available forms of financial organisations with overseas elements at that time were wholly foreign-owned banks headquartered in China, and Sino-foreign joint venture banks. In 1985, the State Council promulgated the Rules on Administration of Wholly Foreign-Owned Banks and Sino-Foreign Joint Venture Banks in the Special Economic Zones. All financial institutions wholly or partially owned by foreign investors

would have to be geographically located in the designated Special Economic Zones and thus subject to their local jurisdictions in accordance with the special policies formulated by the state [32]. As the economic reforms went further, more and more foreign investors expressed their desire to establish financial business presences in China. To cope with the development of Pudong New Area in Shanghai, in 1990, the People's Bank of China issued the Rules on Administration on Foreign Financial Organisations and Sino-Foreign Joint Venture Financial Organisations in Shanghai. In addition to banks, finance corporations, either wholly or partially owned by foreign investors, were also allowed to be formed in Pudong New Area of Shanghai [33].

However, the 1994 Rules on Administration of Foreign Financial Institutions (the 1994 Rules) replaced the above two sets of rules, and became the sole legislation currently regulating and supervising the businesses carried out by foreign financial institutions in China. According to article 2 of the 1994 Rules, foreign financial institutions in China can now be defined by the following five categories: a) a solely foreign-owned bank headquartered in China, referred to as "foreign bank"; b) a branch of a foreign bank headquartered outside China, referred to as "foreign bank's branch"; c) a Sino-foreign joint venture bank; d) a solely-owned foreign finance

corporation headquartered in China, referred to as "foreign finance corporation"; and e) a Sino-foreign joint venture finance corporation.

The 1994 Rules do not impose any restriction upon the required geographical areas where foreign financial institutions ought to be located. Therefore, theoretically foreign investors may have their financial institutions established at any place they think appropriate. In practical terms, however, setting up such financial institutions are still confined to the Special Economic Zones, some key coastal cities, Pudong New Area in Shanghai and other developed big cities.

### 3.6.2 Establishment of foreign financial institutions

Because of the special characteristics of the financial services industry, applications for the establishment of foreign financial institutions in China have to undergo substantial scrutiny by the relevant Chinese authorities.

Application for establishing foreign financial institutions must be filed to the People's Bank of China for approval, and normally has to go through two stages - a preliminary stage and the final stage. Only applicants whose preliminary application materials are accepted will be entitled to receive an official application form from the

People's Bank of China, and to continue to the final stage for further action. Any applicant who fails to receive such an official application form within ninety days after the preliminary application is submitted will have no chance to have the application taken further (article 13 of the 1994 Rules).

(1) The applicant's qualification

As to a foreign bank or finance corporation, to apply for business establishment, the applicant should be in the capacity of an existing financial institution with its representative office, which can merely play the role of liaising and consulting, having operated in China for over two years (articles 6(1) and 6(2)). Its total assets' value must not be lower than US$10 billion at the end of the year before it submits such application (article 6(3)). A foreign bank applicant is required to have the minimum registered capital in convertible currencies equivalent to RMB300 million, and such requirement in the case of a foreign finance corporation sets a lower standard of the equivalent of RMB200 million (article 5).

In the case of a foreign bank's branch, the applicant should have had its representative office in China for more than two years (article 7(1)). Its total assets' value must not be lower than US$20 billion at the end of the year

before the application is filed (article 7(2)). It must allocate to the proposed branch the necessary working capital in convertible currencies, equivalent to not less than RMB100 million (article 5).

Concerning a Sino-foreign joint venture bank or finance corporation, both parties of the prospective entity must be financial institutions (article 8(1)). The foreign side should have already established its representative office in China (article 8(2)), but the 1994 Rules do not mention how long the office is required to have operated. The total assets' value of the overseas side at the end of the year before the application concerned is delivered must not be lower than US$10 billion (article 8(3)), but the 1994 Rules do not indicate any requirement for the Chinese side in this regard.

If in terms of the requirement for financial resources, a foreign bank's branch is the easiest form of presence to be set up. Its weakness is that it must have maintained a representative office in China for more than two years (article 7(1) of the 1994 Rules). Also, its working capital has to be provided by the parent bank which is unavoidably faced with an increase in operating costs at home. If foreign investors wish to get rid of the financial burdens they might have to assume in the case of setting up a branch, an independent foreign bank or finance

corporation is an ideal form of vehicle to be made use of. But such vehicle must also meet the requirement of maintaining a representative office in China for more than two years.

Establishing a Sino-foreign joint venture bank or finance corporation has the advantage that no requirement is prescribed for how long a representative office of the foreign side to the venture should have operated in China. However, the disadvantage of such an entity is that conflicts may arise between the parties to the joint venture. Each side has its own way of understanding and dealing with financial businesses, and how to reconcile such differences might become a matter of great concern to both parties. Since the financial services industry is a very sensitive business having a highly elastic nature, any inconsistency of internal management will definitely affect the image of the organisation and therefore resist the development of the whole venture's cause.

(2) Preliminary application materials

An applicant intending to set up a foreign bank or finance corporation has to provide the People's Bank of China with the preliminary application materials, including the following documents: a) a statement of proposed registered and paid-up capital; b) a description of proposed business

scope; c) a report of the feasibility study for establishing such institution; d) articles of the institution; e) a copy of its business licence in home country; and f) the balance sheets for the past three years (article 9).

An application for establishing a foreign bank's branch has to be submitted by the foreign bank in question to the People's Bank of China along with the following documents: a) a statement of the working capital allocated by the parent institution overseas; b) a description of proposed business scope; c) a copy of the applicant's business licence in home country; and d) the balance sheets for the past three years (article 10).

Regarding a Sino-foreign joint venture bank or finance corporation, both Chinese and overseas sides of the venture will jointly apply to the People's Bank of China by delivering the relevant materials as follows: a) a statement of proposed registered and paid-up capital, and proportion of such capital contributed by each side; b) a description of proposed business scope; c) a report of the feasibility study for establishing such institution; d) articles of the institution; e) copies of the business licences of both sides in their home countries; and f) the balance sheets for the past three years (article 11).

(3) Application materials at the final stage

As a general rule, after receiving the official application form, the applicant must within sixty days further deliver the following documents to the People's Bank of China for final approval: a) a list of names of chief executives and their backgrounds; b) the powers of attorney granted to the above executives; and c) in the case of establishing a branch, a liability guaranty issued by the foreign parent bank ensuring its assumption of the branch's tax and debt obligations (article 14).

A foreign financial institution that has been approved by the People's Bank of China must within thirty days after the approval finish the following formalities: a) registering with SAIC (the State Administration of Industry and Commerce) after paying up the necessary capital and having its capital inspected by the registered accountant in China (article 15); b) collecting a business permit for engaging in foreign exchange business activities from the State Administration of Exchange Control (article 16).

### 3.6.3 Limited scope of permissible activities

Foreign financial institutions may carry out business activities within the limited scope approved by the People's Bank of China. In reality, they can only deal

with foreign exchange business with customers drawn mainly from foreign investment enterprises, foreign individuals or overseas Chinese. Any Chinese currency transaction is excluded from their business scope.

According to articles 17 and 18 of the 1994 Rules, the principal businesses which are allowed to be conducted by foreign financial institutions cover the following range of activities: a) accepting foreign exchange deposits; b) granting foreign exchange loans; c) accepting and collecting remittances from foreign countries and regions; d) settling export and import transactions, and two-way documentary bills; e) providing foreign exchange guarantees; and f) providing trust, credit investigation and consultancy services, etc.

There are basically two main impediments to the development of foreign financial services.

Firstly, foreign financial institutions are unable to be involved in Chinese currency business at present. Such exclusion is the biggest impediment to the development of foreign financial services in China, which implies that they temporarily have no access to most domestic customers. However, this prohibition is attributable to the situation under the current financial system. The characteristics of the exchange control system require that, first and

foremost for the time being, is the maintenance of a stable exchange rate for ensuring the long-term income of foreign exchange earnings from export. Therefore, it is perceived that time is not ripe for liberalising Chinese RMB's convertability, nor is it for allowing foreign institutions to be engaged in Chinese currency dealings. Moreover, many Chinese state banks are still not fully commercialised, and may have to fulfil some compulsory loan commitments under the state's overall economic scheme. Also, these Chinese state banks are subject to a less favourable tax regime than their foreign counterparts which are entitled to preferential treatment in the capacity of foreign investment enterprises [34]. Thus, if foreign financial institutions were allowed to be engaged in business relative to Chinese currency at the present stage, it would be detrimental to the interests of Chinese state banks as they would have to compete with their foreign counterparts on an unequal footing under such circumstance.

Another impediment is that since China has a strong preference for low-interest or non-interest loans directly from international financial organisations or foreign governments, substantial borrowings from foreign commercial banks or other financial institutions remain tightly controlled by the government. Domestic borrowers including foreign investment enterprises have to prove that their proposed projects will produce sufficient foreign exchange

earnings to repay foreign debts. Otherwise, their application for commercial credits from foreign financial institutions may not easily be approved by the Chinese authorities as all foreign exchange borrowings will be included in the country's overall scheme of foreign debts repayment.

Notwithstanding the above difficulties, there are still ways for foreign financial institutions in China to survive. First and foremost, their attention should consistently focus on giant local development projects, in which they may play the intermediary role in organising finance from overseas lenders and in most cases from international consortiums. However, as opportunities for direct lending to domestic borrowers might be limited, it is also suggested that foreign financial institutions in China consider promoting trade finance and actively participate in the provision of export credit facilities to local customers.

In general, since the laws and regulations applicable to foreign involvement in financial markets are in the process of evolution, removal of barriers which restrain foreign financial institutions from freely participating in many transactions may still be delayed for some time. However, early establishment of a business presence in whatever form is essential. Long-term benefits could be expected from

the financial markets in China.

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# CHAPTER 4

## REAL ESTATE INVESTMENT

Investing in real estate is traditionally assumed as one of the most secure forms of investment capable of producing an income.

Whilst since 1989 real estate values in the UK have been in consistent decline; in consideration of the fact that investment in real property is a long-term venture and fluctuations in values are almost inevitable during certain times, it is still worthwhile for foreign investors in the context of the property law to probe into the essence of the UK's real estate market so as to keep to the general orientation of its development.

China's real estate market has great potentialities to be exploited. In order to attract more capital from overseas, specific rules have been made for regulating inward investment in this regard.

This chapter is intended as a basic discussion about the regulations to which foreign investors may be subject when participating in real estate investment in the UK and China. Although the relating subjects can be quite vast

and complex, major treatments are given in the aspects to which each country lays its particular emphasis.

Whereas the UK's property law is most closely linked with the trading of legal rights over land, Part I (UK Part) concerns two issues: one is about the principal doctrines relative to the practice of real estate business in the UK, and the other relates to the main formalities required for estate acquisition.

As the focus of regulations applied in China is chiefly on the activities which fall into the distinctively divided scopes of a primary market and a secondary one, Part II (China Part) discusses the major functions of the primary market as a place from where land use rights can be acquired by various methods, and also deals with the activities on the secondary market where the land use rights obtained can be further traded and the corresponding developments on the land acquired take place.

PART I (UK PART):

The UK's real estate investment market is the place where a particular type of commodity, the land, is traded. The land is foundamentally different in its physical characteristics from physically movable commodities. What the market actually deals in is the legal rights over the land, comprehending the rights over any buildings above it. The benefits from such trading are central to the market's existence and operation that are at all times under statutory control.

Since real estate is by nature durable, immovable and indestructable, an investment on it can be regarded as a long time-scale business in which the rights existing in the estate are the primary objects to be dealt with. Hence, such investment will be inextricably linked with acquisition of the property in question. The process of acquisition usually involves (not necessarily in this order) solicitation of professional advice, completion of purchase contracts, and arrangement of acquisition finance.

## 4.1 DOCTRINES OF REAL ESTATE BUSINESS

The practice of real estate business in the UK has its unique characteristics. The basic principles relating to property matters in England and Wales can mainly be

discovered from the body of legislation passed in 1925, among which the Law of Property Act 1925 (L.P.A. 1925) is the most important. The 1925 property legislation has been amended and/or superseded by later statutes which also have a profound effect upon today's practical issues.

### 4.1.1 Definition of real estate

In the context of L.P.A. 1925, real estate refers to land. The specific meaning of "land" throughout the Act includes not only the soil and things beneath it, but buildings on it as well as rights with respect to land which have no physical existence (section 205(1)(ix)). Since real estate is tangible but immovable, it is not possible to deliver land and buildings in the same way as would be the case with movable commodities. The significance of real estate business lies in dealing in the property owner's rights and interests relating to the estate. That is to say, an estate owner is entitled not only to the exclusive right of occupying the physical units of land, but more importantly to all the legal rights and interests over land and buildings.

Land tenure is the period of time for which the land is held and during which the land owner has the exclusive right to possess the land and enjoy the interests connected therewith. The types of land tenure fall into two

categories - freehold and leasehold. According to section 1(1), the only estates and interests in land which are capable of subsisting or of being conveyed or created at law are - a) an estate in fee simple absolute in possession and b) a term of years absolute, which correspond to the common terms of "freehold" and "leasehold".

(1) Freeholds

In the UK, there is no such thing as absolute private ownership of land, and nominally all land is held of the Crown [1]. In reality, however, most land exists in the form of private ownership. Perpetual ownership is available by becoming freeholder in possession of land. And a land tenure in the form of freehold is the nearest equivalent to absolute ownership. However, although freehold as the fee simple absolute in possession is the highest form of land tenure under the Crown, it is still the nearest to absolute ownership, albeit not absolute ownership in real terms.

Whilst in principle a freeholder may do as he likes with the land, in practice he is still subject to certain restrictions, some imposed by the statute and some under certain inalienable rights [2]. Firstly, while a freeholder may have leased interests in whole or parts of his estate, the statutory protection of tenants restricts

the freeholder's rights to do what he likes, and he has to comply with the ground rules established by the legislation governing the way freeholders and their tenants should behave to each other. Secondly, for the benefit of the public in general, some restrictions are also imposed by statute in regard of town and country planning and the environment in general. A freeholder may not be able to carry out any development scheme on his land unless he receives the consent from the relevant planning authorities. Thirdly, third party rights may exist over the property. And finally, under extreme circumstances, compulsory purchase of land might be carried out by the government.

(2) Leaseholds

In contrast to freehold, leasehold as the other form of land tenure is limited in time. The origin of leasehold lies in the freeholder's creation of a lesser interest over his land. A freeholder may rent the premises he owns to somebody else by giving a lease for a fixed period of time in return for a rent.

In theory, there can be any number of leasehold interests existing over the same piece of land. Similar to a freeholder who may create a leasehold interest conferring on the tenant the right to possess and use the property for

a specific period, the tenant may in turn create a subsidiary lease by disposing of his right to occupy and use the property, and letting the property to a third party [3]. Thus it is likely that various forms of land tenure may exist over a single unit of land at the same time.

#### 4.1.2 Major investment interests

An investor may have investment interests in three major aspects: a) tenure interests; b) financial interests; and c) anti-inflation interests.

(1) Tenure interests

An interest in real estate represents an interest in land of defined duration. Thus, freehold and leasehold interests constitute a crucial aspect of investment interests - tenure interests.

i) Freehold interests

Freehold interests are perpetual interests. They play an important role in fulfilling the investor's goal of preserving or increasing the real value of the property. Also, the investor, as a freeholder, may grant a lease to one tenant or more for the purpose of receiving a flow of profit by acquiring a substantial rental income over time.

However, for all freehold investments, costs will almost inevitably be incurred in the course of purchase, on-going ownership and/or eventual sale of any interest in the property concerned. The actual level of the costs will directly affect the net yield to be achieved by freehold investments. Investors in this instance have no alternative but take the full financial risks of ownership.

Firstly, in acquiring any interest in real estate, the investor has to make allowance for purchase costs in addition to the purchase price itself. These additional costs may normally comprise stamp duties, professional fees, and any VAT charged on these expenses.

Secondly, during the on-going ownership, the rents received from the tenant(s) will largely decide the profit margin over a certain period of time, and eventually determine whether the investment will turn out to be a success or failure. The rent value is determined by an equation of demand and supply in the market, which in turn is influenced by the very diversity of property types involved, and other decisive factors relating to capital supplies, inflation and/or deflation pressures, etc. The risk characteristics of a freehold investment are somewhat akin to those attached to ordinary shares in a company and hence a freehold interest can also be defined as an equity interest [4].

Thirdly, also in the course of the on-going ownership, management costs that are incurred principally from carrying out maintenance obligations are unavoidable. A freehold investment is a positive investment which itself requires active management at all times. It is only by good management that the net yield of investment can be maximised.

And finally, if the property is eventually sold, the costs of selling will be dependent upon the type of estate involved; capital gains tax, professional charges and also VAT may be payable on these expenditures. Also, the property market at the time of selling may happen to be at its low or high end, and this will also influence the cost level of carrying out such a disposal.

ii) Leasehold interests

When purchased as an investment, a leasehold interest has to be subject to a lease granted by the estate's present freeholder. That is to say, the investment benefits of occupying property in the form of a leasehold can only be crystallised by giving up his rights to occupy and use the property, and creating a subsidiary lease. Under such circumstances, the investor behaves in the capacity of the head lessee who sublets the premises to someone else (i.e. the sub-lessee, the actual occupier) [5]. As compared with

a freehold, factors affecting investment interests vested in a leasehold tend to be more complicated.

Firstly, the yield of a leasehold investment will depend on the difference between the rental income received from the actual occupier(s) and the rent paid to the estate's freeholder. The whole operation must be properly arranged in accordance with the terms of both the head lease and the sub-lease. As it is most likely that the terms of the sub-lease will have to be geared in the light of those fixed by the head lease throughout the whole duration, a leasehold investment is therefore a rather passive investment, and the investor involved might have to be restricted by more factors which he himself has no capability to control.

Secondly, it is usual practice that frequent reviews to both the head rent and the sub-rent are provided. The values of these two kinds of rents at a certain time are closely interrelated, and also subject to their respective equation of demand and supply in the market. Therefore, a huge profit rent can hardly be expected to be built up between these reviews.

And thirdly, as a leasehold is created on the basis of a fixed number of years, its life is limited, and the advantage of such attribute is that timing of further trading arrangement of the premises might be easier to be

made than in the case of a freeholder. However, its defect is also obvious. Within a rather short period of time, capital value of a leasehold investment can rarely be expected to grow as fast as the head rent expenditure. And it is especially true in the event of a sluggish market.

In general, if purchased purely as an investment, leasehold interests will be less vital to the investor than those vested in a freehold. It would be more productive if the investor could orientate the majority of his investment activities towards freeholds.

(2) Financial interests

Whereas estate investment needs finance, the financial interests lie in the real estate's role as a vehicle for raising funds. The existing market may provide investors the opportunity of using the property in question as a vehicle for raising funds by way of mortgage.

There are two reasons that the investor may benefit from the possible finance supplied by the market. Firstly, repayment of loans secured from mortgages can be guaranteed by the physical estate in question. And since the increase of real estate's capital value is long time-scaled, many financial organisations may have interests in providing investors a significant proportion of funds required for

acquiring or developing properties. Secondly, as the general trend is that the expected rate of return from rental income keeps abreast of the inflation rate at the same time, financial lenders may be rewarded a rather considerable amount of income from the interest accrued. Therefore, it is likely that investors may obtain the required funds from the existing real estate market by making use of the estate in question as a financing stepping-stone.

However, since mortgages have to be repaid and interest accured on them is charged in advance, the investor must be very careful when deciding his prospective repayment scheme. Consideration should be given primarily in three aspects: a) whether the costs incurred by the possible interest increase can be effectively avoided or reduced; b) whether mortgage interest reliefs can be secured; and c) whether such mortgages are allowed to be used to purchase not only the previous premises from which the loans in question are acquired, but new estates as well.

(3) Anti-inflation interests

Since inflation has the effect of enhancing the monetary value of rental incomes which will in turn be reflected in capital values, one of the main attractions of real estate investment comes from the likelihood that real estate may

become a complete hedge against inflation. Therefore, in history, property has probably formed a major part of investment portfolios merely on this basis [6].

In a published study in the UK by Limmack and Ward (1988) dealing with inflation hedging in an economically defensible manner as regards property investment, the possible relationship between property returns and unexpected inflation was estimated by using a ten-year data sample of quarterly returns from the Jones Lang Wootton property database [7]. The conclusion was that investors could expect returns to be higher in those periods when inflation was expected to be high [8].

### 4.1.3 The system of statutory development control

The system of development control in the UK requires an investor to obtain a specific planning consent for virtually every development to be conducted in real estate business. It is important for the investor to carry out detailed investigation about the possible influence of the relevant legislation on a particular piece of land before any development is intended.

There is a huge mass of detailed legislation controlling the use and enjoyment of land, and the system of development control in the UK is thus supposed to be one of

the most sophisticated in the world. However, the principal planning statute now in force is the Town and Country Planning Act 1990 (the 1990 Act), which consolidates the previous statutes from the Town and Country Planning Act 1947 onwards. To support this basic legislation as well as orientate government policies in planning consideration to the need of development control, a series of guidance has additionally been formulated by the central government in the form of Planning Policy Guidance notes or Ministerial Circulars, and by the local governments in the form of development plans.

Although planning control is ultimately administered by the Secretary of State for the Environment, it is generally exercised by the local planning authorities [9]. By sections 70 and 172 of the 1990 Act, the local planning authority exercises the control by granting or withholding planning permission and can take action against breach of planning control by means of enforcement proceedings, having regard to the development plan and to any other material considerations.

(1) Development plan

The development plan has been described as a key phrase in the planning authorities' vocabulary. It usually consists of a "structure plan" setting out the local planning

authority's policy for the development and other use of land in the area covered by the plan supplemented by local plans which develop the policies and general proposals of the structure plan and relate them to the districts [10]. The investor should be aware that under normal circumstances, he should produce a unitary development scheme which ought to be in compliance with the local authorities' overall development plan. To be more elaborate, his development proposal should be in the framework of structure plan and the Secretary of State's general planning guidance.

However, whilst the determination should normally be in compliance with the development plan, some concessions are available under the central government's Planning Policy notes, in the event of some material considerations which will enable other factors to be taken into account. If the investor appreciates that his development proposal might contradict the local authority's development plan, he must make sure that contrary planning grounds can be demonstrated to justify his proposal, and in this regard the development plan may not be regarded as overriding other material considerations especially where the plan does not deal adequately with new types of development [11]. The investor's justification should cover a multitude of matters, relating to the proposed development, such as its favourable impact on the environment, local

employment and creation of new industry and commerce, etc. In short, he must try to provide the right conditions for encouraging the local economic growth.

(2) The need for planning permission

Once it has been established that a proposed activity constitutes development, it must be decided whether an application should be made for planning permission. In the case that the investor is doubtful about whether his proposed action will constitute development and require planning permission, by virtue of section 64(1), he may apply to the local planning authority for a written determination on the point.

In general, planning permission is required for any development of land with very few exceptions. The need for planning permission depends on the definition of development. Development is defined by section 55(1) as the carrying out of building, engineering, mining or other operations in, on, over, or under land, or the making of any material change in the use of any building or other land.

It is important to grasp the two parts embodied in the above formula - operations and change of use [12]. If a particular operation or change of use involves development

as defined in the stipulation, it will require planning permission. If not, no planning permission is required.

(3) Application for planning permission

The application for planning permission must be made on a form issued by the local planning authority, accompanied by a plan sufficient to identify the land and such other plans and drawings as are necessary to describe the development [13].

Planning permission is in normal circumstances granted by a development order or by express grant. According to section 59(1) of the 1990 Act, the Secretary of State shall by a development order provide for the granting of planning permission. Also under section 59(2), a development order may either a) itself grant planning permission for development specified in the order or for development of any class specified; or b) in respect of development for which planning permission is not granted by the order itself, provide for the granting of planning permission by the local planning authority on application to the authority in accordance with the provisions of the order. The Town and Country Planning General Development Order 1988 is the order of general application providing for the grant of planning permission for the development of land, in the context of the provisions contained in section 59 of

the 1990 Act. Schedule 2 to the Order 1988 sets out in detail a wide range of development for which planning permission is granted by the order itself under the provisions of article 3. The Order 1988 gives consent for various classes of permitted development, and in this way deregulates the planning system to some extents by providing privileges to developers who are entitled to the rights under the order.

In the event that the land in question happens to be in an Enterprise Zone or a simplified planning zone, planning permission will be automatically granted for specific development: in terms of section 88 of the 1990 Act, planning permission may be automatically granted for specified development by an Enterprise Zone scheme; and according to section 82, a simplified planning zone is an area in respect of which a simplified planning zone scheme is in force, and the adoption or approval of such a scheme has effect to grant, in relation to the zone or any part of it specified in the scheme, planning permission for development specified in the scheme or for development of any class so specified.

## 4.2 FORMALITIES OF ESTATE ACQUISITION

### 4.2.1 Professional services for property acquisition

Real estate in the UK should never be acquired without the investor first obtaining competent professional advice and involvement. This professional advice and involvement mainly comprises those services provided by estate agents, solicitors, and chartered surveyors, etc.

(1) Role of estate agents

In the case of an investor who is primarily concerned with acquiring the estate and holding it as his investment, the roles played by estate agents may generally fall into two categories.

Firstly, the investor may instruct an estate agent to find a property to his satisfaction. The estate agent must advise the investor on the physical conditions and the current value of the property discovered, and may subject to securing the investor's approval arrange meetings between the investor and property's present owner. Secondly, after the relevant property acquisition is concluded, the investor may again instruct the estate agent to find a prospective purchaser for the purpose of reselling the property when timing is opportune.

(2) Role of solicitors

Solicitors are principally responsible for conveying

properties to be acquired, and preparing the necessary legal documents throughout the whole life of the investment.

While solicitors provide services on legal matters generally, in the course of acquisition, they are mainly concerned with transferring the legal title of the property to the investor, and also detailing the rights and liabilities incidental to the ownership.

(3) Role of surveyors

Property valuation is an important factor affecting an investment decision. An estate's value is largely determined by the very diversity of property ownership, settings and types, which may give rise to a wide range of approaches to property valuation. A chartered surveyor, with his knowledge of the relevant market, can provide services for valuing the potential property.

**4.2.2 Completion of purchase contracts**

The actual procedures for completing purchase contracts normally comprise four stages: a) pre-contract enquiries and searches; b) contract preparation; c) contract conclusion; and d) transfer in registered title, or conveyance in unregistered title.

(1) Enquiries and searches

Before a contract is created, a number of enquiries and searches usually have to be made by the investor, or his solicitor, to obtain information on matters which could affect the purchase in his decision whether or not to proceed.

Enquiries may generally include basic information about the property, and special attention would be drawn towards whether there have been any disputes in respect of the estate itself [14]. However, due to fears about liability for misrepresentation, it is likely that some property owners, or their solicitors, may give very evasive answers to such enquiries [15], and therefore it will be necessary to conduct a property viewing before the contract is prepared.

Searches are usually made in the local land charges registers. These registers are maintained by the local authorities for the properties in these areas under section 3 of the Local Land Charges Act 1975. The registers contain details of a variety of charges relating to financial, planning and environmental matters [16]. Since all these matters may have a considerable effect upon the use to which the property can be put, it is necessary for all investors to carry out the pre-contract searches. The

local authority's reply to a search includes an official certificate of search (section 8(4)). It is important to obtain such a certificate for it indicates what entries relating to the property appear in the register of charges. If later a charge is discovered which has not been revealed by the certificate, by virtue of section 10, the prospective purchaser can claim compensation against the local authority.

(2) Contract preparation

Generally speaking, a contract for property acquisition should comply with the basic requirements for any other contract. However, because of the considerable finance involved in property investment, creation of a legal relationship under such circumstances requires greater formalities. And in this regard, the date of 27 September 1989 becomes an important demarcation line [17].

Before 27 September 1989, the rules governing contracts made for property acquisition were contained in L.P.A. 1925. Their original main description was represented by section 40(1) as follows: no action may be brought upon any contract for the sale or other disposition of land or any interest in land, unless the agreement upon which such action is brought, or some memorandum or note thereof, is in writing, and signed by the party to be charged or by

some other person thereunto by him lawfully authorised. The biggest defect reflected from this provision was that L.P.A. 1925 did not totally prevent an oral contract from coming into existence. Thus, an amendment was necessary and the law was changed in 1989.

In regard of the most vital formalities to be complied with, the Law of Property (Miscellaneous Provisions) Act 1989 contains the relevant rules which apply to all contracts made on or after 27 September 1989. The new law regulates by section 2(1) that a contract for the sale or other disposition of an interest in land can only be made in writing and only be incorporating all the terms which the parties have expressly agreed in one document or, where contracts are exchanged, in each. It is noteworthy that under the new law, a contract must be made in writing, and the shortcoming of the old law which did not completely render oral contracts invalid is accordingly removed.

The new law also provides under section 2(2) that the terms of the contract may be incorporated in a document either by being set out in it or by reference to some other document. As can be seen, this rule requires that all the terms agreed should be recorded in one document or reflected by making express reference to some other document. The contract will no longer be enforced if a term is agreed but for one reason or another not recorded in the document. A

further formality contained in section 2(3) provides that the document incorporating the terms or where contracts are exchanged one of the documents incorporating them (but not necessarily the same one) must be signed by or on behalf of each party to the contract. That is to say, the contract will not come into existence until both sides sign it. In reality, it is normal practice that two copies of contract are prepared and signed by or on behalf of each side to the contract.

(3) Contract conclusion

Conclusion of the contract, to an investor, can be defined in two aspects. One is the particular method of concluding a contract adopted for acquiring the estate. The other is the prompt arrangement of adequate insurance cover for the investor's own benefit.

The common way of concluding a contract starts from preparation of two identical copies of the contract, each signed by one party, and ends in the exchange of the contracts which thus create a legally binding relationship between the two parties. In addition, it is normal for the investor to pay a portion of the purchase price to the estate owner as an initial deposit [18].

From the moment a valid contract is concluded, the

insurance risk will pass to the investor who is already beneficial owner of the property. Thus, pending the completion of the whole acquisition process, the estate in question will have two owners at the same time. On the one hand, since in the context of section 52(1) of L.P.A. 1925 all conveyances of land or of any interest therein are void for the purpose of conveying or creating a legal estate unless made by deed, the present estate owner remains the legal owner until a deed conveying the legal estate has been signed, witnessed and delivered in the case of his ownership of an unregistered title, or registered in the case of a registered title. He accordingly occupies a fiduciary position as the estate trustee, and must manage and preserve the estate with the same care as a trustee must show with regard to trust property [19], until the sale is finally completed. On the other hand, while the investor becomes the equitable owner once the contract is concluded, he must also bear the risk of any loss or damage suffered by the property, and from the date fixed for completion meet the cost of all necessary outgoings [20]. In the event of the absence of any obligation on the estate owner (i.e. the seller) to maintain any insurance, there is no guarantee that the policy effected by the estate owner will continue to cover the risk suffered by the estate to be acquired. Hence, for the investor's own benefit, it is necessary for him to make the prompt arrangement of adequate insurance from the moment an enforceable contract

is made.

(4) Settlement of property title

After a contract is concluded, the investor should not proceed to accept the physical property until he is convinced after investigation that the title of the present estate owner is good and he is really entitled to pass to the investor the estate which he is offering to sell. Also, the investor should try to verify via investigation that whether there are any third party rights to the property which might interfere with his proposed use of it.

The title to the property can be proven under two separate systems of conveyance. One is the registered system, and the other is the unregistered one. The registered system is principally governed by the Land Registration Act 1925, while the unregistered system is mainly ruled by the provisions contained in L.P.A. 1925 as well as the Land Charges Act 1972.

The registered system is supposed to be the newer system. It exists in the context of the Land Registration Act 1925, which highlights the point by section 1(1) that there shall continue to be kept at the Land Registry a register of title to freehold and leasehold land. The original intention of the Land Registration Act 1925 was to make

future registration of title to the property become compulsory. However, due to the economic depression followed by the war and further recession, the promotion of the registered system was held up until 1984 when the British government pledged that it would make the entire country an area of compulsory registration within ten years [21]. The government's promise has been fulfilled and the last areas became compulsory areas on 1 December 1990 [22]. Thus, now all property falls in an area of compulsory registration, and the investor may simply find out whether a registration has been made by checking at the Land Registry, and making an "index map search" [23]. Nonetheless, even in areas of compulsory registration, the titles to some properties are not registered. There are two reasons for the existence of the unregistered properties: firstly, the Land Registration Act 1925 does not mention that an estate must be registered, although failing to do so is likely to be at the risk of making the acquisition void and eventually losing it (sections 19, 22 and 123(1)); secondly, many property owners may not have their estates registered for fear of the cost incurred by registration.

In the case of the unregistered title, the present estate owner has to demonstrate his legal ownership by producing the title deeds of the property to the investor. Also, as the current owner last conveyed to, he must prove that the

estate has been correctly conveyed from one owner to another over years [24]. The investor may require that the property owner start with a good root of title. The good root of title is a document which records a dealing with the whole legal and equitable interest in the property and which contains nothing to cast any doubts on the validity of the title [25]. And once a good root of title has been shown, the estate owner must produce every deed after the good root of title which has affected the property [26].

Under the Land Registration Act 1925, investigation of any third-party rights in the registered property to be acquired should be conducted by the investor focussing on two possible matters - overriding interests and minor interests. Overriding interests according to section 3(xvi) mean all the incumbrances, interests, rights, and powers not entered on the register but subject to which registered dispositions are to take effect. The investor must be aware that overriding interests are important third-party rights over the property and have the automatic binding effect upon him although they are not indicated on the register. Minor interests are defined by section 3(xv) as those third-party rights in registered property, which are not substantially registrable and not overriding interests, either. Whilst it can be deduced that minor interests are unenforceable at law and void against the investor, the Land Registration Act 1925 provides entries

on the register by means of which minor interests can be noted and accordingly properly protected [27].

In the case of an unregistered property, third-party interests usually embody land charges under the Land Charges Act 1972, and other legal interests which are not land charges. Land charges consist of the interests included on the list in the Land Charges Act 1972, and these interests are accordingly protected by registration at the Land Charges Registry [28]. Also, the investor during the course of purchasing is automatically bound by all legal interests in the land which are not land charges (most are not on the land charges list) [29].

#### 4.2.3 Arrangement of acquisition finance

Real estate and finance are always linked with each other. An investor can usually accomplish his investment scheme by financing either property development, or property acquisition, or both.

(1) Financing property development

Property development needs finance to cover the property's whole construction period. In this case, the investor acts in the capacity of the developer. He has to raise finance to pay for the costs of production including the purchase

of land, building costs, professional fees and marketing costs [30]. Since the construction period involved in property development is relatively short, a mortgage as a major instrument of finance, will rarely be used at this stage, unless at the end of the development period the investor has the property refinanced on a long-term basis for retaining it rather than selling it to realise a profit. Thus, finance for property development is mainly obtained from the banks and exists in the form of bank lending debt on the short-term basis [31].

The cost of financing may vary depending on a series of factors including current market situation, quality of scheme, and commercial prospect of properties to be developed, etc. On the one hand, as the bank lending markets in the United Kingdom are extensively globalised, there are currently a wide range of sources available for the financing of property development. On the other hand, banks providing debt finance will wish to be satisfied with the developer's financial strength, the collateral to be provided as security for the loan, the viability of the project, and the arrangement for repayment of the loan with reference to the investor's track record in previous projects and reliability [32].

Moreover, short-term finance can be quite expensive because of the limited security in an incomplete property.

Therefore, the investor once obtaining the finance should try to finish the construction as quickly as he can and if possible, try to repay the finance by selling the project during the construction period.

(2) Financing property acquisition

As another method of real estate investment, property acquisition can be used to realise its anticipated profit by acquiring the property and then selling or letting it. In reality, it would be unwise for the investor to pay for the purchase of property outright even if he has sufficient finance to do so. Alternatively, the investor should consider obtaining loans. Financing property acquisition is a long-term business and therefore normally less expensive than financing property development on the short-term basis [33]. Ideally, the investor may raise his long-term finance by way of mortgage.

The essential nature of a mortgage is that it is a conveyance of a legal or equitable interest in property, with a provision for redemption, i.e. upon repayment of a loan or the performance of some other obligation, the conveyance shall become void or the interest shall be reconveyed [34]. In such case, the investor is the borrower or mortgagor. He acquires the property by borrowing against it as security for the finance made to

him by the lender (i.e. mortgagee) who in turn obtains an interest in the property. Unlike many other businesses which are subject to statutory control, a Mortgages Act has never come about in the United Kingdom [35]. The legal principles and detailed rules governing mortgages at present are generally prescribed by L.P.A. 1925.

A mortgage can be a legal mortgage, or an equitable one.

L.P.A. 1925 provides under sections 85(1) and 86(1) that a legal mortgage can be created in only one of two ways which are either a demise or a subdemise in terms of freehold or leasehold for a term of years absolute subject to a provision for cesser on redemption, or a charge by deed expressed to be by way of legal mortgages. The difference between a mortgage and a charge is that a mortgage is a conveyance of property whereas a charge conveys nothing but merely gives the chargee certain rights over the property charged. A legal mortgage of freehold tenure is effected by a demise under which a first or only mortgagee shall take a term of three thousand years from the date of the mortgage, whereas a second or subsequent mortgagee shall take a term one day longer than the term vested in the first or other mortgagee whose security ranks immediately before that of such second or subsequent mortgagee (section 85(2)). A legal mortgage of leasehold tenure is effected by a subdemise under which the term to be taken by a first

or only mortgagee shall be ten days less than the term expressed to be assigned, whereas the term to be taken by a second or subsequent mortgagee shall be one day longer than the term vested in the first or other mortgagee whose security ranks immediately before that of the second or subsequent mortgagee (section 86(2)). Instead of granting a long-term demise or subdemise to the mortgagee, according to section 87, the investor may simply executes a deed declaring that he is charging his property by way of legal mortgage with the repayment of the sums specified, so as to give the mortgagee the protection, powers and remedies as if the mortgage had been made lease or sublease. The biggest advantage of creating such a charge by deed is attributable to its simple and more realistic form. A charge by deed can be used for both freehold and leasehold tenures, and thus made it available to replace the first two types of legal mortgage by a shorter and more intelligible mortgage.

An equitable mortgage is normally made by producing to the lender the title deeds accompanied by a memorandum, which defines the purpose of the deposit of the deeds, and contains an undertaking by the investor to execute a legal charge on demand [36].

The primary right enjoyed by the investor is the right to redeem the mortgage on repayment of the loan [37].

Additionally, the investor can also be given a statutory power by section 99(1) of L.P.A. 1925 that provided that he is still in possession of the land, he may create leases which will be binding upon the mortgagee. Furthermore, the investor also has the right to sue in a situation in which there might be necessary for him to take legal action relating to the property, providing that he has not been notified that the mortgagee intends to take possession (section 98).

The rights of the mortgagee may fall into three main categories. Firstly, under sections 85(1) and 86(1), the first mortgagee has the right to take the title deeds from the mortgagor. The mortgagee's entitlement to such rights will in a way hamper the interests to be created by the investor in the estate in question. Secondly, pursuant to section 101(1)(ii), in the event of no express agreement, the mortgagee will be allowed to insure the property against loss or damage at the mortgagor's expenses. The investor must make sure that the property has been properly insured before the mortgage is conducted so that no additional cost has to be borne by him later on. And thirdly, pertinent to section 99(2), the mortgagee who has taken possession is at the same time given the right to grant leases. In this circumstance, the investor will normally have no alternative but to be legally bound by the lease created by the mortgagee.

It is the whole purpose of a mortgage to provide the mortgagee with a security by which his legal interests can be effectively protected if the borrower fails to repay the loan. In this regard, there are a number of remedies - first, the mortgagee can sue for the money due [38], albeit the process might be very time-consuming; second, the mortgagee has the statutory right to sell the property in the case of the investor's default (section 103), and if such a sale happens it will automatically extinguish the investor's right to redeem; and third, the mortgagee has the right to foreclose [39], and the effect of foreclosure is to vest the investor's whole interest in the mortgagee.

PART II (CHINA PART):

All land in China belongs to the state or the collectives. Foreign investors can only obtain land use rights, not land ownerships. Whilst in practice a particular site may exist in possession of a specific land occupier, the primary market of real estate, where land use rights can be acquired by foreign investors to develop and use the land, is ultimately monopolised by the state. Foreign investors may normally have two alternatives to obtain land use rights: a) direct purchase of land from the state; or b) automatic acquisition of the required land use rights as investment substitutes contributed by the Chinese partner in an equity or co-operative joint venture.

Trading activities conducted by foreign investors on the secondary market can be defined in terms of two different ways. First, land use rights acquired from the primary market may be further traded on the secondary market by means of transferring, leasing or mortgaging. Second, incomplete properties to be developed on the land obtained might be sold in advance, and by doing so funds required for the whole construction may be accumulated entirely or partially from the source of the prospective property owners.

**4.3 LAND USE RIGHTS ON THE PRIMARY MARKET**

### 4.3.1 Legal framework of land use system

(1) Separation of land ownership and use rights

Private ownership of land has been abolished in China. The 1982 Constitution says under article 10 that urban land belongs to the state, and rural land is owned by the collectives. Since the rural collectives are administratively subject to the leadership of the central and local governments, it can be generally construed that all land-ownership is controlled by the state.

Although private ownership of land is not available in China, article 2 of the Constitution's Amendment Act 1988 provides that land use rights are allowed to be transferred. The availability of privatising land use rights has enabled such rights to be separated from the land's ownership. Transfer of land use rights has accounted for most of the business activity in the real estate primary market. It is actually a kind of administrative practice by the land administration authority which, on behalf of the government, takes charge of granting permission to prospective land users who have already paid the required land transfer fees [40].

However, it was not until the amendment of the Constitution in 1988 that a land use system was finally permitted to be

established on a leasehold basis which means for a fixed term. Most Chinese organisations in the past were administratively assigned free properties for the purpose of their business use. Because of this historical reason, a dual land use system is operational at present. On the one hand, foreign investors have to pay for the use of the required site. But on the other hand, many local Chinese entities are in possession of the rights to use and control the land they obtained free from the state, and may transfer the land use rights in question to other parties or contribute them as investment substitutes in equity or co-operative joint ventures. Although, in theory, these local entities should make over some of the profits to the land owner, the state, the lack of legal provisions in the existing legislation exempts them from doing so. This is why many foreign investors feel that they are doing real estate business on an unequal basis with their local counterparts.

Unification of the dual land use system can hardly be expected to be fulfilled in a short time. Alteration of the current system is, as a matter of fact, closely connected with the performance of the country's corporation-based enterprise reform, which first of all has to deal with the basic issue of state business entities' property rights. This requires that the state business organisations be conferred the rights to own and use state

assets as independent business entities, with no further administrative influence having applied to them. However, as the market economy reforms are being implemented, more emphasis will be placed on economic benefits; this can only be brought about by implementing a full leasehold system of all land use rights.

(2) Regulatory structure

The main rules regulating real estate business conducted by foreign investors are composed of two parts: firstly, the central government has provided several guiding principles, most notably including - a) the Interim Rules 1990 on Sale and Transfer of State Land's Use Rights in Cities and Towns (the 1990 Interim Rules), and b) the Regulations 1990 on Development and Management of Unreclaimed Land by Foreign Investors (the 1990 Regulations); secondly, a series of regional policies have been promulgated by various local authorities. These local policies are orientated towards providing more incentives to foreign investors and are only applied in particular local jurisdictions, subject to the ultimate governance by the above national guidelines.

However, for the time being many terms and conditions are not sufficiently clear in relation to property matters. Since a complete set of real estate law has not yet been brought in, foreign investors are unsure of the conditions

for long-term development and some of them would rather speculate to make quicker returns. This would greatly hinder the business from becoming a solid industry. It is felt that to maintain a healthy real estate business, a body of legislation will become necessary. Such statutes should guarantee security of tenure, set up an efficient property registration method and an independent judicial system to sort out conflicts, and also lay down reasonable regulations covering state controls.

The State Land Administration Bureau as the designated agency of the government is the regulatory authority responsible for overall administration of the state's land. All the land has to be registered and recorded; the Bureau in turn issues land registration certificates for entitlement of any specific use. No use rights can be acquired from the primary market or further traded on the secondary market if the site concerned has not been given such certificate. To obtain the rights to use the land required, foreign investors have to apply to the State Land Administration Bureau for its initial approval. The State Land Administration Bureau in practice plays the most important role in regulating inward investment activities carried out on both the primary and secondary markets.

**4.3.2 Direct purchase of land use rights**

(1) Basic forms of transfer of land use rights

According to article 13 of the 1990 Interim Rules, direct purchase of land use rights can usually be effected by means of negotiated agreements, public bidding or auction.

In reality, transfer of land use rights by way of negotiated agreement is the way most of the transactions relating to inward investment are effected. Since the investor has to apply to the State Land Administration Bureau in order to purchase usage rights for a particular site (by paying the site use fee), a negotiated agreement is supposed to be the more popular form of transfer (as compared with public bidding and auction); in the latter case the investor is less capable of controlling the price. In the event of negotiated agreement, the investor, who is interested in a particular piece of land, may simply approach the land's present occupier (usually a local Chinese organisation) to express his wish to acquire it. The amount of the transfer fee can be arrived at and be acceptable to both parties after several rounds of negotiation. Then the present land occupier will notify the State Land Administration Bureau that he would like to sell the land use rights to a specific purchaser at a specific price suggested. In many cases, the State Land Administration Bureau will only make a slight adjustment to the suggested transfer price.

The problem of negotiated agreement at present is that although the State Land Administration Bureau has from time to time formulated rules for establishing the permissible lower limit of land transfer fees, many local entities in practice still compete with each other in slashing land prices in order to attract more foreign investment. If this situation continues, it will be the state which eventually suffers. However, this problem can hardly be solved in the short term because of the very diversity of land supply and, more importantly, the urgent need for absorbing foreign funds.

It is suggested that the processes of public bidding and auction be encouraged by the State Land Administrative Bureau for land since these processes are to the benefit of foreign investors, whilst the form of negotiated agreement should still be allowed to continue but ought to be tailored for and confined to the land which is less popular.

(2) Purchasing contract

Direct purchase of land use rights is subject to the terms of the purchasing contract completed between the purchaser (i.e. the investor) and the local branch of the State Land Administration Bureau. Also, it must comply with the requirement of the state's overall urban and rural

construction plans.

The term of land use rights is determined by the actual nature of the project to be undertaken. According to the 1990 Interim Rules, the investor should within the term of the land use stipulated in the contract carry out the intended development programme, and any operational delay will result in the government's withdrawal of the land use rights already acquired (article 17). In the event that the investor wishes to continue his operation on the land after the term of its use expires, renewal of land use rights is possible (article 41), provided that the total term added together does not exceed the maximum permissible length of time. Pursuant to article 12, various maximum terms have been set forth according to the circumstances as follows: a) seventy years for residential buildings; b) fifty years for industrial use; c) fifty yeras for the purposes of education, science and technology, health, and sports; d) forty years for commercial and recreational use, and also for tourist industry; e) fifty years for other uses. In practice, the above maximum terms are provided only as general guidelines. Many local authorities have formulated regional rules which are different from the above provisions and apply only to the business carried out in their own jurisdictions. However, the overall tendency is that the maximum term of land use rights is becoming more dependent on the type of properties to be developed.

To cool the present overheated, haphazard luxury property market, the government is now working on readjusting investment structure by strictly restricting foreign investors from developing luxury estates for recreational and tourist uses [41]. Investors who devote themselves to developing properties for residential use are strongly encouraged.

In principle, application for land use rights ought to be based on one or more concrete development project(s) involved. Therefore, the permissible business scope is limited to the activities which are closely connected with fulfilment of the specific purpose identified in the purchasing contract.

The investor is required to proceed the construction within the confines of the land use (article 17 of the 1990 Interim Rules), and may not arbitrarily use the land for other irrelevant purposes. Further, some experts even suggest that investors be committed to a development expenditure of not less than 25% of the land purchase price, which must be actually spent on the land within the first year after the land is acquired, otherwise the government may withdraw the land in question [42]. However, some concessions may be given if the investor has changed the previous usage of the land with official permission in advance; in such circumstances a new

purchasing contract has to be negotiated with the land use fee adjusted accordingly (article 18).

The land use fee has to be fully paid within sixty days after the purchasing contract is completed, and any delay in full payment may incur the termination of the purchasing contract concerned (article 14). The investor will not be entitled to use the land until he has been granted a land use licence; this will not be issued until full payment of the required land use fee has been made and he has registered with the State Land Administration Bureau in due course as the new land user (article 16). So far there have been no standards set forth governing the fixing of the land use fee. The rates are regularly determined by classification based on the circumstances of different geographical locations, lines of business, proposed investment volumes and terms of use. In practice, the rates for using comparable land may vary considerably. The reason for this can be attributed to the lack of clear legal provisions and also to the serious shortage of qualified surveying professionals. Since land use rights in the past were obtained as a result of free administrative allocation, surveying now appears to be one of the weakest areas in China's real estate industry. Although in the case of acquiring land use rights via public bidding or auction the price issue will be less significant, how properly to fix the land use price is

always a matter of great concern to foreign investors, especially those who propose to complete the deal on the basis of a negotiated agreement.

(3) The right to use unreclaimed land

The right to use unreclaimed land bears a special meaning under the 1990 Regulations. By virtue of article 2, the foreign investor after obtaining the land use rights will be committed to convert the existing unreclaimed land into the land which has basic infrastructure facilities ready for further industrial and commercial development. Also, in the context of this article, he can transfer or rent out the reclaimed land to other parties after the required infrastructure facilities are formed and meet the necessary criteria made by the relevant authorities.

Acquisition of the right to use unreclaimed land enables the foreign investor to administer the reclaimed land for his own benefit. He has more freedom to control the land by either retaining it for further appreciation, or getting rid of it at the appropriate time. To the Chinese government, absorption of inward investment in this way incurs no increase of the state's fiscal burden. Instead, development of infrastructure facilities can be accelerated by utilising foreign money; the government alone has no financial ability to do this.

To carry out the reclamation programme, the developer is required to act in the capacity of either an equity joint venture company, or a co-operative joint venture, or a wholly foreign-owned enterprise (article 4). Therefore, it is necessary for the foreign investor in question to select and establish his specifically-tailored investment vehicle in the first instance.

### 4.3.3 Automatic acquisition of land use rights

Land use rights can be automatically acquired by the foreign investor in the case of an equity or a co-operative joint venture, where the Chinese side supplies the land needed as its investment contribution. Under such circumstances, no matter whether the Chinese partner in question happens to possess the land at the time (since the land was allocated free of charge on an administrative basis in the past), or it obtains the land by directly leasing it from a third party, the joint venture as the whole will no longer need to pay any land usage fee to the government. That is to say, the overseas side in either event is automatically entitled to use the land contributed by the Chinese partner.

(1) Legal basis of automatic acquisition

The legal basis of automatic acquisition can be traced back

to the relevant provisions contained in the Law on Joint Ventures Using Chinese and Foreign Investment of 1979 (i.e. the 1979 Law which governs equity joint ventures) and its 1983 Implementing Rules, and also the Law on Co-operative Joint Ventures of 1988 (i.e. the 1988 Law).

The 1979 Law provides by article 5 that the investment contribution of the Chinese side may include the land use rights provided for the joint venture in question during its operation period. Such stipulation is then further supplemented by the 1983 Implementing Rules which confirms under article 48 that the value of the land use rights contributed has to be equivalent to the usage fee paid for obtaining the land of similar quality. In such event, both foreign and Chinese investors can enjoy the privileges of maintaining the land as the common asset of the joint venture company. To the foreign investor, he is automatically entitled to the rights of controlling the land usage without being involved in any direct land purchasing or leasing. As such, no additional cost has to be borne by him. Also, since in practice the land use right, as the capital contributed by the Chinese side, is valued by the relevant land appraisal authority supervised by the State Land Administration Bureau, and by virtue of article 51 such value after the first appraisal remains unchanged during the company's whole operation term, the foreign investor may more effectively plan and hedge

against his overall future outlay. The Chinese side takes advantage of the land use rights as an appropriate way for attracting overseas capital, and therefore has the opportunity to share the future profits according to the proportion of its capital contribution including land use rights in the joint venture. As in many cases the Chinese partner's investment contribution merely includes land use rights and the land contributed in such a way was previously possessed by the Chinese party on a free allocation basis, investment of land use rights is especially suitable for the Chinese side to solve the problem of inadequate fund required for cash capital contribution.

The 1988 Law accepts under article 8 that land use rights may be counted as investment contributions by the participant(s) in a co-operative joint venture. However, the land use rights contributed by the Chinese side as capital contribution are not valued in the same way as in the case of an equity joint venture company. Contrary to an equity joint venture in which each side must bear the risks and share the profits in proportion to its capital contribution, both overseas and Chinese participants in a co-operative joint venture are legally bound on a contractual basis and have to cooperate as separate legal entities. Investment contribution, risk responsibility and profit distribution are specified on the contract in

advance. Therefore, the Chinese side is rewarded according to the terms of the contract, and may not necessarily share risks and profits strictly in accordance with the investment proportions. In this instance, the land use rights are contributed as a contractual arrangement between the two sides; since how each side is rewarded will depend completely on the terms of the contract, the land use rights in a co-operative joint venture do not need to be valued in currency terms. Compared with the method used in an equity joint venture company, the legal terms in respect of automatic acquisition of land in a co-operative joint venture appears to be more ambiguous. Such ambiguity exerts two different impacts on the interests of investors. Firstly, the investment yield to be divided and the risk responsibility to be shared may in reality very often not be easily defined in the contract. This is almost invariably the cause for many disputes between the two sides who gain no clear indication from existing legal and administrative documents on how to fix each side's interests in the most precise way which can be acceptable to both parties. Secondly, if considered from another angle, the mode of automatic acquisition in a co-operative joint venture has its unique flexibility. Since the investment value of the land contributed is not required to be assessed purely on the technical basis ruled by the appraisal authority, it is likely that the foreign investor may find a way to orientate the prospective profit

allocation scheme to be carried out more effectively in his favour.

(2) Control on automatic acquisition of land use rights

With regard to the automatic acquisition of land by means of establishment of an equity joint venture company or a co-operative joint venture, the most conspicuous problem at present is the rampant use of public land and non-agricultural occupation of farm land. Under such circumstances, neither the Chinese nor the foreign side pays anything for using the land. Since foreign investment enterprises may enjoy favourable privileges, especially in respect of taxation, than domestic business entities, many real estate joint venture companies and co-operative joint ventures are set up purely for the purpose of illicit speculation, profiteering and tax evasion which have seriously disrupted the current property market. The result is that on the one hand a large amount of land is monopolised by a few such enterprises without any concrete development plans, whilst on the other hand the land prices are unreasonably inflated on the market seriously affecting the interests of foreign investors who abide by the land regulations and really wish to conduct estate development.

To regulate the above improper phenomenon, local authorities are starting to take action. Unreasonable land

transfer plans are being banned. And a great number of unscrupulous real estate joint venture companies and co-operative joint ventures have been phased out of business. It has been stressed by the relevant authorities that in the future any acquisition of land by foreign investors must be correspondingly subject to specific development programmes to be conducted, and these developments should be in compliance with the government's investment orientation policy prevailing at the present time [43]. Moreover, in order to ensure the real influx of foreign funds, the Chinese side will not be allowed to provide any loans for the purpose of property development, or guarantee loans from other sources to the overseas partner in one way or another [44]. However, although local authorities are now rigorously enforcing the regulation, such controls can hardly be expected to reap quick rewards until official legislation regarding real estate management rules is brought in.

## 4.4 TRADING ACTIVITIES ON THE SECONDARY MARKET

### 4.4.1 Further trading of land use rights

Once obtained from the primary market, land use rights are allowed to be further transacted on the secondary market.

(1) Re-transfer of land use rights

Theoretically, re-transfer of land use rights is a civil activity, and the government normally plays a supervisory role and may not interfere administratively unless it is necessary to do so. However, carrying out re-transfer dealings have to meet certain criteria. Possession of land use rights does not mean that the rights in question can be immediately re-traded. Whilst such criteria may slightly differ from one local jurisdiction to another, in a general sense, an overseas investor cannot re-transfer the usage rights before the following three conditions are fulfilled: a) full payment of land acquisition fee; b) possession of land use certificate; and c) in addition to land acquisition fee, payment of a certain percentage (usually at least 25%) of the required construction finances for developing the land obtained, as stated in the relevant land acquisition contract [45].

By articles 19 and 20 of the 1990 Interim Rules, a re-transfer of land use rights has to be conducted by agreement. Usually within fifteen days after signing the contract, the new land user will be required to re-register the status of the current land use rights at the State Land Administration Bureau, upon payment of the corresponding re-transfer fees [46]. All the paperwork during the process of transaction may not necessarily be notarised [47]. However, article 21 provides that the previous obligations relating to such usage rights are not relieved,

but still have to be fulfilled by the transferee, and any alteration of the original purpose for using the land is subject to the consent granted by the State Land Administration Bureau. Once the contract is implemented, the rights to use the properties, if any, on the land in question will be automatically conferred to the transferee (i.e. the new land user) (article 23). Nonetheless, the transferee's entitlement does not cover the entire term of land use rights previously decided. It is calculated on the basis of the previous term less the time already used by the transferor (article 22).

The government normally does not interfere in the re-transfer pricing. And there is no existing legal basis for determining such a price. It is principally up to the concerned transferor and transferee to decide what price is acceptable to both parties. However, the price difference for re-transferring land of similar quality may not be unreasonably high. In the event that the re-transfer price in question is conspicuously lower than the prevailing market price, the local government may enjoy priority in purchasing the usage rights of the land in question (article 26). Again, foreign investors proposing land re-transfer should ensure in the first instance that no lower than 25% of the proposed investment volume is already paid up, otherwise any contract made and price decided may become invalid.

(2) Leasing land use rights

The investor may rent out the land use rights acquired to somebody else from whom the rental income is received. In terms of article 29 of the 1990 Interim Rules, such a leasing transaction should be conducted by completion of a leasing contract between the investor who acts in the capacity of a lessor, and the lessee who is correspondingly conferred the rights to use the land. Both sides should come to the State Land Administration Bureau to re-register the leasing transaction within twenty days after the contract comes into being [48].

The essence of leasing land use rights is that the lessee must carry out the development scheme in accordance with the terms and conditions which the foreign investor has proposed and agreed to comply with while previously acquiring such rights. And this purports that the leasing transaction concerned incurs no re-transfer of land use rights in legal sense.

In the event that during the leasing period, the investor re-transfers the land use rights to a third party, such action will not affect the legal privileges enjoyed by the lessee, and the transferee in question should continue to guarantee the effectiveness of the leasing contract signed between the investor and the lessee who is using the land

at the time.

However, the leasing transaction itself does not release the investor from any commitment of fulfilling his original obligation for using the land concerned (article 30 of the 1990 Interim Rules). He must make sure that the land continues to be utilised pursuant to the previous plan, and the objective fixed thereof can be achieved on time.

(3) Mortgage of land use rights

It is likely that the foreign investor may raise mortgages on acquired land use rights from the local financial institutions to which he has to mortgage the land use certificate for the loan required.

A mortgage transaction is normally preceded by signing a mortgage contract between the investor and the lending institution. Within fifteen days after completing the contract, the parties concerned shall register at the State Land Administration Bureau for the mortgage conducted between them [49]. When the contract term becomes due, if the lending institution is fully re-paid, the mortgage registration previously made can be cancelled (article 38 of the 1990 Interim Rules). However, in the event that the investor fails to pay off the loan as previously scheduled, the lending institution may thus have to re-register the

usage rights in the capacity of the land's new user [50].

Mortgage, as a form of real security against a loan, has not been fully made use of in China for raising real estate finance. Few references to this regard can be found from the existing legal documents, and its daily operation is subject to the administrative instructions made by various local authorities and may differ from time to time according to the prevailing financial policy.

The current situation is that it is difficult for foreign investors to borrow from local funders and use them to facilitate the real estate investment conducted in China. Foreign investors are supposed to be the source of funds for domestic markets, and not expected to become the borrowers of Chinese money. To prevent the economy from being overheated and also restrain further influence from the existing inflation pressure, the government may opt to tighten the bank credit at any time they think appropriate, and such retrenchment action will to a large extent reduce the possibility of raising funds from domestic sources by foreign investors in the form of mortgaging their land use rights acquired.

**4.4.2 Pre-development sale of properties**

Properties may under certain circumstances be sold in

advance before their actual development is fully completed.

(1) The type of house allowed to be sold in advance

The types of houses in China can now be classified into three categories by virtue of different kinds of users.

First, houses which are allocated free of charge by the state as domestic accommodation are of no relevance to inward investment, and foreign investors are excluded from being involved in developing this kind of property.

Second, houses purchased in Chinese currency by domestic people or permanent residents are called "commercial residential houses". Foreign investors may invest in them; whilst in reality most investors are reluctant to do so because of the low margins for developing this kind of property at the present time. Also some local authorities even prescribe that ceiling prices should be fixed for any commerical residential houses to be sold [51], and this by all means further hinders the initiatives of foreign investors who are seeking huge profits.

Third, houses, which are specifically tailored as foreigners' accommodation or offices and have to be purchased in hard currency, are labelled as "houses for foreigners", and they may not be purchased and owned by

local Chinese people. In practice, it is these houses which are allowed to be sold in advance.

To sell the above-mentioned properties (i.e. the third type) in advance, one condition must be fulfilled in the first instance: the estate developers in question should be able to deal with matters in connection with foreign exchange payments. Foreign investors, who have acquired the land use rights in foreign exchange, may have little difficulty in this regard. They can start to sell the properties at the very early stage of their proposed developments.

(2) Three kinds of payment

As to the property's pre-development sale, there are a number of ways of payment available to prospective purchasers: a) once-for-all payment; b) payment by instalment; and c) payment by mortgaged bank loans.

The biggest advantage of once-for-all payment to a foreign investor is that he may rapidly accumulate the construction finance which is needed for property development in advance from the prospective property owners. And once the payment is effected, the potential danger of financial risks before properties are fully built up can therefore be greatly mitigated. However, the once-for-all payment method has a

serious downside. Profit margins are very likely to be reduced since the investor normally has to provide some discount to attract house buyers. There would be no point for house buyers to accept such a mode of payment if they could not get big savings by paying in full at the outset.

In contrast to the once-for-all payment method, financing facilities might not be easily obtained by an investor in the case of payment by instalments. But to avoid the possible market risks as well as to spread the acquisition expenditure, many property purchasers may prefer the payment by instalment at the cost of failing to receive some savings. This in a way provides a relatively stable source of market demands to the investor.

If mortgaged loans can be secured from financial institutions by the investor, this type of payment will be very popular and may attract many customers. In this case, the loan arranged will normally not cover the whole purchase price, but a certain percentage of it. And the purchaser will be required to pay an initial deposit (e.g. 10%) to obtain a purchasing option which can be further traded afterwards at his disposal depending on the changes of the market situation [52]. However, in practice it is usually difficult to pursuade financial institutions to render mortgaged loans on houses which are to be sold on the forward trading basis. Mortgaged loans can rarely be

expected from the domestic sources. Chinese institutions are very cautious with regard to delivering their limited foreign exchange resources on real estate business, which may easily respond by pushing the present market demands high enough to incur serious inflation. Overseas financial institutions also take a very conservative attitude. Firstly, they need to have a thorough understanding of the investment project to be carried out, with special attention paid to the properties' geographical locations, the anticipated market demands for such estates and also the potential risks which might hamper the development in question. Secondly, they have to make sure that all the necessary legal documents including various approval certificates issued by the governmental organisations are ready and complete. And thirdly, since the settlement in foreign exchange at different stages can present problems, only those organisations which are familiar with the way the Chinese financial system operates may have interests in providing such loans. In practice, only those foreign financial institutions which are headquartered or have branches in China may find it technically feasible to deal with such lending business.

(3) Criteria for carrying out pre-development sale

Under various local jurisdictions, foreign investors proposing forward sales of properties are subject to

different regional policies. These policies are made by the property administration authorities. Contrary to the State Land Administration Bureau which regulates the land market, the property administration authorities are specifically responsible for supervising the trading activities in regard of completed properties on the land.

Whilst applying for carrying on such transactions to the relevant local property administration authorities, the investor should first of all satisfy the following conditions: a) he has paid off the land use fees required, and also paid up at least 25% of the intended investment volume; b) the land use certificate has been obtained from the State Land Administration Bureau; the land development permit has been acquired from the local construction administration authority; and the sales permit has been issued by the local property administration authority; c) the concrete sales proposal has been made; and d) the relevant supervising authorities, such as accountants and banks, and their supervision plans have been ascertained in due course [53].

Out of the above conditions, the most important one is the minimum requirement of contributed capital to be paid up. The purpose of such requirement is to prevent investors as developers from purely occupying land for further trading, thus safeguarding the interests of prospective property

buyers. Moveover, to further regulate the pre-development sale of properties, some local authorities have taken the corresponding measures and introduced the application of a system of forward trading permit [54]. In this regard, foreign investors must satisfy the property administration authorities by providing the capital examination reports made by the banks or the registered accountants [55]. Otherwise their application for carrying out the forward selling of properties may not easily be approved.

The pre-development sale of property is an important reason for the formation of a "soap bubble" economy on the real estate market. However, its speculative nature may in a way appeal to the potential customers whose participation will in turn boost the liquidity and briskness of the market. This is why the property administration authorities do not simply cancel the transactions but enforce strict control upon them.

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# CHAPTER 5

## TAXATION OF INVESTMENT BEHAVIOUR

Taxation as a cost of foreign investment activity may become an intricate issue due to the coexistence of many differing channels through which a tax system affects business efficiency. The purpose of this chapter is to examine the various tax treatments and particularly the available tax concessions towards foreign investment in both the UK and China.

The analysis extended to Part I (UK Part) centres on the tax aspects of a limited liability company, which as the most commonly used vehicle by foreign investors may face different tax consequences depending on the capacity in which it operates in the UK: by forming a UK resident subsidiary or merely via a non-resident branch controlled overseas. The discussion covers the legal basis of foreign company taxation, the major tax considerations, and the anti-avoidance measures in connection with intra-group transfer pricing and controlled foreign companies.

Part II (China Part) considers the taxation system of foreign investment enterprises in China, which is principally grounded on a large number of incentives for

the purpose of attracting capitals from overseas. The investigation focuses on the favourable tax consequences, and the ways of effectively imputating taxable amounts. It also identifies the likely levy increase made by the 1994 reforms and the subsequent controversies which have arisen between foreign investors affected and the relevant tax authority.

PART I (UK PART):

The charge to corporation tax applies to foreign companies with resident subsidiaries in the United Kingdom, and those trading here through their non-resident branches which are controlled and managed by headquarters overseas. The Inland Revenue as the tax authority is particularly concerned with foreign companies as taxpayers, and their profits covering both income and chargeable gains are liable to corporation tax which constitutes a major part of foreign investors' tax burdens in the UK. Tax planning should be considered by foreign investors initially from the viewpoint of whether to operate through a branch of existing company overseas or to set up a UK subsidiary company, each in certain instances likely to be charged in different ways. Moreover, if the foreign investor has interests in more than one UK company, it would be wise to create a UK group whereby companies in the same group may attract beneficial tax treatment.

There are many anti-avoidance provisions out of which the most relevant ones relate to transfer pricing and controlled foreign companies. In the former case, the Inland Revenue has powers to impose "arm's length" prices in the event that prices for goods and services between associated business entities in different countries are thought to be under or overstated for the purpose of

avoiding tax, albeit that in reality the Inland Revenue will very often prefer to settle cases by negotiation. In the latter case, the main purpose of the legislation is to charge to UK tax the profits of non-resident companies accumulated in low tax territories to which profits that would otherwise have come into the UK liable to corporation tax have been diverted. The practical impact of these anti-avoidance measures upon foreign investors is that their tax liability may not be arbitrarily reduced by carrying out a given transaction in a roundabout way.

## 5.1 LEGAL BASIS OF FOREIGN COMPANY TAXATION

### 5.1.1 General legal framework

In general, there is no single tax code in the United Kingdom, and the statute for a particular tax is to be found in the legislation which introduces it as subsequently amended or consolidated [1]. Tax legislation is increased by each year's Finance Act, and the corresponding production of amendment and consolidation Acts can be ascribed to the necessity of getting rid of out-dated substance and also reducing the number of pieces of legislation which relate to a particular area but which at the time have become redundant.

The leading statute pertaining to company taxation is the

Income and Corporation Taxes Act 1988 (I.C.T.A. 1988), whilst the Taxation of Chargeable Gains Act 1992 (T.C.G.A. 1992), the Capital Allowances Act 1990 (C.A.A. 1990) and the VAT Act 1994 are relevant under certain circumstances. Additionally, a system of extra-statutory concessions and statements of practice is operational at the same time [2]. Under this system, interpretative advice for issues in which the statute is vague or any doubt exists is provided by the relevant government authorities (e.g. the Inland Revenue), and in practice they are normally accepted as complementary guidelines.

### 5.1.2 Impact of double taxation treaty on tax relief

Foreign companies trading in the United Kingdom are potentially liable for taxation in two jurisdictions. However, a double tax relief can usually be identified under a double tax treaty between the two states.

The United Kingdom today has tax treaties with about 100 countries and territories [3]. The principal objective of these treaties is to avoid potential double taxation problems for the purpose of promoting international business, which is primarily achieved through an exemption from tax being granted by one of the two countries concerned.

Many treaties are based on the 1977 or 1992 Model Convention published by the Organisation for Economic Co-operation and Development (OECD) [4]. Whilst it is presumed that a double taxation treaty provision being made under statutory authority and so becoming part of municipal law may generally override the normal rules of the UK tax law, article 3(2) of OECD Model Treaty provides that any term not defined may have the meanings assigned to it under the domestic law of the state in question. Thus, in practice, it is likely that the effectiveness of domestic law may not necessarily be wholly governed by the treaty involved.

## 5.2 MAJOR TAX CONSIDERATIONS

A company which is resident in the United Kingdom is liable to corporation tax on its worldwide profits, wherever earned and regardless of whether or not those profits are remitted to the UK. A company which is not resident in the United Kingdom is only liable to corporation tax on the profits arising from the carrying on of a trade in the UK.

A company incorporated in the United Kingdom is defined by section 66 of the Finance Act 1988 as UK resident. And in the context of I.C.T.A. 1988, it is chargeable to corporation tax on all its profits wherever arising (section 8(1)), and here profits comprise both income and

chargeable gains (section 6(4)).

A non-resident company where its central management control is exercised in a foreign jurisdiction will also be liable to corporation tax if it carries on a trade in the United Kingdom (section 11(1)). By section 11 of I.C.T.A. 1988 and section 10 of T.C.G.A. 1992, chargeable profits of a non-resident company are defined as follows - a) trading income arising from the branch; b) other income from property or rights held by or for the branch; and c) chargeable gains from the disposal of UK assets used or held for the purpose of the branch.

In addition, the concept of a group relationship is in particular worth mentioning. The meaning of group companies may vary depending on different tax relief aims. Provisions in connection with group relief generally apply by reference to 75% and 51% subsidiaries. Broadly, a company is a subsidiary if the other company owns the relevant percentage of its ordinary share capital - more than 50% in the case of a 51% subsidiary, and not less than 75% as to a 75% subsidiary (section 838(1) of I.C.T.A. 1988). A resident company with one or more such subsidiaries in the UK may form a group for special tax purposes.

#### 5.2.1 Corporation tax rates in various brackets

For the financial year 1995, the standard rate of corporation tax is 33%, which has remained unchanged since the financial year 1991 [5]. However, this rate only applies to a company which maintains its profit level within a certain bracket.

There is a small companies' rate which applies to companies with profits not exceeding a minimum level of £300,000; and for the financial year 1995 this special lower rate is 25% (section 32(a) of the Finance Act 1994). Additionally, to avoid anomalies that would otherwise arise from sharp demarcation, there is a marginal relief given to companies with profits between £300,000 and £1.5 million, and it operates on a gradually reducing basis by levying tax on profits to the full rate but grants a credit for the reduced rate to the initial portion of the profits [6]. However, taking advantage of the small companies rate by fragmenting into a number of small companies that are grouped or under common control is generally prevented. In this instance, the upper and lower profit limits are tapered by having them divided by the number of associated companies and allocated equally to each company.

A subsidiary company and a branch are both taxable at the same normal rate. In practice, a branch of a foreign company may only become eligible for the lower 25% rate, if the foreign company is resident in a country having a

double taxation treaty with the UK containing a non-discriminatory clause, or has to be subject to the fragmentation rules discussed above because of the number of associates. Moreover, profit determination of a branch may cause more problems than in the case of a subsidiary company, because a branch is not a separate entity but taxable on part of the profits of its overseas parent, and in practice it might not be an easy thing to split off part of the parent's total profits and decide that this is the part which is attributable to the UK.

### 5.2.2 Profits subject to tax

Whilst the general principle is that a company is chargeable to corporation tax on all its profits, determination of taxable profits is broadly subject to certain deduction and relief rules.

(1) Determination of expenditure deduction

By section 74(a) of I.C.T.A. 1988, if a company's profit arises from trading activities, some expenditures are allowable for tax purposes, but are only confined to those incurred wholly and exclusively for the purpose of the trade. In other words, in order to be allowable, an expenditure must be of a revenue nature. There are some types of expenditure that are specifically disallowed. For

example, capital expenditure is not allowed as a deduction, and by section 74(g) the acquisition of a capital asset is not a cost which may be deducted in arriving at profits for tax purposes; expenses of management which represent business entertainment fees are not deductible (section 577(1)(a)); and bad debts in general are also not allowed as a deduction (section 74(j)).

Interest payments may be deducted as a charge from total profits. The provisions for deduction of interest are very complex. Generally, in accordance with section 338, annual interest paid by a company to a person resident in the UK is allowable as a charge on income. That is to say, a UK resident company will have little difficulty in securing a deduction for interest on normal commercial loan from the country. However, by virtue of section 340, where interest is paid to an overseas lender, there are prescribed conditions as follows which normally have to be satisfied in order for the interest to qualify as a charge on income - a) it must be paid outside the UK wholly or mainly for the purpose of a trade carried on outside the UK; and b) it must be payable in a currency other than sterling and the liability should have been incurred wholly or mainly for the purpose of activities of that trade.

Apart from interest, for corporation tax purposes, annual payment of other charges including annuities, royalties and

qualifying donations to charities are also available for offset as charges on income against the chargeable profits (sections 348, 339).

Whereas one of the expenses that a business charges against its revenue is capital depreciation, a capital allowance system is applied. Capital allowances are allowances for depreciation, calculated as a percentage of the cost of the asset. In the context of C.A.A. 1990, capital allowances are generally available on plant and machinery which are used in the trade (section 24), buildings and structures in Enterprise Zones (section 1), agricultural buildings (section 123), industrial buildings (sections 3 and 18), and hotels (sections 7 and 19). Capital allowances usually have to go through two steps: a) a writing-down allowance during the life of the asset; and b) a balancing allowance at the end of the life of the asset, which is designed to bring the allowances into line with actual expenses [7]. Writing-down and balancing allowances are treated as deductible business expenses, and the amount of deduction will depend on the type of expenditure actually involved.

(2) Relief on capital gains tax

Capital gains made by a company are included in its chargeable profits and subject to corporation tax. They are calculated in accordance with the separate and self-

contained provisions of capital gains tax rules (section 8 of T.C.G.A. 1992). In the context of section 21, virtually all forms of property (assets) which can yield a capital sum arising from disposal and other transactions of the assets are subject to capital gains tax unless they are specifically exempted. Capital gains tax rules apply to both resident companies and non-resident companies that carry on a trade through a branch in the UK (sections 2 and 10). Foreign investors are entitled to seek relief in the course of disposing of their capital assets.

A tax deferral (roll-over relief) is available if the proceeds on the disposal of an asset are reinvested in further qualifying assets. Under section 152, in the event that the proceeds are fully reinvested in qualifying assets within a period of twelve months before and three years after the date of disposal, the tax liability arising on the chargeable gains can be deferred. Also by section 153, a proportion of the gains can still be deferred even where the proceeds are only partially reinvested, but in this case the balance has to be brought into charge. In either event, as the element of gains rolled over is deducted from the cost of the new asset, this relief operates to enhance the potential gains on the eventual disposal of the new asset obtained.

Futhermore, as regards transactions between companies in

the same group, one big advantage is that assets may be transferred from one group company to another without giving rise to tax on capital gains (section 171). Also, under section 175, for roll-over purposes, all the trades carried on by group companies are treated as a single trade and therefore it is possible to roll over a gain made on assets by one member of a group against expenditures incurred by another group member. In other words, where a claim for roll-over of capital gains is made, the reinstatement may be made by another group company.

(3) Relief of losses

Within the context of I.C.T.A. 1988, when a company makes a tax loss in respect of its trading activities, the loss arising may be set off against profits. The losses incurred can be generally divided into two groups - trading losses, and non-trading losses (in the main, capital losses).

A company's trading losses in any accounting period are losses arising from the company's trade in that period (section 393(7)). There are three primary ways in which relief may be obtained for trading losses in terms of current, preceding or future periods. Firstly, the trading losses of a company may be set off against total profits made in the same accounting period, and the company wishing

to set off losses in this way must make a claim within two years after the end of the accounting period in which the losses occur (section 393A of I.C.T.A. 1988, section 73 of the Finance Act 1991). Secondly, where in any accounting period ending on or after 1 April 1991 the company incurs a loss in the trade, the trading losses can to the extent that they cannot be used against the current period's profits be carried back against profits arising in the previous three years with any necessary apportionment of the results of a previous accounting period being made to effect this (section 393A of I.C.T.A. 1988, section 73 of the Finance Act 1991). And thirdly, any trading losses of a company which are not relieved by offset against current or previous profits can be carried forward to be set off against the first available profits of the same trade for subsequent accounting periods (section 393(1) of I.C.T.A. 1988).

Capital losses may be set off against capital gains in computing net chargeable gains. In the event of a company making capital losses in an accounting period, by virtue of section 8 of T.C.G.A. 1992, those losses can generally be set off against chargeable gains made in the same period, and if those capital losses are greater than the chargeable gains they may be set off against gains of a later accounting period.

Relief for surplus charges on income can also be given against the total profits of the period in which the charges are paid. In terms of section 393(9), if profits are insufficient to absorb the charges, the amount of charges paid wholly and exclusively for the purpose of the company's trading activities may be carried forward to the next accounting period and treated as a trading loss to be offset against future trading income of the company.

Losses (other than capital losses) may be set off against profits of group companies. According to section 403, where one company in a group makes a tax loss for an accounting period, it may surrender that loss to a member of the group for offset against that company's taxable profits. The effect is that the tax group as a whole only pays tax on the excess of group profits over group losses.

I.C.T.A. 1988 contains an anti-avoidance provision designed to ensure that trading losses carried forward can only be used against future trading income from the trading activity which generated the losses: losses may not be carried forward, if within any period of three years there is a change in the ownership of the company preceded or followed by a major change in the nature or conduct of the trade carried on by the company, or if there is a change in ownership of the company at any time after the scale of activities in a trade carried on by the company has become

small or negligible and before any considerable revival in the trade (section 768). The Inland Revenue explains "a change in ownership" as a change in more than 50% of the ownership of the ordinary share capital in the company, and "a major change in the nature or conduct of a trade" as including a major change in the type of property dealt in or the services or facilities provided in the trade, or in customers, outlets or markets [8].

### 5.2.3 Taxation of distributions

In the context of I.C.T.A. 1988, the United Kingdom operates an imputation system in respect of dividends and other distributions known as the ACT (i.e. advance corporation tax) system, under which a company resident in the UK paying dividends and other distributions will account for advance corporation tax, whereas a non-resident company is not liable to pay ACT (section 14). The significance of this system to foreign investors lies in the fact that whilst branch profits may be freely remitted abroad without extra taxation, profits of subsidiary companies set up in the UK, if they are remitted in the form of dividends, are subject to payment of ACT. The rate of ACT is usually expressed as a fraction of the amount actually distributed. In contrast to the rate of corporation tax, the ACT rate is a flat rate which is fixed by each year's Finance Act. The rate of the ACT for the

year 1995-1996 assessment is 1/4 [9].

(1) Linkage role of ACT system

The ACT system is adopted by the Inland Revenue as a method of collecting tax at source. The unique characteristics of this system are that it closely links the company and its shareholders by discharging the former's liability for certain amount of corporation tax on profits, and at the same time by taking ACT as a tax credit in connection with any dividends and other distributions received on behalf of the latter.

A UK recipient of the distribution is entitled to a tax credit corresponding to the amount of ACT paid by the company (section 231(1)). This aggregate amount, i.e. the distribution plus the ACT accountable in respect thereof, constitutes a franked payment of the paying company (section 238). Whilst the tax credit is generally available only to residents, if the recipient is a non-resident company, credit may still be claimed by it as it may be under a double tax treaty and in such instance is entitled to a tax credit by being charged on the sum of the dividend and the credit as UK source incomes but the liability will be restricted in the appropriate treaty to a fixed percentage known as withholding tax [10].

(2) Relief for payment of ACT

Whereas a company sets off the ACT against its corporation tax liability for the accounting period in which the dividend is paid, the relief against mainstream corporation tax for ACT is equivalent to the ACT which would be due on a franked payment equal to the profits chargeable to corporation tax. In the case of any surplus ACT (i.e. the ACT exceeds this maximum), in terms of section 239, two main reliefs are available: a) it can be carried back to accounting periods beginning in the six years preceding the accounting period in which the surplus ACT arose, taking later years before earlier years; and b) it may be carried forward and treated as ACT payable in respect of the next accounting period, and if it cannot be utilised in the accounting period, it will be treated as surplus ACT in the following accounting period and carried forward indefinitely until realised.

Also, in a group relationship, a parent company which has paid ACT on dividends in an accounting period may under section 240 as amended by section 97 of the Finance Act 1989 surrender all or part of ACT to any company or companies which are 51% subsidiaries throughout the accounting period. The ACT surrendered is thus treated as ACT paid by the subsidiary. And in these circumstances, dividends paid become group income and may not be brought

into charge to corporation tax in the hands of the recipient.

### 5.2.4 Practice of VAT

The practical effect of VAT applies to a foreign investor while he has business entities in the UK which supply goods and services locally. VAT by nature is not a tax on business profits but a tax on consumer expenditure eventually collected by suppliers. Businesses are charged VAT on their purchases, and in turn charge VAT on their sales. The prevailing statute pertaining to VAT is the VAT Act 1994. British VAT system is administered by the Commissioners of Customs and Exercise, which is given wide power in carrying out their duty of care and management of VAT in the UK (Sch. 11, para. 1(1)).

According to sections 1 and 4(1), VAT is charged on any supply of goods or services made in the UK, where it is a taxable supply made by a trader referred to as "a taxable person" in the course or furtherance of any business carried on by him. Taxable persons may be both resident companies and non-resident companies which make taxable supplies through branches. Supplies are taxed at the standard rate of 17.5% at present [11]. Taxable persons must deliver VAT returns to Customs accompanied by any payment due, showing the outcome for each tax period [12].

In this connection, the real significance of VAT relates to how the suppliers account for VAT correctly. VAT imposed on business purchases (i.e. input tax as defined by section 24(1)) can be offset against VAT collected (output tax) with only the balance required to be paid to Customs, and a business with an excess of input tax over output one is entitled to a repayment [13].

Businesses making taxable supplies in the UK are generally required to register with Customs for VAT if their supplies are expected to exceed a certain amount (£46,000 from 1 December 1994) [14]. Companies in the group may register for VAT in the name of one representative group member [15]. The effect of doing this is that intra-group transactions can be exempt from VAT as all supplies made by and to group companies are treated as made by and to the representative company in question.

**5.2.5 Investment in Enterprise Zone properties**

Enterprise Zone property may be an ideal option for foreign investors who require a full tax deduction on their investment. The legislation in this respect is principally contained in Part I of C.A.A. 1990. Under section 1, an investor may be given a special 100% capital allowance for capital expenditure incurred on the construction of a building occupied for the purpose of a trade carried on

either by the investor himself or his lessee, where the expenditure is incurred at a time when the site of the building falls within an Enterprise Zone, and has done so for not more than ten years.

It can therefore be deduced that where the investor incurring the expenditure is to occupy the property for his own trade, allowances can be given in taxing that trade. It can also be understood that the allowances are available to the investor if he lets the property for occupation by his tenants, and according to section 9 the allowances in this case are given by discharge and repayment of tax.

As developments in Enterprise Zones are often very large, this may make it difficult for small investors to participate. A practical approach to solve this problem is to arrange the funding with some form of syndicate or trust.

## 5.3 ANTI-AVOIDANCE MEASURES

### 5.3.1 Transfer pricing

Transfer pricing is a device as a result of which transactions between associated companies in which profits are transferred from one company to another via artificially fixed prices. In a sale at an undervalue the

chance for profits is passed from the seller to the buyer, and by a sale at an overvalue additional profits accrue to the seller at the cost of the buyer.

(1) Anti-avoidance legislation

In view of intra-group transactions which are likely carried out by foreign investors as a means of reducing tax liability, the United Kingdom has anti-avoidance legislation designed to prevent any outflow of profits abroad through artificial inter-company pricing arrangements.

Section 770 of I.C.T.A. 1988 contains provisions which enable the Inland Revenue to review the pricing of cross-border transactions, and deal mainly with transfer pricing between a buyer and a seller under common control. In practice, these provisions are mostly directed towards transactions between a company resident in the UK and its overseas affiliate.

Section 770 applies where transactions in goods, services or business facilities are provided at a price greater or less than the price which might have been expected if the parties concerned had been independent persons dealing at arm's length. And business facilities here are defined by section 773 as covering lettings and hirings of property,

grants and transfer of rights, interests and licences, etc.

Whilst this anti-avoidance legislation is not directed at any genuine commercial transactions at arm's length, in the event that a UK party has goods, services or business facilities provided to or obtained from its overseas related business entity sold at under-value or purchased at over-value, the Inland Revenue is given power by section 770 to adjust the taxable income of the UK resident company to the amount that would have ensued if the said transaction had been conducted at an arm's length price. Thus, the route of carrying out transactions in a roundabout way by associated companies is greatly narrowed.

(2) International dimension of the prevailing policy

Although section 770 entitles the Inland Revenue to make adjustment as to any transfer pricing transaction in the light of the arm's length price, fixing such a price appropriate to the actual circumstances can be quite complex and is subject to many diverse elements. It should be noted that the statute does not require any automatic application of section 770. Thus in practice, whether section 770 is applied will be completely at the discretion of the Inland Revenue, and most transfer pricing problems may actually be settled by negotiation between the Inland Revenue and the taxpayer in question. And more

importantly, the Inland Revenue's policy executed in the course of reviewing and negotiating is to a large extent based on the relevant international norms.

While there is no legislation governing the setting of appropriate transfer price, the OECD reports in connection with transfer pricing and international taxation to multinational enterprises are taken as important guidelines for the Inland Revenue to review cross-border transactions, since these reports have exerted a profound effect on tax authorities' policies throughout the world.

Moreover, referring to a transfer pricing dispute, the taxpayer in question may seek solution from the relevant provisions contained in tax treaties especially those regarding elimination of effective double taxation, as double taxation might be incurred if any adjustment of cross-border transaction price is made by the tax authority in one of the two jurisdictions related. Also, if the transaction is conducted between a UK resident company and a company resident in any EU country, according to section 815B introduced by the 1992 Finance (No.2) Act, the EC Arbitration Convention 1990 will entitle the taxpayer in question to the arbitration procedure embodied in the Convention, including involvement of an independent advisory committee which delivers its opinion on the case referred to it within a set time limit, and the Inland

Revenue in this instance must follow any agreement or decision made under the EC Convention.

### 5.3.2 Controlled foreign companies

Whilst many foreign investors have companies located in tax-advantaged jurisdictions for the purpose of accruing profits in the course of intra-group transactions, it must be recognised that the traditional attraction in such jurisdictions has diminished considerably, in particular with the enactment and enforcement of the Controlled Foreign Companies provisions.

(1) Anti-avoidance legislation

Section 747(1) of I.C.T.A. 1988 defines a controlled foreign company as a company which in any accounting period is resident outside the UK but controlled by persons resident in Britain, and is subject to a lower level of taxation in its country of residence. Section 750(1) further defines the lower level of taxation as a tax charge which is less than 75% of the corresponding tax charge in the UK. Controlled foreign companies' operation is an area of great concern to the Inland Revenue as a foreign investor may utilise such vehicle in a jurisdiction which has a lower rate of tax than the United Kingdom and escape tax by holding tax-efficient funds for his own benefits.

The anti-avoidance provisions in this regard do not apply automatically but only on a direction by the Inland Revenue (section 747(1)). Where such direction is made, the UK resident shareholders of a controlled foreign company may have apportioned to them the company's chargeable profits, the amount of the tax liability in respect of such chargeable profits being reduced by the company's creditable tax (i.e. foreign tax on the apportioned profits which would have qualified for double tax relief had the company itself been chargeable to corporation tax) (section 747(4)).

(2) Available evasion of anti-avoidance measures

The Inland Revenue cannot make a direction if some defences can be substantiated by the controlled foreign company: for example, the company may pursue an acceptable distribution policy (section 748(1)); or it may actively carry on a trade in its territory of residence having its own staff and premises, engaged in exempt activities that do not fall into a list of precluded activities (section 748(1), paras. 5-12 of Sch. 25); or it is to a significant extent held by the public and quoted on a stock exchange (para. 13 of Sch. 25); or its chargeable profits for the accounting period do not exceed £20,000 (or a proportionately smaller amount if the accounting period is less than twelve months) (section 748(1)).

In practice, the most frequently used defence is to satisfy an acceptable distribution policy. The effect of the relating anti-avoidance provision can be evaded if the amount of the dividends paid to the UK residents is not less than 50% of the company's available profits in the case of a trading company and 90% of the company's net chargeable profits in the case of a non-trading one for that accounting period (paras 2(1) and 2A(6) of Sch. 25). The concept of "net chargeable profits" in the case of a non-trading company is explained as the company's chargeable profits less its unrestricted creditable tax (i.e. the tax relief that in such circumstances would be available in the UK in respect of foreign tax suffered by the company), according to para. 3(4A) of Sch. 25, inserted by the Finance Act 1994 under which a heavier scrutiny is imposed upon unreasonable intra-group transactions by linking the acceptable distribution standard for a non-trading company to the UK taxable (rather than accounting) income profits. However, whilst the Finance Act 1994 makes it more difficult for a controlled foreign company to meet the test standard, this vehicle is still worth making use of as the new regime does not totally withdraw the tax privileges available to it. Whereas companies located in tax-advantaged jurisdictions may serve important commercial purposes, what foreign investors have to do is to justify the grounds for establishing and using such companies and to convince the Inland Revenue that their controlled

companies have no inherent connection with the tax aspects of any intra-group transactions.

PART II (CHINA PART):

As a result of the open-door policy in 1979, a systematic structure for taxation of foreign investment enterprises has been brought into existence, and is continuing to adapt and change in accordance with the interaction of economic, legal and other forces in China. The relevant principles embodied in tax laws underline the provision of favourable treatment to foreign investment enterprises with regard to income tax, whilst efforts are being made to gradually bring the prevailing tax system into more conformity with international common practices. The State Taxation Bureau and its local branches are responsible for administering all the tax issues relating to foreign investment enterprises in China.

## 5.4 FAVOURABLE INCOME TAX CONSEQUENCES

Although China's new uniform income tax rate for domestic and foreign investment enterprises introduced in 1994 to some extents erodes the current favourable treatment for the latter, a large proportion of preferential measures available to foreign investors are still in place. These favourable tax treatments are generally represented by tax concessions and holidays, and tailored for foreign investment enterprises which are engaged in the lines that are specifically encouraged by the Chinese government for

development, and/or located in special areas where inward investment can enjoy the benefits of liberal and generous policies.

### 5.4.1 Background of foreign investment taxation

(1) Evolution of taxation system

Although a substantial body of domestic tax law has been enacted since the founding of the People's Republic of China in 1949, the long-term divorce from Western legal and commercial practices resulted in the non-existence of any single law or code governing inward investment as recently as the early 1980s with the ratification of two major tax statutes, i.e. the Sino-Foreign Joint Venture Income Tax Law 1980 (the 1980 Law) and the Foreign Enterprise Income Tax Law 1981 (the 1981 Law), by the National People's Congress, the legislative body in China. The 1980 Law became the earliest tax legislation to deal with inward investment; this was devised on the basis of preferential tax rates and other incentives. However, the 1980 Law only covered limited tax aspects relating to equity joint ventures. As more and more foreign investors came to China and set up their solely-funded enterprises or co-operative joint ventures with Chinese counterparts, it became inevitable that the 1980 Law was inadequate and was finally substituted by the 1981 Law which played an important role

in filling a main gap in the taxation system by supplementing the rules regulating inward investment activities which were not conducted by equity joint ventures. During this phase of evolution, a preliminary taxation structure for foreign investment was already in place, albeit that the statutory construction was far from perfect.

Whilst the formation and application of both the 1980 and 1981 Laws have had a profound effect upon creation of a legal infrastructure for foreign investment taxation during the 1980s, as more extensive and complex activities emerged, it became apparent that there was an obvious need for a new unified legislative code in which the tax treatment of various transactions could be more concise and explicit. Thus, the above two laws were merged and replaced by Foreign Investment Enterprise Income Tax Law 1991 (i.e. the 1991 Law), which covers all the existing forms of business entities available to foreign investors, embracing equity joint ventures, co-operative joint ventures and wholly foreign-owned enterprises. Additionally, the 1991 Law embodies more preferential tax policies than the former two statutes, and hence becomes the most influential and widely-used tax law at present which directs inward investment transactions carried on in China.

(2) New reform

Where the main emphasis of the current tax system is placed on reducing tax burdens of foreign investors, domestic enterprises often complain that they are competing on an unequal footing with their foreign counterparts, since they have to pay a much higher level of tax whilst the operation of foreign investment enterprises is largely assisted by preferential tax measures. Hence, a new reform scheme implemented in early 1994 introduced two sets of new tax rules which relate to foreign investors, i.e. the Interim Rules 1994 of Levying Value-Added, Consumption and Business Turnover Taxes on Foreign Investment Enterprises, and the Land VAT Interim Rules 1994.

Foreign investors in the past were exempted from paying VAT (including land VAT), consumption tax and business turnover tax, which were applicable to their Chinese partners. The new rules enacted erode foreign investors' entitlement to the previous preferential treatment in the above three matters, thus narrowing the gap between the tax burdens assumed by their Chinese counterparts and themselves.

Also, as the new Interim Rules 1994 of Income Tax for Domestic Enterprises have come into effect, the income tax rates for both domestic and foreign investment enterprises have now converged at the same level [16]. Such

unification largely mitigates the comparative tax advantage previously enjoyed by foreign investors, and therefore helps them two carry out competition on a much fairer basis. The government's final objective has been to enable China to participate in the mainstream international tax community by unifying the prevailing two tax systems which are respectively applied to domestic and foreign investment enterprises, and to realise fair competition among all business entities in China.

To sum up, foreign investors are now in the main subject to tax regimes which can be classified into two categories: a) the 1991 Law, accompanied by its Implementation Rules (the Implementation Rules); and b) two sets of new tax rules, i.e. the Interim Rules 1994 of Levying Value-Added, Consumption and Business Turnover Taxes on Foreign Investment Enterprises, and the Land VAT Interim Rules 1994. The 1991 Law and its Implementation Rules play the foremost role.

(3) Treaties on avoidance of double taxation

To date, China has concluded treaties on avoidance of double taxation with 34 major trading partners (including the United Kingdom) [17]. For the most part, China's treaties are quite closely in conformity with the OECD Model Treaty, but a number of provisions are based on the

United Nations Model [18]. As is the case with many countries their foreign investment laws include a tax sparing provision which is added in their tax treaties with other nations and regions, China also follows suit.

In terms of article 12 of the 1991 Law, income tax paid abroad by a foreign investor on income earned overseas may be deducted from the aggregate amount of all his income tax to be paid in China, but the amount to be deducted shall not exceed the tax payable on the income outside China as computed according to the tax rate prescribed by the Chinese tax laws. The way by which the amount of deduction is calculated is technically explained by the 1991 Law's Implemetation Rules. In terms of article 85, the part that exceeds the amount to be deducted cannot be credited against the tax amount to be paid, nor can it be counted as cost of expenditure; however that part may be cancelled from the amount to be deducted in the following year and may continue to be deducted for no longer than five years.

The above stipulations are deemed as an important leverage for attracting and controlling the inflow of foreign investment. Given the special tax incentives and holidays which are already offered, the inclusion of the tax sparing provision in the tax treaties provides foreign investors with a more secure edge so that their tax treatment in China will not be offset by the possible heavy taxation

encountered overseas.

### 5.4.2 Theoretical tax ceiling

The 1991 Law provides a general framework for regulating the tax rates applied. According to articles 1 and 3, all foreign investment enterprises are liable to tax charged on their incomes. And these enterprises are defined by article 2 as embracing equity joint ventures, co-operative joint ventures and wholly foreign-owned enterprises.

Article 5 provides that the gross income tax rate applied to the above-mentioned enterprises is 33%; this is composed of a general 30% income tax rate and a 3% local surtax of the assessed income tax to be levied.

However, the 33% income tax rate is used more as a theoretical tax ceiling guidance than as a prescriptive rule for most investment transactions. This is especially true after the unification of two different income tax rates which used to apply to domestic and foreign investment enterprises respectively, since if this rate were applied literally, the tax regime would hold little appeal to foreign investors.

### 5.4.3 Particular local attractions

The general direction of the tax rate mentioned above provides a tax ceiling. In practice, the key attractions lie in the provisions of various tax incentives. These tax incentive packages can be broadly divided into two categories: a) tax incentives that are generally orientated towards encouraging foreign investors to participate in business operations of productive nature, especially those that are export-oriented or equipped with advanced technology, and also in the fields of infrastructure industry and low-profit lines; and b) tax incentives created on the basis of particular local jurisdictions in which foreign investment enterprises are located, covering Special Economic Zones, Hainan Island, some specifically designated coastal cities, and Pudong New Area located in the city of Shanghai, etc., in conjunction with the lines mentioned in category a) that are specifically encouraged for development.

The 1991 Law and the Implementation Rules contain provisions relating to tax reductions or exemptions in this regard.

(1) Incentives for lines particularly encouraged

Pursuant to article 8 of the 1991 Law, tax concessions are available to foreign investment enterprises engaged in business of productive nature other than service industries

for a scheduled operation of at least ten years, and in this circumstance the relevant enterprises are entitled to a full tax exemption in their first two profit-making years and a 50% tax reduction in the following three years. Article 8 also provides that foreign investment enterprises in farming, forestry, animal husbandry industries or located in remote backward areas may enjoy a further tax reduction of 15% to 30% for an additional ten years after the above aggregate exemption and reduction periods expire.

Foreign investment enterprises of an export-orientated nature are entitled to a continuing 50% tax reduction in any following year after the two-year exemption period plus the three-year reduction period mentioned in article 8, provided that they can export more than 70% of their products in the year concerned (article 8 of the 1991 Law, article 75 of the Implementation Rules).

Sino-foreign equity joint ventures engaged in port construction with an operational term of more than fifteen years are exempted from income tax from the first profit-making year for the initial five years, and continue to be entitled to a 50% tax reduction in the following five years (article 8 of the 1991 Law, article 75 of the Implementation Rules).

Foreign investment enterprises using advanced technology

are entitled to a 50% tax reduction for a further three years if after the tax exemption and reduction periods they still retain the advanced technology adopted (article 8 of the 1991 Law, article 75 of the Implementation Rules).

(2) Incentives in special areas along with lines encouraged

Foreign investment enterprises engaged in industries of a productive nature located in Special Economic Zones, Hainan Island and Pudong New Area in the city of Shanghai may enjoy the privilege of having their income tax rate reduced to 15% (article 7 of the 1991 Law, articles 69 and 73 of the Implementation Rules). Also in these special areas, rate concessions may be applicable to foreign investment in infrastructure industries (e.g. energy, communications, and port construction, etc.), and in the establishment of financial institutions solely or with local Chinese partners. In these cases, the income tax rate can be reduced to 15%, whilst the financial institutions in question have to maintain capital contributions from overseas side at over US$10 million for an operational period of more than ten years (article 7 of the 1991 Law, article 73 of the Implementation Rules).

In some specifically designated coastal cities (i.e. 14 municipalities in the eastern part of China, which were designated by the government as "Open Coastal Cities"),

foreign investment enterprises established there are taxed at the rate of 24%, providing that they are also engaged in manufacturing business (article 8 of the 1991 Law, article 70 of the Implementation Rules), and in the event of the investment project being technologically intensive or with overseas capital contribution of over US$30 million the enterprise in question will also likely be charged at the 15% tax rate (article 73 of the Implementation Rules).

In Special Economic Zones, foreign businesses in service industries, if their intended operational period is more than ten years and the overseas investment contribution is over US$5 million (in the case of financial industry, the minimum requirement is US$10 million), are entitled to a tax holiday for the first profit-making year and a 50% tax reduction for the following two years (article 8 of the 1991 Law, article 75 of the Implementation Rules).

In Hainan Island as well as Pudong New Area in the city of Shanghai, it is possible for foreign investors in infrastructure projects to have a tax holiday for the first five profit-making years and a 50% tax reduction for the next five consecutive years, provided that their operation term is over fifteen years (article 75 of the Implementation Rules).

The current situation is that tax concessions may vary from

one jurisdiction to another. Rather than the above-mentioned special areas, many other local jurisdictions have also formulated their own favourable policies for attracting foreign capital. Some of those policies may appear to be even more liberal than those embodied in the national tax laws. However, it must be noted that many of them are not established on a very sound legal basis and disputes may easily arise in the course of their actual execution.

**5.4.4 Favourable rate of withholding income tax**

Another preferential treatment is the rate of withholding tax applied. According to article 19 of the 1991 Law, a 20% tax shall be levied on the income arising from China, such as interest, royalties, dividends and rentals, no matter whether the recipient in question has local business establishment or not. Such a withholding tax is aimed at foreign enterprises which have indirect investment interests from China.

Whilst the low rate itself is not the whole picture, the real benefits are principally reflected in the rules about available exemption and reduction in various circumstances.

Pursuant to article 19, this 20% withholding tax may be waived with regard to indirect investors from overseas who

receive profits from foreign investment enterprises in China, or foreign banks which have income from interest on loans given to Chinese state banks at favourable interest rates. Moreover, royalties received from the provision of special expertise for scientific research or infrastructure development are only charged at the rate of 10%, and in certain circumstances (e.g. the expertise is of state-of-the-art nature or such provision is established on favourable terms) can even be exempted from withholding tax with the consent of the tax authority (article 19).

## 5.5 IMPUTATION OF TAXABLE AMOUNT

It is essential that the amount of taxable income should be reasonably determined as this is closely linked to the likely financial burden which foreign investors may assume.

### 5.5.1 Basis of calculation

Concrete calculation formulae can be discovered from article 10 of the Implementation Rules, which classifies taxpayers into three different categories - manufacturing industry, commercial industry and service industry. Although the method of calculation varies slightly from one category to another, the actual principle applied is the same.

The 1991 Law provides that the taxable income of a foreign investment enterprise shall be the excess of its gross income in a tax year over its deductible costs, expenses and losses incurred from production and business operations (article 4).

It should be noted that the taxable income is, as a matter of fact, defined in terms of net income, and this way of definition is in compliance with the general international practice and therefore enables foreign investors to avoid potential double taxation in their countries of residence.

**5.5.2 Losses' offset**

(1) Acceptance of two concepts about tax year

By article 8 of the Implementation Rules, taxable income is computed on a Gregorian calendar-year basis, with a tax year commencing on 1 January and ending on 31 December each year.

As different concepts of a tax year may exist in many other countries, if there were no other option, some foreign investors would have to prepare final accounting statements and audit reports twice in one calendar year in order to comply with the respective requirements of tax authorities in both China and their own countries.

In order to solve this problem, article 8 adopts a very flexible approach and allows foreign investors to calculate their taxable income on a twelve-month basis with the consent of the relevant local tax authorities. This concession is especially helpful to giant enterprises which can therefore simplify their accounting formalities to a large extent.

(2) Allowance of losses to be carried forward

With regard to trading losses, the 1991 Law is quite generous. Article 11 provides that losses incurred from production and business operations in a tax year may be carried over to the next tax year and be offset against a corresponding amount from that year's income. And in the event that income in the subsequent tax year is not enough to counteract the losses in question, the balance may be offset against income in successive years but within a period not exceeding five years (article 11).

### 5.5.3 Depreciation of fixed assets

To keep up with the general trend that depreciation on fixed assets is accelerated in many countries because of the rapid development of contemporary science and technology, Chinese tax law has accordingly responded.

Article 34 of the Implementation Rules requires that depreciation on fixed assets shall generally be computed under the straight-line method. However, if foreign investors want to use other methods of depreciation, they may apply to the tax authorities who will in turn give proper consideration to such requests (article 34).

A minimum useful life is prescribed by articles 35 and 36 for four different categories of fixed assets - a) twenty years for houses and buildings; b) ten years for trains, ships, machines, and other production equipment; c) five years for electronic and transportation equipment other than trains and ships; and d) in the case of enterprises engaged in petroleum exploitation, six years for their fixed assets with no residual value retained and estimated. In order to speed up capital turnover, article 40 supplements these provisions to the effect that in the event of a joint venture whose operational term is shorter than the minimum useful life prescribed by articles 35 and 36, the investors concerned may apply to the tax authorities for further shortening the minimum useful life of the fixed assets of the joint venture.

### 5.5.4 Refund of tax for income reinvested in China

A refunding system applies to foreign investors who reinvest in China. Under article 10 of the 1991 Law, a

foreign investor reinvesting part or all of his profit acquired from the operation of his business entity in China for a period of not less than five years is entitled to be refunded 40% of the income tax already paid on the reinvested portion. However, article 10 prohibits the investor in question from withdrawing his re-investment within five years; otherwise he must repay the refunded tax.

Apparently, this system is proposed for encouraging foreign investors to expand their existing operation scale so as to sustain the momentum of capital influx, which is registering a continuous growth at present.

**5.5.5 Treatment on intra-group transfer pricing**

A foreign investor can establish a number of enterprises in China, and have them controlled under the umbrella of a parent company resident abroad. This group structure may be adopted to carry out a transfer pricing policy among associated affiliates for the purpose of avoiding tax. In practice, this behaviour often results in a rather curious phenomenon under which some foreign investment enterprises become bankrupt in accounting terms, whilst in the meantime they continue to increase capital input and enlarge production scale.

To prevent unreasonable intra-group transfer pricing arrangements, article 13 of the 1991 Law stipulates that business activities among foreign investment enterprises which are subject to a parent company resident abroad should be carried out in the same way as transactions among unrelated persons, and any tax avoidance behaviour via intra-group transactions, if found, must be rectified by the tax authority. It is only in this way that the interests of other taxpayers can be properly safeguarded so that all taxpayers are able to compete with each other on a more equal footing.

### 5.6 OVERVIEW OF NEW TAX LEGISLATION

To foreign investors, two sets of newly enacted tax rules, i.e. the Land VAT Interim Rules 1994, and the Interim Rules 1994 of Levying Value-Added, Consumption and Business Turnover Taxes upon Foreign Investment Enterprises, are also of great significance. These rules are established on the basis of tightening the control upon their current tax treatment.

#### 5.6.1 Tightened tax control

(1) Land VAT

There was no land VAT levied in China before the Land VAT

Interim Rules 1994 came into existence. As more and more foreign investors are involved in real estate transactions, it is necessary to strengthen the control upon various trading activities on the market. Under this background, the Land VAT Interim Rules 1994 start to enhance the burden of foreign investors by levying VAT on all transactions relating to re-transfer of land use rights and buildings on the land.

According to article 2, any organisation or individual having income from dealing in re-transfer of land use rights acquired as well as trading the buildings above the land is liable to land VAT.

By article 7, land VAT is computed at the following four types of progressive rates on the added value of the estate in question - a) 30% levied on the added amount not exceeding 50% of the previous value; b) 40% on the added value exceeding 50%; c) 50% on the added value exceeding 100% but below 200%; and d) 60% on the added amount exceeding 200% of the original value.

Whilst the VAT is now applied, some concessions are still available from the new rules. To encourage foreign investors to play a more active part in developing normal residential properties, article 8(1) provides that taxpayers engaged in developing and selling the above type

of properties are exempted from any VAT should the added amount resulting from the transaction not exceed 20% of the previous value assessed. Moreover, in case of the estate's take-over by the state, in addition to the fact that the estate occupiers will be adequately compensated, in terms of article 8(2), the estates concerned will also be allowed to be freely transacted on the market before the take-over takes place, and in this case no VAT will be levied on income arisen from the trading activities.

(2) Three other new taxes

As of early 1994, a new levy composed of value-added, consumption and business turnover taxes started to apply to foreign investment enterprises in China. The Interim Rules 1994 of Levying Value-Added, Consumption and Business Turnover Taxes upon Foreign Investment Enterprises have completely altered the previous system concerning these three taxes. In contrast to foreign enterprises which were exempted from paying value-added, consumption and business turnover taxes in the past, domestic enterprises have been subject to them since as early as 1984 [19], and have therefore always complained about the much higher tax rate applied to them in comparison with favourable treatment to their overseas counterparts. However, both Chinese as well as foreign enterprises now face the same levying standard.

VAT has a top rate of 17% and covers domestic and imported goods [20]. In the past, the Chinese VAT was applied selectively to a limited range of products, notably those where the production structure tended to be complex [21], but at present the levy is applied in all manufacturing and circulating stages. Consumption tax is levied on 11 commodities, notably such as tobacco, alcohol, petrol, diesel oil, cars and luxury cosmetics [22]. Service sectors including transport, insurance, post and telecommunications, construction, and entertainment are liable for business turnover tax [23].

### 5.6.2 Controversy about the new tax scheme

Since the new taxes discussed above were not relevant to foreign investors in the past, their introduction has unavoidably given rise to many controversies between foreign investors who are worried about the erosion of their preferential treatment, and the relevant government officials who insist that the new levy is not a matter of concern for foreign investors.

The relevant tax authority has repeatedly emphasised that foreign investment enterprises will be properly protected from increased tax burdens [24]. The stipulations contained in the 1991 Law are still valid [25], and foreign investment enterprises can continue to enjoy the relevant

tax concessions and holidays embodied in the law. For example, enterprises set up in Special Economic Zones, specifically designated coastal cities and Pudong New Aewa in the city of Shanghai, the 15% tax rate will still be applied to them if they are engaged in certain business lines (e.g. infrastructure industries). Moreover, Sino-foreign joint venture banks and solely-funded foreign banks established in Special Economic Zones and Pudong New Area in the city of Shanghai will be granted a five-year business turnover tax holiday after coming into operation [26].

For fear of seriously damaging the present momentum of foreign capital influx, the government has introduced a rebating system under the Interim Rules 1994 of Levying Value-Added, Consumption and Business Turnover Taxes upon Foreign Investment Enterprises. In the event of an tax increase, enterprises registered prior to 31 December 1993 may under article 2 apply for a refund of the increased part that is taxed. The purpose of applying this system is to ensure that the tax burden will not be added too abruptly. However, by article 2, this system can only cover a maximum period of five years. That is to say, there will be no refund in any case from the sixth year no matter whether the tax levied remains at the same level as before or not. Also according to article 2, enterprises registered after 1 January 1994 are not entitled to the

benefits under the rebating system, and they will therefore have no alternative but to comply with the new tax scheme.

In general, although the new tax scheme undoubtedly creates extra burdens, whilst the overall principle of sustaining provision of tax incentives to foreign investors remains unchanged, it is nonetheless an enormous leap forward in the process of gradual convergence of different tax treatments now applied to domestic and foreign business entities in China.

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## CHAPTER 6

## SETTLEMENT OF INVESTMENT DISPUTES BY ARBITRATION

Even in the best of circumstances, commercial disputes will almost inevitably arise in the interpretation and implementation of business commitments which are already undertaken. Foreign investors are therefore often concerned about the availability of adequate facilities existing in capital-importing countries so that any differences arising in the course of their investment transactions can be solved swiftly, efficiently, and as inexpensively as possible.

Compared to conciliation and litigation as two other independent methods, arbitration has distinct advantages and is hence perceived as the most popular alternative for settling international commercial disputes. First, arbitration takes a consensual commercial approach to the solution of problems, and therefore is far more dependable than conciliation which merely pursues compromise with a remote possibility for achieving justice. Second, rather than to commence an action in the court, the parties may generally refer their dispute to less lengthy and costly proceedings by a tribunal sitting in private sessions, and unwanted publicity can also be avoided.

The primary purpose of this chapter is to examine settlement of commercial disputes with foreign elements involved under the arbitration systems in the UK and China. Discussion in UK Part is chiefly concerned with English arbitration since the use of private means to settle disputes between parties has long been established in England and the merits of arbitration conducted there (most notably in London) have been widely identified by many foreign businessmen. However, a brief description is given at the end of UK Part about the system of arbitration in Scotland which has developed differently from that in England.

In both Part I (UK Part) and Part II (China Part), two major topics are included - a) conduct of arbitration; and b) challenge and enforcement of arbitral award. Whilst the first topic principally covers the reference of a dispute carried out under domestic arbitral framework, the second one additionally relates to a number of international conventions, to which both the UK as well as China are the signatories, and among which two conventions play the most prominent role in recognising and enforcing foreign awards in each country, i.e. the New York Convention of 1958 (the Convention on the Recognition and Enforcement of Foreign Arbitral Awards) and the Washington Convention of 1965 (the Convention on the Settlement of Investment Disputes between States and Nationals of Other States).

PART I (UK PART):

The agreement to arbitrate is the foundation stone of commercial arbitration. Foreign investors are relatively free to choose their own way of arbitration, provided that all the relating issues are reasonably specified in the agreement beforehand.

The rules that govern the conduct of arbitration under English law are derived from the marriage between statute (i.e. the Arbitration Acts of 1950, 1975 and 1979) and the common law (which is applied by form of judicial decisions in terms of English doctrines of precedent), along with the express agreement of the parties. Whilst arbitration should normally be based on an agreement in writing within the meaning of the Acts, subject to limits to powers of prescribing their own rules imposed by the Acts, the parties may themselves opt for place of arbitration, procedure to be followed, powers to be vested in arbitrators, and constitution type of tribunal in particular circumstances. An arbitration agreement cannot oust the jurisdiction of the court; however in reality the court merely provides a supporting rather than an interfering role. The court's powers to complement the arbitral process in the context of the common law are largely governed by the Acts, and can only be used in the absence of codes in the Acts and agreement between the

parties.

Whilst the court has no general powers to intervene in a pending reference, it may do so after an award is given, and therefore challenge of the arbitral award can be made by appealing to the court for judicial review. Both doemstic and foreign awards can be enforced in England by bringing an action in the court or taking the shape of an order for summary relief under section 26 of the 1950 Act. However, recognition and enforcement of foreign awards may additionally be based on the provisions in the relevant international treaties, principally the New York Convention of 1958 and the Washington Convention of 1965.

## 6.1 CONDUCT OF ARBITRATION

### 6.1.1 Choice of proper law

The parties to an arbitration agreement in England may not necessarily have the proceedings governed by the law of the place where the actual reference takes place. Nor is there any restriction imposed on the choice of arbitration seat.

It is appropriate for parties with foreign elements involved to insert in the agreement a particular clause, specifying their choice of law as well as place of arbitration. As arbitration site can be any suitable venue

at the parties' discretion; it may but not necessarily be at certain famous permanent arbitral institutions e.g. the London Court of International Arbitration. And in the latter case, resolution of dispute is therefore not bound by the model rules ordinarily used by the permanent arbitral body in question.

However, concerning an arbitration which is decided to be held in England, it is common for the parties to choose English arbitration law to govern the substance of their relationships; as a valid agreement this will enable the parties to secure the benefit of a highly developed arbitral system.

(1) Application of domestic procedural law

The principal legislation applicable to English arbitration is contained in the Arbitration Act 1950, which for the most part remains to provide a governing statutory machinery. In addition, the subsequent legislation, most notably the Acts of 1975 and 1979, which consolidate the 1950 Act, also exert some important influences. The 1975 Act is concerned with non-domestic arbitrations in which one or more parties is a foreign national (or a non-UK resident), or a body corporate incorporated (or with its central management and control exercised) in any state other than the United Kingdom (section 1(4)). The 1979 Act

plays a key role in increasing the effectiveness of the arbitral procedure by limiting the right of appeal from arbitrators' awards, thus ensuring that the finality of the majority of arbitration awards can be reasonably respected.

Whilst the legislation applies to arbitrations deriving from valid arbitration agreements, the Acts do not embrace the whole law of arbitration, nor do they provide an exhaustive and comprehensive code. Many provisions of the legislation in practice are not mandatory and may yield to those expressed to a contrary intention in the arbitration agreement between the parties [1]. The parties may themselves determine their own rules of procedures, e.g. what arbitral rules are to be applied, what procedure is to be followed, how to appoint arbitrator(s) and constitute a tribunal, and what powers are to be vested in the arbitator(s) appointed, etc. In these circumstances, the Acts only set out the code which regulates the issues in the absence of agreement to the contrary between the parties. However, the parties' power to prescribe their own rules of procedure are not unlimited. There are certain provisions in the Acts which may not be excluded by express agreement, and almost all of these are concerned with the supervisory powers of the court [2].

Under the English system, the courts always maintain some degree of control over commercial arbitrations. Similar to

the legal system as a whole, the arbitration system is established on the basis of a marriage between statute law and judicial decisions. A part of arbitration law is to be found in judicial pronouncements, which are made in the context of principles laid down by the previously decided cases. However, the passing of the 1979 Act with the right of appeal to the court being more strictly limited, has ensured that the process of arbitration enjoys a great degree of independence and finality. Although an arbitration agreement cannot oust the jurisdiction of the court, it is very rare to find a judicial intervention in a pending reference [3]. While continuing to maintain supervisory jurisdiction over references conducted, the court today is playing a very supportive role in the actual arbitral process.

(2) Application of foreign procedural law

Given that many foreign parties bring their disputes to England and that London is now one of the busiest arbitration fora in the world, a principal reason for this lies to a large extent in the highly flexible system which does not exclude application of foreign procedural laws in England. The existing legislation does not contain any provision, or imply any idea, which prohibits the use of foreign laws in the course of carrying out the reference. It has been acknowledged that the parties in question may

choose the law other than the law of the place where the arbitration is held [4]; thus the choice of law for arbitration may vary greatly.

However, not any set of overseas arbitration law is applicable in England. It is especially noticable that adoption of the UNCITRAL (United Nations Commission on International Trade Law) Model Law on International Commercial Arbitration of 1985, which is commonly deemed as a set of authoritative legal principles with the object of harmonising and unifying the law of commercial arbitration on the worldwide basis, has been rejected in England. Such rejection was mainly established on the recommendation of the Mustill Committee (the Departmental Advisory Committee on Arbitration) in 1989 that the Model Law itself was not suitable for English arbitrations on the ground of considering the actual situations in England [5].

Many foreign parties feel that the English arbitration system is attractive because once they indicate the choice of law in advance, they may avoid being governed by a law to which they are not accustomed and therefore have the disputes settled with the procedures they are already familiar. However, using a foreign arbitration law has its potential shortcomings. Foreign parties should pay special attention to the degree to which an English court will recognise and enforce the foreign law they select. If they

do not it would be much safer to adopt domestic procedural law while conducting the reference in England.

### 6.1.2 Nature of arbitration agreement

Section 32 of the 1950 Act defines the term of an arbitration agreement as meaning a written agreement to submit present or future differences to arbitration. The agreement is usually a fairly detailed document, dealing with issues such as constitution of arbitral tribunal, procedures to be followed, matters to be decided, and how an award is finally given.

An arbitration agreement is indispensable to a successful settlement of any commercial dispute. It serves to evidence the consent of the parties to have any of their differences resolved through the way of arbitration, thus establishing a binding contractual obligation between them. Moreover, it provides the basic source of the powers to the tribunal which in principle may only exercise such powers as the parties confer upon it.

(1) Effect of agreement on staying court proceedings

Although there is no provision in the law denying any party seeking recourse to a judicial settlement, the agreement does form a key reason why the court should normally

decline to exercise its jurisdiction.

In the case that one party to an arbitration agreement commences legal proceedings in the court against the other party in breach of that agreement, the other party may apply to have the court action stayed on the ground that a valid arbitration agreement is already existing between the parties and will have the effect of binding them. The 1950 Act places a mandatory obligation upon the court to stay proceedings wrongly brought in the court under certain circumstances. Under section 1(4), the court will grant a stay if it thinks that there is no good reason why the dispute should not be referred to arbitration.

(2) Autonomy of obligation to arbitrate

Where an arbitration agreement forms an integral part of the original commercial contract (i.e. the main contract) between the parties, the obligation to arbitrate is treated as having a life of its own, severable from the main contract, and capable of surviving so as to give the arbitrator continuing jurisdiction not only over disputes arising from events happening when the contract is still operational but also upon those after it has come to an end [6].

It is important in practice that such an autonomy could

survive the termination of the main contract, since the agreement to arbitrate is the base on which the arbitration is founded, and without it there can be no valid arbitration.

(3) Scope of agreement

Interpretation of what kind of dispute should be referred to arbitration depends primarily upon the wording of the agreement, which is subject to the parties' particular needs and should be decided in advance. While the scope can be quite wide, the parties may not intend to have all their differences settled by arbitration. In the event that the scope needs to be limited, certain general rules have to be considered by the parties and thereafter entered in the agreement as to the types of dispute which are and are not capable of falling within the specified scope.

**6.1.3 Composition of tribunal**

A tribunal can be constituted in a number of different ways. Whilst a common arrangement is for each party to appoint his own arbitrator respectively, arbitration can be commenced by the appointment of a sole arbitrator or more than two arbitrators, depending upon the wording of the arbitration agreement. Appointment can also be made by the court if any party fails to do so or no mutual consent to

such appointment could be made. Furthermore, in the event of the two arbitrators failing to make a unanimous award, an umpire will be appointed, either by the parties or by the court, to take the ultimate decision.

English arbitration law says little about what kind of formal qualifications an arbitrator should possess. However in practice, a validly appointed arbitrator must be qualified to act pertinent to the requirements set forth by the arbitration agreement, and the law in turn enforces any such express agreement regarding the required qualifications [7]. More importantly, the arbitrator should in fact be free of any relationship with either of the parties or of any connection with the dispute referred to him, so that there will be no ground of objection that he lacks impartiality [8].

(1) Sole arbitrator

On grounds of speed and economy, referring a dispute to a sole arbitrator has its obvious advantages. Under the 1950 Act, appointing a sole arbitrator is available either by the parties to the agreement or by the court in certain instances.

The most usual basis for appointment of a sole arbitrator is the agreement of the parties to the dispute. Under

section 6, in the event that the agreement is silent as to the constitution of the tribunal, unless a contrary intention is expressed, it is construed as including a provision that the reference shall be to a single arbitrator. Also, where the agreement provides for a reference to two arbitrators with one to be appointed by each party, if one party fails to fulfil his obligation for seven clear days after the other party appoints his arbitrator, the other party may appoint his own nominee as sole arbitrator (section 7(b)).

The court's power is usually exercised when the parties fail to concur in the appointment. By virtue of section 10(1)(a), where the agreement requires a reference to a sole arbitrator, but the parties cannot agree upon the choice, the court has power to make the appointment on their behalf. Moreover, by section 25(2), appointment of a sole arbitrator can be made by the court when the authority of the tribunal is revoked or removed for some reason even if the tribunal may originally have more than one member. Also, at any time after the appointment of an umpire, the court may according to section 8(3) on the application of any party to the reference order that the umpire shall enter upon the reference as a sole arbitrator in lieu of the existing tribunal.

(2) Two or more arbitrators

Until the Act of 1979 came into effect, a three-arbitrator tribunal was unusual in English procedure because of section 9(1) of the 1950 Act (unamended) that where the agreement provided for one arbitrator to be appointed by each party and the third to be appointed by the two arbitrators nominated, the reference was supposed to be to a tribunal of two arbitrators and an umpire. Now in arbitrations to which the 1979 Act applies, such an agreement takes effect as a reference to three arbitrators, the award of any two being binding unless the agreement provides otherwise (section 6(2) the Act of 1979).

A commercial arbitration conducted by a tribunal of two or three arbitrators is undoubtedly more costly than that conducted by a single arbitrator. It also generally takes longer to obtain an award. However, a tribunal of two or three arbitrators can be very effective in practice, since it is likely to prove more satisfactory to the parties and the ultimate award is more possible to become acceptable.

A reference to two arbitrators usually involves a tribunal consisting of either these two members appointed by each party or sometimes three members with the additional one as an umpire. The case is decided by the two arbitrators, or by the umpire if the two arbitrators cannot agree. The umpire plays the role of replacing the arbitrators if and when they disagree with one and another. By section 6(1)

of the 1979 Act, unless there is an express contrary intention, every arbitration agreement where the reference is to two arbitrators shall be deemed to include a provision that the two arbitrators may appoint an umpire at any time after they are themselves appointed and must do so forthwith if they cannot agree on a mutual award. In the event that the parties who are required to appoint an umpire fail to do so, the court has the power to make such an appointment on their behalf (section 10(1)(c) of the 1950 Act).

A reference to three arbitrators is not the same as that to a two-man panel plus an umpire. Here the third party is appointed as an additional arbitrator and is different from the umpire. He sits with the other two arbitrators and has an equal voice with them in the reference, while the umpire merely sits with the arbitrators in a non-voting capacity until they fail to agree in the proceedings. The court may appoint the third arbitrator under section 10(1)(c) of the 1950 Act, where the parties or the two arbitrators are required or at liberty to make this appointment but fail to do so.

(3) Removal of arbitrator or umpire

Removal of an arbitrator or umpire might be sought by the parties in consideration of their own interests, thus

leaving open the possibility of having a new arbitrator as alternative or umpire appointed to conduct the reference.

Under section 13(3) of the 1950 Act, any party may apply to the court for removal of an arbitrator or umpire who fails to use all reasonable dispatch in entering on and proceeding with the reference and making an award.

Also, section 23(1) empowers the court to remove an arbitrator or umpire who has misconducted himself or the proceedings. Misconduct may have a wide meaning, including anything which makes the proceedings contrary to the natural justice. In practice, however, it is normally at the discretion of the court to decide whether the action is counted as a misconduct or not.

**6.1.4 General course of reference**

An arbitrator is entitled to adopt whatever procedure he thinks fit, provided that the procedure is not contrary to the express or implied terms contained in the arbitration agreement. Due to the existence of a large variety of specialised arbitrations, it is difficult to compose a list of requirements which are fundamental to all references. However, as a general rule, an arbitration should be conducted judicially, in accordance with the common law adversarial procedure rather than by taking an

inquisitorial approach [9]. Under this procedure, the arbitrator seeks out the truth by choosing between two alternative versions of the case forwarded by each party. And these versions must be fully presented and tested.

By section 12(1) of the 1950 Act, unless a contrary intention is expressed, every arbitration agreement is deemed to contain a provision that the parties to the reference will submit to be examined by the arbitrator or umpire on oath or affirmation in relation to matters in dispute, produce all documents in their possession to be disclosed and also do all other things which during the proceedings on the reference the arbitrator or umpire may require. In these circumstances, each party is given the same opportunity to put forward his own case and test that of the other. It is to their own interests to comply with any procedural order made by the arbitrator. Whilst an arbitrator does not have the same powers as a judge in imposing penalties and sanctions for non-compliance, he does have the right to apply to the court for continuing the reference notwithstanding the default of one party in failing to abide by the order (sections 5(1) and 5(2) of the 1979 Act).

The arbitrator may conduct the hearing and decide how the case shall be heard. Whilst a hearing is not a compulsory step in a valid reference [10], once it is intended, the

usual practice is to follow the procedure of an ordinary action in the court, i.e. the plaintiff in such an action corresponds to the claimant in an arbitration and a defendant corresponds to a respondent.

Also, by sections 12(2) and 12(3) of the 1950 Act, an arbitrator has power to examine on oath or affirmation the witnesses in the reference whenever he thinks fit. However, he is not compelled to do so unless the stipulation in the agreement accordingly requires.

## 6.2 CHALLENGE AND ENFORCEMENT OF AWARD

### 6.2.1 Challenge of award

Since in arbitration there is always a winner and a loser, whilst the purpose is to achieve a binding determination for settling disputes, an award which is supposed to be final to both parties may sometimes prove not to be so in practice. Only rarely does each side emerge completely satisfied with the award, which can be attacked in the hope that it will be set aside or at least amended in some way to the benefit of the party making the challenge.

In England, the most effective method of challenge is by means of appealing to the court for varying or setting aside the award, or remitting it to the tribunal for

reconsideration. This appellate system ensures a degree of judicial control over the decisions of arbitral tribunals so that an award which proves to be in clear violation of the law may be corrected in due course. However, under this system, the essential purpose of arbitration for low cost, privacy, speed and above all finality will unavoidably at the risk of being defeated. It is possibly due to this reason that the right of appeal is strictly limited by the 1979 Act. The parties who are in favour of the need for finality may contract out of any right of appeal to the court by reaching an exclusion agreement after commencement of arbitration.

(1) Judicial review of award

The English court normally maintains a measure of supervision over how an arbitral award is finally granted. Under the 1979 Act, the court on the determination of the appeal may by order confirm, vary or set aside the award; or remit the award to the reconsideration of the arbitrator or umpire along with its own opinion, in which case the arbitrator or umpire must make his award within three months after the date of the order unless the order otherwise directs (Section 1(2)).

(2) Securement of leave for appeal

Notwithstanding the fact that an appeal may be brought by one party either with the consent of the other or with the leave of the court (section 1(3)), as the other party may be reasonably satisfied with the award and thus does not consent to an appeal being made, what the party wishing to appeal has to do in this situation is to pursuade the court to grant its leave for the appeal to be filed.

In terms of section 1(4), the court must not grant leave for an appeal to be brought unless it considers that, having regard to all the circumstances, the determination of any question of law arising out of an award could substantially affect at least one party's right; and the court may make any leave given conditional upon the applicant's compliance with such conditions as it thinks appropriate.

(3) Exclusion agreement

Parties to an arbitration held in England are allowed to contract out of any right of appeal to the court on questions of law by means of an exclusion agreement, according to section 3(1). Such a waiver enables the parties to avoid going through the long and expensive proceedings in the court. And more importantly, leaving out the right of appeal is compatible with the increased trend of recognition of the autonomy of the arbitral

process and of the finality of awards.

However, section 3(6) further provides that an exclusion agreement shall be of no effect unless it is entered into after commencement of the arbitration in which the award is made or the question of law arises. The aim of this provision is to protect one party from being taken advantage of by the other in the course of negotiating and executing the main contract, which is likely to happen if the benefits of court protection are really needed but are given up too early.

**6.2.2 Enforcement of award**

Whilst the losing party may wish to challenge an award, it is equally the winning party's desire to have the award legally enforced. There is a distinction between enforcement of a domestic award in England in which the arbitration takes place and enforcement of a foreign award made outside the English territory in which local recognition and enforcement are to be sought. Enforcement of a domestic award is relatively simple, and the successful party may invoke the assistance of the court for obtaining a judgement or order on which he can levy execution. Enforcement of a foreign award in England is more complicated, which is often additionally governed by the relating obligations incurred by the international

treaties to which the United Kingdom is a party.

The New York Convention of 1958 is the most important treaty of modern times regarding international commercial arbitration [11]. The Act of 1975 gives effect to it and under section 3(1) provides for the enforcement in England of foreign awards made in its context either by action or in the same manner as the award of an arbitrator is enforceable by virtue of section 26 of the Act of 1950. Also, the Arbitration (International Investment Disputes) Act 1966 gives effect in the United Kingdom to the Washington Convention of 1965. Up to now, these treaties have exerted an important effect upon acquisition of uniformity in the recognition and enforcement of foreign awards among their signatories, including the United Kingdom.

(1) Removal of protection under sovereign immunity

It is important for foreign investors to take into consideration the English law of foreign sovereign immunity which is codified in the State Immunity Act 1978, particularly when they intend to operate in the capacity of state enterprises directly owned by their governments, since their commercial activities carried out in Britain will not entitle them to immunity from lawsuits in the English courts. This position taken on foreign state

enterprises is likely to be more important so far as enforcement of arbitral awards is concerned. It would be wrong for a foreign party on the ground of its special relationship with its own country to refuse to accept the English court's enforcement of an award against it.

Sovereign immunity to commercial transactions is denied by the State Immunity Act 1978. Under section 14(2), while the central government of a foreign state is entitled to immunity from legal actions in the United Kingdom, a separate entity owned by the state is not entitled to such immunity. Moreover, section 9 provides that where a state has agreed in writing to submit a dispute to arbitration, the state is not immune as respects proceedings in the courts of the United Kingdom in relation to the arbitration concerned. This provision therefore strengthens the enforcement powers conferred upon the English courts in respect of not only domestic awards resulting from the references in England but also foreign awards obtained overseas.

(2) Enforcement of domestic award

There are usually two ways of enforcement in which a judgement or court order can be obtained on a domestic award, i.e. by action on the award, or by application made by the winning party under section 26 of the Act of 1950.

The action may take different forms. It is possible to bring an action in the court on the award to obtain judgement for a sum of money, or acquire specific performance or an injunction to prevent some act being done, or to sue for a declaration that the award is binding [12]. Under these circumstances, the plaintiff must try to satisfy the court that there is a valid arbitration agreement in existence and that the award is secured strictly within its terms agreed upon.

Alternatively, the winning party may apply to the court to obtain an order giving leave to enforce the award as a judgement in the context of section 26 of the 1950 Act. Under this section, an award on an arbitration agreement may, by leave of the court, be enforced in the same manner as a judgement or order to the same effect, and where such leave is so given, judgement may be entered in terms of the award. An application under section 26 definitely provides a quicker and cheaper remedy than bringing an action on an award. However, it is also worth noting that section 26 can only be appealed in cases of a rather simple nature, and any application made under it is not suitable where an objection is taken to an award which cannot properly be disregarded without a formal trial.

Another aspect worthy of mention is that where the loser party's property is located outside England, such an

enforcement will inevitably incur the question of seeking judicial assistance from the relevant foreign court, which will be entrusted by the English court to execute against the loser party's property. This judicial assistance is normally based on the international agreements which the United Kingdom has signed and both an English court and a foreign court may mandate each other to pursue certain legal actions on each other's behalf.

(3) Enforcement of foreign award

Many foreign investors would like to have disputes incurred in England settled by arbitration in a country outside England, e.g. a neutral country without connection with any party to the arbitration agreement, and where English law itself is not against such a preference. Enforcement of foreign arbitral awards is therefore of particular significance to the winning party in question, especially when the asset of the defaulting party happens to be located in England. In practice, if a foreign award is enforced, then it is necessarily recognised by the court, which orders its enforcement as validly made and binding upon the parties to it. Recognition is an integral part of enforcement, and so far as a foreign award is concerned, these two terms are always inextricably linked with each other.

By section 36 of the Act of 1950, procedures for enforcing foreign awards are the same as those for enforcing domestic awards made by English arbitrators, i.e. an action on the award or an application under section 26. The conditions required to be satisfied before a foreign award is enforced depend on whether the award is being enforced at common law by action or under section 26, or under the international conventions which the United Kingdom has joined, while in the latter case the foreign court in question must request judicial assistance from the English court which will enforce the award on its behalf.

### 6.3 THE SYSTEM OF ARBITRATION IN SCOTLAND

The system of arbitration has developed differently in Scotland. Scotland has adopted the UNCITRAL (the United Nations Commission on International Trade Law) Model Law on International Commercial Arbitration through section 66 and Schedule 7 of the Law Reform (Miscellaneous Provisions) (Scotland) Act 1990.

The Model Law, as amended for the purpose of functioning more properly in the Scottish context, applies to international commercial arbitrations held in Scotland. It provides in an easily accessible form a code for resolving commercial disputes by means of arbitration with the aim of promoting the compliance with the unification and the

harmonisation of international common practices. The Model Law emphasises on party autonomy with a top priority placed on the agreement of the parties. It is up to the parties in question to decide the number and appointment of arbitrators, the place and language of arbitration, the rules governing the substance of the dispute, the formalities for conducting the reference, and the procedures for challenging awards, etc. The court in reality is generally in a supportive rather than interfering role in the arbitral process. The reception of the Model Law into Scots law is an event of the utmost significance as it brings about a special legal regime for the conduct of international commercial arbitration, thus significantly improving the attractiveness of Scotland as a convenient forum for arbitration.

However, the Model Law is not a comprehensive law, and a number of matters will continue to be governed by the current Scottish law in connection with arbitration e.g. the Arbitration (Scotland) Act 1894, the Administration of Justice (Scotland) Act 1972 and the relevant common law of Scotland. Moreover, in consideration of the fact that Scotland itself is not a state but part of the United Kingdom, the major treaty obligations of the UK (e.g. the New York Convention of 1958, the Washington Convention of 1965, and some other international treaties for the reciprocal enforcement of judgements founded on arbitral

awards) may in appropriate circumstances have effect of overriding the provisions in the Model Law applied in Scotland.

PART II (CHINA PART):

The Chinese concept of arbitration entails resolution of disputes which arise from inward investment activities, usually between a Chinese party and its overseas partner, with the reference to be held by a permanent arbitral body in China in most circumstances or abroad sometimes. The reference is normally based on an arbitration agreement between the disputants or an arbitration clause contained in the main commercial contract. As the policy of attracting foreign capital has brought to the fore the issue of settling investment disputes, the presence of inadequate guiding law for arbitration is now becoming a pressing problem which the government is most anxious to rectify.

Up to now, there has not been a comprehensive and independent set of arbitration law in China. The question of conducting a reference with foreign elements involved is now being dealt with in a piece-meal approach by borrowing the relating provisions from a number of individual statutes which govern different fields of inward investment transactions. While the current rules only outline a basic legal framework, many details must be further developed so that the prevailing system could operate in a more consistent way with normal international practice.

Foreign investors may seek to detach themselves from arbitration held in China by choosing to have the reference conducted elsewhere in the world. However, whereas the reference relates to both overseas and domestic parties, the Chinese side may insist that it carried out by the local arbitral body. In the case of arbitration held in China, the parties must refer their differences to the China International Economic and Trade Arbitration Commission, which has an exclusive jurisdiction over disputes arising from inward investment in China, and delivers final awards under the context of its own rules as well as the pertinent domestic legislations.

Domestic arbitral awards are final, and the court may not interfere except to assist in their enforcement. Foreign awards can also receive due respect under the current arbitration system, and as China has participated in the New York Convention of 1958 and the Washington Convention of 1965, awards made by foreign arbitral institutions can be recongised and enforced in China by the Chinese courts, providing that the awards are granted in conformity with the requirements set forth in the Conventions.

## 6.4 CONDUCT OF ARBITRATION

### 6.4.1 Choice of law and arbitral place

Selection of an appropriate law for arbitration in regard of differences arising from inward investment transactions is closely linked with where the arbitration is to be held and what subject-matter the investment contract concerned is actually about. In theory, a dispute is not necessarily to be referred to a Chinese arbitral institution and therefore may not compulsorily be resolved under the law of China. However, in practice, foreign parties, especially those involved in joint venture or co-operative investment contracts, may often face pressures from their Chinese counterparts who prefer to use Chinese law for governing the reference and to have the arbitration conducted in China.

(1) Choice of arbitral seat

Choice of arbitral seat, which ought to be specified by the agreement beforehand, is of utmost importance to foreign investors. This decides not only the actual arbitral institution to which the dispute is to be referred, but the arbitral procedure to be applied, and more importantly the governing law to which the reference will be subject.

There is no compulsory provision in the existing law of China which makes it a rule that an arbitration must be held locally. On the contrary, the legislation provides that the reference is allowed to be conducted in the place

specified by the arbitration agreement, including an appropriate venue in China, in the defendant's country, or in a third country (article 110 of the Implementation Rules 1983 of the 1979 Law i.e. the Law about equity joint ventures, article 26 of the 1988 Law i.e. the Law about co-operative joint ventures, and article 37 of the Foreign Economic Contract Law 1985).

In practice, the Chinese party always prefers to have arbitration held locally in the context of Chinese law, and may insist on this option while negotiating the arbitration agreement with its foreign partner. Whereas the arbitration is held overseas, the law of China will not necessarily be used, and the parties may choose appropriate foreign laws to be applied for settlement of their differences; for example, although China is not a member of the United Nations Commission on International Trade Law (UNCITRAL), it does not oppose adoption of the UNCITRAL rules of arbitration (i.e. the Model Law).

However, foreign parties should realise that in reality an option of having arbitration held in their own countries can hardly be accepted by the Chinese side, unless this alternative is used as an exchange for a single-sided beneficial action in favour of the concerned Chinese party. What usually happens is that the bargaining may result in a retreat to the third-country arbitration, which is likely

to become acceptable to both parties.

(2) The law for arbitration applied in China

In the event that the parties to an arbitration agreement explicitly agree to have arbitration conducted by the domestic arbitral body, it is always necessary to use Chinese law as the source of guiding legal principles, and the arbitration must thus be carried out under the control and supervision of the China International Economic and Trade Arbitration Commission in the context of its own arbitral rules. The Commission, as the only permanent arbitral institution in China, is directly affiliated to China Council on Promotion of International Economic and Trade which is a semi-governmental organisation. Although various tribunals formed to conduct references are namely independent, they may nevertheless forward questions about guiding laws and state policies to the Commission for advices and in many cases for firm judgements.

Because of the Commission's official status, whilst its rules are silent as to the applicable law of arbitration, it is clear that the law would always be that of China. However, the relating legislation only provides some clauses of a very general nature, which can principally be identified from the Civil Procedure Law 1991, the Foreign Economic Contract Law 1985, the 1979 Law (with its 1983

Implementation Rules) and the 1988 Law. Therefore, the mechanics of how the reference is to be carried out and the award is to be granted will to a very large extent be subject to the Commission's interpretation and implementation of those general legal principles.

Notwithstanding the fact that by article 5 of the Foreign Economic Contract Law 1985 the parties may choose the law to be applied for handling of contract disputes. In reality, foreign arbitration law can rarely be used in China for settling inward investment disputes. Inward investment contracts performed within China usually only comprise three kinds of subject-matter at present, i.e. equity joint ventures, co-operative joint ventures and wholly foreign-owned enterprises. Under the current system, all the issues are governed by the law of China (article 2 of the 1979 Law, article 3 of the 1988 Law, article 4 of the 1986 Law about wholly foreign-owned enterprises, and article 5 of the Foreign Economic Contract Law 1985). Hence, in practical terms, application of foreign arbitration law is at least for the time being almost completely excluded.

### 6.4.2 Nature of arbitration agreement

Whereas no provision from the existing legislation can be found for defining the term of an arbitration agreement,

such an agreement is usually deemed in China as established on both parties' willingness to have their disputes resolved by a tribunal sitting in private sessions, which is supervised by the China International Economic and Trade Arbitration Commission, rather than by the jurisdiction of the court. This jurisdiction is in practice reflected by the following four aspects.

(1) Exclusion from appeal to judicial organisations

A dispute specified in an arbitration agreement can only be dealt with through the route of arbitration. By article 257 of the Civil Procedure Law 1991, any parties if they agree under an arbitration clause which forms part of an underlying contract or provisions contained in a separate arbitration agreement to bring their disputes to arbitration, are not entitled to file a lawsuit in the court. Thus, the agreement itself excludes any recourse to a judicial settlement, and the court in practice will not accept cases connected with any previous arbitration agreement.

(2) Severance from underlying contract

An arbitration agreement is considered as severable from the underlying contract in which it is embodied. Whereas it is subordinate to the contract, the obligations to which

it gives rise survive the termination or suspension of the main contractual relationship [13]. This survival is crucial to resolution by arbitration of disputes arising upon or after the termination or discontinuance of the underlying contract. Where the contract comes to an end, the parties will continue to be bound by the commitment which makes the obtaining of an award a precondition for claiming any right of recovery. Equally, an arbitration agreement can also survive the failure of any condition that is precedent to the operation of the main contract.

(3) Limitedness of arbitration scope

A matter worthy of mention is the limited nature of the scope of arbitration included in the agreement. It can be seen from article 260(1) of the Civil Procedure Law 1991 that an arbitral institution is not permitted to handle any affairs beyond the scope mentioned in the agreement. Thus any subject-matter referred or appealed to arbitration must be strictly confined to those which fall within the specific terms of the arbitration agreement. And this impassable scope as a matter of fact invests the arbitrator with jurisdiction to adjudicate upon submission of any admitted particular case.

(4) International applicability

International applicability of an arbitration agreement is principally based on two major conventions that China has respectively joined, i.e. the New York Convention of 1958 and the Washington Convention of 1965, and also on other bilateral and multilateral treaties it signed with various countries and regions [14]. These international treaties play a vital role in mutual or reciprocal acknowledgement of effectiveness contained in the arbitration agreement. They are now being used as a foundation stone for judicial judgement purposes and determine whether an arbitral award is recognisable and enforceable in any particular jurisdiction.

### 6.4.3 Composition of tribunal

As it is understood that the China International Economic and Trade Arbitration Commission is now occupying the monopolised position for overseeing local arbitration with foreign elements involved, the Commission is also responsible for supervising a tribunal's composition, which is normally based upon a one-arbitrator or three-arbitrator structure.

(1) Appointment of sole arbitrator or three arbitrators

According to the arbitral rules set forth by the Commission, a tribunal can consist of one or three persons

as arbitrator(s), in which the parties in question may by mutual agreement appoint a sole arbitrator to carry out the proceedings singly (such an appointment may also be made by the chairman of the Commission on their behalf), or each party opts for its own arbitrator to form a three-person tribunal with the third one appointed by the Commission's chairman as the chief arbitrator [15].

Whereas the disputants may receive benefits of economy and efficiency from a sole-arbitrator tribunal, the reference conducted by a three-arbitrator tribunal can be largely influenced by the decision made by the third arbitrator appointed by the Commission, who acting in the capacity of the chief arbitrator plays the similar role to that of an umpire and usually has the final say in making the award. A tribunal composed of two arbitrators with each of them appointed by one party is not available under the current system. The reason is possibly based on the consideration that an umpire will usually be needed in the case of two arbitrators who disagree with each other, and in this instance the tribunal will actually become the same as that of a three-person panel mentioned above in which the Commission enjoys more interfering powers by logically appointing a third person as the chief arbitrator.

Whether a one-person or a three-person tribunal is proposed, the appointment(s) must be made promptly by the

parties within the time limit set forth by the Commission (usually within twenty days after the defendant party is notified of the forthcoming arbitration act); otherwise the Commission may exercise its power to appoint arbitrator(s) automatically on the parties' behalf [16].

(2) Qualifications of arbitrator(s)

The Commission maintains a list of arbitrators who are employed by it for conducting references relating to dispute settlement in China. Arbitrator(s) can only be selected from those who are already on the list [17].

The arbitrators on the list are usually experts in their own fields. As to their qualifications, the arbitral rules of the Commission merely outline that they are professionals with expertise and practical experience in international economic and trade activities, science and technology, and law, etc., including both Chinese and foreign citizens [18]. Whether foreign parties approve or not, they are not entitled to appoint arbitrator(s) other than those on the list kept by the Commission, and thus have no other alternative but to choose from those people as arbitrator(s) for adjudication upon the dispute concerned.

To ensure that an arbitrator acts impartially, any

arbitrator who is found to have an interest in the case shall himself voluntarily request to resign from sitting on the case; otherwise the parties concerned are entitled to apply to the chairman of the Commission for removal of the arbitrator in question [19]. However, although the arbitrator's removal is available under the current system, the Commission is reluctant to do so unless irrefutable evidence can be produced against it. Moreover, such an application must be filed before the first session commences, otherwise it will be up to the Commission's chairman to decide whether the arbitrator concerned is to be removed or not [20].

### 6.4.4 Overview of arbitration procedure

(1) Fundamental prerequisites

It is common practice in China that an arbitration will not be carried out unless both the plaintiff and defendant in question have prepared the necessary documents required for arbitration; and also the proper conservation measures have been taken or will be taken in due course.

Even if it has been specified in the agreement that any dispute arising will be referred to the Commission for arbitration, the Commission will not act on the reference unless the plaintiff submits an application to it of his

own accord. The application will contain information about names and addresses of both parties, the plaintiff's claim, and facts and evidence on which the claim is based. The Commission will then give notification and forward the relating details of intending arbitration to the defendant concerned. The defendant is entitled to raise objections to the claim or make a counter claim to the Commission. However, he must do this within sixty days upon receipt of the notice [21], otherwise the reference will be conducted on the basis of the evidence provided by the plaintiff.

Regarding the assets of one party, the Commission may decide on measures of conservation upon the request of the other by having the property in question placed in the custody of a third party. Such measures are compulsory by nature, and are taken with an aim of preventing the prospective loser from removing, selling or discharging his asset during the course of reference so that the winner party cannot be fully compensated. The Commission itself has no power to keep any party's asset, and the measures of conservation can only be taken upon receipt of the court's consent. However, an order of measures of conservation can be given by the Commission after it files for final judgement to the relevant local court, which should be situated at the place where the asset or the arbitral body is located [22].

In practice, the applicant who applies for this order should also prepare to provide security for the costs of adopting the measures of conservation. It is likely that the Commission may ask him to do so in the event that he finally turns to be the loser party in the subsequent reference and thus becomes liable to pay damage, if any, which might be incurred from execution of such an order.

(2) General course of reference

Once the tribunal is formed, it is the Commission's responsibility to fix a date on which the reference is scheduled to start. The Commission's decision can be challenged. Any party may apply on reasonable grounds to the Commission for extending commencement of arbitration. This application must be filed no later than twelve days prior to the opening date originally set by the Commission [23]. If the request is rejected, the applicant must be present on the opening session as previously planned. Any absence in this instance might be deemed by the Commission as nonattendance with unjustified reasons, and the proceedings will thus be carried out with the award to be made unaffected by such an absence and also with the likelihood of reaching a decision which is obviously not in favour of the applicant.

The procedure adopted in a reference depends upon the

nature of the dispute in particular its complexity.

It is not necessary for there to be a hearing for an arbitration to be valid [24]. And in many circumstances an oral hearing is only contemplated for complicated cases. If a hearing is proposed, the case will normally be heard in closed session; either party may request an open session but in reality they rarely do so. The hearing is conducted by an inquisitorial approach and hence provides an opportunity to both parties to produce evidence in support of the facts upon which their claims are based.

In simple cases, the arbitration is permitted to be carried out merely on the basis of exchanging written pleadings, letters or submissions to identify the issues in dispute [25]. With a view of the case's simple nature, a reference without hearing is more conducive to settling the dispute in an efficient and effective way.

However with a hearing or not, the examination, verification, and evaluation of evidence are totally within the discretion of the tribunal, e.g. if necessary, it may notify the witness to provide testimony, or simply determine the case by virtue of the evidence already collected. The final award is rendered by majority vote of the tribunal.

## 6.5 CHALLENGE AND ENFORCEMENT OF AWARD

### 6.5.1 Challenge of award

An award made by the tribunal is considered as having the same effectiveness as a decision made by the court. In theoretical terms, such an award is of final judgement nature and can hardly be reversed by any party who is not satisfied and intends to challenge it by resorting to a judicial solution. Under the circumstances that the parties have an arbitration agreement, Chinese law strictly limits access to judicial remedies. And by virtue of article 259 of the Civil Procedure Law 1991, the award given is final and binding upon both parties, and neither party is allowed to appeal against it for revision before a court of law.

Nonetheless, the parties concerned are not completely in a passive position. Whilst it is almost impossible to change the award by seeking recourse to the court, under exceptional circumstances, any party who feels that the award is wrongly granted and is able to prove it by producing sufficient evidence may have an opportunity to claim for judicial review upon the case by the court.

The court has the right to stay enforcement of the award providing that any of the following circumstances can be

justifiably identified by the claimant in terms of article 260 of the Civil Procedure Law 1991, i.e. a) there is no written arbitration agreement or clause between the parties; b) the claimant does not receive any notice as to appoint his arbitrator or carry out the reference, or he fails to state his views due to the reasons not of his own; c) the composition of the tribunal or the arbitral procedures applied are not in conformity with the provisions contained in the Commission's arbitral rules; d) the dispute to be settled falls beyond the scope of subject-matters specified in the arbitration agreement, or the arbitral body is not empowered to settle such differences; and e) the enforcement of the award granted, in the view of the court, will be detrimental to the public interests. Under these circumstances, what the court normally does is to refer the case to the original tribunal for re-consideration rather than deciding the substance of the award directly by itself.

But generally speaking, to challenge an award by way of soliciting the court for judicial review can only be used by the dissident party in the extreme circumstances. The current role in which the court is playing at the present time is more of a supportive rather than an interfering nature.

**6.5.2 Enforcement of award**

An arbitral award has the force of law and each party should voluntarily execute it. As it is rarely the case in practice that both parties may become satisfied with the tribunal's decision simultaneously, if any party fails to perform within the time limit mentioned in the award, the other party can approach the court for enforcement. The method of enforcement differs in terms of whether the award is a domestic one made by the Chinese arbitral institution or a foreign one obtained from an arbitral body outside China. It is important at this point that the delimitation of jurisdiction between various countries and China has already been clearly underlined.

As China has not enacted any law which can exert extraterritorial influence upon securement of judicial control over cases involving foreign elements, application of international treaties becomes a key factor for enforcing both domestic as well as foreign awards which are in connection with settlement of inward investment disputes. China joined the New York Convention in 1986 and became a member of the Washington Convention in 1992 [26]. In practical terms, the binding effect of the Conventions are recognised, and these two treaties are operative as part of the law of China without legislative implementation. It is common practice that if any provision in the Convention is found to be different from that in the domestic law, such provision will prevail, with

the exception of those (most notably relating to material public or state interests) to which China has announced its intention to maintain complete freedom to apply its own law.

(1) Removal of protection under sovereign immunity

The doctrine of foreign sovereign immunity may have an important effect upon enforcement of awards. In the case of a party which happens to be a state-owned enterprise, where the award is made against it, the party may claim an immunity from suit in the courts of other states and therefore become entitled to immunity from execution of judgement against its property. This action is especially likely to be taken by the Chinese side, as most foreign investors in practice enter into contracts with Chinese state enterprises which are now playing the predominant role in the whole economy.

Unlike some other countries which have established statutes providing that a waiver of immunity is enforced, the position that China takes with respect to foreign sovereign immunity cannot be clearly figured out from the existing legislation. However, this uncertainty is not unlikely to be removed. The most straightforward method is for both parties to include in their contract a specific clause, indicating an irrevocable waiver of sovereign immunity, so

that the contract becomes the equivalent of one between two private business entities, neither of whom can enjoy the benefit of immunity on the excuse of its special relation to the state.

(2) Enforcement of domestic award

For the enforcement of domestic awards given by the China International Economic and Trade Arbitration Commission which is against the loser party and/or his property located in China, things are relatively easy to handle. If the loser party refuses to implement the award, the winner party may simply apply to the court for enforcement. What the court normally does is to review the arbitration procedures adopted in the reference. The court does not require to have evidence verified, nor does it investigate facts such as the law applied or the actual compensation to be paid to the winner party. Providing that no material irregularity is found in the procedures taken, the court will unhesitatingly enforce the award.

As to enforcement of awards against the loser party and/or his property located outside China, things may become more complicated as the issue of soliciting judicial assistance from foreign courts will unavoidably arise. A request from the Chinese court for judicial assistance from a foreign court is in the main based on the principle of reciprocity

as well as on the international bilateral or multinational agreements on judicial assistance which China has signed. Hence, enforcement of a domestic award abroad may be well performed by a foreign court entrusted by the Chinese judicial body in question.

(3) Enforcement of foreign award

Awards granted by overseas arbitral bodies can equally be recognised and enforced in China. Pursuant to article 269 of the Civil Procedure Law 1991, such enforcement is available by means of seeking judicial assistance from the Chinese courts. As mutual assistance between the countries on the principle of reciprocity and mutual benefit is always required in practice, the Chinese court will normally recognise and enforce a foreign award providing that it is entrusted by the court of a country with which China has reached an agreement on the matter of judicial assistance.

However, before enforcing a foreign award, the Chinese court may consider whether such an award is given in the context of not contradicting the relevant requirements set forth by Chinese law and its execution is not in any way against the local interests. Outwith any guiding legislation, how to handle the case in this regard is completely subject to the decision made by the court. If

the court claims that the award is found to have been given by virtue of the legal principles against the substance of Chinese law and its execution may eventually become detrimental to the state interests, the mandate from abroad for carrying out such enforcement will be refused, and the case will thus be returned to the foreign court which has tried to seek assistance from the Chinese judicial institution.

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# CHAPTER 7

# CONCLUSION

The intention of this final chapter is to synthesise major research results discussed in the preceding chapters by placing them in a conclusive context, and to look towards the future for development of legal regulations as regards inward investment in the UK and China.

## 7.1 ASSESSMENT OF LEGAL FRAMEWORKS

The marketplaces in both the United Kingdom and China appeal to foreign investors. Whilst the common theme is that the legal regime for inward investment is represented by seeking to secure a proper balance between encouraging inflows of foreign capital and maintaining statutory control upon them, the actual performance and structure of the relating laws and policies in each country are based on very different regulatory ethics, thus in the process of implementation exerting impacts of diverse characteristics.

### 7.1.1 Appraisal of inward investment in the UK

(1) The legal regime's implications

The most distinctive feature emerging from the prevailing regime is that the United Kingdom does not have specifically-enacted inward investment laws. This unique characteristic is chiefly attributable to the UK's current status as being a developed country, and the arrival of foreign capital merely plays an ancillary rather than a leading role in invigorating the country's economy. It is in this circumstance that the legal framework renders more emphasis on promoting fair competition on an equal basis other than producing discriminating measures for dealing with indigenous and foreign investments in two different ways.

National treatment policy is applied in the UK with the result that legal regulations to administer investment from domestic and foreign sources are virtually the same. Foreign investors in the course of forming their appropriate investment vehicles, participating in financial markets, carrying out real estate transactions, and dealing with various tax treatments, etc. are almost without exception subject to the same regulatory regime as their local British counterparts in the context of the relating UK laws and the relevant regulations that are universally applicable throughout the whole European Union.

Moreover, the UK's deep integration with the accepted international business norms affords foreign investors adequate protection through a highly standardised commercial "rule-book" approach which has reputedly been practised for many years. This deep integration greatly enhances foreign investors' confidence by ensuring that they can be safeguarded against being subject to any practices of a capricious nature, and this is especially true in the case of tackling cross-border investment disputes by means of conducting commercial arbitration.

(2) The characteristics of investment environment

In general, the United Kingdom is a congenial place to invest. The overall factors which have favourably influenced the investment pattern in the UK comprehend sound legal regulations, liberal government policies, relatively low corporate tax rates, convenience of raising capital, and easy access to worldwide markets especially those in the EU from the UK's long-established trade links.

The current legal framework has given rise to a multitude of consequential features which may most notably be identified from the following perspectives.

First, the UK government takes a very liberal and open attitude towards inward investment, imposing very few restrictions on foreign investors regarding any particular field in which they may or may not be involved.

Second, foreign-owned businesses in the UK, while subject to the same tax regime, are eligible for the same incentives and benefits as are British-owned ones.

Third, as exchange control has been removed, there are no restrictions on inward investment, and profits, dividends or capital can be freely remitted abroad.

Fourth, despite the fact that real estate values are falling in the market, as a traditional investment focus, investing in real estate may still be worthwhile, provided that it can be flexibly conducted (e.g. from the angle of timely acquiring those properties with excellent locations by taking advantage of the UK's highly developed financing facilities and then letting them out for commercial purposes). It would be hard to devise a more suitable recipe for success of carrying out real estate business in the UK than that essential for any successful investment - market timing.

Fifth, as the importance of the European Union to foreign

investors grows, their position set up in the UK will strengthen their presence within the European Union, and accordingly enhance their market-share Europewide. Under such circumstances, foreign investors will have more direct and convenient access to the European Continent: those having UK-based manufacturing enterprises are thus entitled to export their products to the EU countries free of barriers of internal tariffs; and those authorised to carry on banking business and/or financial investment transactions in the UK may benefit from the single banking licence regime and/or reciprocal treatment policy within the EU territories.

Moreover, the UK's long-standing reputation as one of the world's leading financial centres and status as the oldest industrialised country are also factors tempting potential investors.

**7.1.2 Appraisal of inward investment in China**

(1) The legal regime's implications

The performance and structure of inward investment laws and policies in China are based on the regulatory ethic of encouraging inflows of foreign capital while at the same time steering them towards certain specifically needed investment

fields. Viewed against such background, the development of this special legal regime has demonstrated five distinctive features.

Firstly, contrary to the UK, China's foreign investment legal framework is an exclusively separated law regime by reference to its internal laws to which foreign investors are not subject. In consideration of the fact that China is still a developing country which has not set up an authoritative and comprehensive legal framework governing the country's overall economic life and more importantly that there is an insufficiency in China's capital which is even more glaring when compared with its abundant natural and labour resources, there would be no alternative for the time being to postponing the adoption of national treatment approach in regulating inward investment. Instead, many special measures have been introduced which put foreign investors in a position much more favourable than their local Chinese counterparts.

Secondly, the law in connection with inward investment exists at two levels - local rules and national rules. The local rules are applicable only in certain specifically defined geographical areas, which are viewed as the country's showcases of its open-door policy, mostly including Special

Economic Zones, some specifically designated coastal cities, Hainan Island, and Pudong New Area in the city of Shanghai, etc. Although in theory local rules ought to be subject to national rules, in reality they exist in the form of two parallel systems with noticeable differences between them particularly in the area of taxation. These discrepancies have often been created in order to achieve a greater local advantage for attracting capital from overseas.

Thirdly, the legislative pattern of the foreign investment law has been characteristic of a sectional approach, and is at present broadly concerned with three types of investment vehicle, i.e. equity joint ventures, co-operative joint ventures, and wholly foreign-owned enterprises. The most distinctive feature under such approach is that many general rules with regard to documentation, capitalisation, approval procedures, registration, and internal management, etc., which should be applicable to all types of vehicle, are nonetheless enacted repeatedly in specific legislation and policies governing each individual type. Thus, there is a lack of a comprehensive code or a general regulatory framework integrating guidelines that can be univerally applied to all inward investment activities in China.

Fourthly, equity joint ventures, co-operative joint ventures,

and wholly foreign-owned enterprises as the focus of today's legal framework have to be based on concrete projects behorehand. Unlike the situation in most developed countries, a general commercial business entity is basically not permitted to be established as investment vehicle in a simple form. Although the establishment of foreign investment holding companies is beginning on a trial-and-error basis, it must still be subject to the precondition that the concerned foreign investors have already set up their presence in China via any of the above specific vehicles.

And fifthly, if China's financial markets were completely open to overseas capital, it would become one of the most attractive areas to foreign investors because of its virtually limitless potential customers. Unfortunately, despite the fact that foreign investors have continued their efforts to penetrate the financial markets, few of those involved have reaped significant profits. On the one hand, China has not enacted its laws specifically applicable to banking and other financial services. Almost all transactions on the financial markets are merely in the context of rules and policies which are more or less of interim nature. As the management of financial markets is now being characterised by market imperfection, incomplete

commercialisation, legislative indeterminacy and inconsistent regulatory performance, most related activities conducted by foreign investors at present confined to the preliminary level of establishing and developing their long-term relationships with various local authorities and businesses. On the other hand, foreign investors may continually be frustrated by a multitude of practical obstacles incurred by the foreign exchange control system which has seriously hampered free capital movements and also to large extents restricted the business scope of those foreign financial institutions which have already set up their presence in China.

(2) The characteristics of investment environment

Broadly speaking, China is an attractive place to invest. It is richly endowed with an enormous market, cheap labour resources, and with an amazingly high development speed at present. It provides many tax incentives to foreign investors and has great potentialities for developing real estate. China has also shown a determined drive towards the continuing of its open-up policy, and so far achieved a shallow integration with the world economy by speeding up the efforts towards establishing a sound legal framework in response to both the proposed market economy and the

international commercial customary practices. This shallow integration can be reflected by China's participation in the major international conventions and treaties for protection of foreign investment, which would increase investors' confidence especially in connection with arbitrating investment disputes. Furthermore, as in a laissez-faire economy, profits tend to be averaged and the more mature the market is the less likely it would be to secure excessive profits, whereas China is at the preliminary development stage of market economy, the market as well as legal imperfections may in turn provide investors a venture opportunity from which a likelihood exists for obtaining huge or even monopolised profits, and that is what China's attractiveness really is.

However, the country's economic sectors are now only partially open to foreign investors. The government implements an orientation policy which encourages inflows of foreign capital into certain fields while restricting or preventing them from being involved in other specific investment areas. Foreign investors must be aware at all times that their investment projects do not conflict with the orientation policy. The application of such a policy is generally attributable to three factors: firstly, in order to make effective use of foreign capital and to introduce

advanced technology from abroad, it is vital to maintain sound control of the utilisation and focus of foreign capital so that the majority of available foreign funds could be channelled into the most needed sectors and geographical areas, e.g. infrastructure industries and the country's poorest central and western regions which should be given top priority for development; secondly, as China is still in the course of transitting from the old planned economy to the expected market one, market imperfection is now posed as a serious problem affecting many economic sectors, especially in the field of service industries. If these industries were open to foreign capital, domestic and particularly state-owned businesses which are still not fully commercialised would be forced to compete with their foreign counterparts in a very disadvantageous position; and thirdly, also due to the fact that many functions of the previous planned economy still currently remain, absorption of foreign capital will have to be incorporated in a unified national plan for the comprehensive balancing of the economy. Proper arrangement should be made for securing foreign capital on the countrywide basis of balancing the financial, credit, materials, and foreign exchange factors. Therefore, consideration must be given to domestic absorptive capacity, in particular the country's ability of future repayment.

## 7.2 SUGGESTIONS FOR FUTURE DEVELOPMENT

With a view to the impact on economic development exerted by harnessing inward investment, the relating legal regulations are increasingly becoming a subject of general concern because of their decisive role played upon the actual performance of foreign capital absorbed. In this regard, both the United Kingdom and China have room for improvement in developing their future regimes.

Whilst the United Kingdom's current framework is operational from the standpoint that undiscriminating rules are used to treat foreign as well as indigenous investors alike, more specialised regulations in the legislative form should be introduced under appropriate circumstances in the ways in which they could encourage a greater inflow of foreign capital.

Concerning the foreign investment law regime in China, a contrary approach should be adopted by filling out existing legislative lacunae in the first instance and then gradually integrating various specific incentive measures into a comprehensive and unified system under which both foreign and domestic investors are treated in the same way so that they can compete on an equal footing.

### 7.2.1 Policy recommendations for the UK

Provided that the fairness and soundness embodied in the current legal system as a whole remain unimpaired, there is some merit in China's method of legislatively incorporating special preferential measures in either sectional or regional form for attracting foreign investment that the United Kingdom may make use of.

In consideration of the sluggish economy and in particular the deteriorating health of manufacturing industry, these factors are becoming obvious obstacles to effective management of business in the UK, and as a general trend foreign investors sharing in existing facilities may find it more and more difficult to achieve a substantial competitive edge in international markets. Whilst a comprehensive structual change takes time for working through, the UK government should try to carry on some special policies which are of more flexible and even a little controversial nature. Notwithstanding the fact that there are some incentives mainly in the form of regional grants, these incentives will not suffice if a higher level of foreign capital input is desired. It would be more productive if some investment impetus, especially pertaining to taxation, could be provided, with the result that particular economic sectors

and/or geographical areas which are in greatest need for development could be designated as priorities for accommodating overseas capital and entitled to special low tax rates and even tax holidays. On the surface, implementation of such measures will to some degrees be at the cost of sacrificing the norm represented by the advocated fair-play principle. But if the UK wants to remain a receptive and attractive base for inward investment, this alternative might be able to offer some realistic and effective advantages.

### 7.2.2 Policy recommendations for China

Since China's legal framework for inward investment is still in a formative stage, it is hardly surprising that lack of completeness, openness and integrity remains to be a significant problem. The first and foremost task at present is to establish a complete regulatory regime in conformity with accepted international practices, and in this regard China ought to draw some experiences from the United Kingdom.

The current framework is an important indicator of dilemmas that demonstrate a necessity of emphasising on the future legislative pattern's unification and integration. Whilst genuine efforts have been made to develop foreign investment

laws in the past few years, by international standards, the prevailing regime remains a murky realm in which there are many incomplete, confusable and overlapping rules, including not only national regulations as general guidelines but further complicated by many local ones that are applicable only to specific geographical areas governing similar issues but varying haphazardly from one local jurisdiction to another. It should be noted that too many diversified favourable measures may sometimes negative the constructive role played by the proposed incentives. To foreign investors the biggest impetus in the host country will come from nothing but an open and sound legal system. Their major interests lie more in minimising investment risks than in various preferential policies. Whereas their largest concern at present pertains to lack of regulatory certainty, predictability and openness, resolution of this problem can hardly be effected without a unified and integrated legal framework. However, to realise such unification and integration needs the interaction of a number of factors, comprising both internal and external ones. The internal elements are in close connection with the outcome of China's overall reforms, whereas the external ones are mainly concerned with whether China could quickly join the World Trade Organisation whose membership will uncompromisingly be committed to the accepted international commercial norms.

In short, whilst the nature of legal regulation may vary from one country to another, rational utilisation of inward investment is beyond doubt an effective way to accelerate a country's economic development, and this is true of both the United Kingdom and China.

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