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Client Alert

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CHINA AMERICA LEGAL FORUM

DOING BUSINESS AND RAISING CAPITAL PRIVATELY IN THE US
KEY CONSIDERATIONS FOR CHINESE BUSINESSES

Part I of this memo gives an overview of the primary mechanisms used to enter the US market, including launching business operations through the formation of a subsidiary or branch office, or through transactions such as a merger or acquisitions, or joint venture.

Part II describes the market and regulatory landscape for raising money privately in the US, without filing documents or registering the securities with the Securities and Exchange Commission ("SEC") or a listing on a stock exchange. There are many mechanisms available for conducting a private offering, resulting in a private capital market that is over twice the size of the public markets.

The United States welcomes Chinese direct investment. Chinese businesses can form US subsidiaries or divisions, acquire or enter into joint ventures with US businesses, and raise money in the US capital markets even if they do not do business in the US. The intricate US legal landscape provides the basis for a stable business environment, but at the same time presents many legal and regulatory challenges that must be navigated with care.

Part I: Expanding Operations into the United States

Forming a Subsidiary

Choice of Entity

Whether a Chinese business should create a separate legal entity in the US, or operate in the US as a division or branch of your Chinese business, is affected by its desire or need to limit the liability exposure of the parent, and the tax implications of different kinds of cross border business structures.

Entities With Limited Liability. The laws governing entity formation are enacted by each state individually, not federal US law, but each state has basically the same kind of entity classifications. In addition, each state has its own rules for the procedures that authorize a "foreign" entity – one formed outside the state, whether it is formed under the laws of another US state or a different country -- to do business within the state. This paper primarily refers to the state laws of New York and Delaware, being two common choice-of-entity jurisdictions in multinational corporate structures involving the US.

There are several types of business entities that can be established in the United States. The "C-Corp" (which takes its name from the part of the Internal Revenue Code that applies to legal entities of this type) and the Limited Liability Company ("LLC") are the most common types of entities used in the multinational context. The Limited Partnership

is another kind of entity but is not as generally used and does not afford the same benefits as a C-Corp or LLC, and will not be covered in this paper.

The primary feature shared by C-Corps and LLCs is the ability to have perpetual existence, and **limited liability.** Doing business through an entity with limited liability shields the Chinese parent / shareholders / owners from responsibility for the liabilities and debts of the US entity. The liability exposure of an owner (being the shareholders of a C-Corp or Members of an LLC) is limited to the value of the shares it holds (or capital contribution in the case of an LLC), unless the "corporate veil" can be pierced, which is discussed below. However, it should be noted that, with respect to New York entities, the ten largest shareholders remain liable for wages or salaries owed to employees.

"Piercing the Corporate Veil" and the Importance of Corporate Governance Best Practices

The liability of an investor is typically limited to the value of his/her shares, or capital contribution in the case of an LLC. A corporate parent, or shareholders of a C-Corp, and members of an LLC are generally not personally liable if the entity cannot pay its debts, unless the "corporate veil" can be pierced. If the "corporate veil" is pierced, the parent may also be held responsible for other liabilities of the US subsidiary that are based on strict liability rather than fault- based, such an environmental law violations or products liability. The following factors may result in a court piercing the corporate veil and finding the parent, or shareholders /members liable for the entity's debts:

- Control exercised over the entity by the shareholders/members is so complete that the entity has no separate mind from the shareholders/members, and use of such control to commit fraud or some other dishonest act.
- Injury or unjust loss resulting from such control.
- Disregard of corporate formalities: failure to organize the corporation prior to conducting business, commingling of corporate and parent or shareholder assets, failure to maintain books, records and minutes of requisite meetings.
- Undercapitalization. The parent/shareholder fails to provide the entity with assets sufficient to meet its reasonably foreseeable costs.

To preserve limited liability, the US subsidiary must run its affairs in a manner that is indeed separate from the parent.

- Keep adequate books and records of board meetings and the decision-making process;
- Do not co-mingle assets without arms length agreements;
- Keep money in different bank accounts; and
- Appoint officers or managers at the entity level with clear responsibility for making business decisions.
- Parent should refrain from otherwise exercising control over the US subsidiary's daily operations.

Other benefits of good corporate governance practices: A well-maintained set of corporate governing documents helps companies to attract capital because angel and venture capital investors, and investment bankers and underwriters for an IPO or other public or private offering, will conduct due diligence and expect to see a well-run enterprise. A poorly-run operation can adversely affect valuations.

Governance Documentation: Where are the rules that tell an entity how to govern itself?

C-Corporations

The governing documentation for a corporation is the certificate of formation, which typically is called a "**Certificate of Incorporation**" or "**Articles of Incorporation**" depending on the state. The Certificate is filed with a state regulator and is a public document. They range from the very simplest one-page documents that merely state the corporation's name, its authorized share capital including different classes of shares and the rights of those different classes, the name of its agent for service of process if it is sued, and its purpose which quite commonly is broadly stated as "any lawful purpose", to lengthy and complex Articles for public companies that contain many provisions designed to protect management and the board or deal with rules or procedures governing certain shareholder actions, such as hostile takeover bids. Amending the Articles typically requires shareholder consent.

The **By- laws** are the fundamental, detailed governing document of a company, and in Delaware and New York, for instance, are adopted at the first meeting of the incorporators, or if the board is named in the originally filed Articles then the first meeting of the board, and thereafter can be amended by shareholder consent; however, Delaware law provides that the first by-laws can provide that the by-laws can be amended by the board without shareholder consent, but it should be noted that conferring the right of the board to amend the by-laws without shareholder consent does not divest the shareholders of their power to amend or repeal the by-laws. By-laws are a non-public document. Typically corporate law requires that by-laws generally contain:

- Procedures (notice, quorum etc.) for regular and special meetings of shareholders and the board;
- Composition and responsibility of the board, officers and their duties;
- Procedures for approval of major extraordinary transactions (i.e., super majority voting, authorization of new classes of shares or change to the rights of an existing class etc.);
- Circumstances calling for dissolution of the corporation;
- Procedures governing amendments to the certificate/articles of incorporation (which will require shareholder approval if an amendment affects a particular class of shares), and whether the by-laws can be amended by the board without shareholder consent; and
- Procedures for stock transfers.

C-Corp Share Capital Characteristic A corporation is free to issue shares of different classes that have different rights from other classes: voting vs. non-voting, shares with special voting weight in certain matters which can be used to maintain control in a certain group of shareholders such as the founders, preferred shares as to liquidation preference, and so on. However, all shares within the same class must be treated equally with other shareholders in that class.

Shareholder Agreements and Voting Agreements are allowed among shareholders. They are contracts in which shareholders agree to vote a certain way or agree among themselves about how certain transactions may be handled or rights will be exercised, such as rights of redemptions, so that they act as a group. Sometimes shareholders can deposit shares with a trustee who votes on their behalf according to the parameters set forth in a trust agreement.

Public companies sometimes use corporate governance and manipulation of share capital as a defense against hostile takeovers. Due to the diversified ownership structure of a public company where typically one shareholder does not wield enough power to control the board, when faced with a potential hostile takeover by a shareholder who suddenly starts to buy large amounts of stock, boards of directors are apt to take defensive measures to block the potential acquisition at the price offered to the shareholders by the bidder. They are designed to force the bidder, in effect, to negotiate with the board on the offer price, ostensibly to protect the shareholders from having the company taken over at a stock price that is below its value, but these measures are often controversial and seen as a mechanism used by entrenched management and boards to protect their position. The mechanisms include the board amending the by-laws of the target company (if they are allowed to do so in the articles of incorporation) to control the timing of special shareholder meetings, to control the procedure to replace directors, or adopting a "Shareholder Rights Plans", also called a "poison pill". The rights plan gives shareholders of record (other than the hostile bidder) on a certain date extra rights to buy additional shares of the company at a discount if any one shareholder buys a certain stated percentage (a "flip in") or upon a merger or consolidation gives the holder the right to buy shares of the acquirer equal to some multiple (i.e., 2X) the exercise price. Rights plans are intended to dilute the hostile bidder and make the offer economically unviable. The use of these protective mechanisms may lead to shareholder lawsuits (shareholder derivative actions) against the company to have the defensive measure declared void, and if they fail and the mechanism stands then the potential acquiror must raise their price or retreat. Shareholder Rights plans must be carefully structured, adopted and administered in order to be upheld by a court.

Recent examples of Chinese companies adopting shareholders rights plans include ***China Biologic Products*** (traded on NASDAQ) and ***ChinaEdu Corporation;*** however, it is interesting to note that, subsequent to adopting its rights plan, the shareholders of ChinaEdu Corp. approved a reverse merger as a going-private transaction where some shareholders received cash consideration and others received shares in the surviving entity, and upon closing of the merger ChinaEdu requested that trading in their ADSs on NASDAQ be halted and delisted, to terminate its ongoing reporting obligations under the Exchange Act.

Limited Liability Companies

LLCs are governed by the procedures to which the members (owners) agree, which are set forth in a contract among the owners typically called a Limited Liability Company Operating Agreement. Absent an agreement, provisions set out in the state's law as to certain key matters will govern.

LLCs are often used in internal business structuring for their ease of administration, and are also common in cross border joint ventures.

Other important aspects of entity formation

Privacy of owners The identity of shareholder in the US remains private, companies are not required to file a list of their shareholders with any regulator. However, If a company is an Exchange Act Reporting Company, meaning it is subject to the reporting obligations under the Securities Laws (has sold securities in a public offering or is listed on a stock exchange) then a shareholder who acquires beneficial ownership of 5% or more must file a notice of ownership with the SEC (Form 13D).

No "statutory accounts" Unlike many jurisdictions, no entity is required to file financial reports in order to maintain its existence, but companies that have securities registered with the SEC or listed on a stock exchange are subject to the periodic disclosure obligations of the Exchange Act; however, non-US companies that meet the definition of "foreign private issuer" may qualify for an exemption from complying with the US periodic disclosure

obligations if they file, with the SEC, certain information that they make available in their home jurisdiction (see the discussion below about "Exemptions that apply to foreign private issuers").

Minimum capital requirements There are no minimum capital requirements to form an entity under the relevant laws in New York or Delaware and indeed most states; however, as noted above, failure to provide adequate capital for the business to conduct its affairs could be a factor in determining whether the "corporate veil" would be pierced. Also, as discussed below, if the parent will relocate management to the US, in order to obtain a visa the parent must show that it has provided adequate capital to maintain an office and pay the salary of relocated personnel.

Physical Presence or Address Typically state law where the entity will be formed does not require a physical presence or address in the state in order to form an entity. What is necessary is that a person or entity in the jurisdiction must be appointed, as a matter of public record, to receive service of process if the entity is sued, and that also does not require that the company itself have an address in the jurisdiction because, as if often the case, a local agent is appointed; often in the absence of an appointment the default is that the Secretary of State of the State can be served as if it was the company's agent. However, there may be other aspects of the business enterprise that would require a physical address, for example, a physical address is often needed for purposes of getting US visas for foreign employees, as a matter of immigration law, and an entity that wants to take advantage of tax incentive programs will need to meet physical presence criteria in that locality.

Who can own a C-Corp or LLC: There are no restrictions under state corporate law on who can be an owner of a C-Corp or LLC -- an individual or other entity such as another corporation, LLC, or partnership that is either domestic (formed within the state) or foreign (formed outside the state including outside the US) are all acceptable.

An LLC may have one or more members; however, in order to be eligible to elect to be taxed as a partnership for pass-through tax treatment, the LLC must have at least two members, otherwise a single member LLC can elect to be treated as a corporation or as a sole proprietorship. Like a C-Corp, there is no restriction on the type of owner. Members are admitted in accordance with the LLC's Operating Agreement (a non-public document) and applicable statutory provisions.

The owners of both a corporation and an LLC are not required to be disclosed under corporate law; however, if a company is an Exchange Act Reporting Company, meaning it is subject to the reporting obligations under the Securities Laws (has sold securities in a public offering or is listed on a stock exchange) then a shareholder who acquires beneficial ownership of 5% or more must file a notice of ownership with the SEC (Form 13D)

Officer and Director Criteria and Duties

Unlike many jurisdictions, in the US there are typically no specific requirements imposed by state corporate law regarding the number of directors (other than at least one) or officers, or other characteristics of officers or directors – no requirement of residency, domicile or citizenship, for example. A public company, however, is subject to SEC and stock exchange rules and regulations, and the provisions of the Sarbanes-Oxley Act of 2002, which does have some suitability and independence requirements related to the certain director roles, such as audit, nominating and compensation committee members.

Directors of solvent corporations have two basic "fiduciary" duties, the duty of care and the duty of loyalty, owed to the corporation itself and the shareholders.

- "**Duty of care**": Directors must act in good faith, with the care of a prudent person, and in the best interest of the corporation.

- "**Duty of Loyalty**": Directors must refrain from self-dealing, usurping corporate opportunities and receiving improper personal benefits.

The fiduciary duties guard against bad faith, not bad judgment: decisions made on an informed basis, in good faith and in the honest belief that the action was taken in the best interest of the corporation will be protected by the "**business judgment rule**." The adequacy of how a director discharges his/her fiduciary duties is measured against the "business judgment rule". The business judgment rule thus provides significant protection to directors (and officers) from personal liability for their good faith, informed, business decisions. The presumption may be rebutted where it is shown that a director had a personal financial interest in a transaction, lacked independence, did not inform himself of all information that was reasonably available, failed to exercise the requisite level of care, or stood on both sides of the transaction; in these circumstances, the director must show that his conduct meets the stricter standard of "entire fairness" to the corporation. It should be noted that this obligation to prove the entire fairness of a transaction applies where the same person holds dual or multiple directorships, as in parent-subsidiary contexts.

Directors are typically also protected against personal liability by receiving indemnities from the corporation to the fullest extent permitted by law. The indemnification is strongest if it is included in the company's articles of incorporation. Also, directors' and officers' are protected through Directors' and Officers' ("D&O") insurance.

Generally, officers owe the same fiduciary duties as directors. Officers may also have a duty to keep the Board informed. Officers with greater knowledge and involvement may be subject to higher standard of scrutiny and liability.

Directors and officers risk liability to creditors for breaches of fiduciary duties. Also, certain statutes impose director and/or officer liability in specific situations. A few examples include failure to pay taxes and wages, unlawful payment of dividends, fraudulent transfers and breach of duty to an employee retirement or pension plan ("ERISA Plan").

Directors of insolvent companies may have broader duties. It is generally accepted that when a corporation becomes insolvent, directors owe fiduciary duties to creditors. The existence of a duty to creditors does not necessarily mean that duties to shareholders are eliminated, some courts look broadly at a "community of interests" that includes stockholders, creditors, employees and any other group interested in the corporation. Under this view, the board of directors has an obligation to exercise its judgment in an informed, good faith effort to maximize the corporation's long-term wealth-creating capacity; if directors conceive of the corporation as a single legal and economic entity, they are less likely to adopt high-risk strategies that might benefit shareholders, who have no downside risk at insolvency, to the detriment of other interested constituencies.

Special Duties for Directors of Public Companies

In reaction to a series of corporate and accounting scandals in the 1990s that shook the financial markets, Congress passed the Sarbanes-Oxley Act that lead to the promulgation of rules by the SEC and various securities exchanges requiring, among other things, participation of independent (non-executive) directors in certain key roles of the Board, particularly with respect to the audit committee and oversight of internal financial controls and auditors, the nominating committee for new board members, and the compensation committee for executive officer compensation.

Who really controls the entity: Management Structure of Corporations and LLCs

Corporation: We have discussed the role of directors and management in running the company and making decisions, but in fact management and the Board must share some power with the shareholders. Ultimate power

of management and control rests with the board, including choice of officers and management, but shareholders elect the Board and have the power to vote on extraordinary transactions such as dissolution of the entity, amendments to the articles and changes to share capital or the terms of outstanding securities.

Limited Liability Companies may be managed by any one or more designated members, or an appointed manager, who need not be a member. LLCs often adopt a corporate management structure, appointing a board and officers, but in this situation, members still retain their right to vote and approve certain actions such as the issuance of new membership interests or the taking of other dilutive action, and retain protective rights dealing with transfer of interests and dilution.

Branch office - Doing business without creating a US entity

Unlike many non-US jurisdictions, the concept of the formation of a formal "branch office" with special formation requirements does not exist in the US. Under New York or Delaware law, "qualifying to do business as a foreign corporation"(in this case, "foreign" means formed outside the state, either in another state or another country) together with obtaining the required federal tax ID number, will allow a foreign entity to function locally. A branch is not the advisable course of action for any sizeable amount of business dealings as it does not provide limitation of liability protection, and can hinder the ability to raise capital. The procedures are simple:

A non-US company can qualify to do business in a state simply by filing a form with the state's Secretary of State (similar to how an entity formed in one state qualified to do business in another state). It can conduct any business that would be lawful for an entity formed within the state.

The branch is not a legal entity, therefore does not insulate the parent from liability for its actions.

TAX CONSIDERATIONS

Tax System Overview. The principal taxes that apply to most companies doing business in the US are (i) income tax and (ii) if they have relatively significant numbers of employees, "payroll tax" (*i.e.*, payments that the employer must make to government agencies for unemployment insurance and other mandatory social benefits for the employees). These taxes are imposed by the federal government and by the states in which the company is doing business. The local (*i.e.*, city) governments may impose these taxes as well, although very few do so; New York City is the most notable exception. The most important local tax is the tax on the value of real estate, which, of course, only applies to a business that own real estate. The US has no value added tax (VAT), but some states and localities levy a "sales tax" on the price of goods when they are sold to a consumer, which is collected by the vendor who makes the sale to the consumer. If the US subsidiary of a Chinese company will be a commerce or e-commerce company this may be relevant as it poses an administrative burden, the business holds the sales taxes it collects from the consumer in trust and is liable to pay them to the taxing authority, but the tax itself does not come out of the business's revenues or profits.

The federal income taxes apply at the same rates everywhere in the US, whereas the state taxes vary from state to state; the current top federal corporate tax rate is 35%, but the "effective" rate companies pay is often lower after taking into account tax credits, deductions and exemptions. As a general principle, the basis for state tax is where the business activity takes place, not where the business is incorporated. For example, a corporation that is incorporated in Delaware (or China) but that operates exclusively in New York State will be taxed on its income by New York State, not Delaware. If the same corporation did business in both New York and California, some of its income would be taxed in New York and some of its income would be taxed in California.

It should be noted, however, that the jurisdiction of formation will likely require the payment of an annual fee (sometimes referred to as a "franchise tax") to maintain the entity's existence, and these vary widely. The fee for

an LLC is usually a nominal flat fee, $100 in New York for example. The fees for corporations vary depending on the number of authorized shares and the par value, sometime also the amount of assets, and the total tax can be quite a significant cost for large companies.

Subsidiary or branch?

The first tax decision facing a Chinese company that contemplates doing business in the US is whether to do so through a "pass-through" (*i.e.*, transparent) entity or through a subsidiary that is taxable as a corporation. Right away, the Chinese company will have a taste of the subtlety and complexity of the US tax system. The characterization of an entity for US income tax purposes does not necessarily coincide with its legal characterization. First, the easy part: a Chinese company should consider operating in the US directly as a branch only if it is a bank. For non-banks, the usual choice is between (i) a regular corporation, (ii) an LLC that is treated in the same manner as a corporation, or (iii) an LLC that is treated as a pass-through. An LLC generally can elect either type of tax treatment, whereas a corporation is always taxed as a separate legal entity.

If an LLC is a "pass-through," it must file an information return with the IRS, reporting its income and expenses, but it does not pay income tax itself. Instead, its income and expenses are allocated to its members (*i.e.*, owner / Chinese parent(s)), who file US income tax returns and pay the tax on their proportion of the LLC's net income. For example, if a Chinese company forms a wholly owned pass-through LLC to conduct its US business, the Chinese company itself will be obligated to file a US tax return and pay tax on the income of the LLC. Most often, although not always, a Chinese company will want to avoid this, not because it will pay more tax this way, but because it will want to establish a "firewall" in the event of a US tax audit, *i.e.*, limit the reach of the US tax authorities to the LLC.

Tax Planning

Depending on the type of business, its needs for and sources of capital, the locations of its investors, its expectations about expatriation of income from the US and repatriation of income to China (or elsewhere), and the type of assets it will have in the US, various types of planning mechanisms might be advantageous. Tax planning can impact the overall cross border corporate structure because, in some cases, it may make sense to invest through an intermediary company in another jurisdiction, such as the Netherlands, Luxembourg, or the British Virgin Islands. All depends upon the particular circumstances of the business. A Chinese company that seeks the most tax-efficient structure should consult a US tax lawyer or other advisor who is experienced in cross-border transactions. In a substantial transaction, the cost of the advice will be small in comparison to the tax savings.

Labor And Employment Considerations: Tax, non-discriminatory practices, and non-compete agreements

Employee vs. Independent contractor**.** An employer must collect and pay certain state and federal payroll taxes on the wages of its employees. Whether a person providing services is an employee or an independent contractor, for whom payroll taxes are not due, depends on the degree of control exerted by the employer. If the employer has some control over not only the result of the work but also the means, method, tools, location of accomplishing it, then the person is an employee and payroll taxes (income tax withholding, social security, disability and unemployment insurance) must be paid.

Employment at will doctrine applies in all states except Montana: absent an employment agreement specifying otherwise, or other stated company policy to the contrary, an employer may terminate an employee at any time for any reason, and an employee may quit at any time. However, an employee cannot be terminated for a

characteristic that is protected under some federal, state or local law (see below), or for a reason that is against public policy (such as for taking time off to vote or serve on a jury or reporting a violation of law).

Laws Protecting Employees are widespread**.** Federal laws protect employees in a wide array or matters from discrimination on the basis of race, color, religion, sex, age, disability, military service etc. Employees have the right to form labor unions and cannot be hindered in their ability to gather together or share information for that purpose. Laws require minimum wage and equal pay for men and women. There is a regulatory regime governing the creation and administrations of employee benefit plans (such as health and pension or retirement savings). Laws also give employees the right to take unpaid medical and other family leave.

Enforceability of non-competition clauses for terminated employees. Companies who want to protect their trade secrets from disclosure by former employees are limited in their ability to restrict a former employee from working for a competitor. Under the law of most states in the US, a covenant not to compete must be reasonably limited in time frame and geographic reach. The application of this rule depends on the totality of the circumstances, and the two factors are often analyzed in conjunction with each other. If the company does business nationwide or even worldwide then a broad or unlimited geographic scope may be upheld by a court, but the broader the reach means that it will be more difficult to make a case of reasonableness. The duration also must relate to the reasonable amount of time for which the information to which the employee was privy would not be outdated, but courts often uphold one-year duration. Covenants can list specific competitors for which the employee is restricted from working for the period of time, a connection must be shown that doing so is necessary to protect the employer's business. Courts can either strike down part of an agreement that they find to be too restrictive, or strike down the entire agreement if even one part of it is found to be too restrictive.

It should be noted that covenants not to compete are prohibited by law, and therefore unenforceable except in rare circumstances, when applied in California.

Relocating management and immigration issues

The immigrations laws typically limit the ability of a foreign business to relocate personnel to the US to individuals who have an executive or managerial role. There are several visas that may be relevant for relocating management to the US.

B-1 Business Visitor Visa allows individuals to enter the US for a period ranging from one month extendable to several years, but the initial admission cannot be more than one year, typically the first authorization is for 6 months or less.

Permitted activities: attend business meetings, conferences, negotiate contracts, litigate, consult with clients or business associates, solicit orders for goods manufactured outside the US, explore investment opportunities.

L-1 Intracompany Transferee Visa allows a US employer, including the US affiliate of a non-US company, to transfer an executive or manager from one of its non-US offices to one of its US offices (entry granted for up to three years), or to start a US office (entry granted for up to one year). Requirements include a showing that:

- Employer has acquired sufficient physical premises to house an office;
- Employee has been employed in an executive or management capacity by a branch or affiliate of the same employer for at least one year during the prior 3 years immediately preceding entering the US; and
- The US operation will support an executive or managerial position within one year of approval of the petition.

Certain employers can file a "blanket L-1 petition" in advance of filing individual petitions enabling the employer to transfer employees to the US on short notice.

EB-5 Immigrant Investor Visa provides an opportunity for foreign investors to obtain permanent resident status (a "green card") in the US. To qualify, investors must show:

- Minimum capital investment in the US of $1,000,000 in a new commercial enterprise or an existing troubled business. This minimum amount is reduced to $500,000 if the investment is made in a rural or high unemployment area.
- Creation (or preservation, in the case of an existing troubled business) of at least 10 full time jobs for US workers as a result of the investment.

If approved, an investor is granted an initial two years of temporary "conditional" resident status. After that two-year period, to remove the conditions and obtain true permanent resident status, the investor must demonstrate that the requirements above are still being met.

EB-5 visas have been popular in the hotel, resort and restaurant industry, as they can be used to build new facilities, or to add to existing ones such as expanding hotel capacity with a new tower, or adding a spa etc.

Expanding Into the Unites States through Merger, Acquisitions (M&A), Joint Ventures and Strategic Alliances

There are many strategic reasons why a Chinese company may prefer to enter the US by acquiring an existing business or entering into a relationship with a US business to develop a venture together:

- Cheaper than building a business from scratch
- Time to market – buying an existing player can get you there faster
- Increase market share (subject to the limitations of anti-monopoly law, see Hart Scott Rodino below)
- Acquire intellectual property or eliminate a third party that is blocking intellectual property
- Increase manufacturing capacity
- Acquire key personnel
- Buy a customer base
- Vertical or horizontal integration
- Economies of Scale
- Synergies between products markets or personnel
- Defensive buying – prevent your competitors from getting the asset

It can be quicker and cost effective to enter the US by acquiring or merging with an existing business. An acquisition can involve the purchase all the stock or designated assets of a business. An asset acquisition can be costlier because it requires the preparation of detailed schedules of specific assets to be acquired and liabilities to

be assumed but can be the less risky alternative in the case of a business that may have risk or pre-existing liabilities that a new owner does not want to assume. A merger involves one company becoming part of another company and losing its identity, the stock of the non-surviving company is converted into something else.

Some market- specific aspects of an US acquisition that are important for Chinese purchasers to understand include:

- Using local intermediaries to help identify potential targets, such as investment banks, accountants and lawyers.
- Valuation metrics and methodologies that might apply to different industries.
- Buyer's due diligence is critical in assessing the target's strengths, weaknesses, value and whether it is a strategic good fit. Due diligence can be a lengthy, time consuming and expensive process and involves
- Legal due diligence to identify outstanding or potential risks associated with litigation, regulatory issues, employment and labor, real estate asset title and risk, securities based issues, intellectual property, and diligence related to specially regulated industries such as healthcare, financial services, mining, television and radio. The lawyers review contracts, correspondence, board and shareholders meeting minutes etc. for issues that can affect the consummation of the transaction and the valuation. Some specific issues include potential loss of rights upon a change in control, or the need for third party consents, any outstanding litigation or risk of litigation;
- accounting due diligence;
- technology due diligence including privacy and data security policies and risk; and
- other due diligence as is relevant for the company or industry.
- Target's due diligence will be somewhat limited.
- US parties will likely insist on US style transaction documents that are governed by US law.

Regulatory Considerations for Mergers, Acquisitions and Joint Ventures:

Merger Control - Hart Scott Rodino Act

The purpose of the Act is to promote competition and thwart a monopoly. The buyer and seller must file notifications with the Federal Trade Commission and Department of Justice when a proposed transaction—such as a merger, joint venture, stock or asset acquisition, or exclusive license—meets specified "size of person" and "size of transaction" thresholds, which are updated annually, and no exemptions apply.

Size-of-Person Test: met if one party to the transaction has $151.7 million or more in annual sales or total assets and the other has $15.2 million or more in annual sales or total assets.

Size-of-Transaction Test: met if, as a result of the transaction, the buyer will acquire or hold voting securities or assets of the seller, valued in excess of $75.9 million. In addition, if the value reaches a significantly higher level—now set at $303.4 million—a filing can be required even if the size-of-person test is not satisfied.

If the thresholds are met, a notification is required and the transaction cannot close while the statutory waiting period runs (30 calendar days from the date that both the acquiring and acquired entity have been submitted their necessary filings) and the agencies review the transaction.

National Security: FINSA and CFIUS

Foreign Investment in National Security Act of 2007 (FINSA) **c**overs transactions (acquisition, joint venture, merger) in which a non-US person or entity acquires control of a US business in a transaction that might negatively impact national security, and allows the US President, after review by the Committee on Foreign Investment in the United States (**CFIUS**), to block or unwind the transaction. **Neither FINSA nor CFIUS requires pre-transaction review.** The parties may elect to voluntarily disclose the transaction to CFIUS in order to attempt to obtain CFIUS approval, because CFIUS approval will prevent the transaction from being unwound after the closing by presidential order. The parties should conduct a risk analysis of how likely the parties believe that the transaction would be viewed to be of such a nature as to negatively impact national security, and whether an advance filing will assist them with managing the process and presenting data in a manner that will help make a case that the transaction does not negatively impact national security, and will also avoid the huge combined cost of closing a transaction only to be forced to unwind it. The entire review process can take up to 90 days.

FINSA does contain a limited safe harbor for certain minority investments, such as transactions that result in "foreign person holding 10% or less of the outstanding voting interest in the US business" if "the transaction is solely for the purposes of passive investment".

Certain industries are identified as risky, including those involving US defense production, critical technologies and critical infrastructure, international technological leadership in areas affecting national security, US energy requirements, the potential control of the US business by foreign government, and a foreign country's potential for diverting military technology, and its cooperation with US counterterrorism efforts, etc.

There have been several high-profile CFIUS cases involving Chinese owned companies. In 2011 China's Huawei Technologies abandoned its acquisition of a US computer company, 3 Leaf Systems, after CFIUS recommended that it do so, and in 2012 Ralls Corporation, a Delaware corporation with operations in Georgia and which is owned by two Chinese nationals who are executives of the Chinese Sany Group, was ordered by President Obama to divest assets and a windfarm after a post-closing CFIUS review due to the location of the windfarm in and around restricted airspace and a bombing zone maintained by the US Navy. Despite the fact that CFIUS determinations and Presidential Orders are explicitly not subject to judicial review, Ralls sued CFIUS and President Obama in an attempt to enjoin enforcement of the CFIUS divestiture order on the grounds that CFIUS exceeded its statutory authority and acted arbitrarily by not providing Ralls with access to the information upon which CFIUS and the President made the determination that the transaction raised national security concerns, thereby depriving Ralls of due process of law. In July 2014 the appellate court agreed with Ralls, setting a precedent that parties to a reviewed transaction must be provided with the *unclassified* information that formed the basis of the CFIUS recommendation in order to have an opportunity to address that evidence and tailor its submission or rebut the factual premises underlying the Presidential action.

A Note about Reverse Mergers

Another type of merger is a reverse merger which involves a Chinese company merging into an existing US entity, either a shell or an operating company, with the surviving entity being the US entity. It is typically a hybrid structure that combines elements of a merger with a capital raise, which can be private or public. When the reverse merger is into a public company it provides a mechanism by which the Chinese company can become a US company with access to the US public markets without the cost and burden of the SEC filings required for a full blown IPO, because the entity that wants to be public merges into an existing public company. The existing public company can be an operating company but can also be a shell company (one with no operations and no outstanding liabilities), however if the target is a public shell company then the Chinese parent needs to expect that there may be a delay before the SEC will allow it to issue securities publicly, to allow the surviving entity to

build a track record of meeting its periodic reporting obligations of the Securities Exchange Act of 1934 (an "Exchange Act reporting company") and to accumulate current public information about its operations.

The process of merging into a public shell company typically involves the Chinese entity merging into an existing public company whose shares are often listed on the Financial Industry Regulatory Authority-regulated OTCBB ("over the counter bulletin board"), although they could also be listed on the New York Stock Exchange or NASDAQ; any stock exchange listing will subject the listed company to ongoing periodic disclosure obligations. If the public target is an operating entity then a reverse merger also allows the non-public company to inherit assets that may help jump-start operations in the US, and the company can benefit from the potential for higher valuations due to the increased liquidity offered by publicly traded securities. A reverse merger can help a Chinese small and medium-sized enterprise access capital overseas if the capital markets and bank lending in China are not available. However, it must be noted that the market can still be wary of reverse merger entities because, as a category, they have a statistically larger rate of failure than home-grown public companies, and have been associated with many fraud scandals.

It should be noted that there have been notable de-listings of Chinese reverse merger companies in recent years due to the alleged failure to file timely or accurate reports. Also, the Department of Justice has been aggressively pursuing criminal fraud prosecutions, and the SEC has been pursuing civil cases, related to reverse mergers of Chinese companies based on alleged fraud, but because of the difficulty in obtaining audit documents from China due to certain aspects of Chinese secrecy laws, it has been difficult for US regulators to prove fraud. For example, this past spring a mistrial was declared in a case by the DOJ against the former vice president of China North East Petroleum Holdings which was delisted from the New York Stock Exchange, Chao Jiang who was among the executives to face first criminal prosecution in connection with a delisted reverse merger corporation.

Repatriating profits

While there are federal regulations on capital and exchange controls, there are no general restrictions on remittance to a foreign parent of profits or dividends (subject to income tax withholding), or royalties or license fees. This facilitates the opportunity for a foreign parent to repatriate funds if it wishes to do so.

Part II: Raising Capital Privately in the US

Why raise money privately rather than use the public capital Markets?

Both privately held (non-public) and public companies can raise money privately. A company can raise money in the US even if it does not do business there. The private capital markets in the US are huge. According to recent SEC estimates, over $1 trillion annually is raised in private offerings, with the median offering size being $1 million meaning that the private market is not just for big players, there are a large number of smaller offerings taking place. Statistically, the private market is more than double the size of the public market. In addition to access to capital, there are practical reasons to favor the private market, particularly for companies that are privately held:

- Avoid registering the offering with the Securities and Exchange Commission, a time-consuming and expensive process.
- Avoid public disclosure of company information and personal information about officers and directors.
- Avoid on-going disclosure requirements, which can be burdensome and costly, indeed the added cost must be considered carefully as it can seriously impact profitability.

- Avoid becoming subject to the enhanced corporate governance requirements of the Securities Law, Sarbanes-Oxley and Stock Exchange Rules.

What does it mean to raise money privately?

It means that the company is not offering or selling securities – debt or equity – in a manner that triggers the requirement to file a registration statement with the Securities and Exchange Commission, which further subjects the company to ongoing periodic disclosure obligations. Failure to register securities that are offered generally to the public subjects the company to enforcement action by the SEC, fines and sanctions.

Exemptions from registration - Overview:

The Securities Laws require that securities offered in a public offering be registered with the SEC. Consequently, there is a default statutory (**Section 4(a)(2) of the Securities Act of 1933)** exemption for offers and sales of securities *not involving any public offering.* Over time, rules were adopted to create sets of safe harbor criteria such that, if followed, prescribe that an offering would not be deemed to be public and thus not subject to the registration requirement; for most safe harbors, this Section 4(a)(2) exemption is a fallback exemption that will apply if all the criteria of a safe harbor are not met.

Regulation D – Safe Harbor Exemptions

Most capital raised privately relies on one of the safe harbor exemptions under a set of rules referred to as Regulation D, which is made up of several rules (Rule 504, 505 and 506) each with different criteria for the exemption. Two overriding concepts that are relevant in Regulation D safe harbors are the specifications for the type of investor who may purchase the security – "accredited investors" , and the method for reaching out to those investors -- whether the exemption prohibits the use of general solicitation and general advertising. There have been significant changes to the US Securities Laws and SEC Rules and Regulations within the past year, to implement the mandates in the JOBS Act (Jumpstart Our Business StartUps Act) that attempt to make it easier to offer and sell securities by lifting the 80-year ban on the use of general solicitation and general advertising under certain exemptions.

Who may invest: Many exemptions limit sales to **"Accredited Investors"** which is defined to include specified institutional investors typically in financial services related industries, and individuals who meet the following tests:

- individual net worth, or joint net worth with that person's spouse, exceeds $1 million, excluding the value of the person's primary residence (the "net worth test"); or
- annual individual income in excess of $200,000, together with a spouse in excess of $300,000, in each of the two most recent years, and has a reasonable expectation of reaching the same income level in the current year (the "income test").
- It should be noted that the SEC is currently reviewing whether to modify the definition of "accredited investor", and some proposals under consideration include increasing the income and/or net worth tests but also creating a category that is based on a demonstration of skill and sophistication in financial matters without reference to, or limited reference to, income and net worth tests.

Using General Solicitation or Advertising as a method to reach potential investors is regulated

Certain exemptions to registering an offering with the SEC prohibit the use of general solicitation or general advertising, while others allow it under the newly-enacted Rule 506(c). "General solicitation or advertising" is not

defined in the Regulations but examples are provided, such as advertisements published in newspapers and magazines, communications broadcast over television and radio, and seminars whose attendees have been invited by general solicitation or general advertising, and unrestricted websites. Offers to an investor previously known to the issuer are not considered to use "general solicitation". As described below, in some cases the seller has the option whether to nor to engage in general solicitation or advertising, but if it so engages then it has a heavier burden with respect to verifying that the purchaser is a type that fits within the exemption upon which the seller is relying. The issuer may be able to rely on the statutory Section 4(a)(2) exemption if it fails to meet all the criteria of the safe harbor.

Prohibition of the use of general solicitation and advertising is an important concept because it directly impacts how an Issuer can market its securities. The practical effect is subtle and widespread, affects not just obvious advertising of the offering in newspapers, magazines, TV and websites, but care must also be taken when making announcements that may seem to be in the ordinary course of business. Also, the inability to reach out to new investors means that it requires a reliance on using an intermediary banker who has pre-existing relationships with clients who they can contact about a new offering. However, the market is accustomed to it. A safe harbor that allows the use of general solicitation or advertising enables the issuer to say offer its securities on any medium to any person and reduces the burden of monitoring other corporate communications.

Rule 506(b) of Regulation D is The Primary Exemption Relied Upon in the Private Market. It is available to Exchange Act and non-Exchange Act reporting companies, both US and foreign. It allows the company to raise an **unlimited amount of money**, from an **unlimited number of accredited investors** and up **to 35 non-accredited investors** provided non-accredited investors demonstrate a level of business and financial sophistication making him or her capable of evaluating the merits and risks of the investment. However, the method of offering **must not use any means of general solicitation or general advertising.** Market practice has developed for the self-certification by the purchaser of his/her accredited investor status.

Some recent examples of Chinese companies that are public companies in the US and used Regulation D to raise money privately this past year include ***China Mobile Games* and *Entertainment Group Limited*** that sold American Depositary Shares in a private placement that raised US$16.4 Million, and ***General Steel Holdings, Inc***. that privately placed 5 million shares for approximately $7.5 million.

Rule 506(c) of Regulation D is a new exemption that eliminates the ban on general solicitation and general advertising in a private offering. Like Rule 506(b), this safe harbor is available to Exchange Act and non-Exchange Act US and foreign issuers, and also allows the company to raise an unlimited amount of money, but (unlike Rule 506(b)) eliminates the ban on general solicitation and general advertising which means that *offers* can be made by any means to anyone including non-accredited investors, *BUT sales* can only be made to accredited investors (unlike Rule 506(b) which allows sales to 35 non-accredited investors). Additionally, the issuer has a statutory burden to take reasonable steps to verify that the purchaser is indeed an accredited investor, self-certification is not adequate. If the issuer engages in general solicitation or advertising but fails to meet all the requirements of the rule, it may *not* rely on the fall-back statutory Section 4(a)(2) exemption and would therefore be selling securities without a registration statement in violation of the Securities Laws.

An issuer has two options to meet the rule's requirement that it take reasonable steps to verify accredited investor status: a Principles-Based Approach or one of four non-exclusive verification methods to establish a "reasonable belief" that purchaser is accredited:

- Income Test -- Review IRS forms that report income for past two years; or
- Net Worth Test -- Review documents verifying assets and liabilities dated within prior three months; or

- Approved Third Party Certification -- Written confirmation from a third party that *they* took reasonable steps to verify status within prior three months; or
- Pre-Rule 506(c) Investor known to issuer who has previously certified as to AI status.

Although these tests seem clear, the problem is the extreme reluctance on the part of investors to hand over such sensitive personal and identifying data, angel investors as a group disfavor these methods in favor of the principles-based approach below, but there is limited SEC guidance to provide enough comfort in applying vague principles. The alternative Principles-Based Approach is based on the issuer making inquiries and forming a reasonable belief that the purchaser is an accredited investor in the context of the particular facts and circumstances of each transaction," including:

- Nature of the purchaser and the type of accredited investor the purchaser claims to be (i.e. registered broker vs. other natural person);
- Amount and type of information the issuer has about the purchaser, including from public sources;
- Nature of the offering, such as manner or solicitation; and
- Terms of the offering such as minimum investment amount.

Third party providers for the verification process are beginning to crop up in the marketplace, but as these rules are just approaching their one year anniversary, it is a brand new industry and its reliability and market acceptance is not yet proven.

Sales of Securities over the Internet, and Crowdfunding:

The JOBS Act enabled the use of the Internet to offer and sell securities, and coupled with the lifting of the ban on the use of general solicitation and advertising, a new capital market has been spawned for "accredited investor crowdfunding". These sites typically rely on Rule 506(c) private placement exemption for sales to accredited investors, which allows the issuer to engage in general solicitation or advertising, and the sites are beginning to either offer the tools for issuers, or use third party providers, to handle the investor verification requirements.

There is no rule that prohibits a non-US issuer from raising money through an Internet platform, so Chinese businesses can make use of these platforms for offering securities. A particular nascent trend is for companies to do a small capital campaign on a non-securities crowdfunding site such as Kickstarter, in which they offer a perk of some kind such as the first run of the product or a commemorative item, in exchange for the capital, coupled with a social media campaign. Together the two campaigns raise brand awareness and can help the company in a subsequent securities-based crowdfunding raise. The current normal amounts raised are typically from $100,000 to $2 million.

"Retail crowdfunding", allowing any member of the general public to invest money for a security or monetary return on investment, is the topic of proposed SEC rules that implement the provisions of Title III of the JOBS Act, but the rules are not yet final. Consequently, selling securities over the Internet to non-accredited investors in the US is currently prohibited.

Other Regulation D exemptions exist for raising smaller amounts of capital, typically for smaller companies, and all these Rules prohibit the use of general solicitation or advertising**.** They include:

Rule 504 allows companies that are not Exchange Act reporting companies or Investment Companies, to raise up to $1 million per year. Foreign private issuers (discussed below) may rely on the Rule if they qualify for

exemption from Exchange Act reporting under Rule 12g3-2(b). There is no restriction on type of purchaser (may be accredited investors and non-accredited investors).

Rule 505 allows Exchange Act reporting companies, but not Investment Companies, to raise up to $5 million from an unlimited number of accredited investors and up to 35 non-accredited investors, however there are some disclosure requirements for sales to non-accredited investors.

Typical disclosure for Regulation D offerings. The offerings are private and, as such, are not subject to the vast array of specific prospectus disclosure obligations that apply to public offerings. Nevertheless, market practice is such that offering materials be produced describing the company's business, historical financial results and cashflow, projections, risk factors, the terms of the securities being sold, and the use of proceeds, because investors expect it, and more importantly because the anti-fraud provisions of the Securities Laws still apply, so an issuer must not make an untrue statement of a material fact, or omit a material fact in the process of selling securities, or it can be liable for criminal and civil penalties.

Regulation S, Regulation D and Rule 144A offerings may be part of a larger global offering that includes a public offering outside the US, so offering documentation may be subject to the disclosure requirements of other regulators.

Resale restrictions.

Securities that are not sold pursuant to a registered public offering are "restricted" from resale for a period of time, either 6 months or 1 year depending on whether the issuer is an Exchange Act reporting issuer and whether the purchaser is an affiliate, and cannot be resold before the expiration of that period unless sold pursuant to an exemption from registration.

Exemptions for Resales of Restricted Securities in the US: Rule 144A

Rule 144A is an exemption for immediate resale in the US, by an initial purchaser from the issuer, to "Qualified Institutional Buyers" ("QIBs"), of securities that were originally sold by the issuer in a private offering (or in certain other manners that trigger the resale restriction rules) and are therefore restricted securities. The exemption was designed to improve the liquidity of the secondary market for privately placed securities, and a Rule 144A placement is often done as part of a global offering that includes offshore sales by the issuer under Regulation S, described below. Under the new rules implementing the JOBS Act, general solicitation may be used in a Rule 144A offering, but if it is used then the seller must have a reasonable belief that the buyer is indeed a QIB.

Offshore Sales: Selling Privately to US and non-US persons outside the US -- Regulation S, and Rule 144A resales into the US

Regulation S provides that offers and sales of securities occurring outside of the United States are not subject to the registration requirements contained in the Securities Act. Regulation S sets forth non-exclusive safe harbors for extraterritorial offers, sales, and resales of securities. In general, an offering may qualify for non-registration pursuant to Regulation S if it meets two conditions:

- the offer or sale is made in an "offshore transaction" to a person who is not in the US when the offer was made, the buy order was placed, or the order executed; and

- there are no "directed selling efforts" in the United States, which means no activities that could be deemed to "condition the market" in the US for the securities that are being sold overseas including placing an advertisement in a publication with general circulation in the US.

There are additional criteria as well, depending on the nationality and reporting status of the issuer and the degree of US market interest in its securities, to determine if offshore offers and sales can be made to US persons. For certain kinds of issuers who do not trigger tests related to whether they have "substantial US market interest", it may also be possible under the rules to sell to US persons in an off-shore transaction under Regulation S, but before doing so the company and its counsel need to do a thorough examination of the nature and extent of the issuer's connections to the US market because the rules are intricate.

Many issuers engage in global securities offerings whereby they offer and sell securities concurrently offshore in reliance on Regulation S and privately in the United States in reliance on Regulation D (referred to as "side-by-side offerings"), and/or immediate Rule 144A resales. The Regulation S safe harbor prohibits "directed selling efforts" in the United States, which as a matter of practice, prior to the elimination of the ban on general solicition and advertising with the adoption of Rule 506(c), meant that the side-by-side offer had to be conducted in a manner that would prevent the offshore offering or solicitation materials, press releases or website content from being accessible in the US. With the adoption of the new rule, the Commission has confirmed that the use of general solicitation in conformity with Rule 506(c) or revised Rule 144A would not be deemed to be "directed selling efforts" in the United States for purposes of Regulation S, which is a significant breakthrough for global offerings because overseas issuers who are offering securities in offshore markets with a concurrent private placement in the US will now be able to make their press releases and web content available in the US. However, because the prohibition on directed selling efforts in the US remains a condition for relying on the safe harbor, in a Reg S-only offering the prudent course of action is to continue to prohibit directed selling efforts in purchase agreements.

Some notable recent examples of Chinese companies relying on Regulation S include last month's offering by ***Qihoo 360 Technology Co. Ltd***. of nearly US$1 billion (an aggregate US$900 million principal amount) of convertible senior notes with staggered maturity dates convertible into Qihoo's American Depositary Shares, and the offering last spring by ***51Job, Inc***. of US$150 million convertible senior notes convertible into 51Jobs American Depositary Shares. In each case the securities were part of a series of transactions that included an offshore Regulation S offering to non-US persons and an on-shore US offering to QIBs under Rule 144A.

Don't become a "public" company accidentally – managing the number of US holders of record to avoid Exchange Act Reporting Obligations.

For non-public companies, an overriding concern when raising money privately is to manage the number of record holders of its securities so that it does not trigger the periodic reporting requirements of the Exchange Act, effectively becoming a US public company accidentally, without raising any money. Issuers (US or foreign) must register with the SEC within 120 days after the end of its fiscal year when:

- it has total assets in excess of $10 million and
- either 2,000 or more US holders of record (increased from 500) or US 500 holders who are not accredited investors. Securities excluded from the holder-of-record tally included securities received under an employee compensation plan in an exempt transaction and securities sold pursuant to the proposed Regulation Crowdfunding under Title III of the JOBS Act.

Periodic reporting requires quarterly and annual reports, and interim reports to disclose any material event that has occurred in between the annual and quarterly reports. For example, if a Chinese company is listed on a stock

exchange or subject to reporting requirements, it must file an interim report on Form 6-K (an 8-K is for US companies) whenever it issues securities privately or any other material event occurs.

Failure to timely file required periodic reports will result in the SEC revoking the registration of the securities, and the ultimate de-listing of the securities, and may expose the company to shareholder litigation. Also, failure of a company to respond to an SEC action will result in revocation of the registration by default judgment. Unfortunately there have been a number of Chinese companies that have had registrations revoked and securities delisted for these reasons. Examples in recent months include ***China Ruitai International Holdings Co., Ltd, FLM Minerals, Inc. (Beijing)*** and ***China Digital Animation Development, Inc.***

Other registration pitfalls and how a foreign company can avoid them: Exemptions that apply to "foreign private issuers".

"Foreign private issuers" with total assets in excess of $10,000,000 and a class of equity securities held of record by 500 or more persons, of which 300 or more reside in the United States, are subject to registration under Section 12(g) of the Securities Exchange Act of 1934 (the "Act") which puts upon them the obligation to periodically file information with the SEC, and to disclose certain company information, regardless of whether they are raising money. Foreign Private Issuers who are publicly listed outside the US can be exempt from this registration requirement if they have fewer than 300 US holders of record, as long as the foreign exchange is not one on which US persons readily trade. (Rule 12g3-2(a) of the Exchange Act).

However, even it a foreign company meets the tests, Rule 12g3-2(b) provides an exemption from registration under Section 12(g) of the Act with respect to a foreign private issuer that submits to the SEC, on a current basis, certain information that it makes available in its home jurisdiction, including information it has:

- made or is required to make public pursuant to the law of the country of its domicile or in which it is incorporated or organized;
- filed or is required to file with a stock exchange on which its securities are traded and that was made public by such exchange; and/or
- distributed or is required to distribute to its security holders. It does not require the reconciliation of financial information to US GAAP.

The exemption is currently claimed by many Chinese companies that use American Depositary Receipts ("ADR") to raise capital or establish a trading presence in the US. An ADR is a negotiable certificate that evidences ownership of American Depositary Shares ("ADSs") which, in turn, represent an interest in a specified number (or fraction) of a foreign company's shares that are deposited with a Depositary Bank. A few Chinese companies using the Rule 12g3-2(b) exemption include ***Angang Steel Company***, ***Jiangxi Copper Co Ltd***. and ***Shanghai Industrial Holdings Ltd***.

What is a "foreign private issuer"? A foreign private issuer is a company that meets two tests: the first relates to the relative degree of its U.S. share ownership, and the second relates to the level of its U.S. business contacts. Foreign private issuer status is not determined solely by the country in which a company is organized. Companies organized under the laws of a foreign country that have certain characteristics that make them substantially similar to U.S. companies will not be considered foreign private issuers. In contrast, a company that is incorporated in a state, territory, or possession of the United States can never qualify as a foreign private issuer, regardless of the location of its shareholders, assets, or management.

A foreign company will qualify as a foreign private issuer if:

- 50% or less of its outstanding voting securities are held by U.S. residents; *or*
- if more than 50% of its outstanding voting securities are held by U.S. residents and *none* of the following three circumstances applies:
- the majority of its executive officers or directors are U.S. citizens or residents;
- more than 50% of the issuer's assets are located in the United States; or
- the issuer's business is administered principally in the United States.

If a foreign company determines that 50% or less of its outstanding voting securities are held by U.S. residents, it would qualify as a foreign private issuer and it need not consider the second test relating to business contacts. If a foreign company, however, determines that over 50% of its outstanding voting securities are held by U.S. residents, the foreign company must consider the extent of its U.S. business contacts.

Conclusion

- The US welcomes foreign investment.
- Highly-developed body of corporate, contract and securities laws with clear and objective criteria regarding permitted and prohibited activities that bring certainty to the business environment.
- A generally objective enforcement system.
- Regulatory safeguards in place to protect investors by ensuring that they have access to accurate information in a timely manner, which provides the security needed to foster active capital markets.
- Relative freedom under US law to structure a business and its management procedures in a manner the company deems best, and good corporate governance practices can shield the parent from liability.

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