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Private Equity Law

Impact of Mandatory Transfer/Reduction of State-owned Shares on Private Equity Funds and Relevant Relief Mechanisms

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I. Background

In order to fill the coffers of the National Social Security Fund (the “**NSSF**”), the State Council promulgated the “*Interim Measure on Collecting Fund for Social Security by Reducing State-owned Shares*” (the “**Reduction Measure**”) on June 12, 2001, requiring that any joint stock company (“**JSC**”) with state-owned shareholders reduce its shareholding by an amount equal to 10% of the capital raised (the “**Mandatory Reduction**”) at the time of its initial public offering (“**IPO**”) or follow-on public offering (“**FPO**”) on the A-share market or H-share market, by handing in proceeds from selling its shares in the amount equal to 10% of the capital raised or by transferring the to-be-reduced shares to NSSF for their selling. Due to the negative impacts of the Mandatory Reduction on the stock market, the State Council decided to terminate the implementation of the Mandatory Reduction in domestic stock market in 2002. However, Mandatory Reduction still applies when it comes to H-share IPOs or H-share FPOs.

On June 19, 2009, the State Council promulgated the “*Measures on Enriching the Social Security Fund by Transferring Some State-Owned Shares in the Domestic Securities Market*” (the “**Transfer Measure**”) to implement the mandatory transfer of state-owned shares in an amount equal to 10% of the total amount of shares to be offered (the “**Mandatory Transfer**”) through an IPO on the domestic stock market. According to the Transfer Measure, state-owned shareholders of a JSC making A-share IPO after the new and old separation of the reform of non-tradable shares, unless otherwise provided by the

State Council, shall transfer their shares in such JSC to NSSF in an amount equals to 10% of the total amount of shares to be offered by such JSC through its A-share IPO (but in any event not in excess of the total amount of shares actually owned by each state-owned shareholder).

In recent years, more and more state-owned enterprises have participated in sponsoring and raising private equity investment funds (“**Funds**”). If a Fund is deemed a state-owned shareholder of its portfolio companies as a result of its raising state-owned capital, such a Fund may be required to fulfill the obligation of Mandatory Reduction/Mandatory Transfer under the Reduction Measure and/or Transfer Measure when exiting from its investments through A-share IPOs and/or H-share IPOs, which will directly affect the interests of its non-state-owned investors, fund manager or general partner in relevant portfolio companies (and through which their interests in the whole Fund). This commentary will focus on analyzing the impact of the Mandatory Transfer/Reduction on Funds and the feasible relief mechanism.

II. Mandatory Reduction for H-share Listed Companies and Relevant Relief Mechanisms

According to the Reduction Measure, where a H-share listed company makes IPO or FPO, its state-owned shareholders shall make a Mandatory Reduction in the amount of 10% of the capital raised in such IPO or FPO either by handing in the proceeds from selling the Subject State-owned Shares to be reduced (the “**Subject SOSs**”) or by transferring the Subject SOSs to the NSSF in lieu of selling such shares on behalf of the NSSF. In practice, state-owned shareholders of an H-share listed company can also convert the Subject SOSs into H-shares and then transfer such H-shares to the H-share account of the NSSF. In fact, the aforementioned transfer of H-share to H-share account of the NSSF is just a variation of the Mandatory Reduction, which still follows the Reduction Measures rather than the Transfer Measure.

If a Fund with state-owned shareholders will possibly be subject to Mandatory Reduction, it is advisable for the Fund to design and establish a compensation mechanism or empower its general partner to request compensation from its state-owned investors once the Mandatory Reduction occurs in its constitutional documents (including but not limited to limited partnership agreement, article of association, etc.) upon the establishment of such Fund in order to ensure that the non-state-owned investors, fund manager and general partner’s interests in a Fund will not be adversely affected by the Mandatory Reduction.

III. Mandatory Transfer of State-owned Shares

1. Who Should Carry Out Mandatory Transfer

The Mandatory Transfer should be carried out by “state-owned shareholders”. According to the Transfer Measure, “state-owned shareholders” refer to entities in which the State Council and the people’s governments at or above the provincial level (including municipalities separately listed on the State Plan) perform the obligation of capital contributors, and recognized as state-owned shareholders by the special organs responsible for supervising state-owned assets and financial department at all levels responsible for supervising state-owned assets of financial institutions (the “**State-owned Assets Supervising Authorities**”). However, the Transfer Measure does not provide the specific standard for the State-owned Assets Supervising Authorities to identify a state-owned shareholder.

According to the released cases of Mandatory Transfer, in practice, the State-owned Assets Supervising Authorities mainly rely on the “*Reply of the State-owned Assets Supervision and Administration Commission of the State Council on Issues concerning the Implementation of the <Interim Provisions on the Labeling and Management of State-Owned Shareholders in Listed Companies>*” (“**Notice No. 80**”) to determine the status of state-owned shareholders. Pursuant to Notice No. 80, the following entities shall be recognized as state-owned shareholders: (a) Governmental agencies, departments, public institutions, wholly state-owned enterprises, or companies whose investors are all wholly state-owned enterprises (“**Wholly State-owned Entities**”); (b) incorporated enterprises in which one Wholly State-owned Entity exclusively hold over 50% of the shares; and incorporated enterprises in which several Wholly State-owned Entities aggregately hold over 50% of the shares and its largest shareholder is a Wholly State-owned Entity (“**State-controlled Companies**”); (c) subsidiary enterprises at all levels, in which the State-controlled Companies maintain an absolute majority shareholding; (d) subsidiary entities of entities mentioned in (a)-(c) above.

According to the above standards, for an incorporated Fund, once at least 50% of its equity interests are held by Wholly State-owned Entities and its largest shareholder is also a Wholly State-owned Entity, such an incorporated Fund will likely be deemed a state-owned shareholder and therefore will likely be required to fulfill the Mandatory Transfer obligation with respect to its shares in its portfolio company to be listed on the A-share market. There are currently some inconsistencies in applying Notice No. 80 standard to a Fund in the form of partnership (a “**Partnership Fund**”), thus different local State-owned Assets Supervising Authorities may take different views towards the treatment of Partnership Funds. According to our communication with relevant authorities, if state-owned capital represents more than 50% of a Partnership Fund, such a Partnership Fund may be deemed a state-owned shareholder. There have been examples where Partnership Funds were required to fulfill the Mandatory Transfer obligation.

2. Calculation of Amount of Shares to be Transferred and Methods of Transfer

According to the Transfer Measure, state-owned shareholders of a company to be listed on A-share market shall carry out its Mandatory Transfer obligation in an amount equal to 10% of the total amount of shares to be offered upon an A-share IPO (but not in excess of the amount of shares actually owned by each state-owned shareholder) (also “**Subject SOSs**”). More specifically, the formula for calculating the amount of shares to be transferred is as follows:

Amount of share to be transferred by a state-owned shareholder =
Amount of shares to be listed upon A-share IPO x G% x (pre-IPO shareholding ratio of such state-owned shareholder / Aggregate pre-IPO shareholding ratio of all state-owned shareholders) x Aggregate contribution ratio of state-owned investors in such state-owned shareholder

In the above formula, if the aggregate pre-IPO shareholding ratio of all state-owned shareholders equals or exceeds 10%, then G% equal 10%; if the aggregate pre-IPO shareholding ratio of all the state-owned shareholders is lower than 10%, then G% is equal to the actual aggregate pre-IPO shareholding ratio of all state-owned shareholders.

Generally speaking, a state-owned shareholder shall directly transfer the amount of shares calculated according to the above formula to the NSSF. However, the Transfer Measure provides an alternative measure for those state-owned shareholders with mixed ownership to fulfill the Mandatory Transfer obligation either by directly transferring the Subject SOSs to the NSSF or by its state-owned investors' handing in capital (including but not limited to dividends received from such state-owned investors or self-owned capital) in an amount equal to the value of the Subject SOSs to be transferred to the NSSF, either in one lump-sum or installments. In practice, due to the diversified sources of capital of a Fund, if the Fund deemed a state-owned shareholder is probably a state-owned shareholder with mix ownership.

3. Procedure of Mandatory Transfer

Companies listed after the promulgation of the Transfer Measure shall follow the procedures of Mandatory Transfer below:

(a) The largest state-owned shareholder applies for confirmation of state-owned shareholder status of all state-owned shareholders and their respective amount of shares to be transferred. The State-owned Assets Supervising Authorities issue the corresponding reply letter (the “**Transfer Reply**”) and copies the NSSF as well as the China Securities Depository and Clearing Corporation Limited (the “**CSDCC**”);

(b) The state-owned shareholders, pursuant to the Transfer Reply, shall make a written commitment of Mandatory Transfer to the NSSF, specifying matters such as the amount of shares to be transferred or the amount of capital to be handed in;

(c) After receiving the Transfer Reply and prior to the relevant IPO, the CSDCC shall register the Subject SOSs under the stock account of NSFF. For those state-owned shareholders with mixed ownership that choose to fulfill the Mandatory Transfer by handing in capital, their state-owned investors shall hand in the capital to the Central Treasury in an sufficient amount and timely manner pursuant to the Transfer Reply;

(d) After the completion of the Mandatory Transfer, the state-owned shareholders shall file a Mandatory Transfer status report with the State-owned Assets Supervising Authorities for record and with a copy to the Treasury Department and the NSSF.

IV. Solutions or Relief Mechanisms for Mandatory Transfer

1. Communication with Relevant State-owned Assets Supervising Authorities

Currently, there is no clear standard for the determination of state-owned shareholder status, especially with respect to Partnership Funds, and it is up to the competent State-owned Assets Supervising Authority of a state-owned investor to determine the state-owned shareholder status on a case by case basis. Therefore, upon the establishment of a Fund, it is advisable for the Fund's constitutional documents (including but not limited to limited partnership agreement and article of association, etc.) to include provisions requiring its state-owned investors to make best efforts to communicate with their State-owned Assets Supervising Authorities in order to avoid the Fund's being deemed a state-owned shareholder with Mandatory Transfer obligation.

2. Exemption from Mandatory Transfer

In October 2010, the State Council promulgated the "*Notice on Relevant Issues Relating to the Waiver of the Obligation to Transfer State-Owned Shares Held by State-Owned Venture Capital Enterprises and State-Owned Venture Capital Guidance Funds*" (the "**Exemption Notice**"). According to the Exemption Notice, a state-owned venture capital enterprise that has made a record-filing with the National Development and Reform Commission (the "**NDRC**") and is operating in conformity with the relevant venture capital regulations, and a state-owned venture capital guidance fund established according to the "*Guiding Opinions on Regulating the Establishment and Operation of Venture Capital Guidance Fund*", when investing in small- or medium-sized privately held enterprises (i.e., enterprises with employees not in excess of 500 and each of their annual turnover and total assets not in excess of RMB 200 million) may apply for exemption from the Mandatory Transfer.

3. Internal Compensation Mechanism for State-owned Shareholders with Mixed Ownership

According to the Transfer Measure, if a state-owned shareholder with mixed ownership chooses to directly transfer the state-owned shares; its state-owned investors shall compensate its non-state-owned investors. Therefore, a Fund may design and provide for a compensation mechanism in its constitutional documents (including but not limited to limited partnership agreement, article of association, etc.) to ensure that the interests of its non-state-owned investors, fund manager and general partner will not be adversely affected by the Mandatory Transfer.

4. Solution and Relief Mechanisms at State-owned Investors' Level

According to the Transfer Measure, a state-owned shareholder with mixed ownership may choose to fulfill its Mandatory Transfer obligation by handing in capital by its state-owned investors (dividends received from the fund or proprietary capital) to the Central Treasury. In a Fund context, fulfilling its Mandatory Transfer obligation by requiring its state-owned shareholders to hand in capital themselves at the state-owned shareholder level keeps the profit distribution at the Fund level intact and serves to minimize the impact of the Mandatory Transfer on the Fund's operation.

V. Conclusion

The Mandatory Transfer has been implemented for two years, and it serves to provide capital sources for the NSSF. However, there are still lots of ambiguities in the Mandatory Transfer mechanism, which has led to negative reaction of the capital market to state-owned capital. Some Funds with state-owned capital shareholders even start to "de-nationalization". Therefore, it is very necessary for relevant authorities to promulgate implementing rules to clarify the standard of determining state-owned shareholder status and removing or reducing uncertainties. We will continue to pay close attention to outstanding issues relating to the Mandatory Reduction/Transfer mechanism as well as relevant implementing rules that might be promulgated in the future and will keep you updated on relevant information.

The Fund Formation & Management Group of Han Kun Law Offices, located in Beijing, Shanghai and Shenzhen, has profound experiences in setting up and otherwise dealing with funds with state-owned capital. If you have any questions, please feel free to contact us.

Important Announcement

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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