FOCUS: NEW INVESTMENT OPTIONS

# Venture Capital Options Expand—A Bit

Michael E. Burke

As year two of China's World Trade Organization (WTO) membership rolls on, China continues to open its financial services sector to foreign investors. On January 30, 2003 the Ministry of Foreign Trade and Economic Cooperation (MOFTEC—now the Ministry of Commerce [MOFCOM, *see* p.26]), Ministry of Science and Technology (MOST), State Administration of Industry and Commerce (SAIC), State Administration of Taxation (SAT), and State Administration of Foreign Exchange (SAFE) jointly issued the Regulation on the Administration of Foreign-Invested Venture Capital Enterprises (the regulation).

The regulation encourages investment in China's high-technology sector and aims to further develop China's venture capital (VC) investment regime. The regulation covers the creation, operation, and dissolution of foreign-invested

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# China's new venture capital regulations provide limited improvements for investors

venture capital enterprises (FIVCEs), defined as foreign-invested enterprises (FIEs) engaging in venture capital activities. Article 3 of the regulation defines VC activities as investing in the equity of nonlisted high-tech companies, providing VC management services, and earning capital gains over time. A FIVCE must have "venture capital" in its name. The regulation, which took effect March 1, 2003, replaces the ineffective 2001 Provisional Regulation on the Establishment of Foreign-Invested Venture Capital Investment Enterprises (provisional regulations). Many aspects of the provisional regulations, good and bad, reappear in the regulation. An overriding concern, from the perspective of foreign VC firms, is that FIVCEs remain subject to some degree of government interaction and direction.

## Forming a FIVCE

The revised FIVCE structure is a welcome development for foreign venture capitalists, though the regulation imposes some frustrating limitations. Investors have some degree of flexibility in choosing the FIVCE's structure, although a wholly foreign-owned enterprise will likely be the most popular of the FIVCE structuring options. The regulation divides possible structures into nonlegal person and corporate categories—each with its own requirements and procedures. For example, investors in nonlegal person FIVCEs have unlimited liability, while corporate FIVCEs have capped liability. Nonlegal person FIVCEs may elect to have investors pay tax separately at the investor level or to be taxed at the FIVCE level, while corporate FIVCEs are subject to PRC tax on investment returns and gains (though dividends received are currently tax exempt, provided that both issuer and recipient have FIE status).

FIVCEs must have between two and 50 investors, including at least one "principal investor." The principal investor serves as the FIVCE's manager, and must be an experienced venture capitalist that has overseen $100 million in investment (of which at least $50 million must be VC-focused) during the three years prior to the FIVCE's creation. A Chinese principal investor must have overseen ¥100 million ($12.08 million), of which at least half was VC-focused during the three years prior to the FIVCE's formation. Principal investors must employ at least three professional management staffers, each with at least three years of VC experience and each without a disciplinary record in their home jurisdiction. A principal investor in a nonlegal person FIVCE must contribute more than 1 percent of the entity's aggregate capital; a principal investor in a corporate FIVCE must contribute more than 30 percent of the entity's aggregate capital. To satisfy these requirements, a potential principal investor may aggregate its experience and capital contributions with those of its affiliated entities.

Each nonprincipal FIVCE investor must contribute at least $1 million. Aggregate capitalization from all nonprincipal investors must exceed $10 million in a nonlegal person FIVCE and $5 million in a corporate FIVCE.

Principal and nonprincipal investors in a nonlegal person FIVCE may make capital contributions in installments extending up to five years after formation. Existing regulations

## The Birth of MOFCOM

Now defunct, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and the State Economic and Trade Commission were merged into the new Ministry of Commerce (MOFCOM) in March. Although the Regulation on the Administration of Foreign-Invested Venture Capital Enterprises refers to "MOFTEC," such references have been replaced with MOFCOM throughout this article.

affecting corporate FIVCEs, such as regulations on equity joint ventures, specify capital contribution timing for those entities.

In addition to quantitative requirements, FIVCEs themselves must satisfy certain qualitative requirements, such as having appropriate formation documents and employing more than three professional staff members with experience in VC investment (unless the FIVCE entrusts its management to a venture capital investment management enterprise [VCIME]; *see* p.27).

FIVCEs must have a management committee to represent and protect investors' interests: a joint management committee for a nonlegal person FIVCE and a board of directors for a corporate FIVCE. This management committee, in turn, must establish an office to manage the FIVCE's daily operations. Operational management office staff must have full civilian status, no criminal record, and appropriate VC experience. Alternatively, a FIVCE may delegate its operational management responsibilities to a VCIME or another FIVCE.

## Low liquidity and restrictive timing

Foreign investors forming FIVCEs will find that the regulation imposes several cumbersome requirements. For example, most foreign VC investors may have a difficult time reducing their capital contribution or changing investment status during the FIVCE's term. A nonlegal person FIVCE's formation documents may specify capital contribution reduction procedures for nonprincipal investors, but any such reduction requires the consent of investors holding more than 50 percent of the value of the FIVCE's aggregate capital and the consent of each principal investor. A principal investor in a nonlegal person FIVCE may not reduce its capital contribution during the FIVCE's term except in unusual circumstances. Such reduction depends on the principal investor obtaining the consent of the FIVCE investors that hold more than 50 percent of the value of the FIVCE's aggregate capital; transferring its interest to a qualified assignee principal investor; revising the FIVCE's formation and operational documents; and obtaining MOFCOM approval. The regulation prohibits any capital contribution reduction that would cause the FIVCE's aggregate capital to fall below $10 million. Existing regulations cover capital contribution reductions for corporate FIVCEs.

New nonprincipal investors in any FIVCE must satisfy conditions in the regulation and in the FIVCE's formation documents, must obtain the consent of the principal investor and MOFCOM, and must have the FIVCE's formation documents amended. A nonprincipal investor in a nonlegal person FIVCE may assign its FIVCE interest without following the above-mentioned steps, as long as the assignee satisfies conditions in the regulation and the FIVCE's formation documents.

Another shortcoming of the regulation is that the application and registration periods for both FIVCE formation and investments by a FIVCE are too long. If government entities abide by the letter of the regulation, it will take more than 60 days to form a FIVCE. Founders must submit an application to the provincial-level MOFCOM office (based on the FIVCE's proposed location). The provincial-level office must examine the application materials and report to central-level MOFCOM within 15 days of receipt of the application materials. Central-level MOFCOM then has 45 days from receipt of materials from the provincial-level MOFCOM to review, and approve or reject, the FIVCE's application. MOST must also consent before formal approval is granted.

Approved FIVCEs will receive written notification of approval and an FIE Approval Certificate that they must submit, along with other items, to the appropriate SAIC office for registration within one month of receipt. Upon SAIC approval, nonlegal person FIVCEs will receive Business Licenses, and corporate FIVCEs will receive Legal Person Enterprise Business Licenses.

## Restrictions on investment and operational scope

Foreign investors will discover additional concerns when reading the regulation's restrictions on FIVCE investment and operational scope.

- FIVCEs are not permitted to invest in more than "plain vanilla" equity, nor may they invest in varying classes of preferred stock, quasi-equity such as equity warrants (available in Hong Kong) or varying classes of convertible debt.
- FIVCEs may not make investments through loans or any funds other than the FIVCE's own funds, or provide credit or guarantees (excluding investment in bonds issued by an investee company or convertible bonds with a term of at least one year). Further, FIVCEs may not lend an unrestricted amount to their investee companies, even though such lending could result in closer alignment of goals between the FIVCE and its investee company.
- As stated above, a FIVCE may only invest its own funds in unlisted equities, provide VC investment consulting, provide management consulting to investee enterprises, or engage in other operations as approved. FIVCE investment into target entities must comply with the Catalogue Guiding Foreign Investment in Industry and the Regulation on Guiding Foreign Investment Direction. A FIVCE may *not* invest in projects that the catalogue lists as prohibited; directly or indirectly invest in listed securities

(except when the FIVCE invested before the investee's initial public offering); directly or indirectly invest in fixed assets that are not for the FIVCE's own use; or invest in other projects as prohibited by laws, regulations, or the FIVCE's formation documents.

- FIVCE investments, and increases and transfers thereof, are subject to approval and registration requirements and potentially long timelines. When investing in an encouraged or permitted category entity, the FIVCE must notify the local-level MOFCOM where the investee is located. The local MOFCOM office must conclude its review and, if it approves, issue an FIE Approval Certificate within 15 days after receiving the completed application materials. FIVCEs investing in a restricted category entity must notify the local-level MOFCOM where the investee is located, although the local MOFCOM has 45, not 15, days to review the investment application. Upon approval the investee must file its FIE Approval Certificate with SAIC, which will issue an FIE Legal Person Enterprise Business License. A FIVCE must report to MOFCOM within one month of completing any portfolio investment. As service sectors open to foreign investment, FIVCE investments will be examined and approved according to relevant, and new, regulations.

Investee enterprises will enjoy FIE incentive treatment only if aggregate foreign investment (from a FIVCE or otherwise) exceeds 25 percent of the entity's registered capital. An existing domestic natural person enterprise that receives foreign investment and is eligible to become an FIE may retain its original domestic natural person investor's status.

### Problems with profits and payments

As specified in the regulation, a FIVCE's profits are primarily to come from the disposition of its equity interests. A FIVCE may dispose of such interests by selling to other investors; entering into a repurchase agreement with the investee; transferring its interests via the stock markets after the investee publicly lists; or other methods as specified by relevant Chinese laws and regulations. Resale of equity interests held by a FIVCE should be, but is not, allowed automatically when both parties to the transaction are FIVCEs. MOFCOM and SAIC are drafting rules on repurchase agreements between a FIVCE and an investee company.

Nonlegal person FIVCEs may distribute investment gains as provided in their formation documents and as consistent with "international norms," a term left undefined in the regulation. Proceeds from such equity sale by a nonlegal person FIVCE may be distributed directly to the investors and be regarded as a reduction of their capital to the extent that such proceeds are less than an investor's original investment.

The nonlegal person FIVCE must file a notice on the distribution and related capital reduction with MOFCOM and SAFE 30 days before the proposed distribution. This notice must show that the nonlegal person FIVCE's remaining capital exceeds outstanding investment liabilities. The regulation does not specify whether such distribution is subject to approval. SAFE is expected to issue new regulations on this distribution process in the near future. Distributions by corporate FIVCEs are subject to existing regulations.

Though VC investors would prefer that there be no restrictions on the repatriation or transfer of gains, the regulation's foreign exchange process imposes burdensome transaction costs on FIVCEs that repatriate profits. A FIVCE must submit several documents to its foreign exchange bank prior to offshore distribution of profits or other payments. These documents include the management committee's resolution approving

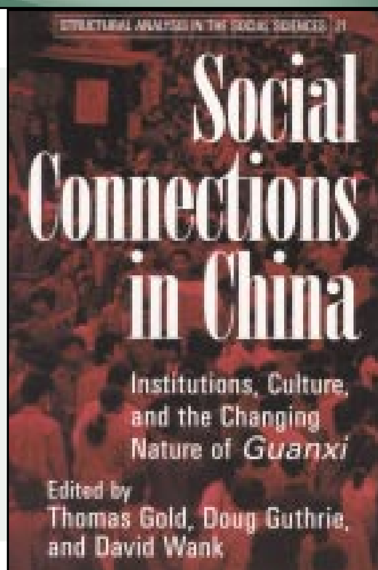
*Continued on page 57*

## Venture Capital Investment Management Enterprises

The Regulation on the Administration of Foreign-Invested Venture Capital Enterprises introduces a new type of entity, a venture capital investment management enterprise (VCIME), subject to many of the same organizational requirements and processes as a foreign-invested venture capital enterprise (FIVCE). VCIME founders must submit an application to the provincial-level Ministry of Foreign Trade and Economic Cooperation (now the Ministry of Commerce [MOFCOM]) office, based on the VCIME's proposed location. The provincial-level MOFCOM has 45 days from receipt of the complete application to approve or reject a VCIME's formation. Upon approval, the VCIME receives a Foreign-Invested Enterprise Approval Certificate that must be registered with the appropriate State Administration of Industry and Commerce (SAIC) office within one month of receipt.

VCIMEs must employ more than three professional management personnel with at least three years of relevant experience each, have registered capital of at least ¥1 million ($120,773), and have a complete internal control system. A VCIME's business scope is restricted to FIVCE management, including the oversight and informational production requirements usually performed by a FIVCE's board of directors or management committee. A potential management contract between a VCIME in China and a FIVCE is not effective until it is unanimously approved by the FIVCE's investors and approved by MOFCOM. An overseas VCIME must file a registration application with the relevant SAIC office within 30 days of execution of a management contract with a FIVCE (though such agreement seems to be effective upon execution).

*—Michael E. Burke*




## Social Connections in China: Institutions, Culture, and the Changing Nature of *Guanxi*

**edited by Thomas Gold, Doug Guthrie, and David Wank.**
**New York: Cambridge University Press, 2002. 272 pp.**
**$60 hardcover, $22 softcover.**

Connections are universally useful in social and business activities. In *Social Connections in China: Institutions, Culture and the Changing Nature of Guanxi*, Thomas Gold, former chair of the Center for Chinese Studies at the University of California, Berkeley; Doug Guthrie, professor of Sociology at New York University; and David Wank, of Sophia University in Tokyo, edit a volume of pieces that attempt to assess the role of *guanxi* in modern China. Some authors argue that *guanxi* itself inhibits the development of modern Chinese society. Others argue that it is—and will continue to be—a necessary regulating factor in ensuring efficiency in social, economic, and legal interactions.

The book begins with an insightful overview of the recent scholarship on *guanxi*, which attempts to define, first, which practices should be considered *guanxi*. The second part examines the methodological and conceptual considerations of *guanxi*, including the problems in evaluating its effectiveness in China, and the third-party effects of its use.

Most of the book delves into the question of the prevalence of *guanxi* in various aspects of Chinese life today. The discussion examines the way *guanxi* is used in economic relations, its influence on the shape of business-state relations, and its role in China's emerging labor markets. The book also analyzes the degree to which *guanxi* is used in job searches in urban China, the connection between *guanxi* and the Chinese concept of face, whether *guanxi* compliments or contradicts the development of China's legal system, the link between *guanxi* and gossip in social interactions, and the ways in which individuals can foster *guanxi*.

Though each chapter could stand on its own, the book's main purpose is to demonstrate that *guanxi* is still present in many aspects of Chinese social and business interaction today. The question the book raises is whether relationships, in the midst of China's massive institutional change, will maintain their importance. All authors, save for Guthrie, agree they will.

Guthrie not only examines the problems inherent in measuring the extent to which *guanxi* produces tangible results, but also argues that the tendency to use *guanxi* is a result of one's social standing. In China's unequal society, those in the upper social strata rely on it less than those at the bottom.

Because of China's increasing integration with the rest of the world, *guanxi* is an important phenomenon to understand in business relations. As the PRC government and Chinese Communist Party system continues to loosen its draconian grip on society, and in light of China's entry into the World Trade Organization, it will be interesting to see the role that *guanxi* plays in its developing legal and economic systems. Though the book primarily deals with urban China, it would be richer if it had explored the role of *guanxi* in China's ethnic minority communities (unless *guanxi* is predominately a mark of Han Chinese culture).

*Social Connections in China* is a well-written and thought-provoking investigation of the use of *guanxi* in business and social dealings in China today. It is a useful book for those interested in sociology, cultural anthropology, law, and business—and provides great insight into the undercurrents of the Chinese political world today. —*Shannon Conrad*

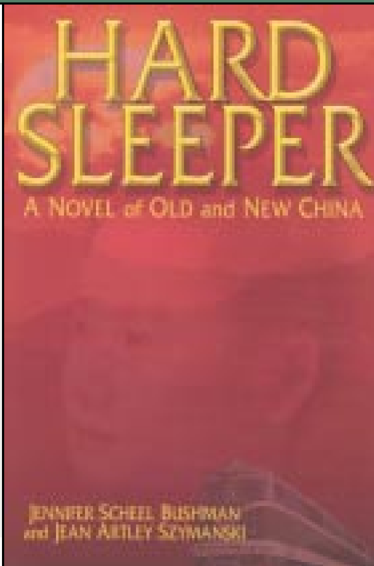
Shannon Conrad is an information specialist focusing on China and Tibet in the East Asian Research Division of the Voice of America.

## China Wireless Landscape (wall chart)

**London: ARCchart (*www.arcchart.com*), 2002. Size: A1 (841mm x 594mm). $99.**

*China Wireless Landscape* is a fairly comprehensive wall chart of wireless activity in mainland China, excluding Hong Kong and Macao. Produced by ARCchart Ltd. and researched and designed in association with Beijing-based MFC Insight, the chart includes data through May 2002 and was published in September 2002. (The chart will be updated in September 2003.) All of the data is also available for purchase in a spreadsheet format. Overall, the chart provides a detailed yet easy-to-read visual snapshot of China's wireless technology market.

The chart's centerpiece is a map of China that lists data for each province: subscribers by global system for mobile communication (GSM), general packet radio service (GPRS), code-division multiple access (CDMA), and personal access services (PAS); primarily mobile service providers; monthly average revenue per



## Hard Sleeper

**by Jennifer Scheel Bushman and Jean Artley Szymanski. Fort Bragg, CA: Lost Coast Press, 2003. 253 pp. $24.95 hardcover.**

*Hard Sleeper*, so named because the story is partially set in a Chinese hard-sleeper train car, is a gripping novel that addresses change, war, family, and mother-daughter bonds. The story unfolds in contemporary times, when an American documentary film producer, Pippa James, attempts to flesh out a documentary lead on a mother-daughter reunion in Chengdu, Sichuan. She is told that the mother, Jane McPherson, is an elderly American who has not seen her half-Chinese daughter, Di Meihua (Mei), for roughly 60 years. Jane, who was born and raised in China until she was 17, and Mei slowly share their life stories with Pippa over the course of a cross-country train ride.

Through a series of flashbacks, readers learn that Jane's parents were missionaries in Beijing in the 1920s and 1930s. After Jane's mother and father are murdered, Jane and her brother move to Shanghai to live with family friends whose lifestyles clash with their missionary upbringing. Because of their parents' unsolved murder—and several other unanswered questions—the novel quickly becomes a suspenseful, page-turning mystery.

The stories of the two women unfold against the backdrop of China in the 1930s, a period marked by the dominance of foreign concessions and other humiliating legacies of the Opium War, warlordism, poverty, internal strife, and the Anti-Japanese War leading up to World War II. *Hard Sleeper* details foreign missionary life as well as the life of swanky, party-hopping Western businesspeople in Shanghai. An American Sinophile who adopts Chinese ways and has many Chinese friends is contrasted with foreigners who live in China years without learning a word of Chinese. Chinese friends, missionaries, servants, communists, businesspeople, and gangsters are also portrayed. Race and class problems pervade the story. At one point, contemporary-era Jane questions whether feelings between foreigners and Chinese have changed over the decades or whether there is still underlying prejudice.

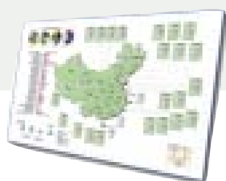
The story's main character, Jane, retains her positive outlook on life despite a series of devastating events, and when she looks back at her early years in China, she finds that "tragedy led to blessing"—a reference to her personal life and to China's history. But even with these positive affirmations, I was exhausted by the myriad of plot twists and personal tragedies.

All in all, *Hard Sleeper* is a fast-paced book that is suitable for a wide range of readers, including those with little knowledge of China (because Pippa is a China novice, ample historical background is provided). The novel will satisfy readers interested in China, history, and mysteries, among other subjects.

The authors—Jean Artley Szymanski, a former foreign service officer in Beijing, and Jennifer Scheel Bushman, who has lived and worked in several countries—wrote as a mother-daughter team. They undoubtedly worked closely over long nights on the book—a project that focused on mother-daughter relations. Adding to the weight of the personal tragedies in the book, Jean Szymanski died of breast cancer in 1998, shortly after the book's completion.

—*Paula M. Miller*

Paula M. Miller is assistant editor, *The CBR*.



user (ARPU); network construction contracts; and mobile penetration rate. A side chart compares the average provincial ARPU and total subscribers for each province.

A small but useful section of the chart is a series of pie graphs detailing equipment vendor network building contracts for each mobile technology: GSM, GPRS, CDMA, and PAS. A corresponding section on mobile handset providers would have been a useful addition. The final part of the chart lists China's telecom service providers and their ownership structures, including overseas listings.

—*Julie Walton*

Julie Walton is Business Advisory Services associate at The US-China Business Council in Washington, DC.

# 中国税收流失问题研究

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# Research on China's Lost Tax Revenue

**by Jia Shaohua. Beijing: Finance and Economics Publishing House of China, 2002. 477pp. ¥32 ($3.87) softcover.**

Recent studies by Chinese researchers have attempted to determine the amount of money lost to China's economy and government budget through smuggling, corruption, capital flight, and value-added tax rebate fraud. In 2002, the country focused unprecedented attention on a crackdown on tax evasion by individuals and companies. The crackdown has coincided with the publication of several studies that try to estimate the amount of money lost to tax evasion, of which Dr. Jia Shaohua's *Research on China's Lost Tax Revenue* has had the highest profile.

Jia, a professor of economics and presently director of the State Administration of Taxation's Yangzhou Tax Reform Institute in Jiangsu, has produced a comprehensive analysis of the losses caused by tax evasion in China. Jia defines tax loss as the revenues that should have been collected under current tax law and regulations from both individuals and companies but went unreported or uncollected. With examples and statistics, Jia estimates the extent of China's missing tax revenue by looking at the official "above-ground economy" data and unofficial underground economy estimates. Analyzing data from 1995 to 2000, Jia estimates losses of ¥371.7 billion ($44.9 billion) for the official economy and losses of ¥72.9 billion ($8.8 billion) for the underground economy in 2000. Among other trends, the chart shows that tax loss from personal income tax has been increasing every year as more earners pass the ¥800 ($96.76) monthly income level, the level at which income tax kicks in. Jia estimates that ¥73.2 billion ($8.8 billion) of personal income tax was lost in 2000, two-and-a-half times the amount thought to have been lost in 1997.

Jia then analyzes the reasons for tax loss by employing game theory and budget maximization models. He suggests that tax evasion in China results from an irrationally designed system, which encourages individuals and enterprises to avoid paying taxes. He says that the lack of supervision, monitoring, and even basic collection mechanisms is preventing tax collection at adequate rates.

The third part of Jia's study offers comparisons with other countries that have addressed similar difficulties in tax collection. He introduces practices used in developed countries, as well as in Hong Kong and Taiwan, to produce a list of 12 recommendations to reduce tax evasion in China. The recommendations include tightening supervision of invoices and payments, developing professional tax auditors, raising penalties, and improving the quality of tax administrators. Jia concludes his book with measures the Chinese government should take to control tax evasion, including strengthening the rule of law and educating the public about the benefits they receive from paying taxes.

With the crackdown on tax evasion by celebrities and the recent institution of a revised Law on Levying and Collecting Taxes and its implementing rules, Chinese officials seem to be taking Jia's advice. *Research on China's Lost Tax Revenue* is a helpful reference for government officials and scholars interested in quantifying the magnitude of China's tax collection problems and seeking means to lessen China's fiscal woes.

*—Brian Goldstein and Sharon Liu*

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Brian Goldstein is former research manager at The US-China Business Council in Beijing. Sharon Liu, a former intern at the Council's Beijing office, now works for KPMG.

# Venture Capital Options Expand—A Bit

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the distribution or payment, an auditing report, proof of and inspection report on the funds injected by the foreign investors, and proof of tax payment and tax examination reporting form issued by an accounting firm. Profits may be used to purchase foreign exchange for repatriation consistent with relevant laws and regulations. A corporate FIVCE's foreign exchange account, capital distribution, and other foreign exchange receipt and expenditure items are subject to existing foreign exchange management regulations. SAFE is currently drafting foreign exchange regulations for nonlegal person FIVCEs.

As with the provisional regulations, the regulation specifies that FIVCEs are to be taxed according to relevant laws and regulations. FIVCE funds thus are at a disadvantage since more tax-efficient structures are possible using offshore or tax haven structures. Ideally, a FIVCE could pass gains and losses to its investors and its affiliates without incurring taxes, deduct losses generated by investments against gains, and deduct financing costs associated with VC investments. Corporate FIVCEs must submit one comprehensive corporate tax payment. A nonlegal person FIVCE may allocate its tax liability to its individual investors as provided in its operational documents—as long as such allocation is consistent with relevant tax laws. SAT is drafting further regulations on the collection of taxes from nonlegal person FIVCEs.

### Termination and liquidation

A FIVCE's term must be stipulated in its organizational documents and normally may not exceed 12 years. MOFCOM must approve any extension of the FIVCE's operating term and must approve a corporate FIVCE's dissolution prior to expiration. A nonlegal person FIVCE may dissolve before its term expires without prior MOFCOM approval if it has disposed of all of its equity investments, satisfied all debts, and provided for capital distribution. In such a case, the nonlegal person FIVCE must submit a notice of dissolution with MOFCOM 30 days before the proposed dissolution date. FIVCEs must apply to SAIC to cancel their registration within 30 days after completing liquidation. This cancellation package must include a report from the FIVCE's management committee, a cancellation application, liquidation report, and other documents as required by applicable laws. The FIVCE will be terminated upon SAIC approval, but the nonlegal person FIVCE's principal investor's obligations extend past the termination of the venture.

### Better, but not good enough

The regulation is an ambitious attempt to nurture China's venture capital and high-tech sectors. But it fails to correct many problems carried over from the provisional regulations. In addition to the problems mentioned above, the regulation does not sufficiently address investors' concerns about the transparency and accuracy of an investee company's books and records—requiring FIVCEs to spend significant time and money on due diligence, thus increasing transaction costs.

Despite this and other flaws, the regulation is a positive step in the development of China's VC market. The qualitative and quantitative requirements placed on FIVCE investors show that the regulation is aimed at attracting investors with market experience, not purely financial speculators. Greater foreign involvement in this sector will continue to drive regulatory development, and VC rules no doubt will continue to evolve. 完

# Toward a Rules-Based FDI Policy Framework

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### Untapped potential

The vast majority of FDI flows among OECD member countries (which account for more than 90 percent of global FDI flows) are now in the form of cross-border M&A. By contrast, cross-border M&A accounts for a negligible proportion of China's FDI inflows, which come mainly in the form of joint-venture partnerships or greenfield investments. Yet M&A offers a tremendous potential for foreign investors to participate in the restructuring of China's state-owned enterprises, many of which are inefficient and could benefit from new management techniques at least as much as from imported, new technology. One reason for the lack of M&A activity is the uncertain legal status of cross-border M&A in China (*see* p.12). A consistent, coherent, and transparent competitive environment would encourage foreign investors to play a fuller role in state-owned enterprise restructuring.

China's capital markets are largely closed to direct foreign involvement. Foreigners have not, in the past, officially been able to purchase A shares, which constitute the majority of shares on the Shanghai and Shenzhen stock markets. FIEs are not permitted to issue bonds in China; only a handful of FIEs are likely to be allowed to issue shares. Allowing foreign investors to participate in China's capital markets on the same basis as domestic investors would help create depth and liquidity in those markets; it would also allow foreign investors greater flexibility in financing their operations in China and engaging in M&A.

Policy options that will enhance the enabling environment for foreign investors will also be good for domestic investors. A rules-based system can create the transparency and predictability that all businesses need if they are to make large-scale, long-term investments. And China's experience over the past two decades demonstrates that opening sectors to FDI is a surer way of strengthening domestic Chinese companies than protectionism. 完