

JESA INVESTMENT & MANAGEMENT CO. LTD.

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NEWS FROM JESA!
The Expo experience

By **Saro Capozzoli**, *Founder and GM of JESA Investment & Management Co., Ltd*

L'Expo di Shanghai che si aprirà a Maggio è una delle pietre miliari nella storia recente cinese, dopo le Olimpiadi e il reintegro di Macao e Hong Kong. Sembra che i cinesi debbano fissare di volta in volta un obiettivo da raggiungere, avere di fronte una sfida che viene raccolta con entusiasmo e con metodicità e senza mai desistere riescano sempre a fare ciò che si sono prefissati. Nel vedere il mega cantiere solo 4 mesi fa, pochi avrebbero scommesso che ce l'avrebbero fatta. Alcune strutture erano ancora pronte solo come scheletro esterno, non si riusciva a distinguere le strade coperte di fango. Ebbene, a poco meno di due mesi, come d'incanto è quasi tutto pronto, si stanno pulendo i vetri, lustrando le ringhiere, impiantando gli alberi lungo le strade, etc. L'Expo è una grande esposizione dei vari Sistema Paese: ogni nazione ha la possibilità di far vedere il meglio di sé al mondo. Non ci troveremo davanti una fiera campionaria, ma ad una fiera di sistema per esplorare nuovi modi di intendere la città: a **Better City for a Better Life**. Sembra che la classe dirigente cinese abbia deciso di porsi nuovi obiettivi che forse saranno più difficili da raggiungere: rispondere alla nuova emergenza della migrazione urbana, al problema dell'inquinamento dell'acqua potabile e dell'aria, al trattamento dei rifiuti, all'energia che non basta mai. Insomma, dare a tutti

l'aspettativa di una vita accettabile. E cosa c'entriamo noi? La risposta è immediata: in tutto questo esiste un'opportunità epocale per l'occidente che può trovare in Cina un grande partner che guidi lo sviluppo del mondo basandosi sulla ricerca di una risposta alle emergenze di cui sopra; tali emergenze riguardano la Cina, ma anche l'India e a breve il sud America e l'Africa. Basteranno le risorse di questa Terra per tutti? È questa la questione: impariamo dai cinesi come gestire questi temi e troveremo delle risposte per il nostro futuro. Loro hanno bisogno dell'occidente per poter raggiungere i loro obiettivi (tecnologie, Know How, etc.) e noi di loro per capire come migliorare la nostra. Le alternative? Non vorrei ricordare Malthus o scenari da Blade Runner, ma per riuscire dovremmo iniziare a lasciarci alle spalle le ideologie del XIX e XX secolo per iniziare a lavorare assieme ai Cinesi nel trovare le risposte che serviranno all'umanità a sopravvivere. Forse non a caso la Cina ha un programma spaziale che li porterà a breve sulla Luna a cercare l'elio3 per le centrali a fusione e su Marte, mentre noi abbiamo abbandonato il nostro programma spaziale perché siamo impantanati in Afghanistan ed Iraq per difendere un dinosauro del passato: il petrolio.

The Expo in Shanghai will open in May and is going to be one of the milestones in the recent history of China, after the Olympics and the reintegration of Macau and Hong Kong. It seems that Chinese people are establishing time to time a goal to reach and they are always able to do what they have set. Seeing the mega job-site only 4 months ago, few would bet that they

would finish it. Some facilities were not ready and they externally seemed just like a skeleton. Well, at less than two months from the start, as by magic, almost everything is ready: they are cleaning the windows, polishing the floors, planting trees along roads. The Expo can be considered as an exhibition of the Country System: every nation has the opportunity to show to the World its best. We are facing with an opportunity to explore new ways of concept the city: a Better City for a Better Life. It seems that Chinese people have decided to fix new objectives that might be more difficult to achieve: giving an answer to the urban migration emergency, to the problem of drinking water, to the lack of energy. In few words, the goal of giving everyone the expectation of an acceptable life. Why are western people involved in this process? The answer is immediate: the West has now the opportunity to find in China a great partner for guiding the development of the World. How can we learn from the Chinese System and find solutions for our future? The Chinese system can teach to the Western one how to achieve its goals and how to improve its efficiency. I would like not to recall Malthus or scenarios like Blade Runner, but in order to succeed we need to leave behind the ideologies of the nineteenth and twentieth centuries and to start working with Chinese people for finding the answers that will help humanity to survive. Perhaps it is no a coincidence that Chinese have a space program that will bring them to the moon, to look for the elio3 for fusion power plants, and on Mars, while we left our space program because we are bogged down in Afghanistan



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and Iraq defending a dinosaur of the past: oil.

Stock Index Future: China has been ready

On January 8th 2010, China has approved in principle the launch of stock index futures. The preparation phase will take at least 3 months and during this period, China Securities Regulatory Commission (CSRC) will supervise the works. The preparation includes the introduction of qualified index futures investors' assessment scheme, establishment of entry policy for financial institutions, approval of index futures contracts, training of intermediaries for securities firms and account opening for futures trading in China.

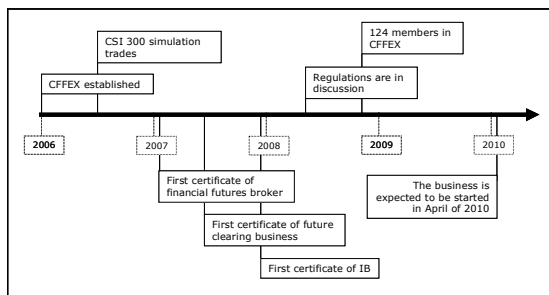


Fig. 1 Memorabilia of stock index future's launch in China

According to the draft published by the CSRC, which was open to public comments until Jan 22nd, investors are required to trade minimum 500,000 RMB in index futures (about 73,250 USD, the average amount traded by 1.39 million accounts at the end of 2009 in A shares) and must have experience in

simulated index futures trading or commodity futures trading. While minimum trading deposit and position limit may be cut to 12% and 100 contracts respectively, existing fuse mechanism has basically been terminated.

The draft requires investors to trade index futures during the trial period for at least 10 trading days and to be involved in at least 20 transactions. Investors will also be asked to complete a training course and pass a test conducted by securities firms.

Meanwhile, the government also approves the launch of margin financing and short-selling, which together with stock index future trading business may boost trading volumes by 50 percent.

Although all the initial specifications indicate that the launching of index futures, short selling and margin financing will be on the conservative side, they will have great impact on the development of stock market in China because of the following reasons:

- Short selling and index futures offer short sale mechanism to the market, which may effectively consolidate the irrational fluctuations in the market, decrease unexpected sell-off pressure, prevent severe market volatility and drive the share price to its fair value.
- The launch of index futures introduces a crucial risk management tool to the market, which will be able to hedge market systematic risk and achieve risk transfer and diversification.

- Index futures may also enhance the information transmission efficiency in the market. Share price may reflect market information timely and rationally through arbitrage.

Market structure

China Financial Futures Exchange (CFFEX) will be the core entity in the market for the stock index futures to be listed and traded, and CSRC will be its supervisor. CFFEX itself does not participate in the trade business, but provides all types of participants in the market with trading and clearing services. Among many CFFEX member companies, the majority is made by futures' companies. Besides, China Futures Association (CFA), clearing banks, information service providers, and registration agencies are all important players in this market.

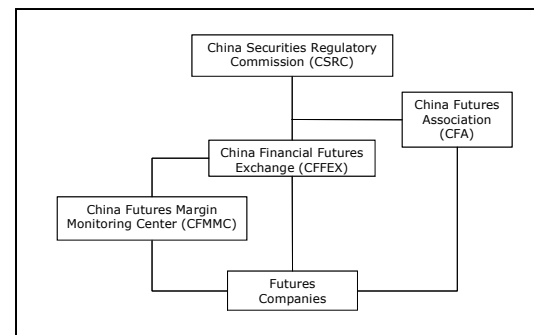


Fig.2 Management structure of stock index future business

As designed by CFFEX, there are three types of members: general clearing members, trading and clearing members and

trading members. By February 1st 2010, the number of CFFEX members reached 124, including 15 general clearing members, 61 trading and clearing members, and 48 trading members.

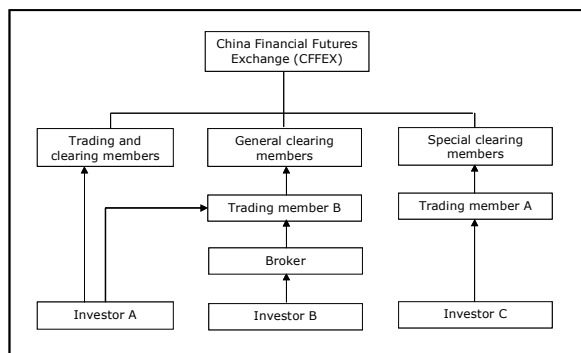


Fig.3 Business structure of stock index future trading system

Futures products

The first trading contract for index futures is based on the CSI 300 Index, which tracks the daily price performance of the 300 most representative A-share stocks listed on the Shanghai or Shenzhen Stock Exchanges and has been the first equity index launched by the two exchanges together.

Each point is worth 300 RMB and the minimum trading unit is 0.2 points. The daily trading limit is 10 percent above or below the previous day's settlement price.

CSI 300 is designed for use as performance benchmarks and as basis for derivatives innovation and indexing.

Date	2010-1-13
Volume (share)	1.1246E+10
Turnover (Rmb)	1.5986E+11
Index Market Cap.(min)	5471439.2
P/E	26.47
D/P	1.32

Fig. 4 CSI 300 market performance

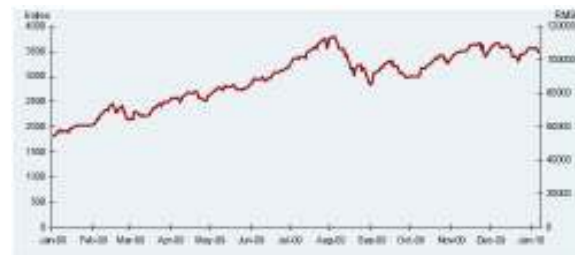


Fig.5 Cost of an index futures contract

Source: JP Morgan's Hands on China Report, January 8, 2010

Risk management

CFFEX's risk management policy is based on deposit, pricing limit, position limit, major reporting, forced liquidation, and risk alerts. The minimum trading deposit is estimated at 12%

to strengthen investor transaction security and market stability; the position limits have been decreased to 100 contracts to inhibit potential speculation and manipulation in the market, and reduce to a certain extent the positioning risk of investors

Laws and regulations

China has started the legislative process of issuing "Futures Act", and *Regulations for the Administration of Futures Trading* (2007) is regarded as the current regulating system for the futures' market. Besides, there are several other documents that are still drafts:

- *CSI300 Stock Index Future Contract (draft)*
- *Regulations for China Financial Futures Exchange Hedging (draft)*
- *Regulations for China Financial Future Exchange Member Administration (draft)*
- *Regulations for China Financial Future Exchange Risk Control Management (draft)*
- *Clearing Business Rules for China Financial Future Exchange Members (draft)*

Investment opportunities

China's stock index future is approaching and it is attracting many investors. Inevitably there will be "Chinese characteristics" in futures' contracts and trading systems.

First of all, there are some differences in contract targets' selection. CSI 300 Index is more representative and is difficult to be manipulated; Secondly, the contract face value is designed at a lower price; Finally, the clearing pricing system is different from overseas market.

In few words, the Chinese authority seems to be moving into this area at a very gradual pace.

However, since China's financial derivatives market is at the beginning, many theories and experiences learnt from mature markets can be very helpful for its development. Therefore, the following points were developed through mature markets' analysis.

- In the long run stock index futures' launch's impact on stock market will be neutral, and market should move according to economic and corporate fundamentals.

It will also help with finding the market value.

Countries/Region	Listing date	Long-term market status	
		before listing	after listing
Taiwan	1998.7.21	Bear market	Bear market
Japan	1986.9.3	Bull market	Bull market
Hongkong	1986.5.6	Bull market	Bull market
India	2000.6	Bear market	Bear market
France	1988.11.9	Bull market	Bull market
Korea	1996.5.3	Violate in market fell	Bull market

Fig. 5 Long-run impact analysis in matured markets

- The approval of margin financing, short selling and index futures will favor market's short-term movements. However, the first impact on the market will probably be negative, while before the launch of short selling and index futures higher liquidity can be expected and demand for blue-chips may increase, thus the A-share market will be favored in the short term. The policy, driven by the interaction between A-share and H-share markets, should impose limited impact on HK market.

Country/Region	Underlying index	Local listing date	Index Performance		
			3-M before listing	3-M after listing	12-M after listing
US	S&P 500	1982-4-21	-0.03%	-3.72%	38.31%
UK	FTSE 100	1984-5-3	7.72%	-6.71%	14.83%
Hongkong	HSI	1986-5-6	8.05%	1.60%	50.30%
Japan	Nikkei 225	1988-9-3	-2.53%	8.91%	247.94%
France	CAC 40	1988-11-9	12.43%	13.86%	21.07%
Germany	DAX	1990-11-23	-2.43%	6.68%	7.88%
Korea	Kospi 200	1996-5-3	8.25%	-17.94%	-34.11%
Taiwan	Taiwan Taiex	1998-7-21	-5.82%	-16.81%	-7.74%
Average			3.21%	-1.77%	42.31%

Fig.6 Index performance of large stock markets in the world before and after the launch of index future

Summary

The index futures contract specifications have not been officially announced yet. Based on the documents still under discussion, these are the rough guidelines:

- There are several expiries available for trading, namely current month, next month and the next two upcoming quarters;
- Final settlement prices for the contracts are calculated off of CSI 300 Index
- A contract multiplier of Rmb300 per index point will be used, each CSI 300 contract represents roughly a Rmb1mln (\$146,500) notional exposure with the CSI 300 trading at around 3500;
- Individual investors can hold a maximum 100 contracts per maturity at any point in time;
- The initial margin requirement is believed to be around 12%.

Past experience shows that the launch of index futures will have two impacts: (i) it will reduce market volatility, (ii) it will allow the market to move towards fair value. In the long run, its impact on the stock market will be neutral and market should move according to economic and corporate fundamentals.

Foreign-Invested Partnerships (FIP) : a new foreign investment vehicle feasible as of March 1, 2010.

On November 25th 2009, the State Council promulgated the Measures for the Administration of the Establishment of Partnership Enterprises in China by Foreign Enterprises or Foreigners (FIP Regulations or Measures) which will become effective as of March 1, 2010, while on February 1st 2010 the State Administration for industry and Commerce (SAIC) released the administrative rules on registration of FIPs. FIP Regulations have been issued after almost three years of preparation which started with the publication of an initial draft of the foreign-invested partnership law in January 2007 by the China's Ministry of Commerce (MOFCOM): before March 1st, 2010 the partnership law provides only for partnerships among PRC legal persons. Since the introduction of the most known vehicles of foreign investment (Wholly Foreign Owned Enterprise, Equity and Cooperative Joint Ventures) in the early 1980's, there have been no major developments until the FIPs Measures were promulgated. FIP Regulations have been long awaited by foreign private equity and venture capital funds interested in investing and raising money in China since limited partnership is the preferred vehicle among PE and VC firms because of high flexibility in terms of internal organisation and tax efficiency. Well-aware about the benefits of foreign financial investors providing funds, like start-up financing, Chinese Government created the Foreign Invested Venture

Capital Investment Enterprise (FIVCIE), a vehicle which allows venture capital funds alone or together with Chinese enterprises to invest in high tech non listed companies. This vehicle can't be considered successful since the establishment of a FIVCIE requires a complex procedure and FIVCIES are not allowed to utilize debt financing. On the local level in Shanghai, Beijing and Tianjin there were attempts to develop rules able to promote the creation of onshore PE/VC funds. However nowadays foreign PEs and VCs often set up their investment vehicles off shore in order to enjoy greater freedom to structure these vehicles and invest into domestic companies subject to China's foreign investment regime.

Summary of FIP Regulations

The FIP regulations provide that foreign enterprises or foreign individuals alone or together with Chinese individuals, legal persons and other organizations may establish partnership enterprises in China. Foreign investors may also join a local partnership by filing a partnership amendment application. The FIP regulations work in tandem both with the Partnership Enterprise Law and associated regulations and with all industrial policies pertaining to foreign investments. Under Chinese Partnership Enterprise Law the limited liability partnership, which contains general partners (with unlimited liability) and limited liability partners will be probably the preferred vehicle for PEs and VCs since limited liability is the most significant issue; general partner will be probably a foreign company. On industrial policies side, restrictions in the foreign investment industry guidance catalogue generally

apply to FIPs. Many voids due to this laws' overlap and to the Measures' briefness (they are 16 Clauses only) are expected to be filled through interpretation by operators and through more detailed rules given by different Chinese authorities. SAIC's administrative rules on registration for instance make FIPs less foreign investment friendly, providing that FIPs are only available for projects where a foreign investor is allowed to hold 100% ownership interest under the Catalogue.

No minimum Capital Requirement and no specific requirement for the form of capital

While for foreign invested enterprises a 30000 RMB minimum is strictly enforced but in practice the minimum capital required is often much higher, there is no minimum capital requirement for FIPs. In the FIP Regulations there are no discussions on the forms of capital a Foreign Investor can use to invest into FIPs. Saic's administrative rules on registration made it clear that capital contribution can be done in the form of in-kinds, Intellectual Property Rights, land use rights or other property rights. Foreign general partners may contribute capital in the form of labour services too.

No prior MOC Approval Required

FIP regulations do not require a pre-approval for FIPs by the approval authority. AIC shall "simultaneously" inform MOC (Ministry of commerce), the approving authority. This point is very important since FIP regulations for the first time in history provide that foreign investors can go directly to local AIC. On the contrary all FIEs have to obtain an approval by MOC before they could register with AIC. FIP regulations also state that if

the FIP is involved in areas where governmental approval for the project is required then such governmental approval is still needed before the FIP may proceed with the AIC registration. SAIC's administrative rules on registration confirm the registration timeline under PRC Partnership Enterprise Law of 20 days after the AIC accepts the application.

Tax advantages

Tax is where the main advantage of partnership lies.

First, companies are subject to Enterprise Income Tax at 25% and foreign shareholders are subject to a 10% tax on dividends; with a partnership the foreign partners (if foreign companies) would be subject only to the 25% tax.

Second, even though losses can be carried forward to later income years, there is a preference to utilise such losses at the earliest possible time: with a partnership, assuming the partners have other taxable income in China in any year, the losses can be utilized to offset that income. However implementation rules by State Administration of Taxation are eagerly expected.

Foreign exchange conversion

Neither FIP Regulations nor SAIC Administrative Rules are able to give answers to the following questions: 1) Is the foreign currency capital contribution made by the foreign partners allowed to be converted into RMB immediately after the contribution or it would be subject to the same conversion approval and restrictions applicable to FIEs? 2) How does repatriation work when the foreign partners receive their FIP distributions or carried interests? 3) According to SAFE (State

Administration of Foreign Exchange) Circular 142 the RMB generated by the settlement of foreign currency paid-in capital cannot be used to make any on shore equity investment. FIVCIEs are among the few types of foreign invested enterprises which are allowed to use capital for reinvestment purposes. Will this practice be inherited by FIPs?

Foreign Investment Funds

Clause 14 of the FIP regulations requires compliance with national regulations addressing foreign invested partnership enterprises that list investments as their principal business. To date, however, the only laws that address this topic are the Administrative Measures on Foreign-Invested equity investment funds (FVCIE Measures). Operators are wondering the extent to which the FVCIE Measures override the FIP Regulations. Some open points remains and they are mainly concerning the comparison between the FVCIE and FIP: 1) The FVCIE Measures mandate a minimum of US\$ 10 million in registered capital while there is no minimum capital requirement in FIP Regulations; 2) The FVCIE Measures only contemplate cash contribution while Saic's administrative rules on registration made it clear that capital contribution can be done in the form of in-kinds, Intellectual Property Rights, land use rights or other property rights. Foreign general partners may contribute capital in the form of labour services too. 3) FVCIE Measures call for review and approval by MOC, while FIP Measures only require registration with AIC.

Conclusion

While some observers have recently pointed out how FIPs should be considered an alternative vehicle for foreign investors, most of law firms' articles, clients' alerts and academic papers which followed FIP regulations promulgation seem to consider FIPs useful only for investors involved in the PE and VC Industry, since Partnership Law advantages in terms of flexibility are probably not balanced by the high uncertainty about the new rules. Some observers, wondering about FIP Regulations' aim, state that these ones are unnecessary, since existing WFOE and JV rules and implementing rules are well established, understood and work well. For sure FIP regulations dashed the hopes of those who eagerly anticipated that the new rules would provide clarity on the procedure for setting up an onshore LLP. Since FIP Measures should be analyzed as a step forward in the doors' opening for foreign funds to come onshore, problems concerning Clause 14 interpretation should be considered crucial. FIP Regulations' impact will likely be huge only when PRC Government will set a framework for foreign PE and VC Firms to utilise the FIP vehicle in order to establish an onshore presence. This point is crucial since it is correlated to the ability to attract and manage a mix of foreign and local capital. However this move is unlikely to be expected in the next future since the need for foreign PE and VC funds is strongly faced by two main PRC Government policy considerations: 1) the desire to maintain control over foreign investment and capital flows; 2) the will to foster the development of the domestic PE industry.

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