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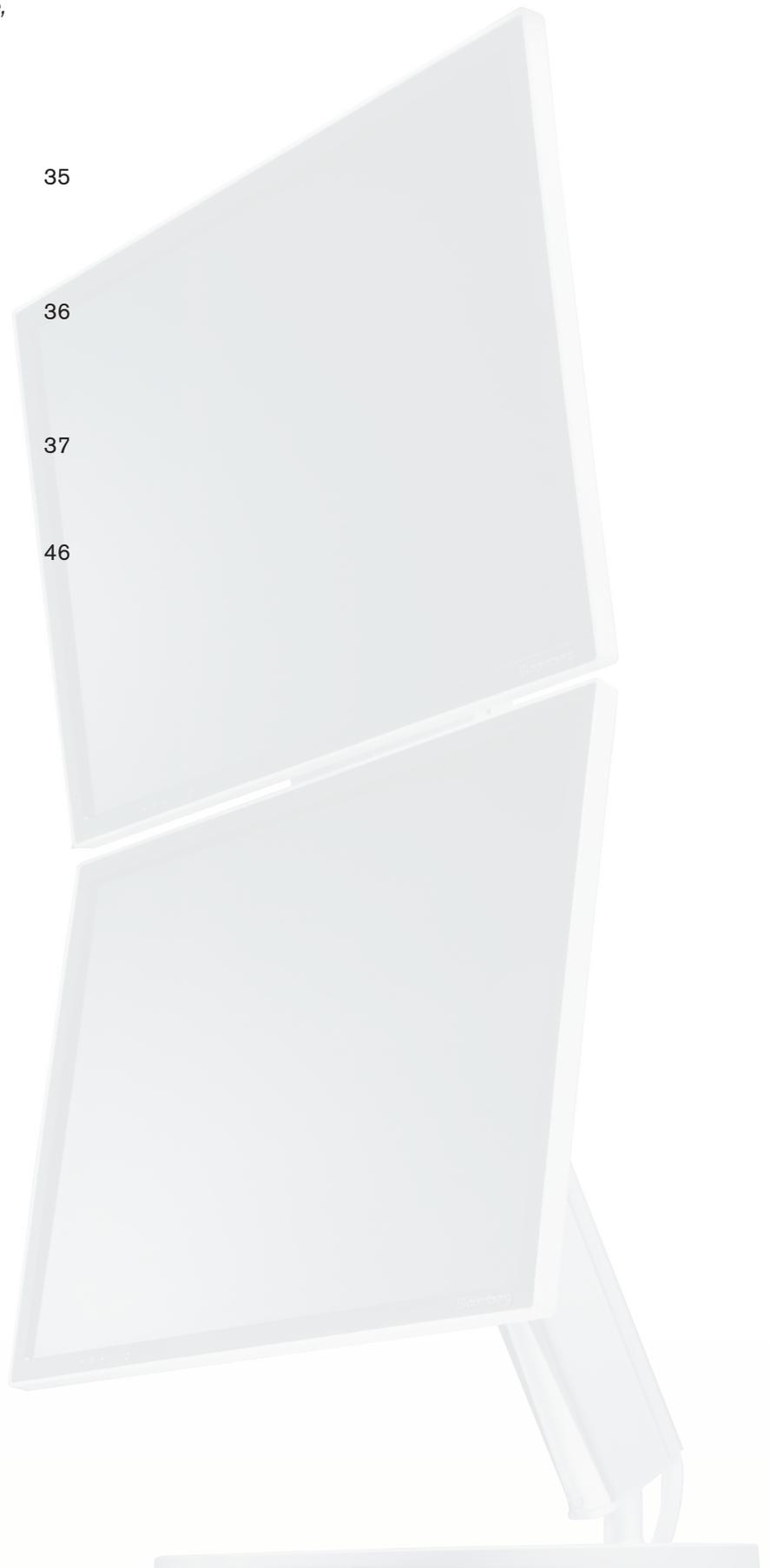
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# Alternative Dispute Resolution

## *The Enforcement of Foreign Arbitration Awards in China*

Article contributed by: Henry (Litong) Chen, MWE China Law Offices and B. Ted Howes, McDermott, Will & Emery

When cross-border business transactions lead to cross-border controversies, arbitration before an international panel of arbitrators—as opposed to litigation in the courts of a particular country—is usually the contracting parties’ dispute-resolution mechanism of choice. Neutrality is a key reason for this. Both the venue for an international arbitration (normally, a third-party country from which neither of the parties in dispute is a citizen) and, more importantly perhaps, the decision makers in the arbitration (normally, a three-member panel of arbitrators where the Chairman is from a third-party country) are considered “neutral” to both sides of the dispute. However, enforceability is at least as important a reason as neutrality. Typically, arbitration awards are far easier to enforce across national boundaries than are the judgments of national courts. This is because more than 140 countries that have ratified the New York Convention on Recognition and Enforcement of International Arbitration Awards (the New York Convention), are treaty-bound to enforce foreign arbitral awards. There is no comparable international treaty for the enforcement of foreign court judgments.

In 1986, the People's Republic of China ratified the New York Convention. Over the more than 20 years that have transpired since China ratified the treaty, Chinese companies have become regular participants in proceedings before the International Chamber of Commerce, the Stockholm Chamber of Commerce, the Hong Kong International Arbitration Centre and similar international arbitral bodies. For many, however, the question remains whether the Chinese courts are faithful to the New York Convention in enforcing foreign arbitral awards, particularly when the awards go against local Chinese companies.

### **Validity of Arbitration in China**

If it can be said that arbitration is generally the preferred method of dispute resolution for international commercial transactions, it can also be said that arbitration is the *vastly* preferred method of dispute resolution for non-Chinese businesses doing business in China. There are good reasons for this, including the relative weakness of the Chinese court system and the difficulty (if not impossibility) of enforcing foreign court judgments in China.

Chinese law certainly recognises the validity of arbitration. However, while most of the requirements for a valid arbitration under Chinese law are similar to those found in the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Arbitration, Chinese arbitration law differs from arbitration laws of most other countries in two critical respects:

- under Chinese law, domestic disputes with no foreign element, including a dispute between a Chinese party and the Chinese subsidiary of a foreign party, must have their seat of arbitration inside mainland China; and
- when the place of arbitration is within mainland China, Chinese law requires that the arbitration be administered by a Chinese arbitration institution rather than an international arbitration institution.

As a result of the limitations that Chinese law imposes on arbitration, Chinese courts have considerably more discretion to “set aside” (or refuse to enforce) arbitral awards rendered inside mainland China. Unlike foreign arbitral awards rendered outside mainland China, which can only be set aside on very limited grounds set forth in the New York Convention, domestic arbitral awards can be set aside by the Chinese courts on the ground that the evidence for ascertaining facts was insufficient or that there was a clear error in the application of the law. Arbitral awards rendered inside mainland China can, in other words, be reversed by the Chinese courts much like a normal court appeal. This, in turn, makes any arbitration inside mainland China ultimately reliant on the views of the Chinese courts if the losing party chooses to challenge the concerned arbitral award.

The fact that the local Chinese courts have less discretion to vacate a foreign arbitral award is a critical point for non-Chinese companies doing business in China. The local courts in China are still mostly financed by the local governments, and certain local Chinese governments have proved all too willing to interfere improperly in the judicial process with a view to obstructing enforcement. Thus, by agreeing that any dispute with a Chinese business will be arbitrated outside mainland China, a non-Chinese business should, in theory, be able to avoid a Chinese court “re-deciding” a case already decided against the Chinese business.

### **China’s Enforcement and “Public Policy”**

As mentioned above, even the New York Convention permits the courts of the signatory states to refuse to enforce foreign arbitral awards in certain limited circumstances. Most significantly, the New York Convention permits the courts of the signatory states to refuse to enforce a foreign arbitral award that violates the “public policy” of the state. In practice,

this “public policy” exception has been interpreted very narrowly by western courts, allowing a foreign arbitral award to be vacated on public policy grounds only when there is clear evidence that the arbitration violated the due process rights of the participants (e.g., evidence that an arbitrator took a bribe from one of the parties).

Legal practitioners outside China tend to believe that the Chinese courts are quite loose in invoking “public policy” as a reason to reject the enforcement of arbitral awards that are rendered outside China. This belief, however, is somewhat of a misconception. On 17 April 2000, the Supreme People’s Court of China (SPC) issued a notice mandating that no foreign arbitral awards could be vacated or refused for enforcement unless approved by the SPC. Therefore, since at least 2000, any decisions by the lower Chinese courts vacating a foreign arbitral award are subject to automatic review by the SPC. In turn, the SPC has been able to monitor efforts by parties and lower courts to prevent the enforcement of foreign arbitral awards since 2000.

This process has apparently had some positive results for the enforcement of arbitration awards against Chinese companies. According to a 2008 speech by Wan E’xiang, a deputy Chief Justice of the SPC, the lower courts of China refused to enforce foreign arbitral awards on public policy grounds seven to eight times between 2000 and 2008.<sup>1</sup> However, the SPC did not uphold *any* of these lower court decisions.<sup>2</sup>

As a result, and according to the deputy Chief Justice, “public policy” has actually not been invoked by the Chinese courts to vacate a single foreign arbitral award, at least, in the 2000–2008 time period. This is because, to quote the deputy Chief Justice, “public policy must be dealt with in a very precautious and prudent way [in respect of the enforcement of a non-Chinese arbitral award].”<sup>3</sup>

Due to the lack of available statistics on judicial decisions in China, the deputy Chief Justice’s remarks cannot be independently verified. That said, there seems little reason to doubt his official representation. Indeed, on 11 August 2008, just a few months after the deputy Chief Justice’s speech, the SPC upheld a decision<sup>4</sup> by an intermediate court in Shandong province that refused to enforce an arbitral award issued by a Paris arbitration tribunal on the ground that the award violated the public policy of China. This case was hailed by the Chinese media as “the *first* case” to “refuse to recognize a foreign arbitral award on the grounds of the public policy.”<sup>5</sup>

### Defining “Public Policy”

All signatories to the New York Convention pledge to honour foreign arbitral awards, by a process in which the enforcing party may present a copy of the foreign arbitral award to the appropriate judicial body in the chosen country for

enforcement. However, as discussed above, the New York Convention allows national courts to overturn a foreign arbitral award if the award violates the “public policy” of that country. Hence, China, like almost all of the other states that have signed on to the New York Convention, can refuse to enforce foreign arbitral awards by invoking public policy.

The problem is that the term “public policy” is not defined under Chinese law. Under some Chinese protocols, the concept of “public policy” has been equated with the social public interests, which is a concept also not defined under Chinese law. For example, according to the Agreement Between Mainland China and Hong Kong SAR Concerning the Mutual Recognition and Enforcement of Arbitration Awards<sup>6</sup>, if a court in the mainland decides that it is against the social public interests of the mainland to enforce an arbitral award that is rendered in Hong Kong, the court of mainland China may refuse to enforce the arbitral award. According to the Deputy Director of the Enforcement Bureau of the SPC, “‘social public interests’ is a concept that falls within the political domain rather than a term of law... For a foreign-related or foreign arbitral award, social public interests are the same as the State’s sovereign interests.”<sup>7</sup>

### Three Case Studies

In order to better understand how Chinese courts understand and apply the concept of “public policy” to foreign arbitration awards, it is instructive to consider three specific case studies.

#### *Case Study 1: Refusal to Enforce a Foreign-Related Award on Public Policy Grounds*

As mentioned above, the SPC has not, at least between 2000 and 2008, refused to enforce a single “foreign” arbitral award on the ground of public policy. A “foreign arbitral” award, however, should not be confused with a “foreign-related” arbitral award. Under Chinese law, a “foreign” arbitral award refers to an arbitral award issued by an arbitration body located *outside* China. A “foreign-related” arbitral award, on the other hand, refers to an award issued by a Chinese arbitration body inside mainland China (e.g., the China International Economic and Trade Arbitration Commission or CIETAC, the Shanghai Arbitration Commission, etc.) with respect to a foreign-related dispute (e.g., where at least one of the parties to the arbitration is not Chinese).<sup>8</sup>

The provisions of the Civil Procedural Law in China do not directly define the terms “foreign arbitral award” and “foreign-related arbitral award.” However, as a matter of practice, arbitral awards rendered by arbitration bodies located inside mainland China which have a foreign element are referred as “foreign-related” arbitral awards; arbitral awards rendered by the arbitration bodies outside of China are referred as “foreign” arbitral awards.<sup>9</sup>

This first case study concerns a “foreign-related” CIETAC arbitration dating from 1977. In this case,<sup>10</sup> a U.S. musical group entered into a contract to perform a concert in China, but the concert was suspended due to what authorities considered to be the objectionable content of the performance.<sup>11</sup> Specifically, the Chinese authorities asserted that the U.S. performers had breached the contract by performing “heavy metal music,” which was not approved by the Ministry of Culture of China and that was otherwise “not suitable” for China.

After not being paid for their concert, the U.S. musical performers commenced an arbitration in mainland China pursuant to the CIETAC arbitration clause in the contract. The CIETAC arbitration tribunal, in turn, awarded damages to the U.S. performers.

The SPC, upon review of the decision issued by the lower court, concluded that the musical performance had in fact violated the social public interest of China, and as such, the Ministry of Culture’s suspension of performance was caused by the breach of contract of the performing party. As a result, the SPC held that the CIETAC arbitral award could not be enforced without causing damage to the social public interests of China. Therefore, pursuant to Paragraph 2 of Article 260 of the Civil Procedure Law of the People’s Republic of China (1991), the SPC refused to enforce the award.<sup>12</sup>

*Case Study 2: Refusal to Vacate a Foreign Arbitral Award on Public Policy Grounds*

In this case, dating from March 1999, a Japanese company commenced an arbitration against a Chinese state-owned enterprise (SOE) under the rules of the Arbitration Institute of the Stockholm Chamber of Commerce.<sup>13</sup> In its arbitration demand, the Japanese company alleged that the SOE had, by contract, assumed the obligation to pay back certain debt owed to the Japanese company by a Hong Kong company, and that the SOE was delinquent in repaying this debt.

After the Stockholm arbitration tribunal ruled in favour of the Japanese company, ordering the SOE to repay the debt, the SOE challenged the arbitration award in China’s Haikou Intermediary Court. Specifically, the SOE argued that the arbitral award violated the “public policy” of China because the repayment of the foreign debt to the Japanese company had not been approved by the State Administration on Foreign Exchange (or SAFE), and that SAFE approval was compulsory.<sup>14</sup> SAFE is an agency of the Chinese government that is in charge, among other things, of approving the flow of foreign currency into and out of China.

The Haikou Intermediary Court, which had original jurisdiction over the enforcement of the proceeding, agreed with the SOE and found against enforcement of the arbitral award. The

Hainan High People’s Court thereafter affirmed the decision of the Intermediary Court, and sent it to the SPC for approval.

The SPC agreed with the lower courts that the SOE had in fact violated the laws and regulations of China regarding the approval and registration of foreign debt and China’s policies on foreign exchange administration. However, the SPC went on to rule that “violation of compulsory provisions in the administrative regulations and departmental regulations *will not naturally constitute* a violation of the public policy of China”<sup>15</sup> (italics added). Therefore, the SPC reversed the lower courts, ruling that the foreign arbitral award was enforceable and could not be vacated on the ground that it violated the public policy of China.<sup>16</sup>

*Case Study 3: Recent SPC Decision Refusing to Enforce Foreign Arbitral Award on Public Policy Grounds<sup>17</sup>*

On 22 December 1995, one Chinese company, Jinan Yongning Pharmaceutical Co., Ltd. (Yongning Company), and three non-Chinese companies signed a contract to set up a joint venture. The joint venture contract provided that any disputes arising under the contract would be submitted to arbitration under the rules of the International Chamber of Commerce (ICC) in Paris. Subsequently, a leasing dispute occurred between the Yongning Company and the joint venture entity. A Chinese court, accepting jurisdiction over the dispute, ruled in favour of the Yongning Company, and ordered that the assets of the joint venture be impounded. As a result of this impounding, the operation of the joint venture was suspended and the joint venture was eventually closed.

In July 2005, the three non-Chinese parties to the underlying joint venture contract, invoking the arbitration clause in the contract, commenced an ICC arbitration in Paris against the Yongning Company. After hearing both sides, the ICC arbitration tribunal ruled that the Yongning Company had breached the joint venture contract by petitioning a Chinese court to impound the assets of the joint venture. As a result, the ICC tribunal ordered the Yongning Company to pay US\$6,458,708.40 as damages.

Because the Yongning Company did not pay the money mandated by the ICC arbitration award, the three non-Chinese companies lodged a lawsuit in Jinan Intermediate People’s Court on 10 September 2007, seeking the court’s recognition and enforcement of the foreign arbitral award. The Court, however, held that the arbitration clause in the joint venture contract only bound the disputes between the contracting parties, and therefore did not bind the leasing disputes between the Yongning Company and the joint venture. As a result, the Chinese court ruled that the ICC arbitration award, by purporting to resolve a dispute that was subject to the jurisdiction of the Chinese courts, violated

China's judicial sovereignty and, with it, Chinese public policy. Accordingly, the Jinan Intermediate People's Court held that the arbitral award should not be enforced, which decision was affirmed by the SPC.

### Conclusion: An Evolving Judiciary

The above three case studies provide at least some parameters about what constitutes "public policy" under Chinese law with respect to the enforcement of foreign arbitral awards. As can be seen from Case Study 2, it appears that administrative regulations, such as the SAFE regulations, do not constitute public policy. In fact, even a violation of a compulsory provision in an administrative regulation does not lead to violation of public policy.

To the contrary, a violation of public policy seems to require proof of an affront to the higher "social public interest" of China as a whole, whether it relates to the moral order of the country (Case Study 1) or the sovereignty of the Chinese courts (Case Study 3). This difficult level of proof may explain why the SPC has apparently vacated only one foreign arbitral award on public policy grounds since (at least) 2000.

It is likely that China's judicial policy toward foreign arbitral awards will continue to evolve in a positive way. This evolution is inseparable from China's business, cultural and economic environment; privatization and rapid economic growth will surely, over time, create the changes that require a more sophisticated and "internationalist" judiciary. China already has travelled far in transforming itself from a closed society to one that is governed by transparency and rule of law. The likelihood is that enforcement of foreign arbitral awards will follow a similar path of integration into the global legal and business system.

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*The views expressed in this article are those of the author and are not to be attributed to Bloomberg Finance L.P.*

<sup>1</sup> Speech by Wan E'xiang, Deputy Chief Justice of the Supreme People's Court of China, on 6 June 2008 at the 50th Anniversary Symposium of the New York Convention (available at <http://www.rucil.com.cn/article/default.asp?id=798>).

<sup>2</sup> According to the deputy Chief Justice (available at <http://www.rucil.com.cn/article/default.asp?id=798>), from the beginning of 2000 to the end of 2007, a total of 12 foreign arbitral awards were not recognized and enforced by the SPC. Of these twelve awards: four were refused because the statute of limitations for application for enforcement had expired; five were refused because the concerned parties had not reached an arbitral agreement or the arbitration clause had been invalid; one was refused because the concerned party against which the arbitral award was enforced did not have any enforceable assets within China; and the remaining award was refused because the concerned party against which the arbitral award was enforced had not received the notice for appointment of arbitrators and arbitration procedure. The deputy Chief Justice did not mention how many foreign arbitral awards were vacated before 2000, or whether public policy was invoked by the Chinese courts to vacate any pre-2000 foreign arbitral awards.

<sup>3</sup> See Endnote 1.

<sup>4</sup> The SPC did not officially publish its decision on the case. The contents of the decision were provided in news reports — see Endnote 5.

<sup>5</sup> See <http://www.chinanews.com.cn/cj/cyzh/news/2008/07-16/1314096.shtml> (last visited 9 March 2009).

<sup>6</sup> See [http://www.law-lib.com/law/law\\_view.asp?id=13](http://www.law-lib.com/law/law_view.asp?id=13) (last visited 29 October 2009).

<sup>7</sup> Available at: <http://cn.cietac.org/TheoryResearch/readbookcontent.asp?cgid=124> (last visited 24 October 2009).

<sup>8</sup> The Civil Procedural Law of the People's Republic of China (2007), Article 267 and Chapter 27.

<sup>9</sup> The Civil Procedural Law of the People's Republic of China (2007), Article 258.2.

<sup>10</sup> See <http://cn.cietac.org/TheoryResearch/readbookcontent.asp?cgid=124> (last visited 24 October 2009).

<sup>11</sup> Reply Letter of the Supreme People's Court Regarding the Request of Beijing First Intermediary People's Court for Refusal to Enforce the Arbitral Award [1997] Ta No.35.

<sup>12</sup> The reader should note that this case was decided in 1977, before China adopted its reform and open door policy. The performance of heavy metal music would almost certainly not rise to the level of public policy in China today.

<sup>13</sup> See <http://www.cninfo.net/news/200710/17022900.htm> (last visited on 24 October 2009).

<sup>14</sup> Available at <http://www.cninfo.net/news/200710/17022900.htm> (last visited on 24 October 2009).

<sup>15</sup> See Endnote 15.

<sup>16</sup> Reply Letter of the Supreme People's Court Regarding the Request of Haikou Intermediary Court for Refusal to Admit and Enforce the Arbitral Award of the Arbitration Inst. of Stockholm Chamber of Commerce (13 July 2005) [2001] Min Si Ta Zi No.12.

<sup>17</sup> The SPC has not officially published this case yet. The facts of this case are taken from the media.

## Antitrust & Trade

### *China's Anti-Monopoly Law: One Year On*

*Article contributed by: James Modrall, Matthew Bachrack and Cunzhen Huang, Cleary Gottlieb Steen & Hamilton LLP*

China's Anti-Monopoly Law (AML) entered into force in August 2008. Since then, the Chinese Anti-Monopoly Commission (AMC) and the anti-monopoly enforcement authorities (AMEAs) have made considerable progress in fleshing out China's antitrust regime, including the issue of a number of regulations, rules, and guidelines. Unusually, jurisdiction for enforcing China's antitrust law is divided among three agencies, responsible respectively (among other things) for merger control, price-related conduct (including both restrictive agreements and abuses of dominant positions) and non-price-related conduct.

Presumably because the AML provides for mandatory notification of mergers meeting specific thresholds and sets out a binding timetable for their review and approval, much of the activity in the AML's first year has focused on merger control. The AMEAs responsible for enforcing the law regarding restrictive agreements and abuses of dominant positions have so far been less active, at least in public, but the first non-merger decisions are expected by year-end. Interestingly, private plaintiffs have filed a number of antitrust suits in Chinese courts, raising the prospect that antitrust litigation will make an early contribution to the development of Chinese antitrust law.

## Merger Control

Under the AML, the Ministry of Commerce (MOFCOM) is responsible for merger control. MOFCOM must review notifiable transactions meeting the relevant thresholds and may review transactions falling below the thresholds. The factors taken into account in such a review include not only competition-related considerations (such as market shares, degree of market concentration, and barriers to entry and expansion), but also factors such as a transaction's effect on "the development of the national economy"<sup>11</sup> and "other relevant undertakings,"<sup>12</sup> not only consumers.

MOFCOM has published rules and guidelines that clarify its merger review procedures, although several remain in draft form. MOFCOM has also published its decisions in five high-profile cases.<sup>3</sup> There are, however, still important uncertainties both regarding MOFCOM's procedures and regarding its substantive analysis.

### *Procedural Framework*

The final rules and guidelines issued in the merger control area include the following:

- Regulation on Notification Thresholds for Concentrations of Undertakings,<sup>4</sup> which provide that a merger must be notified when the prior year's turnover of all the undertakings concerned was more than RMB 10 billion worldwide or more than RMB 2 billion in China, and, in either case, the Chinese turnover of at least two of the undertakings concerned was at least RMB 400 million.
- Rules on the Calculation of Turnover for the Prior Notification of Concentrations of Undertakings in the Financial Industry.<sup>5</sup>
- Guidelines on Notification of Concentrations between Undertakings,<sup>6</sup> Notification Documents and Materials for Concentrations between Undertakings,<sup>7</sup> and Merger Control Review of Concentrations between Undertakings,<sup>8</sup> which set out requirements for what notifications should contain and outline MOFCOM's basic review procedures.

- Guidelines on the Definition of Relevant Markets,<sup>9</sup> which detail the steps to be taken when defining relevant product and geographic markets. While initially drafted by MOFCOM, the final guidelines were issued by the AMC and deal with market definition not only for merger control purposes, but also for the purpose of analyzing restrictive agreements and abuses of dominant positions.

On 22 June 2009, MOFCOM published revised Rules on Acquisitions of Domestic Enterprises by Foreign Investors (the M&A Rules),<sup>10</sup> replacing the merger control provisions in the prior version with a reference to merger control rules under the AML and the Regulation on Notification Thresholds for Concentrations of Undertakings.<sup>11</sup>

In January and February 2009, MOFCOM published several draft rules for comment, and the Legislative Affairs Office under the State Council released revised drafts in March 2009.<sup>12</sup> The draft rules cover the investigation of transactions that are either not legally notified or below the notification thresholds but suspected of being anti-competitive; the circumstances under which a transaction is notifiable and the procedures for filing a notification; the tools available to MOFCOM when it conducts an investigation, such as contacting competitors, customers, and industry associations and holding hearings; and the parties' rights of defence. These rules have not yet been finalised, and the published drafts may undergo fairly significant changes before they are released in final form.

### *Merger Review Decisions*

Through the end of June 2009, MOFCOM received 58 merger notifications and completed its review of 46 transactions, of which 43 were unconditionally approved, two were approved with conditions (InBev/Anheuser-Busch and Mitsubishi Rayon/Lucite), and one was blocked (Coca-Cola/Huiyuan). Since June, MOFCOM has conditionally cleared two additional transactions (General Motors/Delphi and Pfizer/Wyeth). While these decisions provide some insight into MOFCOM's application of its merger review powers under the AML, as explained below, they also give cause for concern.

On 18 November 2008, MOFCOM approved InBev's acquisition of Anheuser-Busch (AB), subject to conditions. In particular, MOFCOM imposed limitations on InBev/AB acquiring additional shares in certain named Chinese competitors. This was highly unusual from a U.S. or EU antitrust perspective, particularly given MOFCOM's failure to identify any competitive harm caused by the transaction.

On 18 March 2009, MOFCOM blocked Coca-Cola's planned acquisition of Huiyuan, in the first prohibition decision adopted under the AML. The prohibition was based on concerns that Coca-Cola would be able to leverage its dominant position

in the carbonated soft-drink market to the fruit-juice drink market, eliminating and restricting competition from current juice manufacturers and in turn harming juice consumers. The decision's reference to leveraging suggests that MOFCOM applied a conglomerate effects theory of the kind abandoned many years ago in the United States and applied in the EU only rarely, cautiously, and in situations where the evidence has been compelling.

On 24 April 2009, MOFCOM approved, with conditions, Mitsubishi Rayon's acquisition of Lucite. The conditions imposed included restrictions against Mitsubishi adding Chinese methyl methacrylate capacity. This condition was inconsistent with generally accepted antitrust principles, since increasing output is usually considered positive from an antitrust perspective.

On 28 September 2009, MOFCOM approved, with conditions, General Motors' (GM) acquisition of certain assets of auto parts supplier Delphi Corp. MOFCOM expressed concern about possible vertical effects, including on the stability, price, and quality of Delphi's supply of auto parts to GM's competitors. MOFCOM also sought to ensure that GM's competitors could switch to other suppliers if necessary, that Delphi would maintain the confidentiality of information of Delphi's other automobile manufacturer customers, and that other domestic auto parts suppliers could still compete to supply GM. In response to these concerns, MOFCOM imposed four behavioural remedies. Specifically, (i) Delphi must continue to supply Chinese automobile manufacturers on non-discriminatory terms; (ii) GM shall not illegally seek from Delphi any competitively sensitive, confidential information of domestic automobile manufacturers, and Delphi will not disclose such information to GM; (iii) Delphi shall cooperate with clients that seek to switch suppliers; and (iv) GM shall continue to employ a multi-source supply strategy on non-discriminatory terms for all auto parts purchases.

On 29 September 2009, MOFCOM conditionally cleared the merger of pharmaceutical companies Pfizer and Wyeth. MOFCOM's investigation revealed that the parties would have had a combined share of 49.4 percent in a market for swine mycoplasma pneumonia vaccines, a market that MOFCOM found to have high barriers to entry. MOFCOM concluded that the combined entity would be able to expand its market share, profitably raise prices, and restrict entry. As a result, MOFCOM required the divestiture of Pfizer's Chinese swine mycoplasma pneumonia vaccine business.

#### *Issues*

MOFCOM has been the most active of the AMEAs in applying the AML, publishing decisions and developing the regulatory framework for merger review in China, but many of

the proposed rules and regulations are still in draft form, and there are still a number of significant ambiguities and issues.

Two significant jurisdictional issues relate to the definition of "control" which is important since acquisition of "control" can lead to a notifiable transaction and the treatment of joint ventures. The second draft of MOFCOM's rules on notification procedures clarified that the acquisition of "protective" minority rights (such as the right to veto modifications of articles of association, increases and decreases of capital, and liquidation) will not result in the acquisition of "control," but the distinction between "control," "joint control," and "decisive influence" remains unclear. With regard to joint ventures, the draft rules indicate that a joint venture will be notifiable only if it is established on a lasting basis and is independently operated. The treatment of joint ventures under the AML has been receiving attention lately in connection with the proposed BHP Billiton/Rio Tinto transaction, which would establish a joint venture for the production of iron ore in Australia. MOFCOM personnel have argued that the transaction is reportable, while the parties may argue that it is a production joint venture only and is not full function.

There are also a number of practical issues relating to notification procedures under the AML. Merger notifications under the AML require a significant amount of information, as well as vaguely but broadly defined categories of documents, many of which may not be relevant to the antitrust analysis of concentrations. MOFCOM's rules do not provide for simplified notifications in cases that raise no substantive issues. Practical questions have also arisen regarding timing, such as whether questions posed by MOFCOM can suspend the review period and whether MOFCOM's Phase I review period can be extended with the notifying parties' agreement.

Some of MOFCOM's published decisions have been surprising from a Western antitrust perspective. MOFCOM was criticised especially for its prohibition of Coca-Cola/Huiyuan. MOFCOM stressed that the decision was based solely on competition law, but the decision's references to effects on domestic small and medium-sized manufacturers and the sustainable and healthy development of the Chinese fruit-juice drink industry suggest that industrial policy considerations played a significant role. If so, MOFCOM's approach seems consistent with the AML requirement that it take account of the "development of the national economy";<sup>13</sup> "other undertakings" (besides consumers)<sup>14</sup> and "other considerations that may affect market competition as identified by the AML enforcement authority."<sup>15</sup>

MOFCOM's approach to remedies also diverges from U.S. and EU antitrust practice. MOFCOM appears to be more willing to consider behavioural remedies than U.S. and EU authorities might be, and some of the remedies imposed are

counterintuitive from a Western perspective. Examples of remedies that would not be imposed by U.S. or EU authorities include prohibitions against acquiring specific competitors or increasing capacity, which is normally considered a good thing from an antitrust perspective. MOFCOM's decisions so far suggest that MOFCOM is ready to use the merger control process to address the possibility of future, non-merger-specific harm. Future decisions will indicate whether MOFCOM's approach to merger control will converge with international standards.

Finally, in transactions involving acquisitions of Chinese companies, the relationship between the AML and the M&A Rules is unclear. When a transaction involving a foreign acquirer and a domestic target may impact national security, MOFCOM's merger control review is conducted in parallel with a "national security review" under Article 31 of the AML. Under the M&A Rules, however, MOFCOM may also carry out a separate "national economic security review". Guidance is needed regarding the relation between the "national security review" and the "national economic security review", including the triggering factors and substantive standards for such reviews.

### **Anti-Competitive Agreements and Abuses of Dominant Positions**

The State Administration for Industry and Commerce (SAIC) and the National Development and Reform Commission (NDRC) share jurisdiction over anti-competitive agreements and abuses of dominant positions. SAIC is responsible for non-price related violations of AML, while NDRC has responsibility for price-related violations.

In June 2009, SAIC adopted final rules on Investigating and Handling of Cases of Restrictive Agreements and Abuse of Market Dominance. These rules, which apply to both anti-competitive agreements and abuses of dominant positions, detail SAIC's procedures, including the jurisdiction of provincial authorities, launching investigations of allegedly anti-competitive conduct, and the tools available to SAIC for conducting its investigations. Abuse of administrative power to eliminate or restrict competition is governed by separate procedural rules adopted by SAIC in June 2009.

#### *Anti-Competitive Agreements*

On 27 April 2009, SAIC published draft Rules on Prohibition of Restrictive Agreements. The draft rules provide guidance with respect to (i) the definition of "restrictive agreements"; (ii) types of restrictive agreements that are prohibited under the AML; (iii) the role of industry associations; and (iv) SAIC's proposed leniency program.

On 12 August 2009, NDRC published draft Rules on Anti-Pricing Monopoly, which apply to price-related

anti-competitive agreements and provide detail as to the types of behaviour that will constitute an anti-competitive agreement. The draft rules prohibit competitors from fixing prices or discounts, using a standard formula to calculate prices, agreeing not to modify prices, restricting output, dividing up markets, and similar conduct.

A disappointment from the first year of AML enforcement is the lack of substantive guidance from NDRC regarding price-related anti-competitive agreements, in particular cartels. Cartels are generally viewed as the most serious violations that antitrust laws are intended to prevent. It is striking that NDRC has not yet proposed the adoption of a leniency regime comparable to that proposed by SAIC.

#### *Abuses of Dominant Positions*

On 27 April 2009, SAIC published the draft Rules on Prohibition of Abuse of Dominant Market Positions, which define a dominant market position and provide further detail regarding SAIC's acts that might be considered an abuse of a dominant position.

The draft dominance rules provide little guidance in an area that has been controversial in the U.S. and the EU in recent years: the interface between the abuse of dominance rules and intellectual property rights. We understand, however, that guidelines are being developed on enforcement of the AML in the field of intellectual property rights.

NDRC's draft anti-pricing monopoly rules provide further detail regarding the definition of a dominant position, the types of conduct that may constitute an abuse, and the circumstances in which a dominant firm may be able to justify its otherwise abusive behaviour. Consistent with the AML, predatory pricing, refusals to deal, "unfairly high" or "unfairly low" pricing, and price discrimination are prohibited.

While the regulators have reportedly received a large number of complaints under the AML, neither SAIC nor NDRC has adopted any decisions, or even publicly launched formal investigations, under the AML. The AML does not seem to oblige SAIC or NDRC to publish its decisions (whether on abuses of dominant positions or restrictive agreements), contrary to MOFCOM's obligation to publish conditional merger control clearances and prohibitions.

A number of private suits alleging defendants' abuses of dominant positions have been filed in Chinese courts. On 23 October 2009, the Shanghai No. 1 Intermediate People's Court rejected an abuse-of-dominance case filed by Sursen Electronic Technology Co., Ltd. against Shanda Interactive Entertainment Ltd. and Shanghai Xuanting Entertainment Co., Ltd. The court's decision appears to be the first decision in an abuse-of-dominance case under the AML and is notable

for the court's willingness to analyze market shares and to treat the assertion and protection of intellectual property rights as a permissible justification for challenged action. Another abuse-of-dominance case was reportedly settled on the same day. This case involved China Mobile, which was charged with imposing unreasonable trade conditions and price discrimination in a case before the Beijing No. 2 Intermediate People's Court. Two other notable cases are *Tangshan Renren Information Services v. Baidu Network Technology Co.* and *Mr. Li Fangping v. Beijing Branch of China Netcom*. Both cases will be closely watched, not least in view of the prominence of the defendants, one a champion of China's developing technology sector and the other a State-owned enterprise. In addition, the Supreme People's Court is working on an interpretation regarding civil cases under the AML.

### *Issues*

While SAIC's and NDRC's published draft and final rules provide welcome guidance, a number of ambiguities remain.

#### 1. *Shared Jurisdiction and Consistency*

The unusual division of authority between SAIC and NDRC creates the potential for overlapping jurisdiction in many cases. Rules on how to handle cases that involve both price-related conduct and non-price related conduct would be welcome on questions such as which agency will take the lead in what types of cases, how SAIC and NDRC will cooperate with one another, and how the decision-making process will work in practice. In addition, care will be required to ensure that the two agencies' rules and regulations are consistent.

In their current form, NDRC's draft rules create the potential for confusion by asserting jurisdiction over restrictive agreements that affect pricing only indirectly. In addition, similar concepts receive differing treatment in the draft NDRC and SAIC rules. For example, NDRC's draft rules define "anti-competitive agreement" and "concerted action" differently from SAIC's draft rules. These differences could result in confusion and complicate companies' compliance efforts.

#### 2. *Per Se v. Rule-of-Reason*

Both SAIC's and NDRC's rules fail clearly to distinguish between cases that are prohibited *per se* and those that should be assessed under a rule-of-reason. Experiences in the U.S. and EU show that *per se* prohibitions should be limited to hard-core violations like price fixing. For the remaining cases, rule-of-reason is a preferable

approach, in particular for cases regarding abuses of dominant positions. Implementing measures should emphasize the need for the AMEAs to show likely anti-competitive effects, to apply economic analyses on a case-by-case basis and address the analysis of common justifications that may be offered by defendant companies. In particular, it would be helpful for SAIC's and NDRC's rules to stress the need to prove consumer harm before prohibiting allegedly restrictive agreements, particularly in the case of vertical agreements, which are normally pro-competitive.

Similar issues arise in SAIC's and NDRC's proposed rules on abuses of dominant positions, which arguably take an excessively formalistic approach in areas such as the "essential facilities doctrine" and the treatment of intellectual property rights.

#### 3. *Concerted Action*

The factors set out in SAIC's and NDRC's draft rules to determine what practices will be considered "concerted" are quite vague. For example, Article 5 of NDRC's draft rules<sup>16</sup> indicate that "concerted action" can be evidenced by "consistent" pricing conduct and communications between businesses. It is unclear if both elements must be satisfied to find concerted action. It is also unclear what exactly constitutes "consistent" behaviour. In addition, the draft states that NDRC will consider whether the alleged consistent behaviour has a legitimate justification. Under the draft, however, it appears that consistent behaviour may raise a presumption of illegality that must be rebutted by the parties.

Inferring coordination based on consistent pricing may chill a company's ability to respond rationally and unilaterally to pricing competition from its rivals. Moreover, it is unclear whether all of the price-related agreements referenced above are prohibited regardless of their impact on consumers. By contrast, there is well-developed precedent in the United States and Europe regarding the analysis of available evidence (known in the United States as "plus factors") to determine whether concerted action rises to the level of an illegal agreement, and the government carries a fairly high burden of proof.

#### 4. *Leniency*

SAIC's draft rules<sup>17</sup> outline the first leniency program to be proposed by an AMEA. However,

the rules do not make clear whether they apply only to hard-core agreements such as cartels, the specifics of the requirements for obtaining leniency and whether the agencies have discretion to deny leniency to applicants that meet the requirements. Unfortunately, although NDRC is responsible for traditional price-fixing cartel behaviour, NDRC's draft rules do not mention the adoption of a leniency regime comparable to that proposed by SAIC.

## Conclusion

The AMEAs have made considerable progress during the AML's first year of application in developing the regulatory framework for their respective activities, publishing numerous final and draft rules, regulations and guidelines. In the coming months, we anticipate that the AMEAs will release final versions of several of these rules and publish a number of additional drafts, including notably SAIC's substantive rules on restrictive agreements and abuse of dominant positions, and guidelines on the enforcement of the AML in the area of intellectual property rights. These rules should help clarify existing ambiguities and fill a number of holes, including a leniency regime for price-fixing.

The AMEAs' progress in developing guidance on the substantive application of the AML is so far less impressive. MOFCOM has published five merger decisions, but these have raised as many questions as they have answered. SAIC and NDRC have so far not published any decisions nor even (as far as they have indicated) launched any formal investigations under the AML, even though numerous complaints have reportedly been filed. In fairness, however, regulators in other jurisdictions have developed their bodies of precedents over many years.

Moreover, a number of private antitrust cases are working their way through the Chinese courts. These cases will be closely watched not only for their intrinsic interest, but also as a sign of whether private litigation may play a larger role in the early development of Chinese antitrust law (outside the merger area) than enforcement activities by the AMEAs.

Many U.S. and European observers have expressed concern that the AML will be used to further industrial policy goals or nationalist sentiments unrelated to antitrust law. At this stage, it is too early to tell if such fears are justified. On the one hand, the AML and the published rules and guidelines are largely consistent with international antitrust norms. On the other hand, the AML and the draft and final rules and guidelines are, perhaps purposefully, quite vague and leave significant discretion to the AMEAs.

The AMEAs have accomplished a great deal in a year's time. The coming year should help to remove some of the existing uncertainty regarding procedural framework and provide further guidance on the AMEAs' enforcement of the AML.

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*The views expressed in this article are those of the authors and are not to be attributed to Bloomberg Finance L.P.*

<sup>1</sup> See Article 27(5) of the AML.

<sup>2</sup> See Article 27(4) of the AML.

<sup>3</sup> Chinese versions of these decisions can be found on MOFCOM's website: <http://fldj.mofcom.gov.cn/ztx/ztx.html?1440535718=3639222316>.

<sup>4</sup> See [http://www.gov.cn/zwqk/2008-08/04/content\\_1063769.htm](http://www.gov.cn/zwqk/2008-08/04/content_1063769.htm).

<sup>5</sup> See <http://www.mofcom.gov.cn/aarticle/b/c/200907/20090706411759.html?1166884518=3639222316>.

<sup>6</sup> See <http://fldj.mofcom.gov.cn/aarticle/xgxz/200901/20090105993824.html>.

<sup>7</sup> See <http://fldj.mofcom.gov.cn/aarticle/xgxz/200901/20090105993841.html>.

<sup>8</sup> See <http://fldj.mofcom.gov.cn/aarticle/xgxz/200902/20090206034057.html?1919216549=3639222316>.

<sup>9</sup> See [http://www.gov.cn/zwhd/2009-07/07/content\\_1355288.htm](http://www.gov.cn/zwhd/2009-07/07/content_1355288.htm).

<sup>10</sup> See <http://www.mofcom.gov.cn/aarticle/b/c/200907/20090706416939.html?3851173542=3639222316>.

<sup>11</sup> See [http://www.gov.cn/zwqk/2008-08/04/content\\_1063769.htm](http://www.gov.cn/zwqk/2008-08/04/content_1063769.htm).

<sup>12</sup> See <http://bmyj.chinalaw.gov.cn/lisms/action/guestLoginAction.do>.

<sup>13</sup> See Article 27(5) of the AML.

<sup>14</sup> See Article 27(4) of the AML.

<sup>15</sup> See Article 27(6) of the AML.

<sup>16</sup> See [http://www.ndrc.gov.cn/fjbak/t20090812\\_296055.htm](http://www.ndrc.gov.cn/fjbak/t20090812_296055.htm).

<sup>17</sup> See <http://www.saic.gov.cn/zwqk/zyfb/qt/fld/200904/p020090429576482039697.doc>.

# Energy

## Renewable Energy

### ***China Discusses Revision of Its Renewable Energy Law***

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In August 2009, China's National People's Congress (NPC) discussed reform proposals relating to the Renewable Energy Law which mainly aim at removing the transmission bottleneck between renewable energy producers and power grids. This article examines the latest developments in the renewable energy sector in China, outlines the proposed amendments to the Renewable Energy Law<sup>1</sup>, and explores how these amendments and developments may affect the industry.

#### **Background**

Due to the country's extensive coal reserves, China's renewable energy sector still continues to struggle in competing with cheap, coal-fired power generation. Over the last decade, China's policy makers have made considerable efforts and, in particular, since the commencement of the reform of the power industry in 2002, published various policy plans, laws and regulations to expand the nation's renewable energy sector.

Such efforts are not only driven by serious air pollution problems and international pressure on China to reduce its greenhouse gas emissions, but also by the desire to reduce the reliance on imported oil. Despite being the world's fifth largest oil producing country, China is currently forced to import approximately half of its oil demand. As a result, 'green power' is viewed as an issue of long term energy security.

One of the most influential vehicles for the promotion of clean energy technologies has proved to be the Renewable Energy Law which came into effect in 2006. In an effort to address some of the challenges China's renewable energy industry is currently facing, a draft amendment bill to the Renewable Energy Law has now been submitted to the NPC for its first reading and discussed during the NPC's most recent session in August. At the same time, the draft bill was made public<sup>2</sup> and underwent a public consultation process which ended on 30 September 2009.

#### **The 2006 Renewable Energy Law**

China's existing Renewable Energy Law takes the form of an umbrella document providing only the overarching framework

of renewable energy policies. These policies have subsequently been implemented by way of a large number of ministerial-level regulations and provincial implementing rules.

The key high-level policies set out in the Renewable Energy Law are the following:

- *Renewable Energy Targets:* The law reiterates the importance of established and future medium and long-term targets set by government authorities for the development and utilisation of renewable energies.
- *Compulsory Grid Connection:* Grid companies are generally obliged to purchase the full amount of electricity generated from renewable energy projects that are located in the areas covered by their grids and must provide grid-connection services and related technical support.
- *Power Pricing Arrangements:* The price that generators receive for the renewable energy generated (feed-in tariffs) is to be determined by the price authorities of the State Council or by public tender.
- *Cost Sharing Arrangements:* A cost sharing system aims to balance price differences between renewable energy and conventional power among the consumers.
- *Subsidies:* The law requires that special funds are provided and financial incentives offered to stimulate renewable energy development.

The existing Renewable Energy Law has done much to encourage the growth of renewable energy in China. However, despite massive progress the effective contribution of renewable energy to the nation's power supply is constrained by a number of factors.

One of the key issues which particularly impedes the wind power generation—the country's second most common source of grid-connected renewable energy after hydropower—is the deficient development of China's power grid, which is failing to keep pace with the construction of wind farms. Last year, more than 20 percent<sup>3</sup> of the country's wind power turbines did not generate any electricity because the equipment was not yet connected to the grid. Secondly, where many wind farms are concentrated in one area, and more than 15 percent<sup>4</sup> of the power may therefore come from intermittent sources, the ability of grid companies to utilise wind power is constrained by their technical ability to keep the system stable. Further, the lack of a fully developed power grid causes difficulties in connecting China's wind farms, which are mostly located in Inner Mongolia, Gansu and Xinjiang, with the particularly energy-consuming cities and towns thousands of kilometres

away on the east coast. Finally, in practice, grid companies are sometimes unwilling to utilise renewable energy power if cheaper alternatives are available—despite their obligation under the Renewable Energy Law to purchase *all* renewable energy produced within their domain.

### **The Draft Revision of the Renewable Energy Law**

In response to these constraints, the proposed amendments to the Renewable Energy Law are mainly aimed at promoting the development of power grids. Apart from a completely new general obligation imposed on the grid companies to strengthen the planning and construction of power grids to increase the ability to utilise renewable energy and a corresponding obligation of the renewable energy producers to co-operate with power grid companies, the proposals contain concrete measures which are intended to remove the transmission bottleneck between renewable energy producers and power grids.

#### *Creation of a Minimum Acquisition Quota*

Foremost among the proposed changes is the creation of a minimum acquisition quota in respect of energy from renewable energy producers which power grid companies must fulfil. However, the draft bill remains ambiguous insofar as the proposed amendments still seem to maintain the obligation to purchase the *full* amount of renewable electricity generated without clarifying how the minimum acquisition quota would interact with this—an ambiguity and inconsistency frequently commented upon during the NPC debates<sup>5</sup>.

The creation of a minimum acquisition quota would contrast with the existing general obligation to purchase the full amount of electricity generated from renewable energy projects and would clearly assist the grid companies by providing flexibility as to the purchasing of renewable energy power—an energy source which is generally much less stable than conventional power. In addition, a minimum acquisition quota would take into account the often deficient connection of renewable energy producers with power grids. Unsurprisingly, it was commented<sup>6</sup> during the NPC debates that maintaining an obligation on power grid companies to purchase the full amount of renewable electricity generated would protect renewable energy producers but not address the challenges that power grid companies face.

#### *Establishment of a New Renewable Energy Fund*

The draft bill also proposes the establishment of a new renewable energy development fund. Under the existing Renewable Energy Law, a development fund had been established and financed by the state, under which grants and loans are extended to renewable energy producers. The intention of the proposed amendments is not only to generate

additional income for the funding of the development fund but also to widen the scope of the activities financed.

The draft bill therefore proposes that, in addition to the funds annually allocated by the state, a new renewable energy surcharge should be levied on the electricity sold throughout the country to help finance the development fund. Unfortunately, the draft does not clarify whether the proposed energy surcharge will be imposed in addition to the renewable energy surcharge already payable by end users today (currently RMB 0.001 per kWh).

As is the case under the existing Renewable Energy Law, the activities to be financed out of the development fund include scientific and technological research activities, pilot projects for exploiting renewable energy, construction of renewable energy projects for domestic use in remote areas, independent power systems in remote areas and islands and the facilitation of domestic production and development of renewable energy equipment. The proposal also goes beyond the existing law, however, in that the fund would also be used to directly subsidise power grid companies in the construction of power grids for renewable energy projects or the purchase of renewable energy to the extent such costs are not recovered from end users—a clear statement to promote the development of the deficient power grids.

#### *Strengthening the Drafting and Implementation of Development Plans*

A last issue addressed in the draft bill relates to the preparation and implementation of the national renewable energy development plans that are published by the central government and, as reiterated in the existing Renewable Energy Law, set out the guiding principles, objectives, targets and priorities for the development of the renewable energy sector. In the past, concerns were raised that the current development plan does not fully correspond with the country's overall energy development strategy. In addition, past development plans were seen as unrealistic and not to take into account technical limitations and local conditions.

In response to this, the draft bill proposes to encourage greater participation from relevant departments of the State Council who shall work together with the State Council's energy department in the preparation of any renewable energy development and utilization plan. In addition, the draft bill sets out more detailed guidelines than the existing Renewable Energy Law regarding the content and principles of new plans and requires that, in the future, plans take into account, amongst other things, the national energy development strategy and local circumstances.

Finally, the draft bill also addresses plans which are prepared by provincial and local governments in order to implement the

national development plan and establishes a new requirement that such implementation plans be filed with the energy department of the State Council and the national electricity regulatory authority. The intention seems to be to increase accountability to these implementation plans and thereby to strengthen the implementation of the national development plans throughout the country.

### **Impact on the Renewable Energy Industry**

The general consensus during the NPC debates on the draft Renewable Energy Law has been one of approval—there is a feeling that the legislature is taking the right steps to address the problems currently faced by the renewable energy industry. In particular, the injection of fresh funds through the new renewable energy development fund and the attempt to harmonise renewable energy producers and energy grid companies are seen as steps in the right direction.

Nevertheless, the question arises as to how the promotion of the power grids as intended under the draft bill will affect other industry participants, in particular renewable energy generators and equipment manufacturers.

In this context, it seems noteworthy that only a few weeks prior to the NPC debates, a benchmark system was introduced for feed-in tariffs for wind power. A circular issued by the National Development and Reform Commission<sup>7</sup> (NDRC) on 20 July 2009, divides China into four different areas, based on their wind resources, and stipulates different benchmark feed-in tariffs prices for each. According to a recent statement<sup>8</sup>, the NDRC is planning to establish a similar framework for large-scale solar photovoltaic projects in the near future. Since the lack of a clear pricing policy has been seen as one of the deterrents to investment in the renewable energy sector, the introduction of a benchmark system is generally seen as a measure to further attract investment by providing increased certainty in future revenues for wind farm developers.

At the same time, in what some industry observers have already called a new revolution, China's central government is currently preparing plans for a substantial increase in its use of wind and solar power over the next decade, aimed at raising the proportion of renewable energy to 15 percent of total energy consumption by 2020. Over the last couple of months, chief policy makers have been repeatedly cited as saying<sup>9</sup> that the NDRC is in the process of drafting a plan for the development of the renewable energy sector, and is now contemplating revised targets of over three times the levels of earlier targets. By way of example, the existing 'Medium and Long-Term Development Plan for Renewable Energy' released by the NDRC in August 2007<sup>10</sup> sets targets for 2020 amounting to 30 GW installed capacity

for wind power and 1.8 GW for solar power. Officials have stated<sup>11</sup> that the goal for 2020 in the new plan expected to be released towards the end of this year could amount to as much as 100 GW for wind energy and 20 GW for solar energy.

Against this background, the proposed amendments to the Renewable Energy Law may be seen as a signal that China's government has recognised one of the key problems China's renewable energy industry is currently facing—the poor state of the country's power grids. Given the importance of power grid connectivity and the current transmission bottleneck, it is therefore likely that the proposed amendments to the Renewable Energy Law will appeal to many industry participants—not only power grid companies but also renewable energy producers and manufacturers of renewable energy equipment.

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<sup>1</sup> For a full text in English and Chinese refer to [http://www.martinot.info/China\\_RE\\_Law\\_Beijing\\_Review.pdf](http://www.martinot.info/China_RE_Law_Beijing_Review.pdf).

<sup>2</sup> The consultation paper was posted on the website of the National People's Congress [http://www.npc.gov.cn/npc/xinwen/lfgz/flca/2009-08/28/content\\_1516272.htm](http://www.npc.gov.cn/npc/xinwen/lfgz/flca/2009-08/28/content_1516272.htm). The full name of the paper is 可再生能源法修正案草案条文及草案说明.

<sup>3</sup> This figure is reported in several articles: <http://www.cwpc.cn/cwpc/en/node/5987>, [http://www.chinadaily.com.cn/bizchina/2009-08/25/content\\_8611790.htm](http://www.chinadaily.com.cn/bizchina/2009-08/25/content_8611790.htm).

<sup>4</sup> This figure is reported in a recent article: <http://www.dundee.ac.uk/cepmlp/gateway/index.php?mode=print&news=30075>.

<sup>5</sup> The key points of the debates (in Chinese) can be accessed through the NPC's website at <http://www.npc.gov.cn/npc/xinwen/lfgz/lfdt/lfdt.htm>. For summaries of the debates refer to [http://www.npc.gov.cn/npc/xinwen/lfgz/lfdt/2009-09/15/content\\_1519152.htm](http://www.npc.gov.cn/npc/xinwen/lfgz/lfdt/2009-09/15/content_1519152.htm), [http://www.npc.gov.cn/npc/xinwen/lfgz/lfdt/2009-09/15/content\\_1519158.htm](http://www.npc.gov.cn/npc/xinwen/lfgz/lfdt/2009-09/15/content_1519158.htm).

<sup>6</sup> See for example the comment from 吕薇委员 at [http://www.npc.gov.cn/npc/xinwen/lfgz/lfdt/2009-09/15/content\\_1519158.htm](http://www.npc.gov.cn/npc/xinwen/lfgz/lfdt/2009-09/15/content_1519158.htm).

<sup>7</sup> The circular is called 《关于完善风力发电上网电价政策的通知》 and is available at [http://www.sdpc.gov.cn/zcfb/zcfbtz/2009zt/20090727\\_292827.htm](http://www.sdpc.gov.cn/zcfb/zcfbtz/2009zt/20090727_292827.htm).

<sup>8</sup> [http://www.ndrc.gov.cn/xwfb/t20090803\\_294551.htm](http://www.ndrc.gov.cn/xwfb/t20090803_294551.htm).

<sup>9</sup> <http://english.caijing.com.cn/2009-05-05/110160326.html>; see also footnote 11.

<sup>10</sup> For an English text refer to <http://www.chinaenvironmentallaw.com/wp-content/uploads/2008/04/medium-and-long-term-development-plan-for-renewable-energy.pdf>.

<sup>11</sup> See <http://english.people.com.cn/90001/90778/90857/90860/6650353.html> and <http://www.rncos.com/Blog/2009/05/China-Wind-Power-Capacity-to-Reach-100-GW-by-2020.html> in relation to the wind power target, and <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aqqpWE1XUFI8> in relation to the solar power target.

## Climate Change

### ***Emissions Trading on Hold in the Asia Pacific, For Now...***

*Article contributed by: Richard Nelson and Lewis McDonald, Herbert Smith LLP, Singapore*

#### **Introduction**

The Asia Pacific's role in international carbon markets has traditionally been as the "location of choice" for international carbon offset projects. Indeed, some 80 percent of all clean development mechanism (CDM) projects are located in Asia, mostly funded by European companies motivated by lower-cost compliance with the European emissions trading scheme.

Prior to the onset of the financial crisis, Australia, New Zealand and Japan announced plans to introduce their own "cap and trade" emissions trading schemes (ETS) and all three countries have now developed the details of these regimes<sup>1</sup>. Although Japan's voluntary ETS has been implemented as planned, the New Zealand ETS is currently under review and the proposed Australian ETS was recently watered down by the Australian Government and then voted down by the Australian Parliament<sup>2</sup>. This represents a shaky start for the notion of emissions trading in Asia.

These developments come at a time of great uncertainty for international carbon markets. The financial crisis has caused the price of carbon to plummet and many are questioning whether the emissions trading approach provides sufficient long-term certainty to encourage the large-scale investments required to combat climate change. There are also doubts over whether the region's economies can afford the additional costs associated with adding the costs of carbon at a time when many are struggling to recover from the economic downturn.

By far the biggest source of uncertainty is the future direction of the international agreement on climate change. The Kyoto Protocol<sup>3</sup> is coming to an end in 2012 and is widely considered to be inadequate to provide the necessary emission cuts to avert dangerous climate change. A two year timeline for the emergence of a successor to the Kyoto Protocol was agreed in Bali at the end of 2007 but little progress has been made

since then. With the December 2009 deadline looming, it is still unclear what the international climate change regime will look like beyond 2012. Although the EU has committed itself to bold cuts by 2020 and the US is racing to get its own ETS up and running prior to Copenhagen, it is still unclear what role other major economies such as China and India will be prepared to play in any future global arrangement and they continue to reveal little about their negotiating position for Copenhagen. Until it is clear that all major emitters will be on board, the efficacy of any domestic ETS is questionable and so most countries have, understandably, adopted a "wait and see" approach.

But there may be benefits in being ahead of the game. Implementation of a domestic ETS increases the credibility of that country at the international negotiating table by demonstrating a serious commitment to emissions reductions and a willingness to play its part. In addition, the experience gained in designing a bespoke ETS and operating an economy within an emissions cap (even where that cap is imposed voluntarily) will be invaluable in determining what that country can accept under any future international agreement. This is clearly the motivation that stands behind the US's push to pass its Waxman-Marley bill ahead of Copenhagen.

The Australian, New Zealand and Japanese schemes contain novel features designed to accommodate local factors and to achieve a balance between environmental protection and economic hardship. Although the Australian and New Zealand schemes have not been implemented in their current form, and the Japanese scheme is voluntary, they provide a strong indication of the positions the governments of these countries are likely to accept in the upcoming international negotiations and so, in this sense, are worthy of review.

This article sets out the background to the development of each of these regimes, along with an overview of their key features. A comparison table is included at the end of this article for ease of reference.

#### **Australia**

A promise to take tough action on climate change was one of the key platforms of the Australian Labour Party's federal election victory in November 2007. True to his mandate, Kevin Rudd wasted no time in introducing measures to deal with climate change<sup>4</sup>. Shortly after taking office, he announced a long-term target of a 60 percent reduction in emissions from 2000 levels by 2050 and promised to introduce an ETS containing targets consistent with this commitment. On 15 December 2008, this promise was partially fulfilled by the launch of a White Paper<sup>5</sup> setting out the details of the "Carbon Pollution Reduction Scheme" (CPRS), which included the

details for an Australian ETS, together with a new renewable energy target and financial incentives for carbon capture and storage and energy efficiency.

A draft of the legislation<sup>6</sup> to implement the CPRS was released in March 2009 amidst strong criticism from industry who sought additional concessions, and from green groups who complained that the cuts did not go far enough. Under this pressure, a revised version of the CPRS was presented to parliament in May 2009<sup>7</sup>, which contained additional concessions and protections against carbon leakage, transitional arrangements, a delayed start date and also a bolder emissions reduction target in the event that a new international agreement was reached.

The revised CPRS proposed by the Australian Government would have committed Australia to a 5 percent to 15 percent reduction in greenhouse gas emissions from 2000 levels by 2020, even if no new international agreement was reached. If an international agreement could be reached which was capable of stabilising atmospheric CO<sub>2</sub> concentrations at 450ppm, the 2020 target would be increased to a 25 percent reduction target. The scheme covered all 6 greenhouse gases covered by the Kyoto Protocol and was to apply to most sectors of the Australian economy.

The scheme was to work in a way very similar to the European ETS, in that companies were obliged to surrender permits each year (in this case a Carbon Pollution Permit or CPP) to cover its actual emissions. If a company did not have sufficient CPPs, it could acquire these from other participants or use international project credits (CERs or ERUs). There was to be no limit on the use of international project credits and, at least until the end of 2012, the so called “hot air” carbon credits under the Kyoto Protocol (AAUs) were not to be accepted. A price cap of AUD\$40 (rising annually by 5 percent) applied to permits during the first 5 years of the scheme. Permits could be banked to future scheme years, and up to 5 percent of permits from future scheme years could be borrowed for use in a current year. As a transitional arrangement, an unlimited number of permits could be purchased for AUD\$10 during the first year of operation although these could not be banked for future years.

Although most permits were to be allocated by way of auction, around 25 percent were to be freely allocated to emissions intensive trade-exposed industry (EITE), where carbon leakage is a concern, and around 10 percent were to be freely allocated to the agricultural sector. The free allocation to EITE companies was to be either 94.5 percent or 66 percent of their requirements based on industry average estimates of emission intensity depending on a company's deemed level of historical emissions per million dollars of revenue. Coal-fired electricity generators who had a historical emissions

intensity above a certain level were also to receive a one-off free allocation of CCPs to the value of AUD\$3.9 billion. These measures are similar to those employed for Phase III of the EU ETS, where some trade-affected industries will receive a free allocation equivalent to 100 percent of emissions produced from the best available technology in the relevant industry.

All proceeds from the auction of CCPs (expected to be AUD23.5 billion over the first 2 years of implementation) were to be used to provide support to households and businesses to help them adjust to the scheme. The White Paper set out a wide range of benefits for low and middle income households and a cent for cent fuel subsidy to cover any increases in the price of fuel.

These concessions, along with the increased targets and flexibility mechanisms, did not prove sufficient to win the support of all stakeholders and an alliance between the Liberal/National Party opposition and the Green Party voted down the revised CPRS in the Senate. Commentators expect that another version of the Bill, with additional concessions for industry, will be introduced to Parliament before the end of the year in order to have an Australian ETS in place before the Copenhagen negotiations.

### **New Zealand**

New Zealand makes a very small contribution to global greenhouse gas emissions, contributing less than 0.2 percent of the total in 2007<sup>8</sup>. But with the passing into law of its new ETS on 11 September 2008, it now looks set to punch well above its weight in international climate change circles and to have a much stronger voice at the negotiating table.

The New Zealand ETS<sup>9</sup> is designed to assist New Zealand to meet its international climate change obligations while maintaining economic flexibility, equity and environmental integrity, at least in the long term. The targets under the New Zealand ETS reflect New Zealand's current targets under the Kyoto Protocol. If a new international agreement can be reached which is capable of stabilising atmospheric CO<sub>2</sub> at 450ppm, a target range of between 10 percent and 20 percent below 1990 levels by 2002 will be set. The scheme covers all 6 greenhouse gases covered by the Kyoto Protocol and, once fully implemented, will cover all major sectors of the New Zealand economy.

The local permit is called a “New Zealand Unit” or “NZU”. Participating companies must surrender one NZU for each tonne of CO<sub>2</sub> equivalent emitted. It does not include any price caps and allows an unlimited number of international project credits (including AAUs) to be used in exchange for NZUs. Surplus NZUs can be banked for use in future compliance periods and only very limited borrowing from future scheme years is permissible. The inclusion of all economic sectors, all

gases and the linkage to international carbon markets without limit are all intended to maximise the flexibility and economic efficiency of the New Zealand scheme.

The caps applicable to individual companies will be determined by sector-based allocation plans. Auctions will be used to allocate most NZUs to participants and there will also be some free allocation to eligible trade-exposed industrial producers, certain forest owners, fishing vessel operators and the agricultural sector. Around 90 percent of NZUs will be freely allocated in the industrial and agricultural sectors until 2018 and this free allocation will be gradually phased out by 2030. Between 2011 and 2013, 50 percent of the NZUs required for fuel emissions in the fishing sector will also be freely allocated. These measures are designed to counter the potential for carbon leakage.

The New Zealand government has been criticised for permitting AAUs to be used in the scheme (as the surplus AAUs of many nations have been produced by the difficulties in their economies rather than real emissions reduction). However, their use simply reflects an extension of the notion that New Zealand should follow the rules set at the international level rather than making up rules of its own. New Zealand will place some restrictions of the use of these AAUs by allowing only “greened” AAUs to be used<sup>10</sup>. These “greening” rules are to be set out in future regulations which are due for release in late 2009<sup>11</sup>. An example of a “greened” AAU would be where a country with surplus AAUs has agreed to invest any money raised from their sale in emissions reduction or other environmental projects or where that country has strong emissions reduction policies.

The NZ ETS is designed to apply to the smallest number of participants possible in order to reduce the administrative costs of the scheme whilst maximising its coverage. In the industrial sector this has led to the obligations being pushed upstream—to the miners, importers and large purchasers of coal and gas and to those operating large-scale industrial activities such as refineries, steel mills and aluminium production facilities. The intention is that these large players will pass the costs of compliance down to their customers and ultimately to consumers.

Even though the New Zealand ETS contains measures to deal with carbon leakage and is designed to be as economically efficient as possible, this may not be enough to save the ETS from being abolished or substantially re-written. The new coalition Government, which took office in November 2008, has set up the Emissions Trading Scheme Review Committee to review the New Zealand ETS. The terms of reference of this committee are extremely broad and represent an opening up of the entire debate on climate change (including a review of the science behind climate change) and New Zealand's overall

climate strategy. The review is expected to be completed by the end of 2009.

## Japan

After a short period of industry consultation, on 21 October 2008, the Japanese Government released an experimental ETS via the Global Warming Prevention Headquarters, part of the Prime Minister's Office<sup>12</sup>.

Japan has some experience of emissions trading through an existing ETS called Japan's Voluntary Emissions Trading Scheme (J-Vets) which has been in place since 2005—but this is very small scale involving only 120 companies. The new Japanese ETS is intended to operate on a much broader scale—covering all major Japanese industrial companies spanning 35 sectors and accounting for 45 percent of Japan's emissions. It is designed to allow Japan to test the impact of an ETS on its economy, in particular its manufacturing and technology sectors.

The new experimental ETS is closely linked to a Voluntary Action Plan (VAP) first established in 1996 with the Nippon Keidanren, Japan's powerful industry lobby group. Under the VAP, each industrial sector covered by the Keidanren agreed to an emissions reduction target to apply to all companies within that sector and each company is obliged to monitor and report on its emissions. The Japanese ETS contemplates that individual companies will volunteer a target to apply to them which is consistent with the target set by its industrial sector under the VAP or Japan's overall Kyoto Protocol target and is more stringent than the target set for that company in the previous year. Participants who are not members of the voluntary action scheme will have a target determined by the government, taking into account the target-setting methodologies used under the existing J-Vets scheme. The target set by a company may either be an emission intensity target (whereby absolute emissions may stay the same or increase provided more output is produced to generate these emissions), an emission reduction target or a combination of the two and is to be set for each year up to FY2012. Verification of the target is determined by policy councils in the same manner as compliance with the VAP. Unlike the EU ETS and the New Zealand and Australian schemes, the Japanese ETS is only intended to apply to CO<sub>2</sub> emissions.

A company can meet its target by reducing emissions or emission intensity, by trading quotas with other experimental ETS participants or J-Vets participants, by purchasing international project credits or by participating in a “domestic CDM scheme”. The domestic CDM scheme is a novel idea and contemplates large Japanese companies investing in or providing abatement technology to small or medium-sized Japanese enterprises in exchange for credits to apply against

its quota. Forestry and biomass projects in Japan may also generate domestic CDM credits which are to be certified under rules set down in Japan's Kyoto Protocol Target Achievement Plan. There are no plans to link the experimental ETS with other international emissions trading schemes at this stage and there are no limits on the purchase of international credits. Emission accounts will be held with the Japanese government and traders can also open accounts and transact emissions allowances.

The experimental ETS does not contemplate any incentives or penalties to encourage companies to join or to comply. It is an entirely voluntary system, relying on the natural desire of companies within an industry to compete on a level playing field and the "moral" pressure applied by complying companies on their peers.

Following its release in October 2008, over 500 companies have signed up to participate in the experimental ETS (including traders and participants in the domestic CDM scheme). Targets for FY2008/2009 were submitted by participants at the end of 2008 where participants were required to report their actual emissions during FY2008/2009 by 31 August 2009. A period of trading then follows and by the middle of December 2009, allowances and credits must have been retired and participants must confirm they have achieved their emission targets. Following this first year of operation, there will be an evaluation of the experimental ETS to review the operation and costs of the scheme and to determine whether it is leading to the development of new technology and emissions reductions in a way that is appropriate for Japan's technology and manufacturing focussed industry.

The fact that the experimental ETS is to be on a voluntary basis and linked closely to the Keidanren's VAP should not come as too much of a surprise to those following climate change policy in Japan—the Keidanren has previously expressed serious reservations about emissions trading<sup>13</sup>, which it views as being prejudicial to the global competitiveness of Japanese industry. In addition, in its international negotiations, Japan has long favoured a "bottom up" sector-based approach with industry-specific targets to emissions reductions rather than a nation by nation approach. A broad-based emissions trading system which complements the existing plans of Japanese industry could therefore give Japan the opportunity to demonstrate this "sector-based" climate change solution to the world. Although the Japanese ETS is voluntary at this stage, if it proves to be successful as a means of encouraging technology development and emissions reduction at an acceptable cost to Japanese industry, it can be expected that it will develop into a mandatory system in the future, with broader application to Japanese companies and other greenhouse gases.

As the scheme is voluntary and no penalties are involved, concerns about carbon leakage do not apply to the Japanese ETS to the same extent as other mandatory schemes. Despite this, Japanese companies have so far shown some reluctance to sign-up to the scheme and have resisted the notion that targets be set on an individual, rather than sector basis. The number of applications received so far has fallen well short of the 1000 plus applications that were expected to be received<sup>14</sup>. Given the current state of the domestic economy in Japan, this is perhaps not a surprise.

In September 2009 the newly elected Japanese Government set a CO<sub>2</sub> reduction target of 25 percent below 1990 levels, far more ambitious than the previous government's 8 percent. Although Japan's commitment is dependant on all other major nations joining in a fair and effective framework for regulating emissions, the new government's statement suggests that Japan will increase its efforts in the pursuit of emissions reduction and potentially take on a more prominent role in Copenhagen.

## Conclusion

Although the timing may not have seemed ideal, the decisions by the governments of Australia, New Zealand and Japan to design an ETS prior to the Copenhagen negotiations are based on pragmatism. Each of these countries recognises the negative impacts of climate change within their territories and acknowledges the inevitability that an effective and equitable global agreement will eventually emerge to tackle the issue. The early design of an ETS that reflects local economic and geographical characteristics and addresses local industry and community needs gives each of these countries an important advantage in terms of entering the international negotiation process with a clear understanding of their own capacity for ETS and therefore a greater chance of achieving a satisfactory outcome in those negotiations. The debate in each of these countries has also allowed the respective governments to craft a bespoke, politically acceptable ETS which includes some common, widely recognised objectives. In that sense, the progress and the lessons learned in these three countries will be invaluable for other countries in Asia Pacific who look (or after Copenhagen, will look) to develop their own market-based, carbon reduction solution.

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*The views expressed herein are the authors' own and do not represent those of Bloomberg Finance L.P.*

Comparison of key elements of the Australian, New Zealand and Japanese Emissions Trading Schemes

	<b>Australian ETS (Proposed revised CPRS)</b>	<b>New Zealand ETS</b>	<b>Japanese ETS (voluntary)</b>
<b>Commencement</b>	White Paper released December 2008. Was due to commence 1 July 2011 but was rejected by the Senate.	Commenced 1 January 2008 (forestry sector only). All major sectors of the NZ economy were to be phased in from 2008 to 2013. Scheme is currently under review.	Approved 21 October 2008. Commenced in Spring 2009.
<b>Emission caps</b>	Mandatory caps will be determined by the Government across rolling 5 year periods. First set of caps (2011 – 2015) will be announced before 1 July 2010.	Mandatory caps are determined by Government following public consultation via allocation plans and determinations.	Voluntary emission targets set by each participant by reference to emissions levels or emissions intensity (or a combination of the two). Should reflect VAP targets.
<b>Permit</b>	Carbon Pollution Permit (CPP) - personal property fully tradable via national register.	New Zealand Units (NZU) — fully tradable via national register.	“Emissions allowances”. Freely tradable between participants in the scheme.
<b>Compliance</b>	Actual emissions to be matched by surrendering CPPs, purchasing international project credits (CERs or ERUs) or domestic forestry credits.	Actual emissions to be matched by surrendering NZUs, CERs, ERUs or “greened AAUs”.	Meet target (level or intensity), buy emission quotas from other participants in ETS or JVETS, Kyoto credits or “domestic CDM scheme”.
<b>Allocation of permits</b>	Auction-based with some free allocation to EITE businesses and coal-fired power generators.	Auction-based with free allocation to EITEs, forest owners with pre-1990 exotic forest land, fishing vessel operators and the agriculture sector.	Companies “self allocate” by setting their own targets (equivalent to free allocation).
<b>Banking</b>	Permitted (except in first year) — CPPs have a vintage (an earliest date they can be used) but can be banked indefinitely.	Unlimited banking of NZUs. “Greened AAUs” cannot be banked for use beyond 2012.	Permitted — no limits
<b>Borrowing</b>	Up to 5 percent of the following years’ allowance can be borrowed for current year.	Very limited.	Permitted — no limits
<b>Target</b>	5 percent to 15 percent below 2000 levels by 2020 (25 percent if a comprehensive international agreement comes into force). 60 percent below 2000 levels by 2050.	Between 2008 and 2012, the target is the Kyoto target allocated to NZ. If an international agreement comes into force capable of stabilising atmospheric CO <sub>2</sub> at 450ppm, NZ will adopt a target of 10 – 20 percent below 1990 levels.	If a comprehensive international agreement comes into force Japan will adopt a target of 25% below 1990 CO <sub>2</sub> emission levels. Longer term target of 60-80 percent below 1990 levels by 2050.
<b>Gases</b>	All six GHGs covered by the Kyoto Protocol	All six GHGs covered by Kyoto Protocol	Only CO <sub>2</sub> .

	<b>Australian ETS (Proposed revised CPRS)</b>	<b>New Zealand ETS</b>	<b>Japanese ETS (voluntary)</b>
<b>Sectors</b>	Stationary energy, transport, fugitive, industrial processes, waste and forestry. Possibly agriculture from 2015 onwards. Deforestation has not been included.	Forestry, liquid fossil fuels (transport), stationary energy, industrial processes, synthetic gases, agriculture and waste. Forestry sector can “generate” emission units.	The sectors in which industrial companies within the Nippon Keidanren participate (this covers 35 sectors within Japanese industry including power, steel and manufacturing).
<b>Emissions covered</b>	Approximately 75 percent	Almost 100 percent by 2013	Approximately 45 percent
<b>Penalties for non-compliance</b>	An administrative penalty will be payable plus an obligation to surrender one CCP for each permit shortfall. The quantum of the administrative penalty is to be prescribed in future regulations.	Surrender one NZU or Kyoto credit and pay NZ\$30 for each unit of emissions without a matching NZU or international credit surrendered. Penalties for false reporting and monitoring	No specific penalties have been proposed, although participant firms will need to publicly report compliance against targets.
<b>Linkage with Kyoto mechanisms</b>	Unlimited access to CERs and ERUs. AAUs will not be accepted until at least 2013. Non-Kyoto units will not be accepted. CPPs cannot be exported.	Unlimited access to CERs, ERUs, “greened AAUs” and RMUs except for CERs and RMUs related to nuclear projects. Provision for non-Kyoto “approved overseas units” to be approved. Participants can sell NZUs internationally as AAUs under Kyoto rules.	Unlimited access to CERs and ERUs. No mention of AAUs.
<b>Number of participants</b>	~1000	Smallest possible number of participants.	523 (as at March 2009)
<b>Price controls</b>	Price cap of \$40 / tonne during rising 5 percent annually during first 5 years. Unlimited emission units at \$10 per tonne during 2011-12.	None.	Restrictions on selling initially allocated allowances. Government is considering price control measures
<b>Reporting and monitoring</b>	Self assessment using National Greenhouse and Energy Reporting System methodologies supported by audit regime.	Self assessment. Participants file annual emissions returns which can be audited. Fines for providing misleading information.	Very few details released at this stage.

<sup>1</sup> See World Bank report ‘State and Trends of the Carbon Market 2009’, pages 23 –27: [http://wbcarbonfinance.org/docs/State\\_\\_\\_Trends\\_of\\_the\\_Carbon\\_Market\\_2009-FINAL\\_26\\_May09.pdf](http://wbcarbonfinance.org/docs/State___Trends_of_the_Carbon_Market_2009-FINAL_26_May09.pdf)

<sup>2</sup> <http://www.climatechange.gov.au/government/initiatives/cprs/cprs-progress/legislation.aspx>

<sup>3</sup> <http://unfccc.int/resource/docs/convkp/kpeng.html>

<sup>4</sup> <http://www.climatechange.gov.au/government/initiatives/kyoto.aspx>

<sup>5</sup> <http://www.climatechange.gov.au/publications/cprs/white-paper/cprs-whitepaper.aspx>

<sup>6</sup> <http://www.climatechange.gov.au/publications/cprs/cprs-exposure-draft-legislation-overview.aspx>

<sup>7</sup> <http://www.climatechange.gov.au/government/initiatives/cprs/cprs-progress/legislation.aspx>

<sup>8</sup> Figures derived from data on UNFCCC website. See [http://unfccc.int/ghg\\_data/ghg\\_data\\_unfccc/ghg\\_profiles/items/3954.php](http://unfccc.int/ghg_data/ghg_data_unfccc/ghg_profiles/items/3954.php)

<sup>9</sup> <http://www.climatechange.govt.nz/emissions-trading-scheme/basics.html>

<sup>10</sup> <http://www.mfe.govt.nz/publications/climate/emissions-factsheets/factsheet-27.html>

<sup>11</sup> <http://www.beehive.govt.nz/release/regulations+being+developed+international+carbon+credits>

<sup>12</sup> <http://www.env.go.jp/en/earth/ets/idmets081021.pdf>

<sup>13</sup> <http://www.keidanren.or.jp/english/policy/2007/080.html>

<sup>14</sup> <http://www.carbon-financeonline.com/index.cfm?section=asiapacific&action=view&id=11758>

# Coalbed Methane Natural Gas

## ***What Lies Below: Recent Developments in Coalbed Methane in China, Indonesia and India***

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With growing interest from the major oil and gas players and increased focus on security of energy supply, the development of the coal bed methane industry (CBM) has drawn greater attention from coal rich Asian governments. As the home of one of the largest combined pools of CBM resources in the world, China, Indonesia and India in particular, have in recent years introduced new CBM specific regulations and policies to help boost their growing CBM markets. This article will look at recent developments in the CBM sectors in each of these countries.

### **Developments in China**

China boasts 37 trillion cubic meters of CBM reserves, the third largest in the world after Russia and Canada.<sup>1</sup> Under China's 11th "5-Year Programme", output of CBM is planned to be 10 billion cubic meters by 2010, 30 billion cubic meters by 2015, and more than 50 billion cubic meters by 2020.<sup>2</sup> So China's CBM industry is set to expand rapidly in the coming years and CBM production is one of China's 16 major projects under this Programme. The Chinese government's backing for the CBM industry has been launched as part of its wider initiative to encourage the use of natural gas, of which CBM is a subset, in order to tackle concerns over the security of its supply. With an increase in production and other ancillary incentives enacted, it is hoped that local industries in China will eventually take up CBM as a fuel.

Recent developments in China are encouraging:

- A production sharing contract (PSC) structure is being used for foreign investment in upstream CBM.<sup>3</sup> The PSC structure is similar to the structure widely used in the upstream oil and gas industry. Initially, foreign investors could only enter into PSC partnerships with monopoly holder China United Coalbed Methane Corp. Ltd (CUCBM)—a 50-50 joint venture between PetroChina and China National Coal Group Corp.—formed in 1996. However, the Chinese government amended regulations and introduced the *Notice of the Ministry of Commerce, National Development and Reform Commission and the Ministry of Land and Resources on Issues Concerning Further*

*Expanding the Cooperation with Foreign Parties in Mining Coalbed Methane* (Notice), issued on October 17, 2007. The Notice allows other entities to apply for rights to partner foreigners in CBM PSC partnerships. Hence the following July 2008, PetroChina sold its half stake in CUCBM and applied under the new regulations.<sup>4</sup> The ability of other Chinese entities to partner with foreigners should provide them with more choices for local partners in the future.

- The Chinese government has introduced a plethora of preferential policies since 2007 to support the growth of its CBM industry and to incentivize foreign investment. For example, power plants developed from CBM enjoy priority rights and preferential pricing;<sup>5</sup> and power projects that fall within the scope of the Catalogue of Comprehensive Utilisation of Resources (2003 revised), and those projects that co-generate heat and electricity from CBM and Coal Mine Methane (CMM) may be granted grid connections if their individual project units meet the threshold minimum capacity level of 500 kilowatt and relevant standards. CBM projects also benefit from other policy support such as land use priority, financial subsidies, tax concessions, and waivers on import duties for CBM equipment.<sup>6</sup> This has meant greater foreign interest in both upstream CBM participation and the establishment of power plants with the cooperation of local coal mining companies.
- International agreements on climate change such as the Kyoto Protocol<sup>7</sup> have created financial incentives for power plants in developing countries to move away from coal and to use clean fuels like CBM instead. Subject to certain conditions, Chinese CBM power plants are eligible for carbon credits under the Clean Development Mechanism (CDM), a Kyoto market-based mechanism, which allows developed countries to offset their carbon emissions by buying carbon credits generated from renewable energy projects in developing countries. The availability of CDM credits has made many otherwise marginal Chinese CBM power plants profitable.
- Clean CBM is also eligible for other benefits. In May 2009, the World Bank approved a loan of US\$ 80 million to the Shanxi Coal Methane Development and Utilization Project to help increase China's development of CBM and reduce greenhouse gases and other air pollutants associated with coal combustion.<sup>8</sup>

- Perhaps the biggest bottleneck for China's CBM industry has been the lack of a natural gas pipeline infrastructure, particularly as the CBM is centered in the Northern coal belt but the demand center is along the Southern and Eastern coasts. Without this, investors have been unwilling to invest in exploration. As companies are starting to extract CBM from virgin coal beds and coal mines, the Chinese government is planning to build a web of 10 CBM transport pipelines in accordance with their 11th Five Year Programme, connecting CBM sources in Central and Northern China to cities along the coast.<sup>9</sup> Industry majors such as CNPC and CUCBM have started to develop and construct CBM pipelines in China as part of this initiative.<sup>10</sup>

The risks associated with investment in China's energy sector are well known—there is a mass of fragmented regulations, and it is often difficult to procure definitive and unambiguous guidance on their application. This is particularly so with regard to China's coal and CBM industries, which are controlled by provincial and central governments that tend to be more bureaucratic. The approval process for CBM projects can also be drawn out and difficult. For example, issues arise where there are overlapping coal and CBM tenures that are both subject to PSCs with different PSC holders. If the PSC holders are unable to work together, mediation will be conducted by the Ministry of Land and Resources who will then assign the overlapping area to one party. The guiding principles in the Ministry's regulations regarding how a decision is made are unclear and leave much room for officials to exercise discretion.<sup>11</sup> However, it seems that the Ministry will generally support the coal mining enterprise to exploit CBM as well as coal.

### **Developments in Indonesia**

The potential for commercializing the CBM reserves of Indonesia is well recognized. Indonesia's vast coal reserves are mainly located in South and East Kalimantan and South and Central Sumatra which make them ideally placed to provide feedstock for major gas project developments (such as the South Sumatra pipeline and the Bontang liquefied natural gas (LNG) project). Indonesia's existing gas transportation infrastructure should also help facilitate the exploitation of its CBM reserves.

Despite this potential, Indonesia has been relatively slow to develop a CBM industry by comparison to other countries with CBM resources such as the United States, Australia, India and China. The uncertainty of the legal and regulatory framework governing Indonesian CBM operations has long been cited as the key barrier to the development of the Indonesian CBM industry. This uncertainty has led to reluctance on the part

of foreign companies to make the considerable investment required to commercialize CBM reserves.

The Government of Indonesia (GOI) has now sought to address this uncertainty by issuing its first set of CBM-specific regulations—Government Regulation No. 33 of 2006, subsequently replaced by Government Regulation No. 36 of 2008 in November 2008 (collectively, the CBM Regulations).

The new CBM Regulations provide greater certainty to CBM project developers in a number of key areas. In particular:

- a new type of tenure for CBM, distinct from conventional oil & gas and coal concessions has been created;
- exploitation of CBM resources must be within the framework of the "New" Oil and Gas Law (Law No. 22 of 2001);
- the holders of oil & gas PSCs will enjoy primacy over coal concessionaries in the event of overlapping oil & gas and coal tenures;
- the legal arrangements for the exploitation of CBM are now set out in standard form PSCs between BP MIGAS (on behalf of the GOI) and CBM contractors; and
- CBM blocks will be awarded through a competitive "direct offer" and open auction process.

These CBM PSCs follow the latest generation of conventional oil & gas PSCs very closely, although the profit split under the CBM PSCs is more generous than that of the conventional oil & gas PSCs. As with other conventional PSCs, certain key commercial terms of the CBM PSC may be negotiated as part of the bidding process. Importantly, a domestic market obligation (DMO) has been included in the CBM PSCs,<sup>12</sup> which follows similar principles found in conventional oil & gas PSCs.

Industry response to these developments has been very positive so far, with a number of CBM PSCs being signed with the domestic companies since mid-2008. International companies with existing onshore oil & gas acreage are also well placed to take advantage of CBM opportunities, including the possibility of obtaining carbon credits through the Kyoto Protocol's CDM. However, the challenges of CBM operations will likely necessitate changes to the economic model deployed in conventional oil & gas PSCs. Also, the recent overhaul of the Indonesian mining tenure system in the form of the so-called "Minerba Law" (Law No. 4 of 2009 Regarding Mineral and Coal Mining) and issues stemming from Indonesia's laws on regional autonomy means that legal uncertainty will still surround CBM projects in Indonesia for some time yet.

## Developments in India

India has the fourth largest proven coal reserves in the world which provide immense potential for the exploitation of CBM.<sup>13</sup> India formulated a policy for the development of CBM in 1997.<sup>14</sup> The Ministry of Petroleum and Natural Gas is the designated administrative agency for CBM, and the Directorate General of Hydrocarbons acts as the upstream advisory and technical regulatory body.

A recent estimate put India's demand for gas at 115 to 135 BCM by 2020.<sup>15</sup> The share of LNG in India's gas consumption mix has jumped from marginal levels in 2002 to 22 percent in 2007.

Domestically produced CBM could have a price advantage over LNG, providing impetus for the further growth of CBM in India. However, the domestic gas transportation infrastructure is poorly equipped to cope with a rapid growth in domestic CBM. On July 6, 2009, the government of India announced that it will develop a blueprint for long distance "gas highways" for a national gas grid.<sup>16</sup> This is a positive step towards the development of much needed gas infrastructure to help CBM producers access the domestic market.

In the three CBM licensing rounds so far, 26 blocks have been awarded.<sup>17</sup> Great Eastern Energy Ltd. (an AIM listed company) has commenced commercial production of CBM from its block in West Bengal. The gas-in-place is estimated at 1.92 trillion cubic feet.<sup>18</sup> Other foreign companies have also formed partnerships with domestic companies in relation to CBM exploration.<sup>19</sup>

India launched its fourth CBM licensing round in April 2009, with 10 blocks on offer amounting to a total area of 5,000 square kilometers.<sup>20</sup> The bid closing date is October 12, 2009.<sup>21</sup> The blocks will be awarded through an international competitive bidding process and a CBM PSC will be signed with the winning contractor.

Some of the attractive fiscal and contractual terms on offer are a fiscal stability clause, exemption from customs duty for equipment and machinery imported for CBM operations, and no minimum expenditure obligations or signature bonus are prescribed.<sup>22</sup> There are no government participation rights; full (100 percent) foreign direct investment is permitted in the CBM sector.<sup>23</sup>

The latest Indian CBM PSCs also contain a DMO such that only gas in excess of domestic demand can be sold outside India.<sup>24</sup> Also, the marketing of gas is subject to the government of India's gas utilization policy.<sup>25</sup>

In July 2009, India reintroduced an income tax holiday for the first seven years of production from natural gas fields.<sup>26</sup> This had been controversially withdrawn in 2008. The withdrawal

is still the subject of a number of disputes. The policy will be applied from the current upstream bidding round but no mention is made of the treatment of CBM acreage awarded in previous bidding rounds.<sup>27</sup>

These are early days for India's CBM industry and a number of issues need to be resolved to the satisfaction of the gas producers. Whilst there are encouraging signs of more favorable commercial terms and improved nationwide gas transportation infrastructure, the DMO and potential restrictions on gas marketing may have implications for the CBM industry in India.

## Outlook For CBM Development in Asia

Although the development of CBM in Asia is still relatively new, the industry is blossoming with increased investment from both domestic and international investors. The CBM potential in China, Indonesia and India is very significant, and while incentives and regulations have improved the attractiveness of certain developments in the region, there is still work to be done: whilst Indonesia benefits from a strong gas transportation infrastructure, India and China have some way to go in their development of a similar network. Whether any of these countries will be able to fully realize their CBM potential, however, will ultimately depend on the development of a regulatory structure that is sufficiently robust to secure large-scale investment in the sector.

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## Liquefied Natural Gas

### Optimising the Value of LNG Sale Agreements by Formulating Strategic Cargo Diversion and Destination Flexibility Clauses

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#### Introduction

The liquefied natural gas (LNG) market has experienced many changes since the first deliveries of LNG were made from Algeria to France and the United Kingdom in 1963, and then in the Pacific Basin from Alaska to Japan in 1969. During that formative period, there were a limited number of LNG buyers, and sellers were keen to ensure their existing buyers were committed to providing funds for the purchase of LNG, whether the relevant cargo of LNG was taken or not. This is the so-called "take-or-pay" arrangement. Also, to ensure an LNG project was economically viable and could secure project financing, buyers were often required to agree on a floor price for LNG being supplied. In turn, whilst there may have been an intermediary buyer, such as a trading company acting on behalf of a gas or electric utility company in the supply chain, end-buyer utility companies provided a real demand for LNG being produced. If LNG was not supplied the lights would literally go out. LNG contracts used during this period were often referred to as "A to B" linear contracts, which required buyer to unload LNG at a specific destination without any flexibility for the buyer to divert to another receiving terminal, whether within the same jurisdiction or otherwise.

However, since those early days, there has been a transformation in the scale and range of the LNG market. Numerous jurisdictions now supply LNG: the Middle East acts as a swing producer to both the Pacific Basin and the Atlantic Basin markets; North Africa, West Africa, Latin America and the Caribbean traditionally supply to the Atlantic Basin; whilst South East Asia, Australasia and Russia supply the Pacific Basin. Receiving terminals have also been built in numerous new markets and recent developments in technology have enabled the use of floating re-gasification facilities. As a result, new markets have opened to sellers as nations seek to diversify their energy supply and achieve security of supply. LNG is also a relatively clean hydrocarbon based fuel, which is increasingly attractive given concerns of global warming. Therefore, volumes of LNG being traded in the global market have increased together with the range of sources and destinations, coupled with certain established sellers no longer being constrained by project finance arrangements on their liquefaction facilities. As a result, the scope for agreeing flexibility of destination for LNG cargoes has increased.

This article considers the different grounds upon which a buyer (Buyer) or seller (Seller) may seek flexibility rights with their counter-parties on the destination of a cargo in an LNG sale agreement, and the key legal issues which need to be addressed for the grant of any such flexibility rights.

### **Diversions Rights v. Destination Flexibility**

A key issue for all LNG sale negotiations is determining which party will be responsible for arranging the shipping. If Seller is responsible for delivery of LNG to Buyer's receiving terminal, LNG sales will be on a DES (delivery ex-ship) basis. For such sales, any right to change the agreed destination of the LNG will be a "diversion right". In the alternative, if Buyer agrees to collect LNG from Seller's liquefaction plant, LNG sales will be on a FOB (free on board) basis. Any ability to change the destination of LNG in an FOB sale agreement will be a right of "destination flexibility".

#### *DES Sales*

For DES sales, Buyer is often an end user or an aggregator for a downstream market of LNG. As a result, Buyer may not wish to incur the cost of procuring the necessary LNG fleet. However, if Seller controls the shipping arrangements, Buyer will need Seller's co-operation to divert a LNG cargo. In such LNG contracts, diversion rights may be negotiated either for the benefit of Buyer, to allow Buyer flexibility if the contracted volume of LNG is not required due to local market conditions or operational constraints affecting Buyer's receiving terminal, or in favour of Seller if there are more commercially attractive markets to sell LNG. However, before agreeing to Seller having diversion rights, Buyer will need to confirm it will

have sufficient flexibility: (i) through its storage facilities; (ii) its contractual arrangements at the receiving terminal; or (iii) its ability to use an alternative fuel to be able to accommodate any such diversion rights.

#### *FOB Sales*

In contrast, Buyer retains its own shipping fleet for FOB sales. However, Seller may wish to limit Buyer's right to destination flexibility to protect its own markets. Seller will not wish to provide Buyer with LNG to enable Buyer to compete with Seller's own customer base. In recent years this concern has increased as certain Sellers have sought to maximize profits and minimize operating expenses by selling LNG to their affiliated companies on an FOB basis, with destination flexibility rights. Such affiliated company Buyers, known as LNG aggregators, generally control their own shipping and have capacity rights at a receiving terminal located in a fluid natural gas market, such as the United States. Such an arrangement allows the LNG aggregator to minimize shipping costs by maximizing utility rates for its fleet, whilst maximizing revenues by directing LNG to optimal value markets. Consequently, Sellers may seek to limit destination flexibility rights for Buyer to mitigation rights if Buyer's receiving terminal is affected by an event of force majeure or other operational constraints.

However, whilst Sellers and Buyers have competing concerns in respect of destination flexibility and diversion rights, these issues regularly arise during the negotiation of LNG sale and purchase agreements. As a result, it is important to consider the operational and commercial issues associated with such rights, together with the legal implications of any such rights. The issues are considered in more detail below.

### **Grounds for Requesting Destination Flexibility or Diversions Rights**

#### *Operational Constraints and Force Majeure*

As noted above, generally accepted grounds for agreeing to destination flexibility or diversion rights in an LNG sale agreement are to mitigate the effects of operational constraints and force majeure events affecting Buyer's receiving terminal. However, even under such circumstances, Seller may wish to limit Buyer's right to claim such relief. For example, as Seller will want to protect its LNG sales market, Seller may wish to limit Buyer's right to change the destination of an LNG cargo to an alternative receiving terminal in Buyer's jurisdiction, or an alternative receiving terminal in which Buyer has an ownership interest or holds capacity rights. Consequently, Seller will ensure demand for LNG in its alternative target markets is not reduced due to over supply.

Similarly, Seller will be keen to ensure that it receives full value for any cargo of LNG diverted due to operational constraints affecting Buyer. As a result, Seller may demand that any

additional costs incurred in the diversion of an LNG cargo will be borne by Buyer, whilst any cost savings associated with such a change in destination will be retained by Seller. In addition, if there is any commercial upside in the sale of LNG to an alternative market, Seller will wish to receive such an upside. Alternatively, if the sale of LNG in a different market has to be at a discounted price, Seller will want to ensure Buyer is obliged to “make good” the price difference so Seller remains whole. This may be acceptable to Buyer, particularly if the sale of LNG will mitigate Buyer’s take-or-pay liability. In this respect, such concerns only apply to diversions and changes of destination requested due to operational constraints affecting Buyer’s facilities as Buyer should be relieved of its take-or-pay obligation upon the occurrence of a force majeure event.

In any event, an associated concern for both Buyer and Seller will be to determine which party will be responsible for identifying an alternative buyer for the relevant LNG. Depending on the nature of Buyer, it may be preferable to allow Seller, with its wide customer base and trading operations, to perform the marketing of such LNG. This will certainly be preferable for Seller as it seeks to minimize the impact of any such diverted cargo on its existing customer base. If any change in destination is driven by Buyer with Seller obliged to conduct the necessary marketing arrangements, Seller may also wish to recover the associated marketing costs. Similarly, Buyer may wish to have the right to approve or reject the terms of any alternative sale, particularly if Buyer will be obliged to make good any shortfall in the LNG price agreed.

Seller will also want to ensure that any mitigation arrangements available to Buyer during the occurrence of an event of force majeure are subject to a backstop date, after which Seller will have the option to terminate the LNG sales agreement. Seller may also seek to require that any change in destination of an LNG cargo remains subject to Seller’s prior approval, particularly if sales are being conducted on a DES basis and Seller is concerned to confirm the alternative receiving terminal has a safe port, safe berth, acceptable conditions of use, is in a jurisdiction which has generally acceptable tax and environmental laws and which does not violate any trade sanctions which may be applicable to Seller or the relevant cargo of LNG. These issues are discussed in more detail below.

There are, however, alternative forms of flexibility which may be built into an LNG sales agreement to provide Buyer with relief from its take-or-pay obligation if the receiving terminal or Buyer’s LNG vessel for FOB sales is affected by an operational constraint or there is a reduction in demand amongst Buyer’s customers. For example, Buyer’s take-or-pay obligation may be fixed at a percentage (less than 100 percent) of the

adjusted annual contract quantity, or Buyer may have the right to exercise downward volume flexibility for a pre-agreed number of LNG cargoes each contract year, possibly linked to a make-good obligation over a period of time. Therefore, the negotiation of diversion and destination flexibility rights involves the consideration of a number of associated issues.

#### *Commercial Diversions*

Increasingly in LNG sale negotiations, each party aims to secure destination flexibility and diversion rights for commercial reasons, to maximize revenues from the sale of LNG. The concerns for Seller with such rights will reflect those out-lined above, that is, Seller will want:

- a.) to ensure Buyer remains liable for the contractually agreed price for such LNG;
- b.) to protect its existing market; and
- c.) if such sales are conducted on a DES basis, to make such rights subject to operational constraints of both the liquefaction plant and its shipping fleet.

Similarly, from Buyer’s perspective, if Seller wishes to have such rights, Buyer will want to ensure Seller’s ability to divert an LNG cargo from Buyer’s receiving terminal is restricted to reflect Buyer’s ability to be flexible and if Buyer is required to use an alternative fuel in replacement of a diverted cargo of LNG, that Seller provides Buyer with appropriate compensation for the additional costs associated with the use of such an alternative fuel.

However, a key issue for both Seller and Buyer with any commercial diversion will be to determine how any profit achieved from the sale of LNG to an alternative market, as compared to the price achievable under the terms of the LNG sales agreement executed between the parties will be shared. This in turn may require an analysis of the basis of calculating the price payable for LNG under the parties’ LNG sales agreement as compared to the price payable for the alternative sale. For example, a price formula which has been calculated on a net-back basis may make comparison to an index based formula problematic. In the alternative, if a price formula is index based, it may be difficult for the parties to compare competing indexes in advance. In this respect, it is worth noting there is no single pricing basis for LNG in the global market.

Different indexes are used to price natural gas in the various markets of the Atlantic Basin and the Pacific Basin. For example, in the United States (Henry Hub) and the United Kingdom (National Balancing Point (NBP)) there are established natural gas markets which allow for market based gas prices. However, in Continental Europe (noting prices

at the Zeebrugge and TFF Hubs are reflective of prices set at the NBP) natural gas prices are often linked to a basket of alternative fuels, such as fuel oil or gasoil, together with elements linked to coal and electricity prices and consumer indexes. Similarly in Asia, there is no established natural gas market price. Instead, LNG prices are linked to the Japanese Crude Cocktail price published in Japan or the Indonesian Crude Price. Therefore, as LNG prices are usually determined on the basis of the pricing index applied in the destination into which the LNG is to be delivered, it can make a comparative assessment of LNG trades complex.

This issue has been partially addressed, at least for Atlantic Basin trades of LNG, by the Chicago Mercantile Exchange's introduction of a new gas swap futures price which is calculated on the basis of the spread between Henry Hub and NBP. However, the absence of a global LNG price, which is reflective of the cost of alternative fuels in each market, can make the commercial decision to divert an LNG cargo for profit problematic. Also, depending on the proposed terms of the alternative sale, it may be necessary for the parties to put in place hedging arrangements to mitigate any currency exchange risk.

As a result, profit sharing mechanisms need to be carefully structured to ensure clarity. It is also necessary to address any concerns which may be raised, particularly by European competition regulators, as to the sharing of price sensitive information and any perceptions of anti-competitive behaviour caused by the inadvertent restricting of LNG sales to certain markets. These issues are considered in more detail below.

## **Issues to Address when Negotiating Destination Flexibility or Diversion Rights**

### *Scheduling*

A key concern for both parties will be the timing of exercise of destination flexibility or diversion rights. One option will be to agree that certain volumes of LNG may be committed for delivery to an alternative destination during the development of the annual delivery programme. As noted above, the parties should have a reasonable understanding of Buyer's ability to agree to such volumes being diverted, based on Buyer's known operational constraints at the receiving terminal, which may include:

- a.) the availability of storage capacity at the receiving terminal and in any pipelines downstream of the receiving terminal, together with any contractual rights Buyer may have to access additional storage capacity at the receiving terminal;
- b.) Buyer's ability to use third party LNG stored at the receiving terminal and Buyer's ability to use an alternative fuel; and

- c.) Buyer's ability to receive and unload an LNG vessel at the receiving terminal, either before or after the diverted cargo of LNG, with a larger capacity than LNG vessels generally used for LNG sales by Seller to Buyer.

In the alternative, the parties may wish to have the right to exercise destination flexibility and diversion rights within a contract year, after the annual delivery programme has been fixed. Again, each party's ability to agree to such flexibility rights will be subject to practical operational constraints. However, the ability to exercise such rights within a contract year, whether within the 90 day schedule<sup>1</sup> or otherwise, will be necessary if an event of force majeure occurs. Similarly, it will be preferable not to limit the exercise of such rights for commercial diversions to the period during which the annual delivery programme is formed as the parties may need to react promptly to market opportunities. However, in such circumstances, Buyer will usually want to make the exercise of any such rights subject to its consent, to mitigate the risk of Buyer being in breach of its commitments to its downstream customers. In turn, Seller may wish to impose an obligation on Buyer to accept a diversion request, limiting Buyer's right to reject a request, for example, to the extent that such a diversion will have a material adverse effect on Buyer or its operations. There are a range of options the parties may consider to form the parameters to the exercise of any such rights.

### *Shipping Arrangements*

Whichever party is responsible for the transportation of LNG will need to be comfortable with the operational arrangements and legal and regulatory regime applicable at the alternative receiving terminal. For example, such party will want to ensure that the LNG vessel is compatible with the alternative receiving terminal. If it is not, the parties will need to agree which party will bear the costs associated with ensuring the LNG vessel is compatible with the alternative receiving terminal. The alternative receiving terminal may also require the owner and/or charterer of the LNG vessel to execute conditions of use for the receiving terminal, which allocate liability for any damage caused to the LNG vessel and the receiving terminal amongst the owner of the LNG vessel, the owner of the receiving terminal and port facilities and any third parties operating within the vicinity of the receiving terminal. The party responsible for transporting LNG will need to carefully review its insurance policies, to ensure it will have adequate coverage upon execution of any such conditions of use. Similarly, as any change of destination could impact the shipping schedule of the relevant LNG vessel, a Party may wish to limit the number of cargoes that may be diverted each contract year, whilst also ensuring diverted cargoes

are conducted on a rateable basis to mitigate the impact of diversions on the shipping schedule.

The parties will also want to confirm in advance the environmental and tax laws which may be applicable to their sale of LNG in the alternative jurisdiction. In this respect, the parties should consider taking legal and tax advice as to the possibility of transferring title to the LNG in international waters before the LNG vessel enters the territorial waters of the alternative jurisdiction as it may be possible to limit the relevant party's exposure to such laws by structuring the sale of LNG in this way.

In addition, given the number of jurisdictions in which re-gasification facilities have been constructed, including the availability of floating re-gasification and storage facilities, the parties should engage legal counsel to confirm that any proposed sale of LNG to an alternative jurisdiction will not breach any trade restrictions applicable to the parties or the jurisdiction from which the LNG is sourced. Similarly the parties should confirm that any sale of LNG to an alternative jurisdiction will not be prevented by the flag under which the relevant LNG vessel operates.

#### *European Competition Law Issues*

For sales of LNG into the European Union, parties need to be careful not to structure any profit sharing mechanism (PSM) in a way which may be deemed to infringe European competition law.<sup>2</sup> In this respect, the Directorate-General for Competition has suggested that for DES sales, a PSM is unlikely to infringe European competition law as the agreement to divert is reached between the parties before title and risk in the LNG is transferred to Buyer. This view is reflected by Sonatrach's settlement with the European Commission in 2007 in which Sonatrach agreed to only apply PSMs to DES sales.<sup>3</sup> In contrast, for FOB sales, if the parties agree to share profit made from the sale of LNG to an alternative market after title and risk in LNG has passed to Buyer, such a PSM may be deemed to infringe European competition law if it reduces the incentive for Buyer to sell the relevant LNG in another jurisdiction within the European Union.

However, a distinction is also drawn between "Raw" PSMs and "Net" PSMs. A Net PSM is applied to profits made from the alternative sale after costs associated with the diversion of the LNG have been deducted from the additional profit margin. Such a PSM is presumed to be acceptable as it does not reduce Buyer's incentive to sell LNG into an alternative jurisdiction. In contrast, a Raw PSM applies when the gross price differential between each market is split between Buyer and Seller, with Buyer required to bear the associated costs of the diversion. A Raw PSM

is presumed to reduce Buyer's incentive to sell LNG into an alternative market and as a result restrict competition and may be presumed to be anti-competitive. Therefore, for sales into the European market, it is important to clearly structure a PSM in a way which will not be deemed to infringe European competition law, if there is a possibility the relevant cargo of LNG could be diverted from one European Union country to another.

In addition, Parties may need to provide that the calculation of a PSM is verified and confirmed by a third party auditor to mitigate the risk that a PSM could cause the sharing of price sensitive information between market participants which could breach principles of European competition law. Also, for sales of LNG into the European market, any restrictions on the proposed resale or end-use of LNG are likely to be deemed to infringe European competition law.

#### *Impact on Take-or-Pay and Deliver-or-Pay Provisions*

If a cargo of LNG is delivered to an alternative destination, it will be necessary to ensure that such a delivery of LNG is treated by the parties as a delivery of LNG duly made by Seller to Buyer under the terms of their LNG sales agreement. Accordingly, Buyer should be relieved of its take-or-pay obligation, subject to making good any reduction in price received from the alternative sale if the diversion was requested by Buyer to mitigate the effect of an operational constraint or a reduction in demand in Buyer's market. Similarly, Seller should be relieved of its deliver-or-pay obligation, subject to an obligation to reimburse Buyer for the cost of using an alternative fuel, if necessary. The allocation of such relief against both the take-or-pay obligation and the deliver-or-pay obligation will need to be carefully structured to reflect the timing of each party's right to exercise diversion rights and destination flexibility, that is, prior to the formulation of the annual delivery programme or within a contract year.

Also, please note that for the purposes of this article, we have only considered the scenario where the parties agree to a proposed delivery of LNG to an alternative destination. There are complex issues associated with the structuring of contractual remedies applicable if Seller diverts LNG or Buyer changes the destination for LNG without the other party's prior consent. However, to address such issues would require an analysis which is beyond the scope of this article.

#### **Conclusion**

Is it possible to optimise the value of LNG sales agreements by formulating strategic cargo diversion and destination flexibility clauses? The answer to this question would seem to be "yes", but any such rights captured in an LNG sales

agreement must necessarily be restricted to reflect the demands and operational constraints of both Buyer and Seller. As a result, such rights are unlikely to be “optimal” for both parties. Global LNG markets, as with all other commodity markets, fluctuate significantly over time between being a seller-market and a buyer-market, as seen in the last couple of years. As a result, the relative negotiating strength of each party and their consequent ability to fix the terms for the exercise of any diversion or destination flexibility rights will similarly change. However, provided both parties appreciate the competing pressures of its counter-party, as with any other contractual mechanic, it should be possible to achieve a balance which achieves an optimal result for both parties.

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<sup>1</sup> The 90 day schedule is typical in LNG sales contracts as the preferred period within which a Buyer and Seller fix the near-term delivery schedule for LNG. The 90 day schedule is a rolling three month scheduling process which is usually confirmatory of the delivery schedule set-out in the annual delivery programme, agreed between the parties before a contract year. Such a period is a matter of operational convenience rather than a statutory obligation.

<sup>2</sup> H. Nyssens and I. Osborne, “Profit splitting in a liberalized gas market: the devil lies in the detail”, *Competition Newsletter* 2005, Spring (1) p. 25.

<sup>3</sup> IP/07/1074 of 11 July 2007. See press release “Commission and Algeria reach agreement on territorial restrictions and alternative clauses in gas supply contracts”.

# Labor Law

## *The Path to Strengthening Trade Unions with Chinese Characteristics: Trade Union Ascendancy in China*

*Article contributed by: Elizabeth Cole, corporate partner in Orrick, Herrington & Sutcliffe LLP's Beijing and Shanghai offices*

In the depth of the world financial crisis, a set of Guiding Opinions on “Responding to the Current Economic Situation and Stabilising Economic Relations”<sup>1</sup> (the Guiding Opinions) was issued in January 2009. The Guiding Opinions were jointly issued by the PRC Ministry of Human Resources and Social Security (MOHRSS), the All China Federation of Trade Unions (ACFTU), the China Enterprise Confederation and the China Enterprise Directors' Association with the aim of exhorting the government, business and trade unions to work together to “ensure and maintain stability through strengthening tripartite consultation, dialogue and common action”<sup>2</sup>. Trade unions were required to “actively direct and encourage the employees to care for the survival of enterprises”<sup>3</sup>.

Three months earlier in October 2008, PRC Vice President Xi Jinping stated at the opening ceremony of the 15th National Congress of the ACFTU that “China's trade unions should unswervingly stick to building trade unions with Chinese characteristics”<sup>4</sup>—a concept that embraces the principles of maintaining the leadership of the Communist Party over the unions, as well as putting the workers first and protecting their rights and interests in line with the laws. This message was reiterated later in the same Congress by President Hu Jintao who called on the country's trade unions to earnestly safeguard the legitimate rights and interests of employees and coordinate labour relations to promote social stability<sup>5</sup>.

The Guiding Opinions and these statements of the Chinese leadership illustrate how a combination of new laws and the economic crisis has led to the growing importance of unions in China and their developing role of protecting the rights of workers while acting as an intermediary with employers to help maintain economic and, thereby, political stability.

### **Recent Growth of the Trade Unions**

China has had a trade union system in place for some time. The PRC Trade Union Law<sup>6</sup>, originally promulgated in 1992 and amended in 2001, recognises a hierarchy of unions—“higher level” government supported unions and “lower level” company unions. Higher level unions are government supported oversight bodies and consist of the ACFTU and its local provincial, city and district level offices. Higher level unions have the power to issue directives to, and in respect of, the operation of lower level company based unions. In

general, industry based unions are not recognised, although some regulations do allow for local industry unions in transitory industries, such as construction and entertainment services.

The Trade Union Law states that labour unions are to be organised by employees voluntarily and that enterprises with more than 25 members should establish a basic labour union. However, the Trade Union Law is silent on who should be directly responsible for the establishment of the union and, until recently, there was no real penalty or incentive for private companies, including foreign invested enterprises (FIEs) such as joint ventures and wholly foreign owned enterprises, to encourage their employees to form unions. Employees too, who were used to the steady increase in wages and improvement in employment conditions that flowed from continued economic growth, had limited need to seek union protection. Where they did, the laws relating to employment protection lacked teeth. As a result of these factors, the number of FIEs with active unions in China has historically been small.

Changes in Chinese employment laws over the past two years, in particular, the Labour Contract Law<sup>7</sup> which came into effect on 1 January 2008 and the Labour Dispute Mediation and Arbitration Law<sup>8</sup> which came into effect on 1 May 2008, have introduced more detailed rights for unions and employees to be consulted on, and involved in, a myriad of labour related issues. The frameworks established by these legislative changes have been strengthened by a number of union related edicts issued by, or jointly with, the ACFTU, the government supported union oversight body. These edicts have the effect of subsidiary or implementing legislation and many are a direct response to the economic crisis reflecting a genuine concern on the part of the government to address employment related issues that could give rise to social instability. At the national level alone, over 20 such edicts have been issued since the beginning of 2008, including notices on protection of women's union rights, assisting migrant workers to find jobs, education on occupational health and safety and union involvement in labour disputes.

On a practical level, the ACFTU has also been working to promote the formation of unions in FIEs. In July 2008, the ACFTU announced a 90-day campaign to introduce unions into Fortune 500 companies operating in China. One of the objectives of the campaign, which is one of several in recent years, was to increase unionisation among the Fortune 500 in China to 80 percent, up from its reported existing 60 percent. By December 2008, the ACFTU reported that 313 labour unions have been set up by 83 percent of headquarters of multinationals in China and that in some provinces like Hebei, Hubei and Liaoning, more than 95 percent of multinational entities have been unionised<sup>9</sup>. Although the accuracy of these statistics is hard to verify, anecdotal evidence shows an

increasing number of FIEs forming unions primarily as a result of personal visits from ACFTU representatives and employee initiated discussions.

Under the new employment law regime, companies that fail to form unions upon the request of their own employees or through the encouragement of the ACFTU could face penalties. There may also be a strategic advantage for a company to encourage or at least support the formation of a company union when requested to maintain the goodwill of employees and avoid negative publicity. The ACFTU has used the press as a weapon in its campaigns against "recalcitrant" companies on more than one occasion. Several high-profile multi-nationals who had failed to form unions after the most recent ACFTU campaign were named in its report.

One of the most notable examples of a targeted campaign is Wal-Mart, which for many years resisted calls for unionisation of its Chinese employees until significant public and government pressure finally resulted in it permitting the formation of unions at its stores in China in 2006. Last year, the benefit of such unionisation was held up by the ACFTU when it was announced that over 100 unionised Wal-Mart stores had each reached collective agreements on monthly pay for grassroot workers. This year, the official Chinese Xinhua news agency reported on 20 April 2009 that Wal-Mart had halted a plan to reshuffle its mid-level executives in China after local trade unions stepped in. The plan included transfers of 54 managers and officers to outlets in other cities, demotions or leaving the company<sup>10</sup>. A concern was raised that the transfers were proposed as an indirect means of termination which would otherwise have been difficult under the Labour Contract Law.

### **Role of Trade Unions in China**

The Trade Union Law provides that the primary function of the company trade union is to be engaged in the democratic management and supervision of employees. This role, as expanded by the Labour Contract Law and the related legislation, includes the following:

1. *Formulation of Company Rules and Regulations*

An employer must ensure the employees, their representatives or company trade union leaders have full access to the internal policy making process of the company. The trade union acts as a representative of the employees' interests in the adoption or revision of company rules and policies, including those involving employee compensation, working hours, compliance, insurance and benefits, and other material matters having a direct bearing on the immediate interests of employees. While final decision making discretion is reserved to

the employer, the Labour Contract Law requires employers to engage in “equal consultation” with trade unions or employee representatives and communicate the adopted rules to all employees.

#### 2. *Assisting Employees to Negotiate Individual Labour Contracts*

According to the Labour Contract Law, a trade union must assist and guide employees in negotiating their individual labour contracts with the employer, including providing specific suggestions and advice to the employees on terms of probation, employment term, termination, leave, payment and labour protection and acting as a representative of the employees in negotiations with the employer.

#### 3. *Negotiating Collective Contracts*

The trade union should act as the representative of employees in negotiation of a collective agreement with their employer. Since the introduction of the Labour Contract Law, there has been a push from the unions for employees to negotiate more collective contracts to introduce greater protection, even though such contracts still appear to be a small portion of those signed by FIEs.

#### 4. *Enforcement of Labour Laws and Contracts*

If an employer violates labour laws or regulations or breaches a labour contract or collective contract, the company trade union has the right to demand rectification of the matter. The union representatives also have the right to represent workers and participate in the dispute resolution process.

#### 5. *Consultation on Redundancy and Termination*

Under the Labour Contract Law, an employer must give advance notice to the trade union of a unilateral decision to terminate an employment contract, which has the right to notify the employer if it disagrees with the basis for termination. The employer must take the trade union’s opinions into consideration, and notify the trade union of the final resolution of the matter in writing.

Additionally, the Labour Contract Law requires the employer to give 30 days advance notice to the trade union and consult with them in the event of a lay-off involving more than 20 employees or 10 percent of the work-force. While the employer is not obligated to implement any comments received from the trade union during such consultation, many locations in China have implemented lay-off reporting procedures that require union and/or employee comments together with any steps taken to address such comments to be included as part

of the formal report to the local labour bureau. This opens the door for a dialogue between unions and employers that goes beyond mere lip-service.

#### 6. *Harmonising the Labour Relationship*

The trade union should be engaged in mediating labour disputes, and establish a negotiation system with enterprise and government authorities to solve the problems which have immediate relationship with employees’ interests. This involvement extends to having local labour dispute arbitration committees within the union and supporting employees who are engaged in arbitration or legal action against the company. If a dispute arises in connection with the performance of a collective contract, the trade union may apply for arbitration or institute a legal action on behalf of the employees.

#### 7. *Providing Free Legal Aid to Employees*

The trade union should establish a legal aid system to provide free legal services to employees, personnel in the trade union and the trade union itself whose lawful rights and interests have been infringed. Guidelines for the establishment of a legal aid system were set out in the Measures for Legal Aid of Trade Unions issued by ACFTU on 11 August 2008 (Legal Aid Measures)<sup>11</sup>. Under the Legal Aid Measures, an employee may apply to the union for legal aid if he or she meets the standards of economic hardship for the local trade union to provide legal aid or where his or her. Rights have been seriously infringed upon and he needs the legal aid of a trade union to protect them. Migrant workers claiming unpaid wages or work-related injury compensation are not subject to an economic hardship test. This automatic right to legal aid for migrant workers reflects their disadvantaged status and one of the key goals of the expanded role of the ACFTU—to provide assistance to migrant workers.

A substantial portion of China’s manual work force consists of an estimated 200 million plus migrant workers who have moved from rural or less developed cities to the coastal areas and larger cities to find work. Such workers are often poorly educated and have limited access to official social services as these are ordinarily linked to their registered place of residence in their home towns. According to the ACFTU, during the 2009 New Year Holiday and the Spring Festival, it helped claim RMB1.09 billion Yuan (US\$159.6 million) of back wages for 430,000 migrant workers<sup>12</sup>.

#### 8. *Protecting the Special Interests of Female Employees*

If a company has 10 or more female members, it should set up a trade union female employees committee to safeguard and focus on the special interests of female employees including health and safety and during pregnancy and pre-and post-natal protection periods<sup>13</sup>.

#### 9. *Educating Employees*

The trade union should educate employees on their rights as well as on important issues such as health and safety. Recent joint edicts from the ACFTU and various government ministries have included guidance on improving education of workers in the areas of occupational health and safety and coal mine safety.

### **Status and Protection of Union Representatives**

A company trade union, once approved through the formal approval process at the higher level and registered, has separate legal person status. With this status, the union is able to open its own bank account to control the trade union funds, including funds allocated to it by the company.

The chairman of a company trade union should not be the general manager, deputy general manager or the head of human resources or a shareholder of the company or related to such individuals. The chairman should also not be a foreign employee. Other middle-management personnel are eligible to hold the chairman position. The chairman is protected against being re-assigned or terminated during his or her term of service as chairman. The trade union chairman also acts as the union's legal representative<sup>14</sup>.

### **Union Funds and Financial Management**

Trade union funds are composed of membership fees contributed by labour union members, funds allocated to the labour union in the amount of 2 percent of the aggregate, pre-tax monthly salaries of all company employees, income distributed by the company and government subsidies.

The primary source of funding is the amount equal to 2 percent of the total monthly salaries which are required by the Trade Union Law to be contributed by the company. This obligation is reiterated in the Implementing Regulations for the Law on Sino-Foreign Joint Ventures and is also a mandatory provision required by most Chinese approval authorities in FIE articles of association. In practice, many companies have not complied with this requirement due to lack of serious penalty or have allocated the funds to general employee activities. However, the ACFTU recently has become more proactive in policing compliance, possibly due to the fact that company trade union must turn over a certain percentage of the employer's union fund

contributions to the higher level unions, providing a valuable source of funding for its activities.

In 2005, the ACFTU issued regulations allowing for deduction of the 2 percent labour union fees from a company's monthly taxable income, provided the company submits a receipt issued by either the Ministry of Finance or the ACFTU. Funds allocated to labour union fees for unions established by company management rather than through the higher level government union representatives, may not qualify for this favourable tax treatment.

Interestingly, one of the most recent union related edicts was a Notice of the Ministry of Finance and the ACFTU on the Implementation of the new Accounting System of Trade Unions<sup>15</sup> issued on 10 July 2009. This Notice requires trade unions at all levels to adopt by no later than 1 January 2010, a new accounting system utilising government approved computer software. The stated purpose of the new accounting system is to help China's trade unions to standardise their organisation, strengthen internal management, improve awareness of accounting laws and regulations, and promote transparency with regards to accounting information. No doubt the government has recognised that with the growing strength of the union movement comes greater funds under management and the inevitable temptation to abuse or misuse funds.

### **Role of the Union in the Economic Crisis**

The Guiding Opinions referred to at the beginning of this article urge unions to encourage the employees to care for the survival and development of the enterprises, adhere to the principle of "advancement according to law, mutual benefit and win-win, joint consultation, and adjusting measures to local conditions, to guide and educate the employees to understand and support the enterprises' adoption of flexible working hours, on-the-job training, wage consultation and other measures, and mobilise to offer advice and make contributions to the development of enterprises, to strive to improve the labour productivity, reduce the production and operation costs and to help the enterprises get over the hard times and seek common development".

It is clear that unions in China have a delicate balancing act to perform. There are tens of millions of disadvantaged workers who need a voice and protection. At the same time, economic and social stability is a major concern of the government and one that the unions must play a role in maintaining both internally, through good management and financial controls, and externally at the regulatory and operational level through considering the interests of employers, if they are to continue to be supported to develop and grow with Chinese characteristics.

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*The views expressed in this article are those of the author and are not to be attributed to Bloomberg Finance L.P.*

<sup>1</sup> 《关于应对当前经济形势稳定劳动关系的指导意见》，available in: [http://www.gov.cn/gzdt/2009-02/01/content\\_1219057.htm](http://www.gov.cn/gzdt/2009-02/01/content_1219057.htm)

<sup>2</sup> *Ibid.* In the first paragraph.

<sup>3</sup> *Ibid.* In the second paragraph.

<sup>4</sup> "China's Xi Jinping Addresses Trade Union", Xinhua, 18 October 2008, available in: [http://news.xinhuanet.com/english/2008-10/21/content\\_10230509.htm](http://news.xinhuanet.com/english/2008-10/21/content_10230509.htm)

<sup>5</sup> *Ibid.*

<sup>6</sup> 《中华人民共和国工会法》，[http://www.gov.cn/banshi/2005-08/05/content\\_20697.htm](http://www.gov.cn/banshi/2005-08/05/content_20697.htm). The English translation is available in: [http://en.china.cn/content/d50052,b8d27c,1427\\_4023.html](http://en.china.cn/content/d50052,b8d27c,1427_4023.html).

<sup>7</sup> 《中华人民共和国劳动合同法》，[http://www.gov.cn/flfg/2007-06/29/content\\_669394.htm](http://www.gov.cn/flfg/2007-06/29/content_669394.htm). The English translation is available in: [http://www.fdi.gov.cn/pub/FDI\\_EN/Laws/GeneralLawsandRegulations/BasicLaws/P020070831601380007924.pdf](http://www.fdi.gov.cn/pub/FDI_EN/Laws/GeneralLawsandRegulations/BasicLaws/P020070831601380007924.pdf).

<sup>8</sup> 《中华人民共和国劳动争议调解仲裁法》，[http://www.gov.cn/flfg/2007-12/29/content\\_847310.htm](http://www.gov.cn/flfg/2007-12/29/content_847310.htm). The English translation is available in: [http://www.110.com/fagui/law\\_312803.html](http://www.110.com/fagui/law_312803.html).

<sup>9</sup> "Most multinationals set up labour unions in Chinese mainland", Xinhua, 24 December 2008. Available in: [http://news.xinhuanet.com/english/2008-12/24/content\\_10554549.htm](http://news.xinhuanet.com/english/2008-12/24/content_10554549.htm).

<sup>10</sup> "Wal-Mart's China restructuring plan falters as unions step in", Xinhua, 20 April 2009. Available in: [http://news.xinhuanet.com/english/2009-04/20/content\\_11223504.htm](http://news.xinhuanet.com/english/2009-04/20/content_11223504.htm).

<sup>11</sup> 《工会法律援助办法》，available in: [http://www.njsfj.gov.cn/www/njsfj/2009/flyz4-mb\\_a390901138020.htm](http://www.njsfj.gov.cn/www/njsfj/2009/flyz4-mb_a390901138020.htm).

<sup>12</sup> "Trade unions extend aid for migrant workers in financial crisis", Xinhua, 15 February 2009. Available in: [http://news.xinhuanet.com/english/2009-02/15/content\\_10824384.htm](http://news.xinhuanet.com/english/2009-02/15/content_10824384.htm).

<sup>13</sup> The Provisions on the Work of Enterprise Trade Unions (for Trial Implementation) (Deliberated and adopted at the ninth plenary presidium meeting of the 14th Executive Committee of All-China Federation of Trade Unions on 6 July 2006), 《企业工会工作条例（试行）》（2006年7月6日中华全国总工会第十四届执行委员会第九次主席团全体会议审议通过），available in: <http://www.jsrgjy.gov.cn/Item/3856.aspx>.

<sup>14</sup> Measures on the Election of Chairman of Enterprise Trade Union (Temporary) issued by the All-China Federation of Trade Unions effective 25 July 2008, 《企业工会主席产生办法（试行）》，available in: [http://www.gov.cn/jrzq/2008-08/28/content\\_1081236.htm](http://www.gov.cn/jrzq/2008-08/28/content_1081236.htm).

<sup>15</sup> 关于做好贯彻实施新《工会会计制度》准备工作的通知，available in: [http://szs.mof.gov.cn/kjs/zhengwuxinxi/zhengcefabu/200907/t20090727\\_187658.html](http://szs.mof.gov.cn/kjs/zhengwuxinxi/zhengcefabu/200907/t20090727_187658.html).

## Securities Law

### *Hong Kong Proposes to Enhance Investor Protection*

*Article contributed by: Angelyn Lim, Kher Sheng Lee, and Carmen Cheng, Hwang & Co in association with Dechert LLP*

The Hong Kong Securities and Futures Commission (SFC) announced landmark proposals to overhaul the existing regulatory framework for unlisted investment products in a bid to further safeguard investor interests.

#### Introduction and Background

In its Consultation Paper on Proposals to Enhance Protection for the Investing Public<sup>1</sup> (the Consultation Paper) issued

on 25 September 2009, the SFC published wide-ranging proposals to address some of the perceived short-comings in the current regulatory environment for the sale of unlisted investment products to the public.

The proposals were formulated in the aftermath of heavy losses suffered by retail investors arising from failed investments in certain retail structured products (generically referred to in the media as Minibonds) triggered by the collapse of Lehman Brothers in September 2008 and the subsequent global financial crisis<sup>2</sup>. The public outcry that ensued and the politicization of developments resulted not only in (i) both government officials and senior management at the Hong Kong Monetary Authority (HKMA) and the SFC being questioned by the Hong Kong Legislative Council (Legco) in public; but also in (ii) the first mass settlement of its kind in Hong Kong where distributors of Minibonds agreed to compensate affected investors for at least 60 percent of their original principal investment<sup>3</sup>. Very much in focus was the SFC's statutory duty (entrenched in the Securities and Futures Ordinance or SFO)<sup>4</sup> to protect retail investor interests.

The Consultation Paper follows on the heels of reports submitted to Legco by both the HKMA and the SFC. As a result, the proposed reforms impact all stages of the investment process from an investor's perspective, from the pre-sale stage (with proposed requirements for product documentation and the codification of advertising guidelines) to the sales stage (with enhanced scrutiny on intermediaries' distribution processes and conduct during the actual sale to prospective investors, and proposed requirements for disclosure of commissions received), to post-sale arrangements (requiring continued disclosure by product issuers and the proposed introduction of a "cooling-off" period in respect of some products). These proposals are discussed in further detail below.

The proposed SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Products will, for the first time, codify in one document the different codes of practice governing the structure and offering of unlisted investment products to the retail public, consistent with the approach adopted in other jurisdictions with a comparable regulatory regime, such as the UK, Australia and Singapore. Excluded from the scope of the Consultation Paper are real estate investment trusts, listed structured products, mandatory provident fund schemes, pooled retirement fund schemes and immigration-linked investment schemes, all of which are governed by existing legislation or codes of practice.

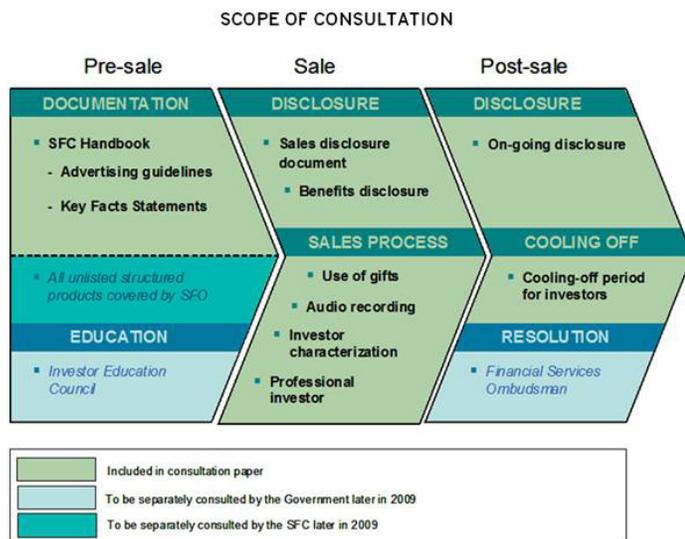
In addition, there is a separate consultation planned to consolidate the existing Companies Ordinance<sup>5</sup>—which currently governs offering documentation requirements for

structured products—into the regime under Part IV (Offers of Investments) of the SFO, a move that will reinforce a consistent approach to regulating the offering of retail products in Hong Kong. There are also additional consultations (all targeted to take place by the end of this year) planned to:

1. bolster investor education (which was found to have been very much lacking during the Minibond scandal); and
2. establish a Financial Ombudsman.

## Proposals

In summary, the scope of the Consultation Paper is set out below:



(Source: Hong Kong Securities and Futures Commission)

Following are the key aspects of the proposals.

### Products: Pre-Sale Documentation

The purpose of these proposals is to clarify and ensure a consistent application of documentation standards and common principles to all unlisted retail investment products. Criteria that the SFC will normally consider in authorising offering documentation and advertisements relating to a retail product will be consolidated into the SFC Handbook (see *Consultation Paper Part II*).

The new SFC Handbook will comprise:

- a new *Code on Unlisted Structured Products* (the SP Code) (see Consultation Paper Part II, Section 1, page 24);
- a revision to the existing *Code on Unit Trusts and Mutual Funds* (the UT Code) (see Consultation Paper Part II, Section 2, page 41); and
- a revision to the existing *Code on Investment-Linked Assurance Schemes* (the ILAS Code) (see Consultation Paper Part II, Section 3, page 56).

A consistent requirement across all three codes is the product Key Facts Statement (Product KFS) that will form part of the offering document, and is to be in short form (ideally no more than four pages long) and drafted in user-friendly language. Key principles have been set out in the SFC Handbook as well as sample templates. Information to be covered in the Product KFS includes the name of the management company, the investment strategy of the relevant product, key risks, asset allocation and fees and charges payable.

### New SP Code

The new SP Code seeks to provide a flexible regulatory framework within which unlisted structured products may be offered to the public in Hong Kong. To enhance transparency in (i) product infrastructure and maintenance; (ii) the appointment of parties playing key roles in respect of a structured product; and (iii) matters such as valuation of the product from manufacture through to maturity, the following have been proposed:

- eligibility requirements for issuers, guarantors and reference assets (to which a structured product is linked) of products;
- where the issuer is a special purpose vehicle, additional safeguards in the form of structural and eligibility requirements;
- a category of service provider called the “product arranger” who would be a Hong Kong-licensed entity answerable to the SFC for certain administrative matters and ongoing regulatory compliance in relation to the relevant structured product; and
- in relation to collateralised structured products, additional collateral criteria.

### Revised UT Code

The proposed revisions to the existing UT Code seek to:

- modernise the regulatory framework for SFC-authorized schemes and broaden the scope for product development, in response to developments in the financial markets, regulatory changes in major overseas funds jurisdictions, and new product proposals presented to the SFC by industry practitioners;
- provide a broadly level playing field between UCITS III schemes and non-UCITS schemes; and
- codify regulatory principles for structured funds and provide increased flexibility for retail funds to invest concurrently in collective investment schemes and other financial instruments.

These suggested revisions are elaborated upon below.

*Key proposals to modernise the regulatory framework of the UT Code include the following:*

- “structured funds” will be added as a type of “specialised scheme” with specific authorisation requirements, which will be set out separately in the revised UT Code as a new Chapter 8.8;
- annual reports will be required to be published in both English and Chinese for SFC-authorized schemes that are not “recognised jurisdiction schemes”<sup>6</sup> and that have Hong Kong investors;
- a Product KFS will be required to be produced for each single fund, or for each sub-fund of an umbrella fund;
- the current 50 percent value restriction for connected party transactions will be replaced by general principles, such as arm’s-length terms, fees and commissions to be capped at prevailing market rate, and disclosure of benefits in the annual report; and
- performance fees may be calculated on more flexible bases than is currently permitted (e.g., they may be calculated with reference to the performance of a benchmark or an asset class), which is likely to be welcomed by industry participants.

*To level the playing field with UCITS III schemes:*

- SFC-authorized non-UCITS schemes will have the flexibility to invest in financial derivative investments (FDI) for investment purposes, in the same way that UCITS III schemes may, with exposure thresholds in line with those applicable under the UCITS III regime.

*To provide increased flexibility for retail funds to invest in other schemes:*

- A retail fund may (i) invest up to 10 percent of its net asset value (NAV) in non-recognised jurisdiction schemes; (ii) invest in one or more SFC-authorized schemes or recognised jurisdiction schemes provided that no more than 30 percent of its NAV may be invested in any one of these schemes; and/or (iii) invest more than 30 percent of its NAV in an SFC-authorized scheme (but not a recognised jurisdiction scheme).

#### *Revised ILAS Code*

The ILAS Code is proposed to be revised to codify existing practices, enhance disclosure in the offering documents of ILAS and implement the key recommendations on investment

products made in the SFC’s report to the Financial Secretary in December 2008. Apart from the Product KFS, other key proposals include:

- deleting the existing chapters in the current ILAS Code dealing with (i) appointment of a Hong Kong representative, (ii) Broker Managed Funds, and (iii) Investment-linked Savings Plans; and
- codifying the practice that non-guaranteed returns will not be taken into account for the computation of surrender values.

#### **Conduct by Intermediaries: Sales Process and Disclosure**

The Consultation Paper proposes to revise the Code of Conduct for Persons Licenced by or Registered with the Securities and Futures Commission, as well as the Securities and Futures (Professional Investor) Rules, both of which have come under heavier regulatory scrutiny in the recent past. Key proposals, and the rationale for such proposed revisions, are set out below:

- *Sales Disclosure Document.* To regulate intermediary conduct and distribution practices in the sale of investment products in Hong Kong (given that the Hong Kong regulatory regime for the sale of investment products rests on the two important principles of disclosure of product information and suitability of the product for the investor), certain information will be required in the sales disclosure document, including (i) the capacity (whether as principal or agent) in which an intermediary is acting; (ii) the affiliation (if any) of the intermediary with the product issuer; (iii) disclosure of monetary and non-monetary benefits paid or payable to the intermediary; and (iv) the terms and conditions under which an investor may receive a discount of fees and charges from an intermediary.
- *Investor Characterisation.* To reinforce the point that asset thresholds and portfolio size are not, *per se*, sufficient indicators of a “professional investor” status, intermediaries will be required, as part of the “Know Your Client” process, to seek from clients, information in relation to each client’s knowledge of derivatives. Unlisted derivative products may only be promoted to investors with “knowledge of derivatives”. Also, the term “professional investor” will be redefined to include only those investors with sufficient knowledge, expertise and investment experience in the relevant financial products, as well as having an investment portfolio of an appropriate size.

- *Pre-Sale Disclosure of Benefits.* To address potential intermediary conflict of interests issues regarding benefits received, intermediaries must make disclosure to the prospective investors of both monetary and non-monetary benefits received by the intermediary from the issuer (or others).
- *Prohibition of Use of Gifts.* To prevent unsophisticated investors from being distracted by gift incentives from intermediaries without paying sufficient attention to the features of the investment product, intermediaries will be prohibited from using gifts in promoting any specific investment product.
- *Audio Recording.* To ensure that a clear record of the relevant processes is undertaken in case of future dispute, the financial services industry is being consulted as to whether audio recording of the client risk profiling process and the advisory or selling process for investment products should be made mandatory.

## Post-Sale Arrangements

### *Cooling-Off Period*

The SFC has proposed the introduction of a cooling-off period, in order to provide investors in long-term investments for which there is no ready secondary market, an opportunity to change their minds within a short period after the initial investment decision. During this period (ranging from 2–21 (or more) days), it is proposed that investors in such products be able to exit the investment or cancel the order, and receive a refund of capital and related commission, subject to a reasonable administrative charge and any legitimate market value adjustment.

### *Continued Disclosure*

Proposals are included for issuers (particularly those of structured products) to provide investors with information on an ongoing basis, post-investment, including financial updates and any material adverse changes affecting the issuer, and (in the case of structured products) regular indicative valuations of the relevant product.

### *Inevitable Reform: The Way Forward*

The SFC noted in the Consultation Paper that, post-Minibonds, “it is not possible to consider returning to business as usual and intermediaries must recognise the need for enhancement of the regulatory environment in which they sell investments to the public . . . [w]e urge respondents to focus on what is the right answer in the context of recent events and then to *consider how to implement the necessary changes*”<sup>7</sup>. (emphasis added)

It is recommended for intermediaries to establish internal cross-functional teams with representation from all relevant divisions (including the legal, compliance, risk management, product, business development and marketing teams) to identify points of concern and coordinate a coherent response to the proposals. It may also be timely to commence the necessary groundwork for an appropriate implementation plan—we believe that most of the proposals are likely to be adopted in one form or another. At least in part a reaction to the events surrounding the Minibond saga, it is now widely accepted that enhanced regulation in Hong Kong of the offer of retail investment products is inevitable. This is consistent with general regulatory developments and trends in other parts of the world, particularly the United States and Europe.

The consultation period for the proposals ends on 31 December 2009. It is likely that the Consultation Conclusions will be available sometime in the first quarter of 2010.

## Conclusion

The proposals will have significant implications for both issuers and distributors of most investment products that are offered to the public in Hong Kong. They also require serious consideration by any asset manager (including overseas-based managers) considering accessing the investing public in Hong Kong, either directly or indirectly via sub-investment management mandates for collective investment schemes that are offered to the Hong Kong public. We will, in subsequent publications or events, comment on issues that warrant more detailed discussion.

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The views expressed in this article are those of the authors and are not to be attributed to Bloomberg Finance L.P.

<sup>1</sup> Available at: [www.sfc.hk/sfc/html/EN/speeches/consult/InvestingPublic.html](http://www.sfc.hk/sfc/html/EN/speeches/consult/InvestingPublic.html).

<sup>2</sup> For a more detailed discussion of the Minibond saga and related developments, please refer to [www.dechert.com/library/FS%20\\_1\\_01\\_09\\_Hong\\_Kong\\_Securities.pdf](http://www.dechert.com/library/FS%20_1_01_09_Hong_Kong_Securities.pdf), [www.dechert.com/library/Financial%20Services%20Report%20-%2003\\_09.pdf](http://www.dechert.com/library/Financial%20Services%20Report%20-%2003_09.pdf) and [www.dechert.com/library/Financial\\_Services\\_Report\\_10-09.pdf](http://www.dechert.com/library/Financial_Services_Report_10-09.pdf).

<sup>3</sup> "SFC, HKMA and 16 banks reach agreement on Minibonds", 22 July 2009, <http://www.sfc.hk/sfcPressRelease/EN/sfcOpenDocServlet?docno=09PR100>.

<sup>4</sup> Cap. 571, Laws of Hong Kong.

<sup>5</sup> Cap. 32, Laws of Hong Kong.

<sup>6</sup> "Recognised jurisdiction schemes" are schemes listed in Appendix A1 to the existing UT Code (currently schemes domiciled in France, Germany, Guernsey, Ireland, the Isle of Man, Jersey, Luxembourg, the UK and the United States).

<sup>7</sup> Page 6, [http://www.sfc.hk/sfc/doc/EN/speeches/consult/q3\\_consultation.pdf](http://www.sfc.hk/sfc/doc/EN/speeches/consult/q3_consultation.pdf).

# Bankruptcy Law

## Tax & Accounting

### ***Hong Kong Court of Appeal Refuses Application for Leave to Appeal Appointment of Receivers in Akai Holdings Liquidation Case***

***Akai Holdings Ltd. v. Ho, HCMP 1718/2009, HCMP 1720/2009, HCMP 1722/2009***

On 24 September 2009, in a consolidated case involving three separate proceedings, the Hong Kong Court of Appeal refused an application by first defendant Christopher Ho Wing-on and intervener Accolade, Inc. for leave to appeal from the judgment appointing joint and several receivers over the assets of the first defendant, Christopher Ho Wing-on and the intervener, Accolade, Inc.

#### **Background and Prior Proceedings**

The instant case arises from the liquidation of electronics conglomerate Akai Holdings Limited and companies in the Akai Group (collectively, "Akai"). In 2000, Akai reported losses over a one year period in excess of US\$1.72 billion. Akai brought a negligence suit against first defendant Christopher Ho Wing-on, a former partner in the accounting firm of Ernst and Young, and second defendant The Grande Holdings Limited (Grande Holdings), a company listed in Hong Kong. Mr. Ho holds 69/70 percent of the shares and is a director of Grande Holdings, as well as several other companies listed overseas. Akai's liquidators alleged that Akai's former chairman, James Ting, made a covert agreement with Mr. Ho in November 1999, transferring power over the company to Mr. Ho and Grande Holdings to allow diversion of hundreds of millions of US dollars in assets away from Akai.

In February 2009, Hong Kong High Court judge William Stone made a Mareva injunction freezing US\$200 million (HK\$1.56 billion) of Ho's assets and issued disclosure orders against Mr. Ho and Grande Holdings. Mr. Ho filed a notice of appeal which was subsequently abandoned. The court found that Mr. Ho was beneficially entitled to the Ho Family Trust which was held 100 percent for Mr. Ho by Accolade, Inc., a company incorporated in the British Virgin Islands. The shareholders of Accolade are Ho's sisters, Dr. Sabrina Ho and Ms. Christine Asprey. On 1 June 2009, Stone J granted a substantial proportion of the reliefs sought by plaintiffs' specification summons made on 27 April 2009, finding Mr. Ho's efforts at compliance with disclosure amounted to "little more than a gesture." *Akai* at ¶ 30.

On 6 July 2009, Akai's liquidators issued a summons seeking discovery on the part of Grande Holdings and an order for advance notice relating to the sale of the Grand Building as well as an order that Mr. Ho provide full details of his assets. In response, Mr. Ho stated in his fifth and sixth affirmations that he had never been a director and shareholder of Accolade and statements made by his legal representatives that he owned a majority interest in Grande Holdings were incorrect. The court found Mr. Ho's assertions contrary to the submissions made during the Mareva application. On 23 July 2009, the court ordered Mr. Ho to file and serve on Akai an affidavit providing with full particularity all the details of his assets. By summons dated 28 July 2009, Akai applied for the appointment of receivers over Mr. Ho's assets. Consequently, Accolade applied by summons: 1) to be joined as a party to this action, 2) for adjournment of Akai's receivership summons pending final determination of Accolade's application to vary the Mareva Order and the 1 June 2009 order, and 3) for variation of the Mareva Order to permit funds to be released to Accolade for the provision of legal fees. On 1 September 2009, the court appointed joint and several receivers over Mr. Ho's assets. The court found "good reason to suppose that Mr Ho has substantive control over the Ho Family Trust Assets." *Id.* at ¶ 48. The court permitted Accolade to be joined and authorised the release of funds but refused to adjourn the receiver's summons pending determination of the intervener's application to vary the Mareva Order and the 1 June 2009 order. Accolade's application for leave to appeal the court's refusal to adjourn was dismissed.

#### **Accolade's Assertions**

Accolade asserted that it had not been given sufficient time to defend the application for the appointment of receivers. Particularly, Accolade submitted that Akai had not served the February Mareva and June orders on Accolade, its directors, and its solicitors until 22 July 2009, more than five months after the February order. Additionally, Dr. Ho asserted

the Mr. Ho had no control over the Ho Family Trust. Thus, Accolade requested that the February and June orders be varied because the orders should not have covered the trust assets of the Ho Family Trust.

### **Court of Appeal Dismisses Application for Leave to Appeal**

Hon Tang VP dismissed the application for leave to appeal, finding no reasonable prospect for the receiving order to be discharged. Reviewing the evidence, the Court of Appeal (CA) found ample reason to suppose that the trust assets were in the control of Mr. Ho. In addition, the CA rejected Accolade's claim that they had insufficient time to defend the application for the appointment of receivers. In the CA's view, a "reasonable person" who believed that its properties had been wrongly included in a Mareva injunction against a person who had no beneficial interest in them, would not have waited until August before applying for joinder. *Id.* at ¶ 56. Applying *SCF Finance Co. v. Masri* [1985] 1 WLR 876, the CA noted that since the lower court was dealing with an interlocutory application and had made no final determination, the Mareva injunction was permitted to continue pending the determination of ownership of assets issue. Because a trust corporation does not have the same broad powers given to receivers, the CA rejected Accolade's suggestion that as an alternative to the appointment of receivers, new trustees be appointed in the place of Accolade as trustee of the family trust. The CA concluded "[t]his is a case which cries out for the appointment of receivers." *Id.* at 66.

## **Corporate Law**

### ***Minority Shareholder's Petition for Winding Up In Respect of Alleged Breach of Duties an Abuse of Process of the Court***

***In the Matter of Shun Tak Holdings Ltd. and In the Matter of Section 168A of the Companies Ordinance, Chap. 32, HCMP 1377/2007***

The Hong Kong Court of First Instance ordered a petition presented under Section 168A of the Companies Ordinance (Chapter 32) to be struck out as an abuse of process of the court. The court ruled that since the essence of the complaint was breach of duties and remedy provided by law would adequately redress the misconduct, the proper vehicle for seeking relief is a derivative action rather than a petition under Section 168A.

#### **Background**

Shun Tak Holdings Limited (Shun Tak), a company listed on the Stock Exchange of Hong Kong Limited, is mainly engaged in property development, transportation, hospitality, and investment holding businesses. Shun Tak is a shareholder

of Sociedade de Turismo e Diversões de Macau, S.A.R.L. (STDM), a private company incorporated in Macau which operates casino businesses. Shun Tak holds 60 percent of its issued shares in Interdragon Limited (Interdragon). Ho Hung Sun, Stanley (Stanley Ho) is the largest shareholder and chairman of the board of directors of Shun Tak as well as the managing director of STDM. Stanley Ho's daughter, Ho Chiu King Pansy Catilina (Pansy Ho), is a major shareholder of Shun Tak, chairman of the executive committee of the board of directors of Shun Tak, and a director of STDM. So Shu Fai Ambrose (Ambrose So), an employee and company secretary of Shun Tak, is an executive director of Shun Tak and a manager of STDM. Stanley Ho's sister, Ho Yuen Ki Winnie (Winnie Ho) and Mutual Stand Limited, a company wholly owned by Winnie Ho, are minority shareholders in Shun Tak and in STDM. Following a disagreement with Stanley Ho in 2001, Winnie Ho was dismissed as a director of Shun Tak and as a director of STDM.

#### **The Petition**

On 24 July 2007, Winnie Ho and Mutual Stand Limited (collectively, "petitioners") presented a petition under Section 168A against Stanley Ho, Pansy Ho, Ambrose So, and Shun Tak (collectively "respondents"), alleging a knowing failure by the three individuals to cause Shun Tak, or cause Shun Tak to procure Interdragon, to pursue STDM for proper payments of dividends. Namely, petitioners alleged: (1) non-payment of preferential dividends payable by STDM to Interdragon in respect of 9,204 shares, which should be preferential shares and not ordinary shares (the Interdragon issue); (2) underpayment of dividends properly payable by STDM to Shun Tak in respect of 4,250 ordinary shares, in that 9,204 shares in STDM were held in treasury before STDM contributed these shares to Interdragon and under Macau law, dividends were not payable in respect of shares held in treasury (the Sleeping Dividends issue); (3) improper retention of net profits in contravention of article 46 of STDM's articles of association (the Article 46 issue); and (4) inaction of Shun Tak to inquire into the complaints, to enforce its rights as holder of preferential and ordinary shares in STDM, and to take action against Stanley Ho, Pansy Ho and Ambrose So for breaches of duties in failing to pursue the complaints against STDM. The petitioners sought orders that Shun Tak bring, or cause to bring in the name of Interdragon, proceedings against STDM for recovery of dividends and an order against the named individuals for damages for their breaches of duties.

#### **The Striking Out Summonses**

In 2009, the respondents issued summonses to strike out the entire petition as an abuse of process of the court under Order 18 rule 19(1) of the Rules of the High Court and the inherent jurisdiction of the court on the grounds the complaints

in the petition were of misconduct alleged against the named individuals rather than allegations of mismanagement of Shun Tak. The respondents submitted that the petitioners should have brought proceedings by way of a derivative action or should have sued STDM directly as shareholders of STDM. Regarding Interdragon, the respondents also contended the complaint should have been struck out in view of a supplemental agreement between STDM, Shun Tak Ferries Limited, and Interdragon which confirmed that STDM shares held by Interdragon as part of a joint venture between STDM and Shun Tak Ferries, were ordinary, not preferential shares. Further, the respondents asserted that the position in the complaint relating to Interdragon was inconsistent with the position taken by Winnie Ho in legal proceedings she brought in Macau to challenge the validity of Interdragon's shareholding in STDM.

### Legal Posture

Reviewing Section 168A(2), the court determined that it was within the court's power to make the kind of orders sought in the petition. Relying on *Re Chime Corp. Ltd.* (2004) 7 HKCFAR 546 (*Chime*), the respondents submitted that although the court had jurisdiction, the petition may be held to be an abuse of process where the relief sought was for a complaint of misconduct as opposed to mismanagement. The court, citing *Re Charnley Davies Ltd. (No. 2)* [1990] BCLC 760, stated if "the essence of the complaint" were due to a director's misconduct rather than mismanagement, "the proper vehicle for seeking and obtaining such relief would be a derivative action, rather than a s.168A petition." *Shun Tak*, ¶ 33. The court explained that the procedural device of a derivative action was invented by the courts to protect minority shareholders from wrong committed by those in control of a company. The court noted that, unlike a Section 168A petition, a filter was required for a derivative action, whether brought under common law or by statute, by the threshold requirement set forth in *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)* [1982] Ch 204, or the leave application pursuant to Section 168BC(3), to prevent unmeritorious or adverse claims. The court concluded that to distinguish between misconduct and mismanagement, the essence of the complaint as well as the remedy necessary for relief must be examined.

### Court Orders Petition Struck as an Abuse of Process

Reviewing the complaints, the court determined the "whole gist of the complaints is plainly misconduct." *Id.* at ¶ 66. The court noted that although the petition claimed unfairly prejudicial conduct of Shun Tak's affairs, the claims were premised on breaches of duty owed by the named individuals as directors of the company. Further, the court found that the objective of the petition was to seek redress for Shun Tak for the misconduct, and the remedy provided by law would adequately redress

the misconduct. The court concluded the proper vehicle for seeking and obtaining relief in the instant case is a common law or statutory derivative action or direct suit against STDM. The court remarked that since STDM and Interdragon are not parties to the petition, they are not bound by any findings made in the petition and it would not be unfair to have the same issues re-litigated in a derivative action. Additionally, the court noted the risk of double jeopardy if the petition were dismissed after trial since a derivative action in the name of Shun Tak or a multiple derivative action in the name of Interdragon could be brought against the individual respondents. Turning to the Interdragon issue, the court found that the supplemental agreement confirmed that the shares held by Interdragon were ordinary shares, not preferential shares as claimed by petitioners. Further the court observed that the petitioners brought legal proceedings in Macau challenging the validity of Interdragon's shares in STDM, while asking the court to assume the shares were valid in the instant case.

For the above reasons, the court ordered the petition be struck out as an abuse of process of the court.

## Bloomberg News Wrap Up

### *Bloomberg News Wrap Up: September to October 2009*

#### Antitrust & Trade

*(30 October) China Asks Panasonic to Cut Stake in Toyota Venture*

China is requiring Panasonic Corp. to reduce its stake in a battery venture with Toyota Motor Corp. if the Japanese electronics company is to get Chinese regulatory for its takeover of Sanyo Electric Co. Panasonic must cut its stake in the venture to 19.5 percent from 40 percent, China's Ministry of Commerce said on its Web site today in a statement giving the acquisition conditional approval. The Osaka-based company must also give up its right to appoint directors to the venture's board and abandon voting rights at shareholder meetings, according to the statement. The 806.7 billion yen (\$8.87 billion) takeover will give Panasonic access to Sanyo's solar-cell technology and make the world's biggest maker of rechargeable batteries used in mobile phones and laptop computers. Panasonic's acquisition of Sanyo will also hurt competition in the market for batteries used in electronics and automobiles, the Chinese government said. In addition to reducing its stake in the Toyota venture, China told Panasonic to sell Sanyo's unit that makes coin-style rechargeable lithium batteries, used in mobile phones and digital cameras.

Panasonic must also sell either its or Sanyo's business that produces civilian-use nickel metal hydride batteries, the ministry said. In addition, China told Panasonic to sell its unit making nickel metal hydride batteries for hybrid electric vehicles. The company has six months after completing the acquisition of Sanyo to dispose of the businesses, the ministry said. Panasonic can also request an extension of a further six months, according to the statement.

*(21 September) Hong Kong Asks EU Not to Fine Asian Carriers in Antitrust Probe*

Hong Kong told the European Union that fines against Asian airlines such as Cathay Pacific Airways Ltd. and Singapore Airlines Ltd. in an air cargo price-fixing probe would conflict with the city government's rules. Hong Kong's Civil Aviation Department sent European Commission President Jose Barroso two letters detailing that its rules force the airlines to share data on prices and the conduct doesn't constitute an antitrust violation, said Stephen Kwok, assistant director general of the department. "We sent the letters to explain clearly that the airlines were in compliance with the regulation in Hong Kong," Kwok said in a telephone interview. The commission issued complaints to 26 airlines in December 2007 following what regulators said were the largest coordinated antitrust raids. Investigations in the U.S., South Korea and Australia have led to more than \$1.6 billion in fines against airlines. Michael Tscherny, a former commission spokesman who now advises companies on cartel investigations at GPlus Europe in Brussels, said it's unusual for another country to complain about an EU cartel investigation. Such conflicts may become more common as antitrust enforcement because more global, he said. "There will probably be more of these issues, as Japan and Korea are getting active and the more the cooks in the kitchen, the bigger the chance that they wield a knife and get in the way," Tscherny said.'

*Agree on Details'*

Norman Lo, director general of the Civil Aviation Department in Hong Kong, sent an initial letter in September 2008 expressing concerns about conflict of laws. In the second letter, dated 3 September 2009, he said airlines that fly to Hong Kong are legally required to "agree on the details of the collective application, including the amount of the surcharge for which approval was sought." The letter also states that the EU regulator doesn't have jurisdiction to overrule a Hong Kong authority's regulation. The letter didn't mention any airlines by name. Cargo airlines often work together to carry freight, setting aside as much as 10 percent of space for partners. Carriers' price structures include surcharges that change depending on reasons such as oil prices and security measures. Under EU rules, companies can be fined 10 percent of annual sales for antitrust violations.

## **Banking & Finance Law**

*(4 November) Thailand Approves Plan to Boost Bank Competition*

Thailand's government approved a plan aimed at increasing competition and spurring mergers and acquisitions in the nation's financial industry. The so-called financial master plan, to be effective between 2010 and 2014, will focus on "increasing competition in the sector, which will lead to lower costs," Finance Minister Korn Chatikavanij said in Bangkok today. Central Bank Governor Tarisa Watanagase said the plan also may lead to more acquisitions in Thailand, where Industrial & Commercial Bank of China Ltd., the world's largest by value, bought a majority stake in ACL Bank Pcl in September. "Our aim is to strengthen our financial institutions, increasing efficiency, so they will be ready for further liberalization," Tarisa said. "We want the financial institutions to be strong and offer a wide range of services." Thailand has 14 commercial banks, including Bangkok Bank Pcl, Siam Commercial Bank Pcl and Kasikornbank Pcl. Foreigners can hold up to 49 percent of a local lender, with stakeholdings above that limit requiring finance ministry permission. Indonesia, which has 122 commercial banks, allows foreign companies to own as much as 99 percent of a local lender. Microfinance, Islamic Banking Thailand's central bank will grant new licenses to companies providing microfinance and Islamic and investment banking services, Tarisa said. Foreign banks that already operate in Thailand will be allowed to have as many as 20 branches, she said. "At the end of the plan in 2014, we will review the situation again to see whether we should grant more licenses to normal commercial banks," she said. "We have a lot of commercial banks already. We don't want too many players yet." Also approved today was a plan to sell shares in the Stock Exchange of Thailand, which operates the nation's stock market, Korn said. An initial public offering will be held in 2011, according to the plan, which was first announced in January. "This is the first development plan for our stock market since its establishment," he said. "We want the stock market to be effective and become the main source for fundraising, not just an alternative like today."

*(16 October) China Sets Target for Nationwide Bank Coverage, Regulator Says*

China's government set a target to ensure every village, township across the country has access to some kind of financial services within three years, the China Banking Regulatory Commission said in a statement on its Web site today. As of the end of June, 2,945 townships didn't have any banking outlets, 24 percent of that figure had no access to any kind of financial services, Chairman Liu Mingkang said in the statement.

## Bankruptcy Law

*(23 September) Ernst & Young Settles Akai Collapse Lawsuit, Suspends Partner*

Ernst & Young LLP settled a lawsuit over its role in Hong Kong's biggest corporate collapse and suspended a partner after the accounting firm was accused of falsifying documents. The firm agreed to pay a "substantial" amount to settle claims of negligence in its auditing of Akai Holdings Ltd. Between 1997 and 1999, liquidator Borrelli Walsh said in a statement today. Akai, a consumer electronics maker, went bankrupt in 2000 owing creditors about \$1.11 billion. Borrelli Walsh alleged at the trial's opening on 16 September that files dating since 1994 were altered later to give the "semblance of an audit trail." Ernst & Young, which had denied the allegation at Hong Kong's High Court, said today that it had started an internal investigation and was "dismayed." "This investigation has made clear that certain documents produced for the audits in 1998 and 1999 could no longer be relied on due to the action of the audit manager in early 2000," Ernst & Young said in an e-mailed statement. The firm said it has informed the relevant regulatory body and that a former employee may also have been involved. It didn't identify the partner who was suspended or specify the settlement amount. The liquidator had said in court documents it was seeking "hundreds of millions of dollars" in damages from the Hong Kong office of Ernst & Young. Enron Legacy New York-based Ernst & Young, one of the so-called Big Four accounting firms, and auditors have come under added pressure since the 2001 collapse of Enron Corp., which brought down Arthur Andersen LLP. PricewaterhouseCoopers LLP's Canadian unit is being sued for its role as auditor to one of the funds linked to Bernard Madoff's \$65 billion Ponzi scheme. Akai at its peak employed 100,000 workers and had annual sales of HK\$40 billion (\$5.2 billion) with brands including Singer Sewing Machine Co. of the U.S. Its Shanghai-born, Canadian-educated owner James Ting was jailed for six years for false accounting in 2005 and freed the following year because of errors in the prosecution's case. Ting was accused by Borrelli Walsh's lawyer Leslie Kosmin of being a "fraudster within Akai who brought down the company and whose clear and obvious fraud" Ernst & Young failed to detect, according to court documents. Ernst & Young's audit documents from 1994 contained handwriting from an auditor who was not employed by Ernst & Young until 1998, Kosmin said at the trial's opening. 'Critical Documents' The allegedly falsified documents "permeated the defence" case that was prepared by Ernst & Young, he said then. Electronic versions of some documents had been altered with the addition of information years after the documents had been dated, Kosmin said. Mark Hapgood, lawyer for

Ernst & Young, disputed at the opening that documents had been altered and said they had been verified by experts. "The importance of the documents that were said to be tampered with was critical and with these documents discredited in evidence the core of EY's defence was removed," said Jeff Lane, a partner at Hong Kong-based Gall & Lane, a commercial litigation law firm. "A settlement was perhaps made inevitable." Gall & Lane doesn't represent either party. The trial, which had been scheduled to run for six months, was one of Asia's biggest against an auditor, lawyers said. Litigation against Ernst & Young started in 2004. "Very significant costs and court resources will be saved as a result of the settlement," Cosimo Borrelli, managing director of Borrelli Walsh, said in the statement.

### *'Very Serious'*

The allegations are "very serious," Winnie Cheung, chief executive of the Hong Kong Institute of Certified Public Accountants, said by phone today. The regulator may take disciplinary action if wrongdoing is proved, she said. Ernst & Young is co-operating with the institute's enquires, Cheung said. "We are dismayed by the unexpected circumstances that have arisen," David Sun, Ernst & Young co-area managing partner of the Far East, said in the firm's statement. Last month, Borrelli Walsh won \$22.5 million as well as interest and costs after it sued Thailand's Kasikornbank Pcl. over a \$30 million loan pledged against Akai shares. The Hong Kong company was restructured in 2003 and renamed Hang Ten Group Holdings Ltd., a clothing retailer, after a separate share sale. The case is Akai Holdings Ltd. (In Compulsory Liquidation) v. Ernst & Young (A Hong Kong Firm), HCCL 29/2004, Court of First Instance.

*(16 September) Ernst & Young Falsified Akai Files, Lawyer Says*

Accounting firm Ernst & Young used "false documents" in audit work for Akai Holdings Ltd., a lawyer representing the failed company's liquidator told a court during a trial in Hong Kong today. "It is Akai's case that audit files since 1994 had been the subject of systematic falsification in certain cases," Leslie Kosmin, a lawyer for Borrelli Walsh, told the High Court. Mark Hapgood, lawyer for Ernst & Young, denied the allegation. Ernst & Young's Hong Kong unit is defending claims from Borrelli Walsh that it breached its obligations as an auditor for consumer electronics maker Akai from 1997 and 1999. The liquidator said in court documents that it is seeking "hundreds of millions of dollars" in damages from the New York-based firm, one of the so-called Big Four accounting companies. Audit documents from 1994 were back-annotated by Ernst & Young to "give semblance of an audit trail," Kosmin said today. The allegedly falsified documents "permeated the defence"

case that was prepared by Ernst & Young, he said. Kosmin said audit documents 1994 contained handwriting from an auditor who was not employed by Ernst & Young until 1998. Kosmin also said electronic versions of some documents had been altered with the addition of information years after the documents had been dated.

#### *Singer Sewing Machine*

Akai once employed 100,000 people and had annual sales of HK\$40 billion (\$5.2 billion) of brands including Singer Sewing Machine Co. of the U.S., declared bankruptcy in 2000, owing creditors about \$1.11 billion. The company had also made stereo systems and video players. Ernst & Young didn't perform sufficient checks on Akai's assets, including about \$200 million of land in Japan and Germany for which the company lacked proof of ownership, Kosmin said. "We emphatically deny anything was done by anyone to mislead," Hapgood said at the hearing. He disputed the allegation the documents had been altered, saying they have been verified by experts. Judge William Stone said he was surprised by the allegation of falsification of the audit documents, which Kosmin said were based on evidence uncovered last week, and didn't form part of the original legal submissions. "If you were correct in your supposition, it's quite clear to me that it will have a wholly profound effect on the course of this trial," Stone told Kosmin at the hearing. The allegations were "volcanic" and "a bombshell," the judge said.

#### **Energy Law**

*(4 November) India's Top Court to Hear Ambani Gas Case Afresh With New Judge*

India's Supreme Court will commence fresh hearings today in a natural gas supply dispute between the billionaire Ambani brothers after a judge recused himself citing a potential conflict of interest. Justice B. Sudershan Reddy replaces R.V. Raveendran on the three-member bench headed by Chief Justice K.G. Balakrishnan. Raveendran stepped down yesterday saying his daughter works at a law firm that advises Mukesh Ambani's Reliance Industries Ltd. The bench on 20 October began hearing a plea by Reliance Industries to overturn a lower-court order to supply gas to a company owned by Anil Ambani at 44 percent below the state-set price. Raveendran had earlier dropped an offer to withdraw after lawyers of both companies said they don't object him even though he owns shares in the companies run by the estranged siblings. "It's very, very unusual," said Homi Phiroze Ranina, an independent lawyer based in Mumbai. "He could've made his position clear, and if all the lawyers had no objections, he could've continued." The decision by the judge may delay the completion of

arguments by a week, said Mahesh Agrawal, a lawyer for Anil's company. Raveendran holds 772 shares of Reliance Industries and 783 shares of Reliance Natural, according to a list of assets owned by judges on the Web site of the Supreme Court. "I do not want to be a party to this case," Raveendran said yesterday. "I spoke to my daughter who is in Bangalore and she works with AZB & Partners, which is advising Reliance Industries on other projects for global acquisitions."

#### *Company Statements*

Reliance Industries wasn't aware of the association and hadn't been informed about it by AZB, the company said in an emailed statement yesterday, expressing regret for the loss of six working days of the court. Reliance Industries should've disclosed the information before the hearing, Anil Dhirubhai Ambani Group said in a separate statement yesterday. Reliance Industries shares gained 5.6 percent to 1,920.70 rupees in Mumbai trading yesterday, compared with a 3.3 percent increase in the benchmark Sensitive Index. Anil Ambani's Reliance Natural Resources Ltd. shares rose 2.6 percent to 68.15 rupees. The nation's top court started hearings on the dispute last month after agreeing to skip preliminary hearings. The case is SLP(C) No. 14997/2009 between Reliance Natural Resources and Reliance Industries in India's Supreme Court.

#### **Intellectual Property**

*(14 October) Asian Domain Name Dispute Resolution Centre Forms Special Investigation Committee*

The Asian Domain Name Dispute Resolution Centre (ADNDRC) announced on 5 October that the ADNDRC Council had formed a special committee to investigate whether there are potential liabilities of ADNDRC in connection with its handling of domain name disputes in view of the potential claims which have been made against the Hong Kong Office of the ADNDRC and its personnel. The special committee is comprised of Justice Michael Hartmann (chair), Mr. Robin Peard JP and Mr. Fred Kan. The special committee will report its findings to the ADNDRC Council for such action as it deems appropriate. A domain name applicant, Frank, recently made claims to the Hong Kong International Arbitration Centre (HKIAC) alleging fraud in an arbitration involving Cheung Kong (Holdings) Limited, Hutchison Whampoa, and the Li Ka-Shing Foundation. Frank alleges that arbitrators including David Kreider and other staff helped the parties win the case by fraud. The ADNDRC, managed and operated by HKIAC, is a provider of dispute resolution services in regards to generic top level domain names to meet the business arbitration demands in South East Asia.

*(9 October) Japan Researcher's Infringement  
Conviction Overturned*

A former University of Tokyo researcher who developed Winny file-sharing software was found not to have violated Japanese copyright law, the Mainichi Daily News reported yesterday. The Osaka High Court overturned a lower court ruling finding Isamu Kaneko violated copyright law by distributing the software, according to Mainichi Daily News. The high court said Kaneko hadn't promoted the software to be used to violate copyright law, according to the newspaper. Kaneko released the software through his own Web site in May 2002 and was initially accused of assisting two people in violating copyright law, the newspaper reported.

*(8 September) McDonald's Loses Appeal  
Against Malaysia's McCurry*

McDonald's Corp., the world's largest restaurant chain, lost an attempt to stop a Kuala Lumpur eatery selling Indian food from using the name McCurry. Judge Arifin Zakaria of Malaysia's highest court dismissed the application by McDonald's as its "questions were not properly framed." The three-member Federal Court upheld a decision that McCurry Restaurant (KL) Sdn. Bhd. hadn't passed off its business as being related to McDonald's by using the prefix "Mc" in its name. "At last the eight-year legal battle is over," said McCurry's owner A.M.S.P. Suppiah, 55. McDonald's lawyer Wong Sai Fong and Liam Jeory, McDonald's Hong Kong-based spokesman for Asia-Pacific, Middle East and Africa, said the company will abide by the court's decision and declined to comment further. The Oak Brook, Illinois-based fast food chain in 2004 lost an attempt to stop Singapore-based Future Enterprises from distributing products with names like "MacTea," the same year it won a 16-year fight to stop L.C. Big Mak Burger Inc. of the Philippines from marketing a burger with a name similar to the "Big Mac" sandwich of McDonald's. "There are other similar cases where McDonald's failed," said Tan Tee Jim, a partner at Singapore-based Lee & Lee who acted for Future Enterprises, citing a Canadian ruling allowing another company to use "McBeans" for gourmet coffee. As long as there is no trade mark infringement, "smaller companies definitely have a fighting chance against the big brand names," he said.

*Fish Head Curry*

The Malaysian restaurant's logo is a chicken giving a thumbs up with the wording "Malaysian Chicken Curry." It opened for business in 1999 and serves dishes including fish head curry and breads including roti chanai and tandoori naan, according to the restaurant's website. Judge Gopal Sri Ram of the Court of Appeal had ruled in April that McCurry is a typical Indian restaurant selling Indian and local dishes while McDonald's "is a multinational vendor of fast food such as burgers, French

fries and milkshakes." "We have nothing similar with them at all," said Suppiah's wife and business partner Kanageswary, 50. She added that plans to expand their fast-food restaurant had been put on hold because of the legal fight. The Federal Court awarded McCurry costs of

*10,000 ringgit (\$2,846).*

"It's a classic case of whether or not the registration and use of a mark, that is said to closely resemble that of another party's, will cause confusion and deception," said Gilbert Leong, a partner at Singapore-based Rodyk & Davidson LLP's intellectual property practice. "Obviously, the courts in Malaysia didn't think that it would."

**Landlord & Tenant Law**

*(24 September) Zegna Sues MTR for Leasing  
Hong Kong Shop to Louis Vuitton*

Ermenegildo Zegna SpA's Hong Kong unit is suing property developer and landlord MTR Corp. for compensation for allegedly breaking an agreement over a shop lease in favour of Louis Vuitton Hong Kong Ltd. The century-old Italian clothing maker accused MTR of failing to honour a 2006 leasing agreement after allowing Louis Vuitton to occupy the shop's premises in August, according to a 22 September writ filed at Hong Kong's High Court. Closely held Zegna said it paid MTR about HK\$2.8 million (\$361,000) for the lease at the Elements mall in the city's Kowloon district. The Hong Kong business of LVMH Moet Hennessy Louis Vuitton SA paid MTR a higher price for the shop premises, Zegna alleged. Retailers are seeking to expand in Hong Kong as the city emerges from a yearlong recession and to meet demand boosted by tourists from China, the world's fastest-growing major economy. "The MTRC, having agreed to let the premises to the plaintiff, thereafter agreed to let the premises to LVHK to the financial advantage and profit of the MTRC," according to the writ. In March, MTR told Zegna that the premises at the Elements shopping center "no longer existed," after signing a lease with Louis Vuitton in January, according to the writ. MTR "urged" Zegna to take other units at the mall, the document said. 'A Commercial Matter' "This is a commercial matter, and we will handle it according to suitable procedures," said James Tsui, a spokesman at MTR, which operates Hong Kong's trains and subway. The company gets most of its profit from developing properties near its rail stations. MTR has gained 45 percent in Hong Kong trading this year, matching the Hang Seng Index's 46 percent advance. The stock fell 1.5 percent to HK\$26.05 today. Suitmaker Zegna last year had the largest share of China's luxury menswear market, followed by Hugo Boss AG, Cie. Financiere Richemont SA's Alfred Dunhill and Giorgio Armani SpA, according to Armando Branchini, executive director of Altagamma, an association of Italian

luxury companies. Porcia Leung, spokeswoman for Louis Vuitton Hong Kong, said she couldn't immediately comment on the case. Zegna officials in Hong Kong and China didn't return calls or e-mail messages seeking comment. Zegna had sales of 871 million euros (\$1.3 billion) last year, according to its Web site. The case is Ermenegildo Zegna (Hong Kong) Limited v. MTR Corporation Limited (HCA 1987/2009) and the docket link: X1Q6L7CC6282

## Law Firms

*(29 October) Lovells, Hogan Managers Approve Law Firm Merger Plan*

The management committees of Lovells LLP, the U.K.'s sixth-largest law firm, and Washington-based Hogan & Hartson LLP recommended that their partners approve a merger that would create one of the world's biggest law firms. The combined firm would rank third by number of lawyers, with about 2,500, and eighth by revenue, with as much as \$1.8 billion, according to figures compiled by the American Lawyer, a trade magazine. The firm would have 40 offices in the U.S., Europe, Asia, Latin America and the Middle East, Lovells and Hogan said today in a joint statement. "This would be the first transatlantic merger of two top- 30 global law firms, creating a unique global firm covering the U.S. and other international markets," Hogan Chairman J. Warren Gorrell Jr. said in the statement. Both firms have strong corporate, merger-and-acquisition, finance, regulatory, dispute resolution and intellectual-property practices, said Lovells Managing Partner David Harris. The proposed firm aims to be "genuinely global" and to continuously increase its breadth and depth in the U.S., the U.K., Europe and Asia, said Tony Williams of London-based Jomati Consultants LLP. Williams advised Hogan on the strategic aspects of the U.K. and international markets. The merger proposal reflects a recognition that clients in the Fortune 100 have stronger international presences than ever before-and are at the same time looking to use fewer primary law firms, Williams said today in a phone interview.

### *'Level of Quality'*

"There's never before been a merger of two firms of this level of quality," Peter Zeughauser, chairman of Newport Beach, California-based Zeughauser Group LLC, said today in a phone interview. He predicted that the merged global platforms "should attract quite a bit of work." Zeughauser, who advised Lovells on its assessment of the U.S. market, hailed Hogan's "pre-eminent" regulatory practice in Washington and its New York corporate practice. Lovells, based in London, is advising the trustee of Bernard Madoff's estate on asset-tracing matters in Europe, the government of Iceland on a \$2.1 billion recapitalization of its banks, and BTA Bank in Kazakhstan on asset-recovery work in its

restructuring, according to the firm. The firm's clients also include the property and development company Segro Plc, Morgan Stanley, Citigroup Inc. and Jefferies International Ltd. Clinton, Wolfowitz Hogan last month lured attorney Robert S. Bennett from the firm Skadden, Arps, Slate, Meagher & Flom LLP. Bennett, 70, is a defense lawyer whose clients have included former U.S. President Bill Clinton; Paul Wolfowitz, former president of the World Bank; and the accounting firm KPMG LLP. The firm's partners included John Roberts, before he became chief justice of the U.S. Supreme Court in 2005. The managements of Hogan and Lovells will ask partners to approve the merger, the firms said in their statement. Voting is expected to take place in mid-December, with a target for completing the merger by 1 May, according to the statement. One of the possible obstacles to gaining full approval for the merger is deciding on a compensation model. Lawyers at Lovells are paid primarily based on seniority, or lockstep, while Hogan lawyers are paid mainly based on performance. 'Groundbreaking Proposition' "There's never a merger without challenges, but this is a sufficiently exciting and groundbreaking proposition, and the pie is sufficiently big that I'm sure there will be flexibility all around" when it comes to working out a compensation model, Williams said. If completed, the merger will likely spur other discussions between U.S. and U.K. firms, according to Sheena Brand of Hong Kong-based legal management consultants Professional Development Asia Ltd. "Strategically, the merger makes a great deal of sense," New York-based legal consultant Bruce MacEwen said in an interview today. "And if they get the synching of compensation models right at the beginning, when enthusiasm for the deal is at a peak, they'll be well on their way." The merged firm will likely move away from lockstep toward merit-based pay, and many lawyers will leave in the first year or two, said MacEwen, who isn't involved in the merger talks. "If you were a beneficiary of lockstep and your compensation declines under a merit-based system, you have two choices: Step up your performance or find a new home," MacEwen said. To prepare for the next round of voting, partners at each firm will receive a prospectus explaining the rationale for the merger as well as the respective firms' policies on matters such as technology, professional staffing and compensation, according to Zeughauser.

### *'Secret Sauce'*

"When you have two successful firms talking about merging, they worry, 'Are we going to screw up our secret sauce?'" Zeughauser said. "Because partners are lawyers, they want to know all the details." Lovells had revenue of 531 million pounds (\$849 million) during the year ended 30 April, according to the firm.

*(27 October) Weil Gotshal Targets China Mergers  
With Simmons & Simmons Hires*

Weil Gotshal & Manges LLP, the third-ranked legal adviser on mergers and acquisitions, hired Henry Ong and Jasson Han from London-based law firm Simmons & Simmons to target an increase in China-related deals. The New York-based firm will also expand to offer Hong Kong legal advice, which has become important with many Chinese transactions now having Hong Kong takeover code implications, according to Asia Managing Partner Akiko Mikumo. Ong and Han add to Weil's 30 lawyers in Beijing, Shanghai and Hong Kong, Mikumo said today. Their arrival boosts the firm's position in cross-border mergers and private equity transactions, according to Chairman Stephen Dannhauser. Weil Gotshal joins U.S. firms such as Skadden, Arps, Slate, Meagher & Flom LLP and Latham & Watkins in expanding their Hong Kong offices to practice local law. New entrants such as New York-based Proskauer Rose LLP have set up offering clients that capability. China-related stocks now account for half of market capitalization in the city, up from 5 percent in 1993. Hong Kong ranked as No. 2 globally for funds raised through initial public offerings in the first half of this year, after Brazil, according to data released by the city's bourse. The Hong Kong exchange, Asia's third-largest, has attracted 34 listings this year, according to data compiled by Bloomberg. Weil Gotshal opened its Hong Kong office in 2007 and will initially advise on local law through an association with a firm established by Ong to comply with Hong Kong Law Society rules. Han, who had formerly been a partner at Beijing-based law firm Jun He Law Offices, will divide his time between Hong Kong and Beijing, according to a statement. Weil Gotshal has advised on 90 deals worth \$178 billion so far this year according to Bloomberg data.

*(4 October) South Korea Permits Some Foreign  
Law Firms to Open Offices*

South Korea will allow law firms from countries with which it has a free-trade agreement to open offices in the nation, the Ministry of Justice said. The government passed a bill on 26 September to allow foreign lawyers to act as legal consultants in South Korea, according to the ministry's Web site. The lawyers will continue to be barred from appearing in Korean courts. Foreign legal consultants will require at least three years work experience outside South Korea and must reside in the nation for more than 180 days a year, according to the ministry. South Korea has free-trade agreements with Singapore, Chile, the Association of Southeast Asian Nations, and European Free Trade Association. Its June 2007 accord with the U.S. has been stalled by legislators in both countries.

*(18 September) Freshfields Hires Citigroup's  
Miller for Asia Finance*

Freshfields Bruckhaus Deringer LLP, the top legal adviser for Asian mergers and acquisitions, said Citigroup Inc.'s Royce Miller will join as a partner and head its Asian financial services practice early next year. The managing director and general counsel of Citigroup's Asia Pacific institutional clients group will join Freshfields' Hong Kong office, the London-based law firm said in an e-mailed statement today. Miller, 48, was previously general counsel for Citigroup's markets and banking division in Asia, and had also worked in Europe for the New York-based bank. He will have "an immediate impact advising our clients on the ever-changing financial landscape in Asia," said Freshfields' Asia Managing Partner Simon Marchant. Freshfields' clients in Asia include Nomura Holdings Inc., Deutsche Bank AG and HSBC Holdings Plc. It has more than 200 lawyers in its China, Japan and Vietnam offices and advising on Indian transactions, according to Marchant. The law firm this year has advised on 32 deals involving Asian companies worth \$19.4 billion, according to Bloomberg data. Regulatory scrutiny is intensifying in Asia as the region's economies grow and mature, Miller said in the statement. Citigroup was cleared of insider trading in Australia in 2007. It shut its private bank in Japan in 2004 amid money laundering charges.

**Securities Law**

*(5 November) Hong Kong Proposes Class Actions  
After Lehman Losses*

Hong Kong's Law Reform Commission proposed allowing class-action lawsuits in cases such as the losses thousands of investors in the city suffered on notes guaranteed by failed Lehman Brothers Holdings Inc. If there was misrepresentation in the advertising or prospectuses for such unlisted securities, investors could be able to litigate as a group, the chairman of the commission's sub-committee on class actions, Anthony Neoh, said today. "This would be an additional weapon" for people without the financial ability to seek damages, he said. The value of an estimated \$1.8 billion of Lehman-backed products known as "minibonds" sold to more than 40,000 investors collapsed after Lehman's bankruptcy, sparking street protests. Hong Kong banks in July offered to pay at least 60 cents on the dollar to them after regulatory and legislative investigations. "The need for a new approach to handling multiparty claims has long been recognized," said Nigel Francis, Asian disputes head at Minter Ellison in Hong Kong. Consumer-related claims might be more suited to class actions than complex misrepresentation claims involving securities, he said. "Such claims, while they may involve a single product

and some common issues, will each ultimately be decided on their own facts,” Francis said. Class actions allow a representative of several people with a common complaint to litigate on the group’s behalf, with an aim of helping lower the costs for each individual. Restrictive, Inadequate A class action regime is appropriate for “a society that has become more advanced,” Neoh said today. Hong Kong currently only allows multiparty proceedings under rules the city’s chief justice criticized as restrictive and inadequate in 2004. Today’s proposals were published after three years of study by Neoh’s committee, which invited public comment until 4 February 2010. Neoh said he then hopes to make final recommendations for the necessary changes to the law by November next year. The 314-page consultation paper doesn’t recommend allowing lawyers to take cases on contingency, or being paid only if they win money for their clients. It also said that allowing litigation funding companies would require adequate supervisory measures to be in place. “Lawyers shouldn’t have a financial interest in the outcome of a case,” said Neoh, a lawyer who acted for a retired couple who sued DBS Group Holdings Ltd. for failing to comply with securities laws while selling minibonds.

#### *Allocating Risk*

There are no concrete proposals on how to fund class actions and to allocate the risk of losing them if they were to be allowed, so the likelihood of a regime coming into effect in the next few years is low, said Gareth Thomas, Hong Kong commercial litigation head at Herbert Smith. As of 28 October, 97 percent of the minibond investors eligible for compensation have accepted the settlement offer, according to the Hong Kong Monetary Authority. The notes were guaranteed by Lehman and linked to debt of Hong Kong companies like Hutchison Whampoa Ltd. and Sun Hung Kai Properties Ltd. Among buyers were elderly and poorly educated people as well as mentally ill individuals, according to an investigation by the city’s central bank that was made public by lawmakers on 28 April.

#### *(7 October) France’s CIC Sues Former Singapore Client, Straits Times Says*

Credit Industriel et Commercial, a French bank, is suing a former client for about S\$6.4 million (\$4.6 million) after he allegedly failed to pay for some investments, the Straits Times reported. The bank is alleging that Teo Wai Cheong failed to pay for shares acquired in 2007 under investments known as accumulators, the Singapore-based newspaper reported, citing the first day of proceedings at the city’s High Court. CIC, as the bank is known, is claiming that Teo instructed his relationship manager, Ng Su Ming, to purchase accumulators for China Energy Ltd. and

SembCorp Marine Ltd., the report said. Teo denied this, telling the court that he had told Ng to limit his exposure to the structured products to S\$1 million and to restrict the investments to so-called blue-chip companies, according to the newspaper. Manoj Sandrasegara, CIC’s lawyer from Drew & Napier LLC, and Teo’s lawyer, Sean Lim, couldn’t immediately be reached for comment because they were in court.

#### *(25 September) Citibank Sued in Hong Kong Over Lehman-Linked Notes, SCMP Says*

Citibank was sued in Hong Kong by a nurse who bought HK\$500,000 (\$64,500) worth of Lehman Brothers Holdings Inc. equity-linked notes, the South China Morning Post said, citing a writ filed with the District Court. The writ accused Citibank of acting in breach of its duties to Chan Mei-ying because the bank recommended a high-risk product, unsuitable for her, the English-language Post said. The lawsuit is the first using the Consumer Legal Action Fund, according to the report. Officials at Citibank in Hong Kong didn’t answer phone calls seeking comment.

#### *(21 September) China Halts Institutional IPO Bid Licenses, Dow Says*

China hasn’t increased the number of institutional investors allowed to take part in subscriptions for initial public offerings in four months, Dow Jones Newswires reported, citing an unidentified person. The Securities Association of China hasn’t issued licenses needed to take part in offline subscriptions for IPOs in the past four months in a bid to curb excessive liquidity, according to the report. An official at the association, who declined to give his name, declined to comment by telephone and didn’t immediately responds to faxed questions. A spokeswoman for the China Securities Regulatory Commission declined to comment. China ended a moratorium on new listings four months ago, when regulators approved Guilin Sanjin Pharmaceutical Co.’s initial public offering in Shenzhen on 18 June. The government had halted listings in September 2008 after the nation’s benchmark Shanghai Composite Index fell 56 percent in the first eight months of last year. The gauge has gained 63 percent so far in 2009. The price range for initial public offerings in China is determined based on bids by institutional investors for shares. Institutional investors are then allotted stock in a so-called offline subscription process and retail investors in a so-called online subscription process. Institutional investors must have good credit records and a comprehensive internal risk control mechanism to qualify to participate in the IPO bidding process, according to the China Securities Regulatory Commission’s Web site.

Metallurgical Corporation of China Ltd. rose 28 percent in its Shanghai trading debut today. That trailed the average 68 percent first-day gain of the 22 other IPOs this year.

*(18 September) Former Morgan Stanley Banker  
Du Jailed for 7 Years*

Former Morgan Stanley managing director Du Jun was sentenced to seven years in prison and fined HK\$23.3 million (\$3 million) by a Hong Kong court for insider trading. "I can't think of another reason other than being driven by sheer greed for his action," District Court Judge Andrew Chan said today. The sentence is the longest the court can hand out for insider trading. Du, 40, is the sixth person sent to jail in Hong Kong since April for insider trading, as the Securities and Futures Commission cracks down on the offence. The commission has won convictions in all 10 cases it has brought since the city made insider dealing a crime in 2003. "The SFC is sending a signal to the market that they're taking a serious position," Raymond So, a professor at the Chinese University of Hong Kong's department of finance, said before the sentencing. "Even if you're an influential tycoon there could eventually be a case against you." Judge Chan last week convicted Du of nine counts of insider trading and one count of advising his wife to deal in shares of Citic Resources Holdings Ltd. in 2007. "The defendant was given the opportunity twice to walk away by his supervisor who warned him of his action," Judge Chan said. "His action was a serious breach of trust." Du's lawyer Alexander King declined to say whether he will appeal the sentence. Compliance System Du bought shares of Citic, a unit of China's largest manager of government businesses, after learning of its plan to buy a Chinese oilfield while helping the company sell bonds. He sold half of the shares in July 2007 for a profit of about HK\$33.4 million after a 8 May announcement of a deal, Prosecutor Charlotte Draycott had told the court. He borrowed HK\$50 million in margin financing from Morgan Stanley for the transactions, more than double his 2006 basic salary and bonus of HK\$19 million, she said. Du was also ordered today to pay more than HK\$933,000 in investigation costs to the SFC. He will be jailed for an additional 12 months if he fails to pay his fines within nine months, Chan said today. New York-based Morgan Stanley's compliance system was "deficient," Chan said 10 September. Du's lawyer argued that the banker wouldn't have sought and gained approval to trade the shares from the department had he known the information he gained while assisting the company in selling bonds was relevant.

*'Over the Wall'*

Chan said he was satisfied Du "must have realized he's over the wall and he was clearly over the wall," referring to the compliance status at banks when staff have material non-

public information on a deal. "Morgan Stanley expects all of our employees to uphold the highest ethical standards," Nick Footitt, a spokesman for the New York-based bank in Hong Kong, said on 10 September. Du's misconduct "was identified by the firm and reported, and the employee was terminated," he said. "The wrongdoing by a former employee of our firm was a violation of Morgan Stanley's values and policies," he added. A Beijing-native, Du worked for Morgan Stanley in Hong Kong from 2001 until May 2007 when he was fired. He returned to Hong Kong from Beijing last year after HK\$46.5 million of his assets in the city were frozen by the SFC. He was arrested at the airport on his return. Insider dealing, now carrying a maximum prison sentence of 10 years and fines of up to HK\$10 million, was only punishable with fines until 2003 in Hong Kong. Before then, insider-trading charges were heard as civil cases at the Insider Dealing Tribunal, an agency under the city's Financial Secretary. Du was tried in District Court, which can impose only a maximum sentence of seven years. Former BNP Paribas Peregrine Capital Ltd. banker Ma Hon-yeung was jailed for 26 months in April. Ex-CLSA Asia-Pacific Markets banker Allen Lam and former HSZ (Hong Kong) Ltd. fund manager Ryan Fong were given prison terms in July. The case is Department of Justice v. Du Jun, DCCC 787/2008, Hong Kong District Court No. 33.

*(8 September) Hong Kong Court Declines to Alter  
Billionaire's Freeze Order*

Hong Kong's High Court today rejected a Securities and Futures Commission's application to change an asset-freeze order on two companies owned by Chinese billionaire Huang Guangyu, China's second-richest man. The court upheld an earlier decision to freeze about HK\$1.66 billion (\$214 million) of assets held by Huang, his wife Du Juan, Shinning Crown Holdings Inc. and Shine Group Ltd. in Hong Kong. Of these assets, about 779 million shares of Gome Electrical Appliances Holdings Ltd. owned by Shinning Crown and Shine Group are being held by the court. The commission had sought a mechanism to safeguard the assets' value because Gome's share price "will go up or down daily," Simon Westbrook, the securities watchdog's lawyer told reporters today. Huang, Gome's founder and biggest shareholder, owns Shinning Crown and Shine Group. "It's undesirable for the court to have such discretion", Judge Susan Kwan, said at today's hearing on the filing against Huang, Du and the two companies. "The proposal by the SFC is a lot more restrictive than the court's order," Kwan said. Gome fell 2.2 percent to HK\$2.18 at 3:25 p.m. in Hong Kong. The stock has more than doubled since resuming trading 23 June after a seven-month halt that followed the detention of Huang, also known

as Wong Kwong Yu. The 779 million shares are worth about HK\$1.7 billion at today's price. Huang and Du are accused of organizing a share repurchase by Gome in January and February last year so Huang could use the proceeds to repay a HK\$2.4 billion personal loan, the commission said 7 August. Huang Still Detained Huang, who resigned as Gome's chairman in January, was detained by Beijing police in November for "economic crimes" and hasn't made a public statement or appearance since. The police haven't responded to faxes asking about his whereabouts. Du is also under investigation, Beijing police said in a faxed statement in January. Huang and Du are still detained in China, Winston Poon, a lawyer for Shinning Crown and Shine Group told the court today. Huang wholly owns both companies, the SFC's Westbrook said. "We reserve the right to come back and ask to top up the share deposits so that the proximate value of HK\$1.65 billion is maintained," Westbrook said. "If there's a substantial, sustained drop, then we'll probably come back." The securities commission is investigating the assets and an injunction will ensure there are sufficient resources to cover any restoration or compensation orders, it said last month. It is seeking orders that Huang, Du and the two companies owned and controlled by them reimburse the parties who lost money in the buyback, in particular Gome, or pay damages to the retailer. The electronics retailer, which had 859 stores in China at the end of last year, isn't a defendant in the case, it said last month. The company declined to comment on today's hearing. Gome's first half profit fell 50 percent to 580 million yuan (\$85 million) after Chinese consumers cut spending on big-ticket items. Sales fell 18 percent to 20.5 billion yuan.

*News contributed by: Shiyin Chen, Wing-Gar Cheng, Cynthia Cotts, Victoria Slind-Flor, Lindsay Fortado, Shinhye Kang, Mark Lee, Sophie Leung, Matthew Newman, Ranjeetha Pakiam, Kyunghye Park, Natalie Obiko Pearson, Andrea Tan, Theresa Tang, Douglas Wong, Kelvin Wong, and Suttinee Yuvejwattana.*

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