



Foreign direct investment in the consumer products and retail sector in China



Permitted investment vehicles

Since December 2004, foreign retailers have been permitted to establish Foreign Invested Commercial Enterprises (FICES) to engage in wholesale, retail and/or franchise activities in the consumer products and retail sector in China. The most popular structures for FICES in the sector are wholly foreign-owned enterprises (WFOEs) and sino-foreign joint ventures (JVs).

The Ministry of Commerce (MOFCOM)'s current policies permit both WFOEs and foreign majority-owned JVs to engage in the retail and wholesale of general commodities in most areas. There are a few exceptions, most relevantly direct selling through either mail order or e-commerce.

A foreign retailer opening more than 30 outlets in China and selling certain staple commodities under a range of brands from different suppliers must be incorporated in the form of either an equity joint venture or a co-operative joint venture and may not be more than 49 per cent foreign owned.

Minimum capital requirements are low in this sector (currently RMB500,000 for wholesale businesses and RMB300,000 for retail businesses) but must be fully paid-up where retail outlets are to be opened.

Within the confines of these restrictions, the relaxation of the foreign direct investment rules in this sector has allowed brand owners to navigate structures that allow them to control their brands in this important emerging consumer market.

Franchising

WFOEs are permitted to operate as both franchisors and franchisees in China, and cross-border franchise models are also permitted. The initial minimum term of a franchise agreement is three years, unless the franchisee agrees to a shorter minimum period.

Franchisors need not have had any previous business activities or physical presence in China itself but to be qualified as a franchisor, an enterprise must:

- have owned and operated at least two outlets anywhere in the world under the same brand for a minimum of one year each (the so-called '2 plus 1' requirement);
- have a mature operational model; and
- be capable of providing operational guidance, business training and technical support to franchisees on a continual basis.

Franchisors are required to file certain additional documents with central or provincial-level branches of MOFCOM (depending on the location of the franchising activity) within 15 days of execution of their first franchise agreement in China. The filed documents should include copies of a sample franchise agreement, business and marketing plans for the franchise and store layouts.

Franchisors are also required to notify MOFCOM by 31 March of each year of all franchise agreements that have been entered into, terminated, renewed or amended during the previous year.

The approval process

All foreign investment in the PRC requires government approval. Investors must submit specified application documents to the relevant authorities for approval.

WFOEs and JVs

Under MOFCOM's most recent rules, central MOFCOM approval for the establishment of an FICE is only required in certain limited circumstances, including for:

- FICES engaged in retail activities from remote locations without and not through physical outlets, such as telephone sales, television sales, mail order, the internet or auto-selling machines; and
- FICES engaged in wholesale sales of video products or books, newspapers or periodicals.

The establishment of all other FICES is instead subject to approval by provincial level branches of MOFCOM, regardless of the size of the investment.

Main steps for setting up an FICE	Approximate timing
Pre-registration of the proposed company name with the provincial Administration of Industry and Commerce (AIC).	Five working days for pre-registration of name
Approval of the articles of association and any JV contract by central MOFCOM or its local counterpart.	30 to 60 working days
Issuance of a business licence by the central or local AIC. The application should be made within 30 days of receipt of MOFCOM approval.	10 working days
Post-incorporation registration with other business and regulatory authorities in the relevant province (eg the Statistics Bureau, Police Bureau, Financial Bureau, State Tax Bureau, the Customs Authority and the Foreign Exchange Authority).	–

FICES engaged in certain types of commerce, including sales and distribution of pharmaceuticals, books and periodicals, automobiles and operation of petrol gas stations, will need to comply with other industry-specific rules that may include a different timetable.

Competition law issues

The merger control regime in China's Anti-monopoly Law may apply to the establishment of JVs or the acquisition of control over domestic enterprises.

Transactions that involve a change of control (which may include the establishment of a 'greenfield' JV) and that meet *either* of the following two alternative turnover tests will need to be notified to MOFCOM's Anti-Monopoly Bureau. Each test has two threshold components. The filing requirement will be triggered where *both* thresholds of *either* test are satisfied.

Test 1	combined <i>worldwide</i> turnover of <i>all</i> parties to the transaction	more than RMB10bn (approx US\$1.46bn)	- and -
	individual PRC turnover of each of <i>at least two</i> parties to the transaction	more than RMB400m (approx US\$58.5m)	
Or			
Test 2	combined PRC turnover of <i>all</i> parties to the transaction	more than RMB2bn (approx US\$293m)	- and -
	individual PRC turnover of each of <i>at least two</i> parties to the transaction	more than RMB400m (approx US\$58.5m)	

Turnover is measured based on the previous financial year and refers to group turnover.

There is a two-phase review timetable of either 30 days for simple cases, or an additional 90 days for more complex cases, that can be extended by a further 60 days in certain circumstances.

Developing an Intellectual Property strategy for China

In the brands-led consumer products and retail sector, the intellectual property (IP) portfolio is a critical business asset that should be aligned with the medium to long-term objectives of the business so as to ensure that key IP rights are secured in a time frame that is consistent with business plans.

A holistic business approach to IP is best

The appropriate registration of patents, trade marks, domain names and copyright are the critical building blocks of any effective IP enforcement strategy. But such measures will deliver exponential benefits only if complemented by other commercial measures to form a holistic business approach to the issue. In our experience, the following mix of measures have proven beneficial:

- product protection measures: these are features embedded within a product that make it difficult for potential infringers to replicate the product or for purchasers of counterfeit goods to achieve full functionality or after-sales support;
- process protection measures: process protections can be relationship directed (eg developing integrated relationships with suppliers or retailers to closely manage the supply chain) or involve knowledge management tactics (eg compartmentalising the entire production process, segregating

information or having an important production step done off site or even offshore); and

- HR measures: these involve providing sufficient employee compensation and demonstrating a long-term investment in career development so as to create disincentives to IP leakage from within. Also important are: stringent non-disclosure and enforceable non-compete agreements; express assignments of employee-generated IP rights under employment agreements; making records of registered IP rights with customs; and recording licences of registered IP rights with the trade mark, patent and copyright offices.

Branding

Trade mark and domain name hijacking remains prevalent in China. It is strongly advisable to ensure that protection is sought for key brands before entering the market or even before opening dialogue with potential domestic partners. It is important to ensure that the appropriate filings are made as early as possible, particularly given the existing time delay to achieving registration of trade marks in China (currently between 24 and 36 months for the application to be examined).

Careful thought should be given to localization of the brand, and regardless of whether or not a bi-lingual branding strategy is to be adopted for China, defensive filings of Chinese transliterations are recommended. Similarly, Chinese domain names corresponding to key brands in the .cn ccTLD should also be sought.

Our approach to IP enforcement

We have witnessed tremendous developments in the standards of IP protection in China since its accession to the World Trade Organization in 2001. The number of IP rights cases is increasing year-on-year and the size of typical damages awards is also trending appreciably upwards. The increasing number of high-profile cases involving foreign multinationals such as Lacoste, Burberry, Louis Vuitton, Ferrero Rocher, German bus company Neoplan, Pfizer and Starbucks have shown that Chinese courts are willing to protect the legitimate rights and interests of foreign businesses in China. We are also seeing increased enforcement activity by Chinese rights holders against foreign parties.

Effective enforcement involves working closely with the administrative bureaus, customs and other law enforcement authorities, as well as with the Chinese courts. We adopt a strategic and staged approach when working with our clients to manage IP infringement issues efficiently.

- *Stage 1*: identify the most suitable enforcement options and the most strategically beneficial enforcement targets to prioritise having regard to product type, sector, supply chain and distribution channels and develop an enforcement strategy.

- *Stage 2*: deploy resources to match the stated business objectives.
- *Stage 3*: execute agreed actions, delegate tasks and monitor the outcomes.

We often assist clients with multi-jurisdictional enforcement programmes, co-ordinating actions both at the 'source' and in important export markets.

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