

TO BE OR NOT TO BE

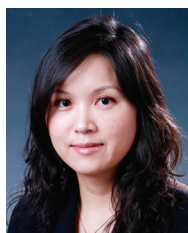
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New regulations offer clarity on the administration of foreign representative offices; however, this investment vehicle may no longer be an optimal arrangement for some overseas companies wishing to enter the Chinese market.

A representative office (rep office) has been a relatively low-cost way for foreign companies to establish themselves. By setting up a rep office in China initially, a foreign company can learn about the China market before deciding whether to upgrade to an operational branch (if the foreign company operates in an industry that is allowed to have a branch) or a wholly foreign-owned enterprise (WFOE). Recently updated rules governing rep offices may make them a less attractive option for certain foreign companies.

In November 2010, the State Council issued the Regulations for the Administration of the Registration of Resident Representative Offices of Foreign Enterprises (外国企业常驻代表机构登记管理条例) (Regulations). The Regulations will become effective March 1 2011 and will replace the Measures for the Administration of the Registration of the Resident Representative Offices of Foreign Enterprises issued in 1983

(关于外国企业常驻代表机构登记管理办法) (1983 rules). The Regulations reinforce the stricter supervision of rep offices under the Notice on Strengthening Administration for Registrations of Foreign Enterprises Resident Representative Institutions (关于进一步加强外国企业常驻代表机构登记管理的通知) (Notice) issued in January 2010 by the State Administration of Industry and Commerce (SAIC) and the Ministry of Public Security.

Many regard the Regulations as China's measure to curb abuses by foreign companies whose rep offices do not act strictly in accordance with the 1983 rules. The Regulations achieve that by tightening the rules on the establishment and operations of rep offices, and increasing the penalties for violation. At the same time, the Regulations provide bright line rules in certain respects. The major changes brought about by the Regulations are summarised below.

Non-profitmaking activities

The Regulations continue to prohibit a rep office from engaging in profit-generating activities, but unlike the 1983 rules, the Regulations provide expressly what the permissible non-profit-generating activities are:

- Market research, product display and publicity activities relating to the foreign company's products or services; and
- Liaison activities relating to the sale of products or provision of services, and local procurement or investments, by the foreign company.

Annual report requirement

The Regulations require rep offices to submit annual reports to the registration authority (which in most cases is the local Administration for Industry and Commerce (AIC)) between March 1 and June 30 each year. The report must include the status of the foreign company, the activities carried out by the rep office, and financial information audited by an accounting firm.

Under the 1983 rules, an annual report is only required upon renewal of the rep office's business registration and no audited financial information is required. Starting from 2011, foreign companies with Chinese rep offices must budget in annual audit costs.

The Regulations introduced one ambiguity. The 1983 rules provide that the validity period of a rep office's registration is only one year, although in practice the business registration may be valid up to three years. Instead of the term "validity period", the Regulations use the term "existence period", which may not be longer than the duration of the foreign company establishing the rep office. The Regulations do not include a requirement for annual registration. It is not clear whether the existence period is the same as

the validity period or if the one year validity period as stated in the Notice remains effective. It is possible that the regulators find that the annual report requirement gives the regulatory authority sufficient control over the activities of rep offices. Further interpretations issued on this matter would be welcomed.

Additional requirements for the establishment of a rep office

The requirements for setting up a rep office are (i) registration with the AIC and obtainment of any other necessary regulatory approvals and (ii) submission of the following documents, including two new items denoted by asterisks (*):

- Registration application;
- Proof of the foreign company's domicile and legal existence for at least two years;*
- The foreign company's articles of association or other organisational documents;*
- Letters appointing the chief representative and other representatives;
- Resume and proof of identity of the chief representative and other representatives; and
- Reference letter issued by a financial institution that has dealings with the foreign company.

Although not expressly indicated in the Regulations, based on prevailing practice it is believed that the notarisation and consularisation of at least the bank reference letter and the foreign company's articles of incorporation will continue to be required. Notarisation and consularisation can

be time consuming. Foreign companies should consider this factor in their decision to establish a rep office.

A new requirement is that the foreign company must make a public announcement of change of registration or cancellation of registration of its rep office through the media specified by the regulatory authority at the time of establishment. Public announcement represents an additional cost of establishment and operation.

While the 1983 rules do not limit the number of representatives a rep office may have, the Regulations specify that a rep office must have one chief representative and up to three other representatives. Finally, the Regulations include disqualifying circumstances (one of which relates to national security) under which an individual may not be the chief representative of a rep office.

Stricter penalties

The Regulations increase the maximum amount of fine that can be imposed on a rep office, from Rmb20,000 under the 1983 rules to Rmb500,000, and add specified circumstances in which a rep office may be subject to fines or other penalties. The various offences and their penalties are listed on the next page.

In serious cases of offences #2 through #5, the registration may be revoked. Once the registration of a rep office is revoked, the foreign company may not establish a rep office in China for five years.

OFFENCE	PENALTY
1. Operating a rep office without approval	Fine of Rmb 50,000 to Rmb 200,000
2. Engaging in profitmaking activities	Fine of Rmb 50,000 to Rmb 500,000; seizure of profits from and equipment, raw material and products of the illegal activities
3. Failure to cease engaging in profitmaking activities by the time specified by the regulatory authority	Fine of Rmb 10,000 to Rmb 100,000
4. Failure to register a change in registration, carry out activities under the rep office's registered name, file annual report, or alter premises as directed by the relevant authorities	Fine of Rmb 10,000 to Rmb 300,000
5. Fraudulent conduct in registering	Fine of Rmb 10,000 to Rmb 100,000; those directly in charge may be fined Rmb 1,000 to Rmb 10,000
6. Engaging in conduct that is against national security or public interest	Revocation of registration

Miscellaneous

The Regulations also specifically give the AIC the power to investigate possible violations and directs the AIC to establish a mechanism to share information about a rep office with other government authorities. Information sharing will facilitate control over rep offices by the Chinese government. For example, the Exit and Entrance Bureau will be able to obtain information regarding whether representatives of a Rep Office should be subject to the visa/work permit requirement and the

compliance status. The Tax Bureau will be able to track the identity of representatives and their compliance with individual income tax filing.

Finally, the Regulations establish clear deadlines for the foreign applicant, the rep office, and, more importantly, the registration authority to act. For example, the AIC must decide whether to approve the registration of a rep office within 15 days after submission of the application. The Regulations also give the foreign company or rep office expanded flexibility in taking required actions.

For example, a rep office may renew its registration any time within 60 days (30 days under the 1983 rules) before expiration of the registration.

While the Regulations remove some uncertainty arising from the 1983 rules, they also increase the cost of setting up and operating a rep office in China. Foreign companies should carefully consider whether using a rep office to get into the Chinese market is the optimal option compared to, for example, a WFOE, which can engage in profit-generating activities and can now be established with registered capital as low as Rmb 100,000. Foreign companies that already have rep offices in China should review their activities to make sure that they fall within the confines of the Regulations and should put in place procedures to comply with the Regulations.

If the foreign company intends to undertake activities that are not expressly permitted by the Regulations, it should consider a branch or an WFOE.

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