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Legal Updates

1. 2022-23 Data Analysis on China Life Sciences Licensing Key Terms

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In recent years, license-in/out transactions have become the most common way for innovative drugs and medical devices (including medical aesthetics) companies to collaboratively develop and commercialize medical products and related technologies. According to public information, in China, the total amount and number of investment and financing in life sciences sector have witnessed a significant decline from 2021 to 2023, with the investment amount being only a quarter of that in 2021. However, the upfront payment for business development (BD) transactions in life sciences sector has reached 5.045 billion US dollars in 2023, with a potential payment totaling up to 54.89 billion US dollars[2]. The scale of license-out transactions has been continuously expanding.

Our team has been 100% dedicated to the legal work in the life sciences field, and we are honored to have the privilege of assisting numerous multinational pharmaceutical and medical device companies, as well as leading innovative biotech companies in China, in conducting licensing transactions and research collaboration projects. Such collaborative projects involve various small molecule drugs, ADC drugs, RDC drugs, mRNA drugs, AI pharmaceutical technologies and products, cell therapy products such as CAR-T/CAR-NK/TIL, medical aesthetics products, various innovative medical devices for treatment or diagnosis (IVD/LDT), etc. Previously, we have analyzed the key terms of the license-in/out transaction projects from the perspective of regulatory compliance. (please refer to: *Anatomy of Licensing Deals from China Regulatory Perspective*).

At this very beginning of the new year, in order to enhance industry's understanding of the key terms of license-in/out projects and the noteworthy considerations between collaborating parties, we have reviewed over fifty licensing agreements (including co-development agreements) handled in the past two years. We have selected several key terms to compare these agreements horizontally with respect to seven aspects including marketing authorization applications, license grants, financial terms, intellectual property, diligence obligation, exclusivity, and termination terms. In this article, we would like to present our observations on the characteristics of licensing transactions in China in recent years, hoping to provide some reference for future transactions and developments in the industry[3].

Marketing authorization applications

The selection of the Market Authorization Holders of drugs or the registrants or record filing parties of

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[1] Leyi Wang and Shuwen Sun have contributions to this article.

[2] MybioBD: The 2023 annual report on China's life sciences licensing BD transactions has been released with great significance, February 19, 2024, https://mp.weixin.qq.com/s/DiSDuW48MGr1J5tpftQRew.

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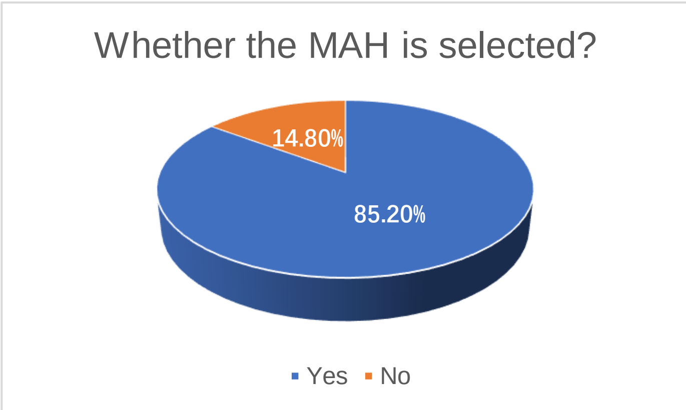
medical devices (collectively referred to as "**MAH**") is crucial for future commercialization of the products and the allocation of responsibilities between the collaborating parties. We have found that, in the vast majority (85.2%) of the projects, the collaborating parties have explicitly stipulated in the licensing agreement who will be the MAH for licensed products. The rest 14.8% of the projects do not specify the MAH. Such projects share a common characteristic that they are all targeting products in early development stages such as pre-clinical research, and arrangements for the MAH of the final product therefore can be temporarily postponed. If these projects progress further, the parties will negotiate the selection of the MAH.



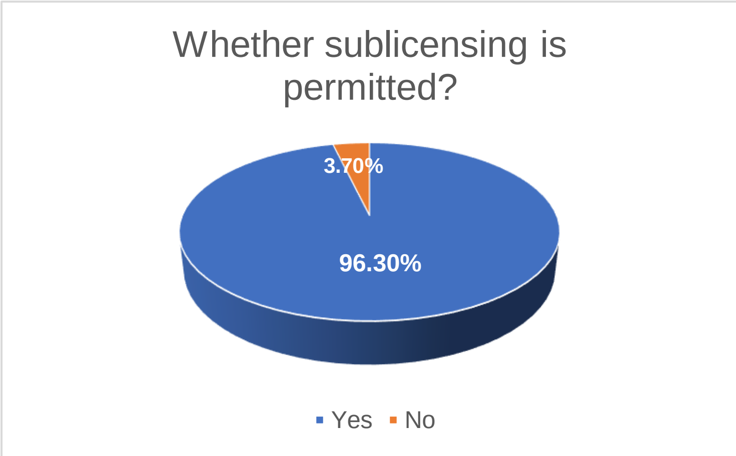
Among the projects with clear MAH arrangements, on one hand, all of the one-way licensing agreements specify that the licensee ("**Licensee**") shall be the MAH for the licensed products within licensed territory with the rights and responsibilities to submit and maintain all relevant regulatory filings in its own name. In some agreements, the Licensee's affiliates, sublicensees ("**Sublicensee**"), or mutually agreed third parties may also be chosen by the Licensee as the MAH. On the other hand, the allocation of MAH is more diverse in co-development projects.

Additionally, in approximately 7.4% of the projects, further arrangements regarding MAH have been made for the early termination of the project. Depending on different circumstances that result in the early termination, a transfer of the MAH may take place.

License grant

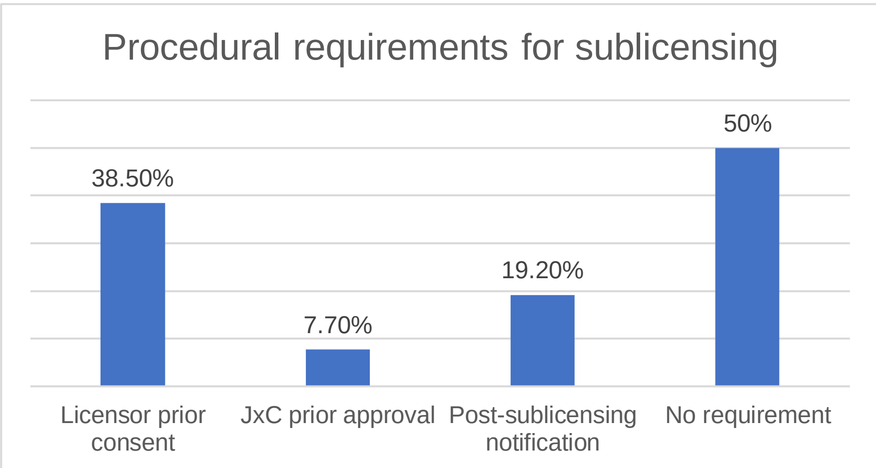
I. Sublicensing

In the vast majority (96.3%) of the projects, the Licensee is granted the right to sublicense the licensed technology, while only 3.7% of projects do not permit sublicensing. Among the projects that allow sublicensing, 3.8% of them explicitly restrict the scope of Sublicensee, prohibiting the Licensee from sublicensing to any third party other than those Sublicensees listed in the agreements.



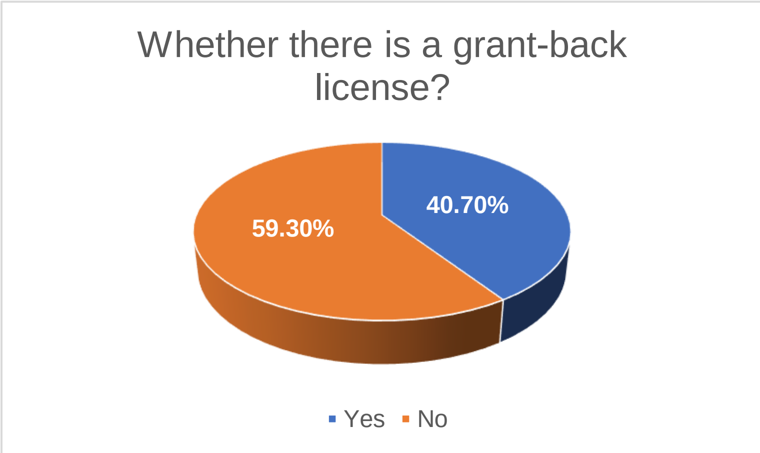
In order to supervise the Licensee's performance of its sublicensing rights, the licensor ("**Licensor**") may require that the grant of sublicenses must be subject to its prior approval, or the Licensee must provide timely notification and furnish copies of the sublicense agreements after granting sublicenses. We have found that in projects that permit sublicensing, approximately 38.5% of them require prior approval (usually in writing) from the Licensor, 19.2% of them require the Licensee to notify the Licensor and provide a copy of the sublicense agreement within a certain time period after sublicensing, 7.7% of them require the sublicensing to be approved by the joint project committee (JxC), and about 50% of them do not have procedural restrictions on sublicensing.

A considerable proportion (about 30.8%) of the projects have applied a combination of various procedural restrictions. For example, different requirements may be applied depending on the categories that Sublicensees belong to. Additionally, in a small portion of co-development projects, each cooperating party may be subject to different procedural requirements. This demonstrates that in practice, taking into account different collaboration backgrounds and business needs, there are flexibilities among the collaborating parties in arranging the conditions of the sublicensing right.

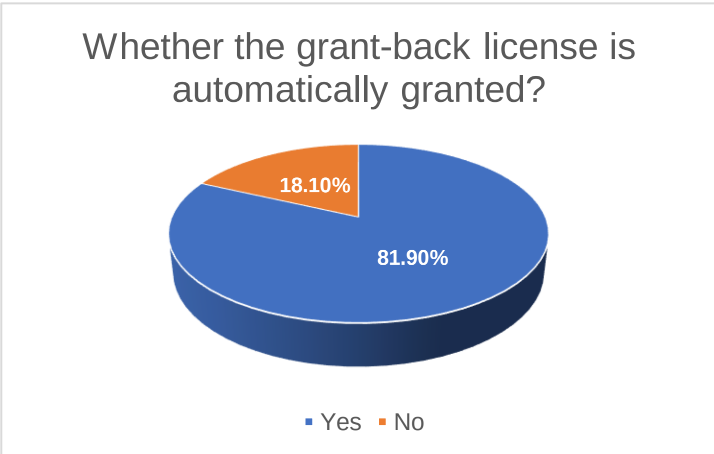


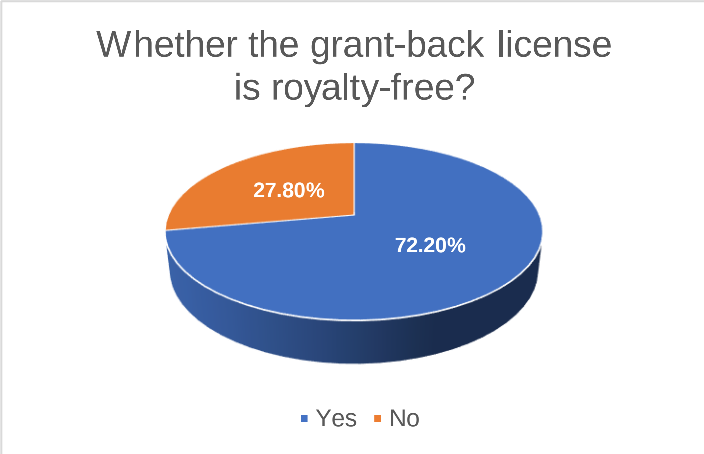
II. Grant-back license

In practice, the Licensor may also require the Licensee to grant back a license with respect to the technology improvements generated by the Licensee, authorizing the Licensor to use such improvements outside the licensed territory or licensed field. However, we have found that projects with explicitly defined grant-back licenses do not yet represent the majority, accounting for only about 40.7%, while the remaining 59.3% do not have such provisions. We understand that this is related to the specific situations of the collaborating parties involved in each project and the nature of their business operations. Factors to be considered mainly include whether the Licensee is likely to generate valuable intellectual property in the project and whether the Licensor's future business operations will require the use of such intellectual property.



In projects with grant-back licenses, 18.1% of such licenses are not automatically granted; instead, what the Licensor owns is an option right to require the Licensee to grant the license in the future. The financial considerations and other conditions for such grant-back licenses may be separately agreed upon. Furthermore, in the majority (72.2%) of such projects, the grant-back licenses are royalty-free.





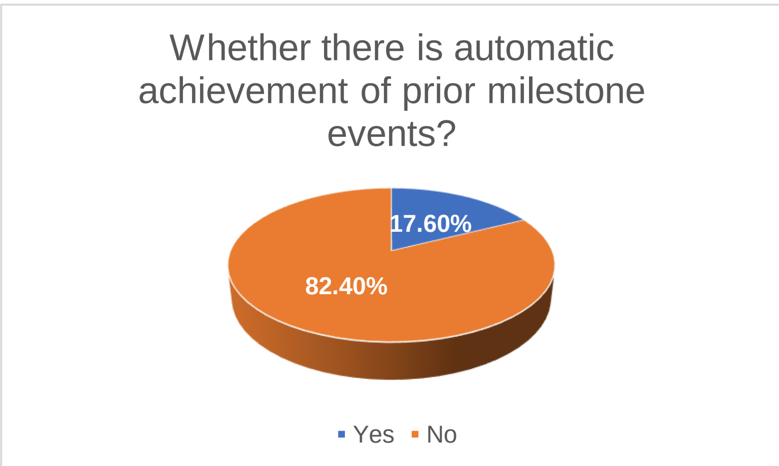
Financial terms

I. Milestone payment

Approximately 63.0% of agreements include provisions for milestone payments. We further analyzed some details of these provisions.

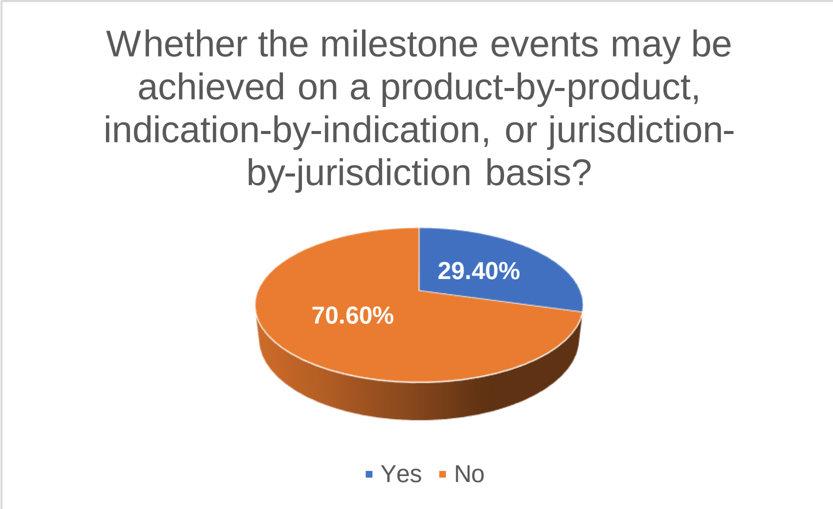
1. Automatic achievement of prior milestone events

Under some licensing agreements, when a later milestone event is triggered, all prior milestone events are considered to be achieved automatically. As a result, the Licensee is required to pay the amount corresponding to the triggered milestone event as well as all prior milestone events. We have found that, among all agreements with milestone payment, only 17.6% of them have such arrangement. This indicates that this arrangement has not been widely adopted in practice.



2. Milestone events

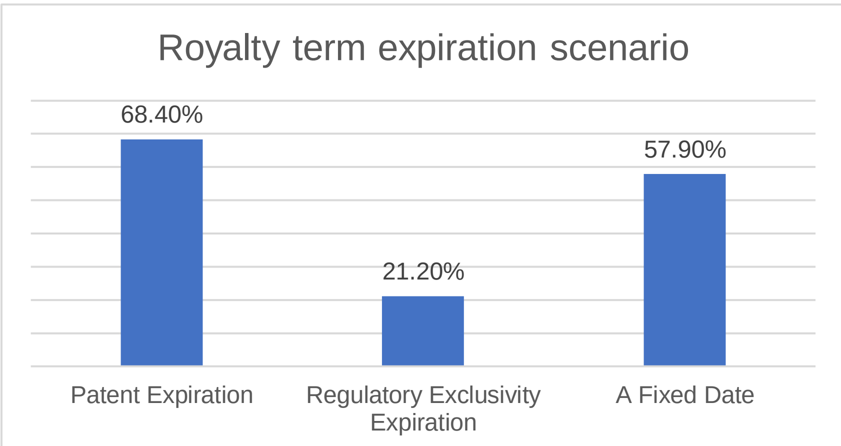
Sometimes, a licensing project may result in more than one licensed product, target more than one indication, and/or involve more than one jurisdiction. In such projects, the Licensor, in order to maximize economic benefit, may require the milestone events to be achieved on a product-by-product, indication-by-indication, jurisdiction-by-jurisdiction basis. As a result, a single milestone event may be triggered more than once, and accordingly, the Licensor may seek multiple milestone payments for each product, indication or jurisdiction. Among all projects with milestone payment agreements, we have found 29.4% of them have adopted such approach.



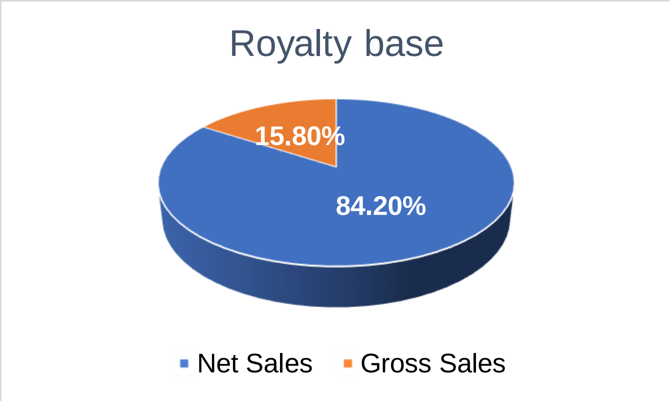
II. Royalty

Approximately 70.4% of the projects include provisions for royalties. We have conducted further analysis on the royalty terms, bases, and reductions of these projects.

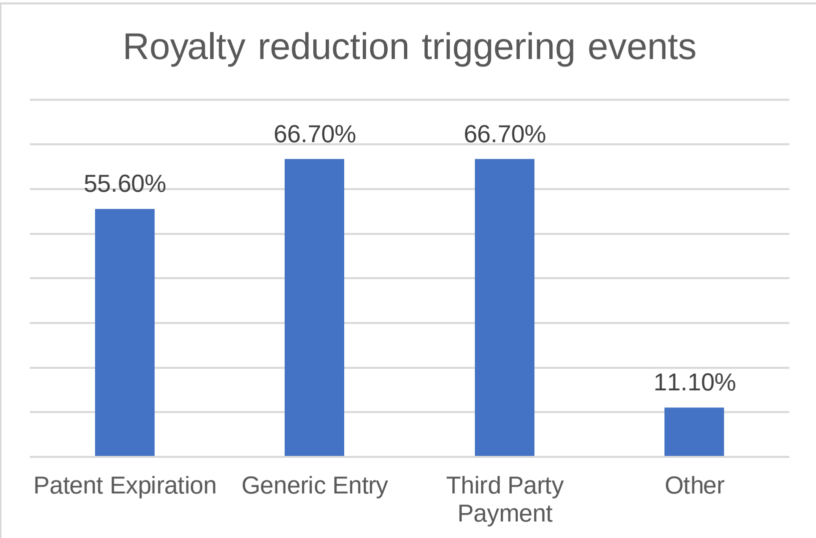
The royalty terms of almost all projects start from the first commercial sale of the licensed products, while the expiration date of such terms varies. About 68.4% of projects set the expiration date of the last-to-expire valid claim as one of the expiration events. 57.9% of projects set a fixed period as one of the expiration events. 21.2% of projects set the expiration date of all regulatory exclusivity as one of the expiration events. It is worth noting that 42.1% of the agreements have combined two or more triggering events mentioned above, with the expiration date being the earliest/latest occurrence among these events. There are also some agreements under which the obligation for the Licensee to pay royalties will remain valid for an extended period.



As to the royalty base, 84.2% of the projects use “net sales” as the base for royalty calculation, while the remaining 15.8% use “gross sales” instead. Choosing “net sales” as royalty base remains the predominant industrial practice. It is worth noting that each agreement may contain subtle yet impactful differences in the definition of “net sales”.



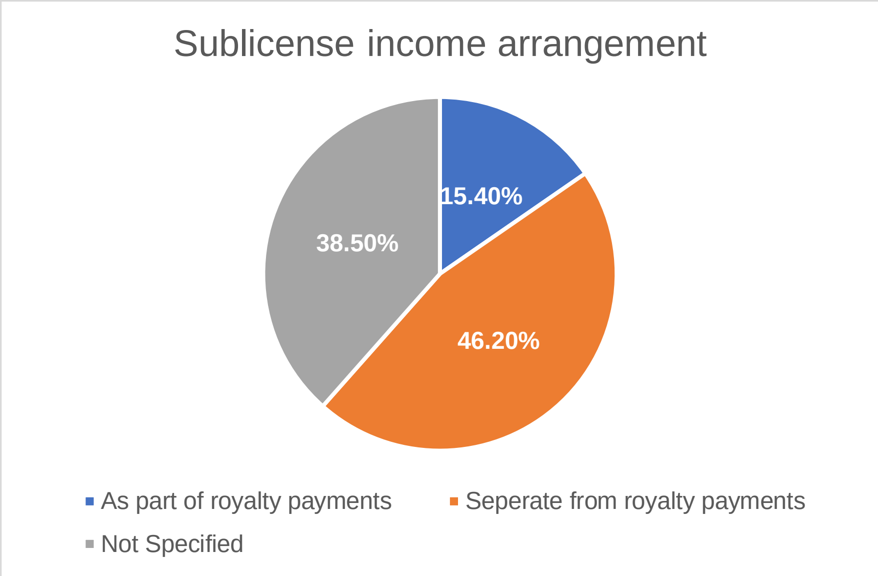
In terms of royalty reductions, nearly half of the projects outline specific conditions under which the royalties can be reduced. Common triggering events may include patent expiration, generic entry and third-party payment. Among all projects with royalty reductions, 55.6% of them attribute patent expiration as the reason for reduction, 66.7% cite generic entry as the triggering event (with nearly half of them further requiring that the entry of generic drugs must result in sales of the licensed products falling below a specific threshold), and 66.7% specify that certain third-party payments can be deducted from the royalty amount due and payable. 11.1% of the projects have also mentioned other triggering events, such as compulsory licenses or reductions because of the U.S. Inflation Reduction Act. Over half of all projects provide multiple reduction scenarios mentioned above.



III. Sublicense income

In license-in/out transactions permitting sublicensing, the allocation of sublicense income provides another essential avenue for the Licensors to gain economic interests. Typically, the Licensors may seek sublicense income by either including such income in the royalty base or by separately obtaining a share from the sublicense income.

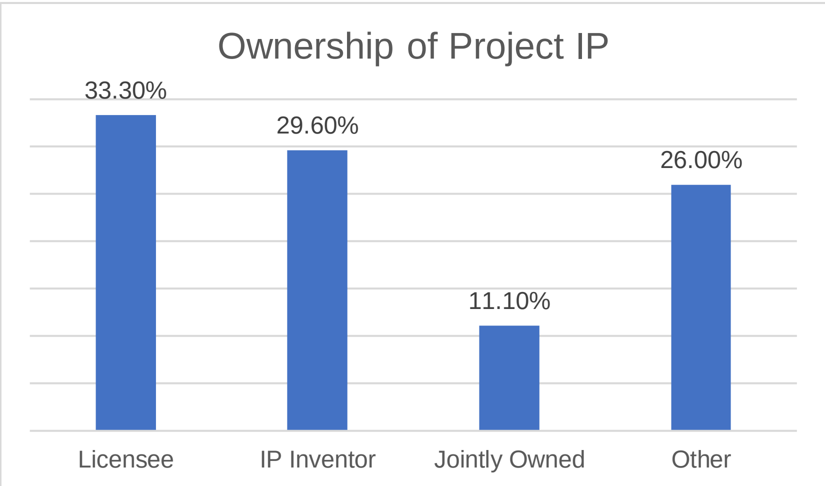
We have found that around 15.4% of the projects permitting sublicensing have employed the former approach, while approximately 46.2% opt for the latter. In 38.5% of the projects, arrangements for sublicense income remain unspecified.



Intellectual property

I. Ownership of Project IP

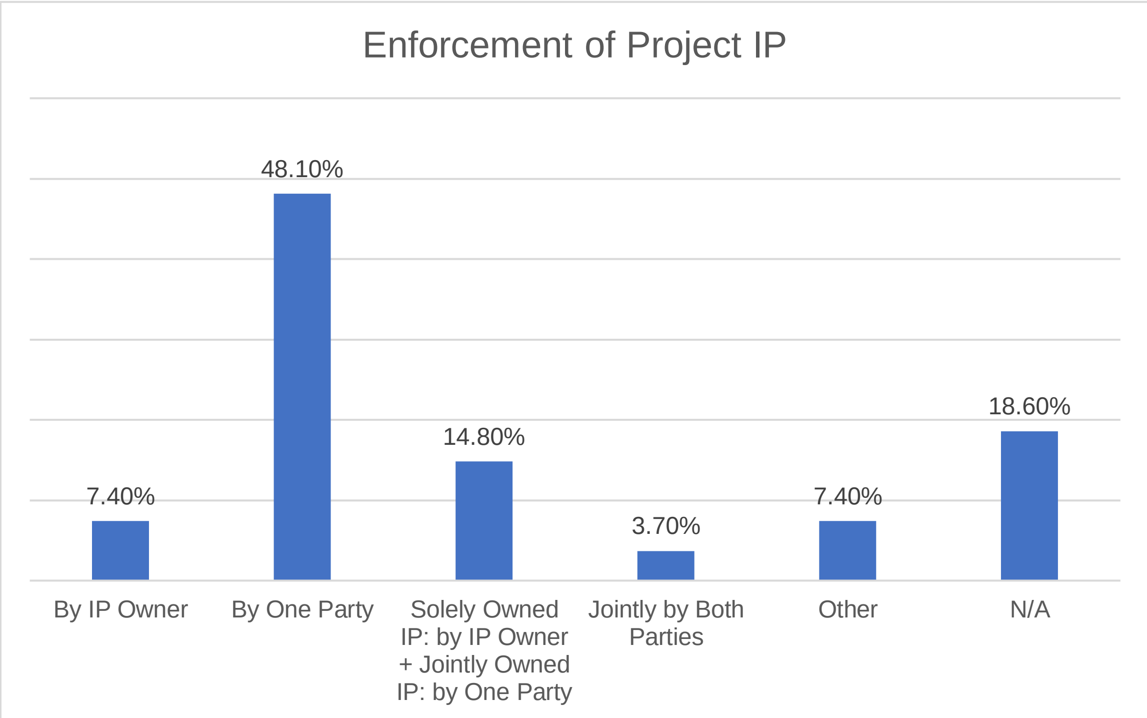
With respect to the ownership of project intellectual properties ("**Project IP**"), around 33.3% of the projects specify exclusive ownership by the Licensee, constituting the most common arrangement. Approximately 29.6% of the projects provide that the Project IP shall be owned by the inventor. If such Project IP is jointly invented, it shall be jointly owned by both collaborating parties. Under 11.1% of the agreements, the Project IP is jointly owned by both parties. The remaining agreements provide other allocation rules, such as determining the ownership based on the specific content or type of the Project IP. Such flexible arrangements are more common in co-development projects.



II. Responsible party for IP enforcement

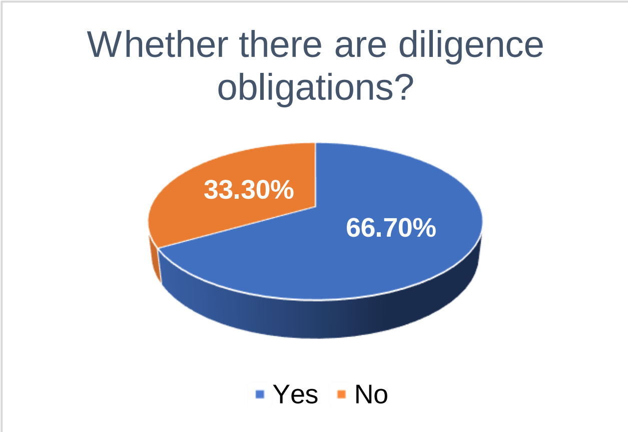
Firstly, regarding the licensed intellectual properties, 59.2% of all projects specify that the Licensor shall be responsible for the enforcement, 25.9% provide that the Licensee shall hold such responsibility, while the remaining 14.9% do not explicitly define the responsible party.

Secondly, regarding the Project IP, the scenarios are more varied and decentralized. 48.1% of the projects provide that the enforcement of all Project IP is solely the responsibility of one party. Under 14.8% of the agreements, each party is responsible for its solely owned Project IP while the enforcement of jointly owned Project IP is responsible by one of the parties. 7.4% of the projects provide that each party shall merely be responsible for the enforcement of the Project IP owned by itself. 3.7% of the projects state that both parties shall jointly enforce the Project IP. Additionally, 7.4% of the projects opt for alternative arrangements, such as assigning such responsibilities based on different territories controlled by different parties. The remaining 18.6% of the projects do not address this matter.



Diligence obligation

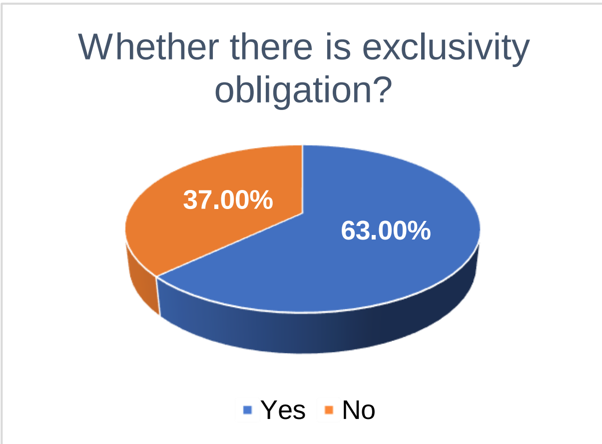
To facilitate the successful exploitation of the licensed products, licensing agreements may outline the diligence obligations of the Licensee in one-way licensing projects (or both parties in co-development projects) throughout the development and commercialization phases. Approximately 66.7% of all projects have set out diligence obligations, while the remaining 33.3% do not explicitly specify such obligations.



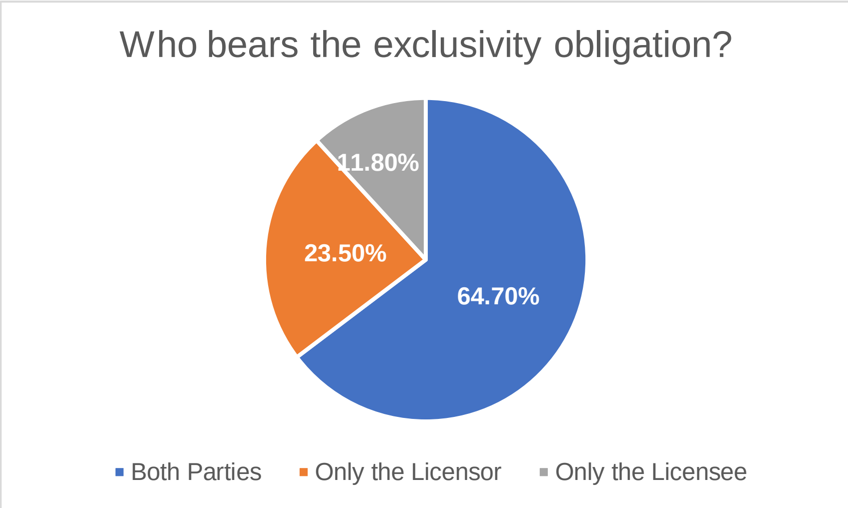
The diligence obligations may have various standards. For the majority of agreements, the "commercially reasonable efforts" standard applies. The remaining minority have employed the "diligent efforts" standard or the "best efforts" standard. Apart from these abstract standards, a few agreements also stipulate some objective standards. For instance, approximately 33.3% of agreements have established specific diligence milestone events, and around 5.5% of agreements require the Licensee to make minimum annual commercial payments to the Licensor.

Exclusivity

To ensure that the collaborating parties are both committed to advancing the development and commercialization of the licensed product, licensing agreements may outline non-compete obligations for each party. This helps to prevent detrimental effects on the interests of the other party. We found that approximately 63% of the agreements explicitly incorporate non-compete obligations, while the remaining 37% are silent on this matter.



Among the projects where the exclusivity obligation is explicitly stipulated, most of them (64.7%) provide mutual obligations for both cooperating parties. Under 23.5% of the agreements, only the Licensor bears the exclusivity obligation, while under the remaining 11.8% of the agreements, only the Licensee bears such obligation. The inclusion of non-compete obligations is closely related to the bargaining positions of each party, and it will significantly impact their future business endeavors.

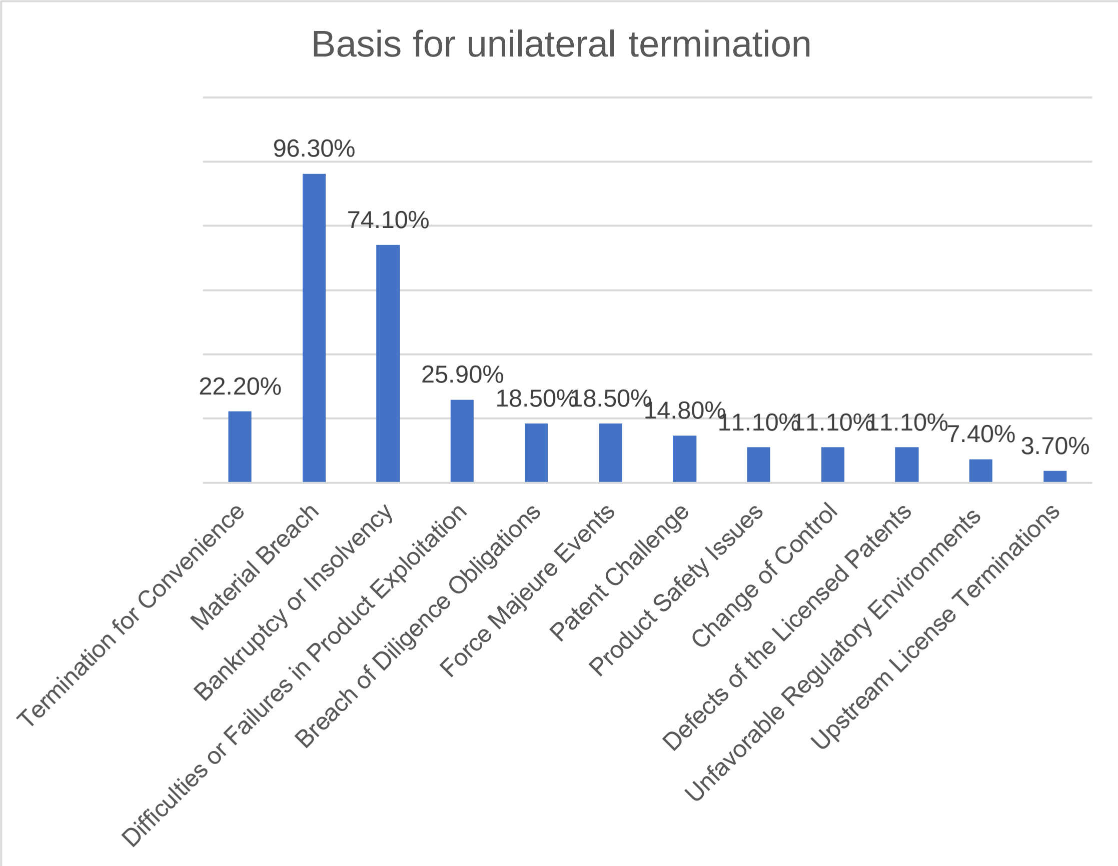


Termination term

I. Unilateral termination right

Unilateral termination rights are common in license agreements. In most projects, both collaborating parties have unilateral termination rights, although there may be differences in the conditions for each party to exercise its rights. In a minority of projects, only the Licensor has unilateral termination rights.

In terms of the triggering events for exercising unilateral termination rights, termination for material breach and termination for bankruptcy or insolvency are the most common, accounting for 96.3% and 74.1% respectively in all agreements. Generally, both the Licensor and the Licensee enjoy unilateral termination rights under these two scenarios. Other possible events include: difficulties or failures in the development or registration of the licensed products, the Licensee's breach of diligence obligations (such as failure to meet diligence milestones), force majeure events, patent challenge by the Licensee, product safety issues (such as SAE), a party's change of control, defects of the licensed patents (such as being rejected or invalid, infringing third-party intellectual property rights, etc.), unfavorable regulatory environments (such as trade controls), terminations of upstream licenses, etc. Additionally, in 22.2% of the agreements, one or both parties enjoy the right of termination for convenience.

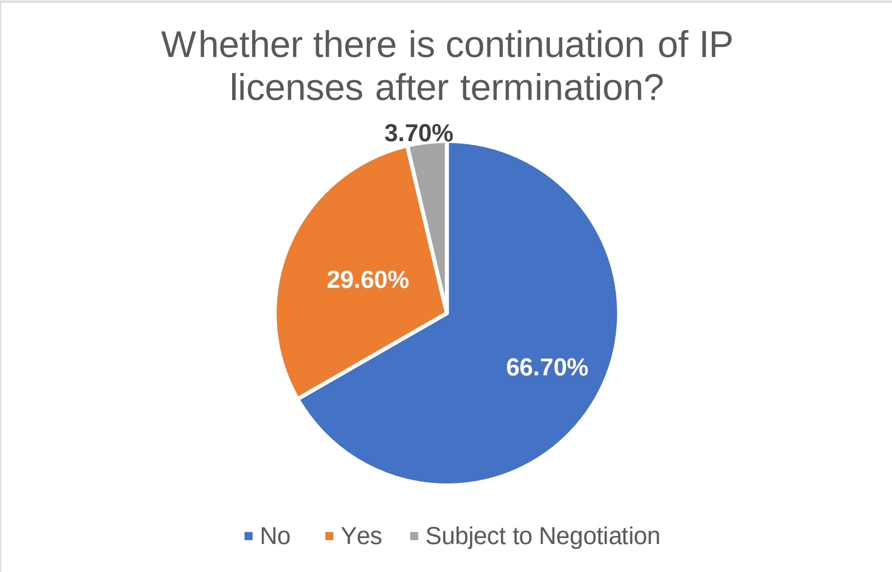


II. Termination effect

Typically, the license grant under a license agreement automatically terminates upon the agreement's termination or expiration. However, depending on the project's nature and the reasons for termination, some license agreements may also stipulate that the license may continue in part or in full after the termination or expiration of the agreement. We have found that 29.6% of the agreements have adopted this approach. Another 3.7% of the agreements specify that after termination or expiration of the agreement, the parties may otherwise negotiate the continuation of certain licenses.

Such arrangements are more common in co-development projects. Among all the projects where licenses remain partially or fully valid after the termination or expiration, 75% of them are co-development projects. This is mainly because, following the termination of such projects, one of the collaborating parties may intend to proceed with the development and commercialization activities independently or with a third party. As a result, they may still need the license from the other collaborating party to continue such activities.

In approximately half of the projects where the Licensee continues to get the licenses from the Licensor after the agreement's termination, such termination shall be due to the material breach or bankruptcy or insolvency of the Licensor. Moreover, the vast majority of such continuing licenses are royalty-free.



The preceding discussion provides a statistical summary of recent license-in/out projects handled by our team. While many agreements share similarities to some extent, there are also highly customized arrangements tailored to the specific backgrounds of different projects. When negotiating and drafting future licensing agreements, industry participants may bear in mind that other than adhering to common industry practices, they are never bound by any rigid rules. In order to promote friendly collaborations as well as protect one's own interests to the greatest extent possible, the parties may flexibly adjust the terms of the licensing agreements taking into account practical business needs and bargaining power of each party.

2. CIBM Bond Repo to be Further Opened to Overseas Investors

Authors: Ting ZHENG | Raymond YAN | Eryin YING | Lin ZHU | Shirley LIANG

Background

On 24 January 2024, to deepen the opening-up of the bond market and further facilitate the liquidity management of overseas institutional investors, the People's Bank of China ("**PBOC**") and the State Administration of Foreign Exchange published the *Announcement on Further Supporting Overseas Institutional Investors Engaging in Bond Repurchase Business in the China Interbank Bond Market* (draft for comments) (the "**Announcement**") (*《关于进一步支持境外机构投资者开展银行间债券市场债券回购业务的公告(征求意见稿)》*) to solicit public opinion. On the basis of the opening-up of cash bond trading to overseas institutional investors, the Announcement aims to further open up the onshore bond repo business in the China Interbank Bond Market ("**CIBM**") to overseas institutional investors to meet their liquidity management needs.

CIBM opening-up history

Since 2005, the CIBM has been advancing its reform, innovation and development processes, steadily promoting the opening -up, and progressively introducing overseas investors. In line with the market development needs, it has launched the CIBM Direct / settlement agent model and the Bond Connect model.

In August 2010, the PBOC issued the *Notice of the People's Bank of China on Issues Concerning the Pilot Program on Investment in the Interbank Bond Market with RMB Funds by Three Types of Institution Including Overseas RMB Clearing Banks* (Yin Fa No. 217 [2010])(*银发[2010]217 号《关于境外人民币清算行等三类机构运用人民币投资银行间债券市场试点有关事宜的通知》*), allowing overseas central banks or monetary authorities, RMB business clearing banks in Hong Kong and Macao regions, and overseas participating banks for RMB settlement in cross-border trade to engage in bond investment business in the CIBM.

In May 2015, the PBOC issued the *Notice of the People's Bank of China on Bond Repo Trading by Overseas RMB Business Clearing Banks and Overseas Participating Banks in the Interbank Bond Market* (Yin Fa [2015] No.170) (*《银发[2015]170 号<关于境外人民币业务清算行、境外参加银行开展银行间债券市场债券回购交易的通知>》*), permitting overseas RMB business clearing banks and overseas participating banks to carry out bond repo trading in the CIBM.

In July 2015, the PBOC promulgated the *Notice on Issues Concerning Investment of Overseas Central Banks, International Financial Institutions and Sovereign Wealth Funds with RMB Funds in the Inter-bank Market* (Yin Fa [2015] No.220) (*《银发[2015]220 号<关于境外央行、国际金融组织、主权财富基金运用人民币投资银行间市场有关事宜的通知>》*), allowing overseas sovereign institutions to conduct cash bond trading and bond repo business, among other types of transactions, in the CIBM.

In February 2016, the PBOC issued the PBOC Announcement [2016] No. 3 (*《中国人民银行公告[2016]第 3 号》*) to allow overseas commercial institutions to entrust a settlement agent competent in international settlement business to carry out cash bond transactions (excluding bond repo) in the CIBM under the settlement agent model.

In June 2017, the PBOC released the *Interim Measures for the Administration of Mutual Bond Market Access between Mainland China and Hong Kong SAR* (*《内地与香港债券市场互联互通合作管理暂行办法》*). According to PBOC's Q&A, cash bond trading is available for overseas investors through the Northbound Trading under the Bond Connect model for the moment. In the future, the trading instruments of bond repo, bond lending and borrowing, bond forwards, interest rate swaps and forward rate agreements will gradually be available to overseas investors.

Upon the official implementation of the Announcement, all overseas institutions that have entered the CIBM, including overseas sovereign and commercial institutions under the CIBM Direct / settlement agent model and the Bond Connect model, may participate in the bond repo transactions.

Key points and interpretation of the Announcement

I. Scope of overseas investors

According to Article 1 of the Announcement, any overseas institutional investor that has engaged in cash bond transactions in the CIBM may conduct bond repo transactions in the CIBM. As mentioned in Section II above, prior to the issuance of this Announcement, only overseas sovereign institutions, overseas RMB business clearing banks and overseas participating banks can participate in bond repo transactions under the settlement agent model. The Announcement will significantly broaden the scope and trading channels of investors for trading in the CIBM repo market. Specifically, in addition to the existing overseas RMB business clearing banks and participating banks, overseas central banks, international financial organizations and sovereign wealth funds, various financial institutions (such as commercial banks, insurance companies, securities companies, fund management companies, futures companies, trust companies, and other asset management institutions), and medium and long-term institutional investors (such as pension funds, charitable funds and endowment funds) will be granted access to bond repo transaction through the CIBM Direct / settlement agent model or the Bond Connect model.

Since the Announcement has not addressed bond repo transactions under the Southbound Trading under Bond Connect, it remains uncertain whether domestic investors will be able to trade overseas bond repo through the Bond Connect in the future.

II. Repo transaction mechanism

According to Article 2 of the Announcement, the bond repo business mentioned in the Announcement, including pledged repos and outright transfer repos, refers to the transaction under which the cash borrower (the repo party) sells bonds to the cash lender (the reverse repo party) and simultaneously receive funds, and both parties agree that the repo party will repurchase the underlying bonds from the reverse repo party at an agreed price on a certain future date and pays funds. The PBOC further clarified in the explanatory drafting note of the Announcement that the Announcement aims to support the convergence of the CIBM repo market with international practices, explicitly stating that when overseas institutional investors engage in bond repos in the CIBM, the underlying bonds should be transferred by purchase and sale, regardless of pledged repos or outright transfer repos, to facilitate the disposal of the bonds by the reverse repo party.

Based on the Announcement and its explanatory drafting note, the Announcement should cover both types of pledged repo and outright transfer repo. The arrangement in the Announcement aims at bridging the gap between the CIBM bond repo market and the overseas bond repo market, i.e., pledged repos account for over 90% of the bond repo transactions in the CIBM while the majority of the bond repo transaction in overseas markets are outright transfer repos. However, the following issues of the bond repo transaction mechanism under the Announcement still need clarification:

1. Title of bonds under pledged repo: title transfer by way of security vs nominal holding?

According to Article 3 of the *Measures for the Administration of Bond Transactions in the National Interbank Bond Market* (*《全国银行间债券市场债券交易管理办法》*), Article 2 of the *Provisions for the Administration of Bonds Outright Repurchase Business in the National Interbank Bond Market* (*《全国银行间债券市场债券买断式回购业务管理规定》*) and Article 24 of *China's National Association of Financial Market Institutional Investors Bond Repurchase Master Agreement (2013 Version)* ("**NAFMII Bond Repo Master Agreement**")(*《中国银行间市场债券回购交易主协议(2013 年版)》*), CIBM repo market includes two types of bond repo transactions, namely pledged repos and outright transfer repos. The pledged repo means the transaction under which one party (repo party) pledges the repurchased bonds to the other party (reverse repo party) and the reverse repo party pays the purchase amount on the purchase date to the repo party simultaneously, and both parties to the transaction agree on a certain date (i.e. the repurchase date) on which the repo party pays the repurchase amount to the reverse repo party and the reverse repo party release the pledge over the repurchased bonds. The outright transfer repo means the transaction under which one party (repo party) sells the repurchased bonds to the other party (reverse repo party) and the reverse repo party pays the purchase amount on the purchase date to the repo party simultaneously, and both parties to the transaction agree on a certain date (repurchase date) on which the repo party will repurchase the repurchased bonds from the reverse repo party at an agreed price(repurchase amount).

Given the above, the core difference between pledged repo and outright transfer repo in the current CIBM lies in whether the title of the underlying bond has been transferred. Under the pledged repo, the title of the underlying bonds remains vested in the repo party and the underlying bonds are not transferred to the reverse repo party but marked as pledged in the repo party's bond account. But under an outright transfer repo, the title of the underlying bond shall be completely transferred to the reverse repo party before the repurchase.

However, according to the Announcement and its explanatory drafting note, the underlying bonds shall be transferred anyway regardless of pledged repos or outright transfer repos, which raises a question as to the belonging of the title to the underlying bonds. We tend to take a view that there are two possible interpretations of the pledged repo transaction mechanism under the Announcement:

<u>**Title transfer by way of security**</u>

Article 68 of the *Interpretation of the Supreme People's Court on the Application of the Security System of the Civil Code of the People's Republic of China* (*《最高人民法院关于适用<中华人民共和国民法典>有关担保制度的解释》*) confirms the validity of title transfer by way of security. The pledged repo under the Announcement contemplates the transfer of title to the underlying bonds onto the reverse repo party by way of security and as the collateral for the repurchase obligation of the repo party. Where the repo party fails to pay repurchase amount upon the repurchase date, the reverse repo party may, by referring to the provisions on security interests in the PRC Civil Code (*《中华人民共和国民法典》*), enforce the underlying bonds by way of conversion into value, auction or private sale and get repaid in priority from the proceeds therefrom, but the reverse repo party cannot claim title to the underlying bonds without the enforcement procedure given the prohibition of strict foreclosure under PRC laws.

Although the aforesaid mechanism of title transfer by way of security can achieve similar security effect as the pledged repo, on the one hand, title transfer by way of security is not equivalent to pledge, and it poses uncertainty to whether such repo transaction can still fall in the scope of pledged repo as it cannot fit into the definition of pledged repo; on the other hand, where the title to the underlying bonds are transferred by way of security, some issues need to be further clarified, such as how to ensure that the reverse repo party, as the secured party and owner of the underlying bonds, does not dispose of the underlying bonds during the repurchase period, how to ring-fence the self-owned bonds of the reverse repo party from the underlying bonds as collateral, and how to protect the underlying bonds held by the reverse repo party from enforcement by the creditors of the reverse repo party.

<u>**Nominee holding**</u>

Under the pledged repo transaction under the Announcement, despite the title transfer of underlying bonds, the reverse repo party only serves as the nominal holder of the underlying bonds to hold the underlying bonds on behalf of the repo party, while the repo party remains the beneficial owner of the underlying bonds. The bond registration, custody and settlement institutions may facilitate the pledge registration over the underlying bonds by means of registering the beneficial owner, the pledgor, the pledgee and creating pledge mark on the bonds.

The nominal holding system allows the pledged repo under the Announcement to align with the existing definition of pledged repo to the greatest extent, but the bond registration, custody and settlement institutions need to make adjustments to the existing pledge registration system.

The title transfer by way of security and nominal holding above represent our speculation, based on the limited available information, on the potential operational models of the pledged repo contemplated under the Announcement. The specific operational model of the pledged repo contemplated under the Announcement is still subject to further clarification by regulatory authorities and bond registration, custody and settlement institutions.

2. Pledge registration

In accordance with Article 441 of the PRC Civil Code, where a pledge is created over bonds, the pledge shall be perfected upon the delivery of documents of title to the pledgee. Where there is no document of title, the pledge shall be perfected upon the registration of the pledge. Under the pledged repo stipulated in the Announcement, the underlying bond is transferred to the reverse repo party, similar to an outright transfer repo. However, how the repo party can conduct pledge registration over the bond already transferred to the reverse repo party needs further clarification by the bond registration, custody, and settlement institutions.

In addition, the Northbound Trading under Bond Connect adopts the internationally prevalent multi-layer custody structures, i.e., the Central Moneymarkets Unit of the Hong Kong Monetary Authority ("**CMU**") opens nominee holder accounts with the Shanghai Clearing House (**"SHCH**") and the China Central Depository & Clearing Co., Ltd. ("**CCDC**"), overseas investors open Bond Connect sub-accounts with CMU through CMU members, and overseas investors' accounts are held by CMU members. The bonds purchased by overseas investors through the Bond Connect channel are registered under the nominee account opened by CMU with SHCH or CCDC. Under the aforementioned multi-layer custody structure, the procedures for completing pledge registration for pledged repo transactions between overseas investors and domestic counterparties, and how the reverse repo party can dispose of the underlying bonds smoothly in the event of default by the repo party, require further clarification in detailed business rules.

According to Article 4 of the Announcement, the relevant CIBM infrastructures shall formulate or revise the business rules and detailed operating rules and report them to PBOC as required, and properly carry out the service and monitoring work for the relevant transactions, custody, settlement and clearing, and timely handle and report significant problems and abnormal situations to the PBOC. Therefore, we anticipate that the bond registration, custody and settlement institutions will review their business rules to adapt to the special transaction mechanism under the Announcement.

3. Coordination with the existing bond repo market

The pledged repo transaction mechanism under the Announcement differs significantly from the current pledged repo trading mechanism, in particular with respect to the title transfer of the underlying bonds and the pledge registration. Further observation is needed to determine whether and how adjustments to the existing bond repo market are necessary after the Announcement takes effect.

III. Transaction documentation

In December 2012, the PBOC promulgated the *Announcement on Promulgating the Master Agreement on Bond Repurchase Transactions in the Interbank Bond Market (PBOC Announcement [2012] No. 17)* (*《关于发布<中国银行间市场债券回购交易主协议>的公告》(中国人民银行公告(2012)第 17 号)*), requiring market participants to sign the NAFMII Master Repo Agreement when engaging in bond repo transactions and file the executed NAFMII Master Repo Agreement and its supplemental agreements to National Association of Financial Market Institutional Investors ("**NAFMII**") in a timely manner.

According to the *Business Process for Overseas Commercial Institutional Investors' Access to the Chinese Interbank Bond Market* (*《境外商业类机构投资者进入中国银行间债券市场业务流程》*)and the *Business Process for Overseas Central Bank Type Institutions' Access to the Chinese Interbank Bond*

Market (《境外央行类机构进入中国银行间债券市场业务流程》), overseas central banks and sovereign institutions, overseas RMB business clearing banks and participating banks that participate in bond repo transactions through CIBM Direct / settlement agent model are required to sign the NAFMII Master Repo Agreement.

Based on the above, before the issuance of the Announcement, all participants in the CIBM repo market need to sign the NAFMII Master Repo Agreement to conduct bond repos. The Global Master Repurchase Agreement ("**GMRA**") issued by the International Capital Market Association ("**ICMA**") is commonly used to document repo transactions in the international market. Several associations and overseas institutions expressed their wishes that the PBOC would allow overseas institutions to use the GMRA to document their onshore bond repos.

Article 5 of the Announcement provides that the overseas institutional investors shall enter into the bond repo master agreement with their counterparties, and the relevant self-regulatory organization shall file such master agreement with the PBOC. The following points regarding the transaction documentation of the master agreement for the bond repo under the Announcement need to be further clarified:

1. Whether the GMRA can be used

The Announcement does not clarify whether the bond repo master agreement mentioned in Article 5 only refers to the NAFMII Master Repo Agreement. Considering that overseas central banks and sovereign institutions, overseas RMB business clearing banks and participating banks are still required to enter into the NAFMII Master Repo Agreement, we tend to believe that once the Announcement comes into effect, overseas commercial institutions will also be subject to the same rules and cannot use GMRA.

Notwithstanding the above, on the one hand, in 2020, several financial regulatory authorities including the PBOC jointly issued the *Opinions on Accelerating the Building of Shanghai into an International Financial Hub and Financially Supporting the Integrated Development of the Yangtze River Delta* (《关于进一步加快推进上海国际金融中心建设和金融支持长三角一体化发展的意见》), permitting that overseas institutions may sign the NAFMII Master Agreement, Securities Association of China Master Agreement and International Swaps and Derivatives Association Master Agreement for derivatives transactions at their sole discretion. The PBOC may adopt a similar approach to allow overseas institutions to sign GMRA at their sole discretion; on the other hand, Article 5 of the Announcement requires that the relevant self-regulatory organizations should make a record filling of the master agreement with the PBOC, while the NAFMII Master Repo Agreement has already been filed with the PBOC. Whether this clause is intended to leave room for ICMA to file the GMRA with the PBOC, and allow overseas agencies to use the GMRA to document bond repos, requires further clarification from the PBOC.

2. Filing requirements

Whether the filing requirements of the master agreement under Article 5 of the Announcement shall apply to the executed bond repo master agreements by various overseas institutions or to the master agreement templates promulgated by various self-regulatory organizations, including ICMA's GMRA, remains to be further clarified by the PBOC. If overseas institutions are permitted to use the GMRA to document bond repos, it remains to be seen how to make a record filing of the GMRA.

3. Coordination with the transaction mechanism of the announcement

As mentioned in Section 3.2 above, the transaction mechanism of the pledged repo under the Announcement is different from the currently prevailing pledged repo. Whether and how the terms of the NAFMII Master Repo Agreement need to be adjusted to align with the transaction mechanism under the Announcement remains to be seen.

Outlook

The Announcement expands the scope of overseas institutions (i.e., overseas commercial institutions) and the channels (i.e., Bond Connect) through which they can participate in the bond repo business, thereby increasing the liquidity of CIBM and satisfying overseas investors' risk management needs. However, there are still many ambiguities about the bond repo transaction mechanism under the Announcement, which are inconsistent with the existing bond repo transaction mechanism and still need to be further clarified by the regulatory authorities, relevant financial market infrastructures and self-regulatory organizations, including but not limited to the bond transfer mechanism under the pledged repo, pledge registration arrangement, and execution and recording filing requirement of the master agreement. We will closely monitor the further development of relevant transaction mechanisms in the Announcement and promptly share our insights.

3. The Revised Company Law — A Foreign Investment Perspective

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Introduction

I. Background and highlights

On December 29, 2023, the Standing Committee of the National People's Congress (the "**NPC**") formally adopted revisions to *the Company Law of the People's Republic of China* (the "**Revised Company Law**"), which will come into effect on July 1, 2024. China's Company Law was first adopted in 1993 and has since undergone several rounds of revisions over the last 30 years. The Revised Company Law features a comprehensive overhaul of the current Company Law, as it substantively revises around 40% of the provisions of the current Company Law. There are various reasons for revising the current Company Law, which include: (i) the need to address certain practical issues and challenges; (ii) the demand for keeping up with the ever-evolving society and economy; and (iii) the aim to foster a more adaptive corporate legal regime to develop a better and healthier business environment.

Below is a glimpse of the highlights and significant changes under the Revised Company Law.

- Improvements are made to the capitalization regime for the two basic corporate forms: the limited liability company and the joint stock limited company. These include establishing a statutory deadline of five years for capital contributions in limited liability companies, requiring promoters of joint stock limited companies to fully pay for subscribed shares before the date of establishment, taking a series of measures to enforce timely contributions, and allowing joint stock limited companies to issue classified shares and shares with or without par value.
- Corporate organizational forms are optimized. This includes relaxing certain existing restrictions to broaden companies' autonomy with respect to corporate governance structures (especially for joint stock limited companies), stressing the role of the employees' representative congress, etc.
- Responsibilities of directors, supervisors and senior officers are strengthened. The Revised Company Law outlines the scope of the fiduciary duties which directors, supervisors, and senior officers are subject to, and establishes certain restrictive rules along these lines.
- Other notable changes such as enhancing the protection of shareholders' rights, strengthening the responsibilities of the actual controlling person, and streamlining the process for incorporation and shareholder exits.

II. Importance for foreign investors

1. The Old FIE Laws

At the beginning of China's opening to the West in 1978, there was no corporate law, commercial law, or contract law. *The Law on Chinese-foreign Equity Joint Ventures* (the "**EJV Law**") was adopted in 1979 and was the first PRC corporate law. The EJV Law was a cornerstone in China's opening up and its adoption marked the beginning of a legal regime which allowed foreign investors to conduct business in China. In 1986, the NPC adopted *the Law on Wholly Foreign-owned Enterprises* (the "**WFOE Law**"), which permitted foreign investors to establish and operate 100% foreign-owned subsidiaries in China. In 1988, the NPC adopted *the Law on Sino-foreign Contractual Joint Ventures* (the "**CJV Law**", together with *the EJV Law and the WFOE Law*, the "**Old FIE Laws**") under which foreign investors could invest in so-called "contractual joint ventures".

The Old FIE Laws have played an institutional role for decades and oversaw a surge of foreign investment into China. However, with their immaturity, vagueness and lack of transparency and consistency in implementation, the old regime failed to provide foreign investors with an effective and fair mechanism for investing into China.

2. The Foreign Investment Law

In response, the NPC adopted on March 15, 2019, *the Foreign Investment Law of the People's Republic of China* (the "**Foreign Investment Law**"), which became effective on January 1, 2020. On December 26, 2019, the State Council promulgated *the Regulations for the Implementation of the Foreign Investment Law of the People's Republic of China,* which took effect concurrently with the Foreign Investment Law. The Foreign Investment Law is essentially an investment promotion law applicable to all direct and indirect foreign investment activities in China unlike the Old FIE Laws, which are corporate laws. The Foreign Investment Law mandates a broad structural reform of the foreign investment regulatory system.

Throughout the Foreign Investment Law, China has pledged a "national treatment" regime whereby foreign investors and domestic investors shall be treated equally, subject only to exceptions as provided in special administrative measures, i.e. the negative list. Further, the Old FIE Laws were repealed by the Foreign Investment Law. There is no longer a separate category of foreign-invested enterprises (the "**FIEs**") and all FIEs are now equally subject to the provisions of the Company Law and *the Partnership Enterprise Law of the People's Republic of China* (if the entity takes the form of a partnership, rather than a corporation).

3. Transitional period under the Foreign Investment Law (i.e., before January 1, 2025)

The Foreign Investment Law requires that existing corporate-structured FIEs conform to the provisions of the Company Law, subject to a transitional period which expires on January 1, 2025. Given that FIEs are now equally subject to the Company Law and the five-year transitional period initially provided under the Foreign Investment Law is about to expire in less than one year, it is advisable for foreign investors to closely examine the provisions of the Revised Company Law, not only to ensure compliance, but also to gain insights into how it may affect their investments in China.

Implications for foreign investors doing business in China

I. Selection of investment vehicle — "LLC" or "JSLC"

There are two basic corporate forms under the Company Law: the limited liability company ("**LLC**") and the joint stock limited company ("**JSLC**"). The LLC in some respects resembles the limited liability company form under U.S. laws (other than taxation), while the JSLC is akin to a corporation under U.S. state laws. The major distinctions between an LLC and a JSLC under the Revised Company Law are summarized below:

#	LLC	JSLC
Number of shareholders	1 – 50 shareholders	1 – 200 promoters (i.e., founding shareholders), of which no fewer than half must be domiciled in China **Note: under the current Company Law, there must be between 2 – 200 promoters*
Capital contribution requirement	Pursuant to the articles of association, but no later than five (5) years from the date of establishment.	Fully paid for the subscribed shares by promoters before the date of establishment.
Transparency of shareholding structure to the public	<u>Compulsory filing</u>: An LLC must file the name(s) of its shareholder(s) with the State Administration for Market Regulation and its local counterparts (the "**SAMR**"), which will be available to the public via the National Enterprise Credit Information Publicity System (which is an online platform run by the SAMR to publicize the information of Chinese enterprises). <u>Compulsory disclosure</u>: An LLC is required to disclose: (i) the amount of capital contributions subscribed for and actually paid by the shareholders; (ii) the method and date of capital contributions; (iii) the information on equity changes to the public via the National Enterprise Credit Information Publicity System.	Essentially the same as the LLCs, except that: ■ A JSLC is only required to file the name(s) of its promoters with the SAMR and is not required to file the name(s) of subsequent shareholder(s) with the SAMR; the company needs to maintain a complete and updated register of shareholders internally, which is not required to be disclosed to the public. ■ A JSLC is required to disclose (i) the number of shares subscribed for by the promoters; and (ii) the information on changes in shares held by the founding shareholders via the National Enterprise Credit Information Publicity System.
Issuance of shares	N.A., but in practice, an LLC may utilize a shareholder agreement to assign preferential rights to certain shareholders such as veto rights on certain reserved matters, dividend/liquidation preference, etc.	A JSLC may: ■ issue shares with or without par value; ■ issue classified shares (i.e., shares with weighted voting rights, preference over distribution etc.); ■ authorize the board of directors to, within three years, issue not more than 50% of the issued shares. However, if the capital contributions are to be made using non-cash property, they shall be subject to a resolution made by the shareholders' meeting.
Equity/Share	Unless otherwise provided in the	By default, a shareholder may freely

#	LLC	JSLC
Transfer	company's articles of association: ■ A shareholder may freely transfer its equity interests to other shareholder(s); ■ A shareholder may transfer its equity interests to third parties, while the other shareholders are entitled to the right of first refusal.	transfer its shares to other parties unless otherwise provided in the company's articles of association.
Corporate governance	■ Board of Directors: shall have no less than three members, but an LLC of small scale or with a small number of shareholders may have only one director (who may serve concurrently as the manager of the company). ■ Board of Supervisors: shall have no less than three members, but an LLC of small scale or with a small number of shareholders may have only one supervisor or opt to forgo any supervisory position with unanimous shareholder consent. ■ An LLC may set up an audit committee composed of directors in the board of directors, which exercises the functions and powers of the board of supervisors as prescribed by this Revised Company Law, with no board of supervisors or supervisors established.	■ Essentially the same as LLCs under the Revised Company Law, except that a JSLC of small scale or with a small number of shareholders cannot forgo establishing a supervisory position, even with unanimous shareholder consent (but, same as an LLC, a JSLC may have only one supervisor or an audit committee in lieu of the board of supervisors or supervisors(s)). **Note: Under the current Company Law, a JSLC of small scale or with a small number of shareholders does not have the flexibility of rationalizing the board of directors and the board of supervisors. The board of directors has to be of at least five members and the board of supervisors has to be of at least three members.* ■ However, a JSLC still has relatively little flexibility in formulating its own rules on meetings and voting proceedings, which are subject to the provisions of the Revised Company Law, e.g., mandatory annual meetings of the board of shareholders, and the board of directors to convene at least two meetings annually.
Public financing	N.A., but as a practical matter, an LLC may receive various forms of non-public financings.	■ A JSLC may issue convertible bonds. ■ A company must be in the form of a JSLC to seek a listing on the Chinese stock exchanges or to be quoted through the National Equities Exchange and Quotations.

In practice, very few FIEs have been formed as JSLCs or converted into JSLCs under the current Company Law, partly because: (i) a sole shareholder may not form a JSLC due to the limit on the minimum number of shareholders; (ii) there is little flexibility in organizing a streamlined corporate governance structure; and (iii) JSLCs are generally considered to be structured for large-scale companies or companies with a substantial number of shareholders, which are positioned to publicly issue shares in Chinese capital markets.

Now, the Revised Company Law has evened up these odds. It is likely that the JSLC form will become a more popular investment vehicle in the future due to a number of advantages, such as the flexibility of issuing classified shares and convertible bonds, and the possibility of issuing shares to the public to provide a realistic exit strategy for foreign investors.

Notably, the Revised Company Law allows a JSLC to be formed by a sole shareholder but requires that no fewer than half of its shareholders be domiciled in China. Based on this, a wholly foreign-owned enterprise (WFOE) will be eligible to establish a wholly-owned JSLC as a PRC domiciliary. No guidance has been published as to how the requirement may apply to foreign companies. If foreign investors cannot directly establish a wholly-owned JSLC, then they may instead have to set up a joint venture with a Chinese partner or establish the JSLC through an existing or intermediate FIE.

II. Establishment and operation

The Revised Company Law adopts a number of significant changes to accommodate the practical requirements of the ever-evolving society and economy. Below are certain highlights that are relevant to the establishment and operation of FIEs.

1. Demand for improving registration efficiency

SAMR is the official registry for PRC-registered entities and enterprise information such as shareholders, registered capital, and the names of directors. Following SAMR's verification of the FIE's proposed name and registration application documents, SAMR will mark the formal establishment of an FIE by issuing a business license, unless industry regulatory pre-approval is required, such as permits for education, hazardous chemicals, banking permits, etc. For negative-listed FIEs which require no regulatory pre-approval or post-registration permits, SAMR will, before issuance of the business license, verify compliance with the special administrative measures in terms of shareholding limitations, etc.

Local SAMR counterparts provide detailed registration application checklists on their websites. However, in practice, the local SAMR counterparts have the discretion to require additional application documents and raise substantive comments on the content of the documents such as the articles of association, which lowers the predictability and efficiency of the registration process. Per Article 41 of the Revised Company Law (excerpted below), it appears that lawmakers realize that this has become an issue and have urged the administrative authority to make improvements.

"Article 41 The company registration authority shall optimize the procedures for company registration, enhance the company registration efficiency, strengthen information technology development and promote online handling and other convenient methods so as to raise the level of facilitation in

company registration.

The market regulatory department under the State Council shall, according to this law and the provisions of relevant laws and administrative regulations, formulate specific measures for company registration."

It is anticipated that the State Council and SAMR will subsequently formulate supporting regulations or detailed rules in response to this demand, so that the establishment of an FIE will be much more straightforward and simpler than before.

2. Enhancing the creditability of "registered capital"

"Registered capital" is the equity capital subscribed for by the shareholder(s) of a company and represents the company's initial funds until it is able to fund itself through operations. The shareholders of an LLC have the flexibility in making capital contributions either in a lump sum or in instalments pursuant to the timeline as prescribed in the LLC's articles of association. The permitted forms of capital contribution include cash, in-kind, equity interests in an existing company, creditor's rights, intellectual property rights, land use rights, and other forms of assignable non-cash assets.

The current Company Law allows the shareholders of an LLC to contribute the registered capital they subscribe for at any time during the term of the company. While this grants shareholders great flexibility to determine the timing of capital contributions, it has resulted in many companies with abnormally high amounts of registered capital and/or abnormally long capital contribution periods (e.g., 99 years), which severely undermines the creditability of the registered capital concept. Lawmakers intend to resolve this issue by adopting a series of measures, especially including imposing a statutory deadline of five years for capital contributions, which has been highlighted and heatedly debated.

A. Statutory deadline for LLC capital contributions

Under the Revised Company Law, the shareholders of an LLC are generally subject to a statutory deadline of five years as of the date of establishment or a subsequent capital increase, unless it is otherwise provided for by other specific regulations or rules (e.g., the registered capital of foreign-invested banks is required to be fully paid up before establishment). As such, following the effective date of the Revised Company Law, the shareholders of a newly established LLC will be subject to the statutory deadline for capital contribution.

As for existing LLCs established prior to the effective date of the Revised Company Law but having a contribution period that exceeds the statutory deadline, the Revised Company Law requires these companies to revise the period to conform to the statutory deadline "gradually" or, in the case of the period and/or amount of capital contribution is "obviously abnormal," SAMR can request adjustment of the capital amount/contribution schedule "in a timely manner". The State Council is tasked with promulgating implementing rules in this area, which are expected to be issued soon.

B. Acceleration of shareholder's capital contributions

Per the Revised Company Law, notwithstanding the capital contribution schedule, where an LLC is unable to pay off its due debts, the company or the eligible creditors may request shareholders who have subscribed for the capital contributions but whose time limit for capital contributions has not expired to make capital contributions in advance.

C. Potential liability of co-founders

Where any shareholder fails to make actual capital contributions in accordance with the articles of association, or the actual value of non-monetary property for actual capital contributions is obviously lower than the amount of capital contributions subscribed for at the time of establishment of a LLC, the Revised Company Law now requires other shareholders at the time of establishment bear joint and several liabilities with such shareholder to the extent of the insufficient capital contributions.

D. Forfeiture of equity interests or shares with flawed contributions

The Revised Company Law requires the board of directors to verify the capital contributions of shareholders and urges shareholders who fail to fully or timely pay their capital contributions to make such contributions within a grace period of no shorter than 60 days. In case of failure to fulfil the capital contribution obligations within the grace period, the shareholders will be deemed to forfeit their equity interests or shares to the extent of such flawed contributions.

3. More flexibility with respect to corporate governance structures

FIEs are legally required to have corporate governance structures under the current Company Law, which include the following elements:

- Shareholders' meeting or sole shareholder;
- Board of directors or executive director;
- Board of supervisors or supervisor(s); and
- Legal representative.

The Revised Company Law adopts revisions to relax certain restrictions under the current Company Law, so that companies would have more autonomy with respect to corporate governance structures.

- It is optional to establish a board of supervisors or supervisor(s). In the alternative, the Company Law, for the first time, permits (i) an LLC and JSLC to set up an audit committee composed of directors in the board of directors to exercise the functions and powers of the board of supervisors in lieu of the board of supervisors or supervisors, and (ii) in the case of an LLC, forgo any supervisory position with unanimous shareholder consent.
- As illustrated in Section 1 above, a JSLC of small- scale JSLC or with a small number of shareholders now has the flexibility in organizing a streamlined corporate governance structure in the same manner as an LLC, which may potentially make the form of JSLC a more popular vehicle.
- Under the current Company Law, the legal representative must be either the chairman of the board of directors, the executive director (if no board of directors), or the manager of an FIE. In contrast, the Revised Company Law permits a director or manager who represents a company to manage corporate affairs to be the legal representative, which, similar to the companies in the common law

system, essentially expands the scope of nominees for legal representative to include all directors.

Given the potential personal liabilities attached to the role of legal representative, the Revised Company Law also provides for a mechanism to resolve a potential deadlock that the legal representative may be permanently fixed to the position if no successor is available. If a director or the general manager who serves as a legal representative quits his or her position as a director or manager, he or she shall be deemed to have resigned as the legal representative simultaneously and the company shall appoint a new legal representative within 30 days from the date of quit.

4. Measures to foster a democratic decision-making mechanism with the participation of the employees' representative congress

To better protect the rights and interests of the employees, the Revised Company Law generally requires a company to foster a democratic management regime with the participation of employees' representative congress and specifically mandates the following.

- A company must solicit the opinions of its trade union and listen to the opinions and proposals of the employees through the employees' representative congress or by any other means when making a decision on any important matters, such as restructuring, dissolution, applying for bankruptcy, formulating any important regulation, or any other matters that are material to the business operation.
- If the board of directors has three or more members, it may include an employees' representative. As for medium-large size companies with 300 or more employees, they will be subject to a mandatory requirement of including employees' representative(s) either into the board of supervisors or the board of directors. The employees' representatives on the board of directors will be democratically elected by the employees through the employees' representative congress, employees' congress, or by other means.

5. Strengthened responsibilities for senior managers and controllers

The current Company Law generally subjects the directors, supervisors and senior officers (collectively, "**Senior Managers**") to the fiduciary duties, i.e., the duty of loyalty and the duty of diligence. The Revised Company Law further outlines the scope of the fiduciary duties and establishes certain restrictive rules along these lines:

A. Fiduciary duties

Duty of loyalty: Senior Managers must take measures to avoid conflicts of interest and may not seek improper interests by taking advantage of their powers.

Duty of diligence: When performing their duties, the Senior Managers must act with reasonable care and in the best interests of the company.

B. Rules on related-party transactions

In the case of a proposed related-party transaction (i) directly between the company and any Senior Managers or (ii) indirectly between the company and the Senior Managers' close relatives, the enterprises directly or indirectly controlled by the Senior Managers or their close relatives, or affiliates who have other affiliate relationships with the Senior Managers, the concerned Senior Managers are obligated to report this to the relevant decision-making body (the shareholders' meeting or the board of directors, per the articles of association) of the company to seek an approval.

C. Rules on conflicts of interest

The Senior Managers may not take advantage of their positions to usurp any business opportunity that belongs to the company, unless it has been reported to and approved by the relevant decision-making body of the company or the company cannot make use of such business opportunity pursuant to the laws and regulations or the articles of association.

The Senior Managers may not engage in for themselves or others any business that is similar to that of the company, unless it has been reported to and approved by the relevant decision-making body of the company.

D. Rules on recusal from voting for a related director

To the extent that the board of directors is the decision-making body of the matters discussed above, the related director(s) must not participate in the voting and their voting rights shall not be calculated into the total voting rights. If the number of unrelated directors present at the meeting of the board of directors is fewer than three, then such matter shall be escalated to the shareholders' meeting.

Notably, other than the Senior Managers, the Revised Company Law also subjects the controlling shareholder and/or the actual controller ("**Controller**") to fiduciary duties when the Controller acts as a "de facto director", i.e., the Controller actually manages the affairs of the company though he/she does not serve as a director. Further, where the Controller instructs any director or senior officer to carry out any act damaging the interests of the company or other shareholders, i.e., being a "shadow Senior Manager", the Controller will bear joint and several liabilities with such director or senior officer.

III. Exit

Foreign investors may exit the Chinese market through equity transfer (if the company is in the form of an LLC) / share transfer (if the company is in the form of a JSLC), or through reduction of registered capital, dissolution and liquidation, or bankruptcy. The Revised Company Law adopts certain notable changes with respect to the equity transfer and the dissolution and liquidation of a company.

1. Equity transfers

A. Simplified process for equity transfers

The easiest way to exit is to transfer the equity/shares in an FIE to its existing shareholders or to a third party. Under the current Company Law, equity transfers between shareholders do not inherently require approval unless otherwise provided in the company's articles of association, and transfers to third parties still require the approval of 50% of the other shareholders. Where a shareholder votes against the transfer, such shareholder must exercise its right of first refusal to purchase such equity interests; otherwise it shall be deemed to have consented to the sale. The Revised Company Law removes the statutory approval requirement for equity transfers to third parties, but the transfer is still subject to the right of first refusal of other shareholders unless otherwise provided in the articles of association.

B. Liability regime for the transfer of "shell equity" and equity with flawed contributions

The Revised Company Law establishes a liability regime for the transfer of "shell equity" (i.e., the equity of which capital contributions have been subscribed for but the time limit for capital contribution has not expired), and equity with flawed contributions (i.e., the shareholder underpays or fails to pay in time the capital contribution):

- As for "shell equity", the transferee bears the obligation of making such capital contributions. If the transferee fails to make a capital contribution on time and in full, the transferor will bear supplementary liability for the transferee's overdue capital contribution.
- As for equity with flawed contributions, the transferor and transferee bear joint and several liability to the extent of the capital contribution shortfall. If the transferee is not aware and ought not to know about the existence of such flawed contribution, the transferor will be liable for the contribution shortfall.

C. What marks the completion of an equity transfer

Under the Revised Company Law, an equity transfer is deemed completed after the updating of the register of shareholders. The transferring shareholder is obligated to request the company to update the register of shareholders and to file the shareholder change with the SAMR. If the company refuses to do so or fails to reply within a reasonable time limit, the transferee and the transferor may file a lawsuit against the company.

2. Liquidation and deregistration

A. Enhanced responsibilities for directors in liquidation

An FIE may be dissolved upon the expiry of its operating term or if it suffers serious losses, experiences serious difficulties in its business, or is ordered to cease operations. Per the Revised Company Law, upon the occurrence of a cause of dissolution, the directors are the liquidation obligors of the company and are required to establish a liquidation committee which, by default, is composed of the directors unless it is otherwise provided for in the company's articles of association or it is otherwise elected by the shareholders. The liquidation obligors are liable for compensation if they fail to fulfill their liquidation obligations in a timely manner which causes any loss to the company or the creditors.

The liquidation committee will take over the day-to-day management of the FIE and notify known creditors through notices and unknown creditors publicly in newspapers or via the National Enterprise Credit Information Publicity System so that the creditors can declare their claims and the liquidation committee can register and verify such claims. The Revised Company Law subjects the liquidation committee to the fiduciary duties: (i) any member who neglects to fulfill his/her liquidation duties, thus causing any loss to the company shall be liable for compensation; and (ii) any member who causes any loss to any creditor due to their intention or gross negligence shall be liable for compensation.

B. Summary deregistration and compulsory deregistration

Typically, the liquidation committee will apply for deregistration of the company upon the completion of liquidation. The Revised Company Law permits two types of deregistration without liquidation.

- Summary deregistration: If a company has not incurred any debts or has paid off all the debts, then the company may announce deregistration through the National Enterprise Credit Information Publicity System for a period of no less than 20 days; if there is no objection, the company may apply for deregistration of the company within 20 days after the expiry of the announcement period. However, the shareholders are required to guarantee the authenticity with respect to non-existence or settlement of the debts. If such commitment is untrue, the shareholders are jointly and severally liable for the outstanding debts.

- Compulsory deregistration: Where, after three years since the business license of a company was revoked, or the company was ordered to close down or was revoked, the company fails to apply for deregistration, the SAMR may announce the deregistration through the National Enterprise Credit Information Publicity System for a period of no less than 60 days; if there is no objection, SAMR may deregister the company after the expiry of the announcement period. However, the deregistration of the company will not impact the liability of the shareholders or liquidation obligors.

Next steps

As discussed above, the Revised Company Law presents significant amendments to the current Company Law that will impact the interests of foreign investors and affect their way of doing business in China. Below is a list of to-do items that foreign investors should be aware of as we move toward the implementation of the Revised Company Law.

➢ Monitor regulatory developments for implementing rules, which are expected to be promulgated before the Revised Company Law comes into effect on July 1, 2024. The implementing rules will likely clarify the following issues, among others:

  - whether a sole foreign investor can form a JSLC;
  - the mechanism for requiring legacy LLCs, established prior to the effective date of the Revised Company Law, must conform to the revised provisions of the law; and
  - whether FIEs need to reconcile other matters that do not conform to the Revised Company Law (e.g., the mandatory requirement of including employees' representative in the corporate governance structure for medium-large size companies with 300 or more employees) within the five-year transitional period ending on January 1, 2025, as prescribed by the Foreign Investment Law.

➢ Conduct a gap analysis of the FIE's currently effective articles of association against the Revised Company Law (including the forthcoming implementing rules) to identify non-conforming items against the mandatory requirements, as well as the potential optimization of corporate structures.

For FIEs which are joint ventures, additionally:

- Remind the board of directors to verify the existence of any flawed contributions by shareholders, and/or, to the extent practicable, secure an indemnification letter from co-founders, so as to mitigate the risk of assuming supplementary liability; and
- To the extent necessary and practicable, require the company to procure liability insurance for the Senior Managers, as the Revised Company Law strengthens responsibilities for senior management.

➢ Accordingly, FIEs should consider amending or restating their articles of association before the end of the five-year transitional period on January 1, 2025. In addition, FIEs that face a potential capital contribution issue should pursue a capital reduction or equity transfer to remedy any capital structures that do not conform to the Revised Company Law.

Important Announcement

This Newsletter has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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