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Newsletter

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Legal Updates

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Legal Updates

1. Commentary: Regulations for the Implementation of the Law on the Promotion of Privately-run Schools (Review Draft) (Authors: Andy LIAO, Laixiang LI, Huanhao HE)

On August 10, 2018, the Ministry of Justice published on its website the *Regulations for the Implementation of the Law of the People's Republic of China on the Promotion of Privately-run Schools (Revision Draft) (Draft for Review)*[1] (the "**Review Draft**") for public comment, which the Ministry of Education has submitted to the State Council for deliberation. The current round for public comment will end on September 9, 2018. The Review Draft follows the Ministry of Education's issuance on April 20, 2018 of the *Regulations for the Implementation of the Law of the People's Republic of China on the Promotion of Privately-run Schools (Revision Draft) (Draft for Comment)*[2] (the "**Comment Draft**") and is the most recent legislative progress in revising the *Regulations for the Implementation of the Law on the Promotion of Privately-run Schools*.

Below, we provide brief comments on several issues that have drawn attention in the Review Draft:

I. Foreign Investment Access and VIE Control Agreements

The Review Draft at Article 5 stipulates that "foreign-invested enterprises established within the territory of China and social organizations controlled by non-Chinese persons shall not run, participate in or actually control the operation of private compulsory education schools; the operation of other types of private schools shall meet the relevant national provisions for foreign investment." Compared to the Comment Draft, the Review Draft adds a clause emphasizing that foreign investors cannot "actually control the operation of private compulsory education schools." The emphasis on the prohibition of actual control over investments in private schools is rooted in the foreign investment access restrictions for the education industry. Pursuant to the *Special Administrative Measures (Negative List) for Foreign Investment Access (2018)*,[3] offshore investors are prohibited from investing in compulsory and religious education institutions. Foreign-invested pre-schools, ordinary high schools and institutions of higher education are limited to Sino-foreign joint ventures and the Chinese investor must lead the operation of the schools (the principal or primary administrators are required to be Chinese nationals, and the Chinese investor must have no fewer than half of the seats on the council, board or joint management committee).

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[1] [Circular of the Ministry of Justice on Seeking Public Comment for the Regulations for the Implementation of the Law of the People's Republic of China on the Promotion of Privately-run Schools (Revision Draft) (Draft for Review)] (Min. of Ed.; issued Aug. 10, 2018 for public comment until Sept. 9, 2018).

[2] [Announcement of the Ministry of Education on Seeking Public Comment for the Regulations for the Implementation of the Law of the People's Republic of China on the Promotion of Privately-run Schools (Revision Draft) (Draft for Comment)] (Min. of Ed.; issued Apr. 20, 2018 for public comment until May 20, 2018).

[3] [*Special Administrative Measures (Negative List) for Foreign Investment Access (2018)*] (Nat'l Dev. Ref. Comm., Min. of Commerce Decree [2018] No. 18; promulgated June 28, 2018, effective July 28, 2018) 2018 ST. COUNCIL GAZ. 24.

Many offshore-listed private schools have employed variable interest entity ("**VIE**") structures to avoid these foreign investment access restrictions. That is to say, the offshore-listed entity, through contractual agreements, ultimately controls the private schools located in China through a wholly-owned enterprise established in China (which acts as the main operating entity and is the school operating license holder), so that the financial statements of the private schools can be consolidated into the financial statements of the offshore-listed entity. From the perspective of ownership structure, the foreign-owned enterprise does not directly or indirectly hold any equity or interest in private schools, so as to formally comply with the foreign investment access restrictions. The legitimacy of the use of the VIE structures in this context, however, remains controversial.

The Review Draft responds to the controversy over foreign investment in compulsory education by clearly specifying that actual control structures cannot be used to participate in the operation of private schools at the compulsory education stage. However, Article 5 of the Review Draft still appears to have a loophole as it stipulates that private schools engaged in compulsory education may not be controlled, but it remains silent as to other types of private schools. In fact, the VIE structure also addresses the need to avoid the existing Sino-foreign joint venture requirement for non-compulsory educations.

II. Related-party Transactions

The *Law on the Promotion of Privately-run Schools (2016 Revision)*[4] stipulates that no for-profit private schools may be established to provide compulsory education. Nevertheless, the compulsory education stage is undoubtedly very important to enterprises in the K-12 education industry, whether it is as a source of enrollment or the proportion of time that compulsory education comprises in academic careers. As a result, many private schools have been unable to abandon compulsory education and continue to provide compulsory education in the name of non-profit schools following the effectiveness of the *Law on Privately-run Schools (2016 Revision)*. Many sponsors even choose to classify non-compulsory private schools as non-profit private schools in order to qualify for greater tax incentives and policy support. The sponsors of such non-profit private schools often utilize related-party transactions to obtain profits in the name of non-profit schools. In addition, private schools under VIE structures will themselves have a large number of related-party transactions because the structures often involve exclusive service agreements among the related parties.

The Review Draft retains the Comment Draft's restrictions on related-party transactions between private schools and related parties. The "interested related parties" of a private school refer to the organizations or individuals who are sponsors, actual controllers, directors, supervisors, etc. of the private school and those whose mutual control and influence over the foregoing organizations or individuals would result in transfers of interest in the private school. The Comment Draft only

[4] [Law of the People's Republic of China on the Promotion of Privately-run Schools] (*as revised by* Standing Comm. Nat'l People's Cong., Pres. Order No. 55; promulgated Nov. 7, 2016, effective Sept. 1, 2017) 2016 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 6.

indirectly restricts VIE control by restricting related-party transactions and through information disclosures:

- Related-party transactions shall be open, fair and equitable, and shall not harm the interests of the state, schools, teachers and students;
- An information disclosure system shall be established for related-party transactions;
- When councils, boards of directors, or other decision-making bodies vote on related-party transactions, members who have an interest in the transaction shall avoid voting and may not exercise their voting rights on behalf of other members.

The Review Draft further grants the competent authorities the right to supervise and examine the relevant agreements concerning related-party transactions. The Review Draft at Article 45 stipulates that "[t]he administrative departments of education and the departments of human resources and social security shall strengthen the supervision of agreements signed between non-profit private schools and interested related parties, and examine and audit the necessity, legality and compliance of agreements involving major interests or long-term and repeated implementation." In practice, private schools often transfer profits to related parties in the form of management fees, consulting fees and service fees by signing long-term management consulting agreements or service agreements. If Article 45 of the Review Draft becomes effective, these profit transfer agreements signed between private schools and related parties will be subject to competent authority supervision. The competent authorities will not only be required to examine the legal and regulatory compliance of such agreements, but also their substantive necessity.

In addition, the Review Draft at Article 44 stipulates that "[n]on-profit private schools shall use accounts filed with the competent departments for collecting fees and carrying out activities. The competent authorities shall supervise the accounts and organize audits together with the relevant departments." This means that not only will related-party transaction agreements themselves be regulated, but also that financial transactions arising from such agreements will be subject to supervision.

III. License Classifications

The Review Draft follows the Comment Draft with respect to the operating license classification principle:

Private Education Institution Type	Approval Organ and Level
Private schools providing pre-school education, secondary education and academic education at lower levels	Education administrative departments of the people's government at or above the county level
Private schools providing higher academic education.	Education administrative department of the State Council and the people's government of

	the province, autonomous region or municipality directly under the central government.
Private schools providing vocational qualification training and vocational skills training ("**private vocational training institutions**")	Department of human resources and social security of the people's government at or above the county level, with a record-filing submitted to the department of education of the same level.
Private training and education institutions set up to enroll children and adolescents of the appropriate age in kindergartens, primary and secondary schools, and to provide cultural and educational activities related to school cultural and educational curricula or supplementary tutoring related to school admissions and examinations.	Examination and approval of the education department of the people's government at or above the county level.
Private training and education institutions set up to provide language, arts, physical, science and technology, research and other educational and teaching activities conducive to quality improvement and personal development, as well as private training and educational institutions for cultural and non-academic continuing education for adults.	Direct application for legal person registration

The Review Draft at Article 16 establishes different licensing requirements for online education:

- Provision of online academic education: education operating licenses and Internet operation licenses for similar academic education of the same level are required to be obtained;
- Provision of online training and educational activities or vocational skills training: the corresponding Internet operating licenses shall be obtained and a record-filing shall be submitted to the education administrative department of the provincial people's government and the human resources and social security department of the place where the institution is located.

Compared with the Comment Draft, the Review Draft no longer requires online private vocational training institutions to obtain licenses to operate schools, but merely requires record-filing. That is to say, the qualifications for online private vocational training institutions are lower than those for offline vocational training institutions[5]. However, while the Review Draft does not require non-

[5] Review Draft, Art. 14: "The establishment of private schools for the provision of vocational qualification training and vocational skills training mainly based on vocational skills shall be examined and approved by the human resources and social security department of the people's government at or above the county level in accordance with the limits

academic cultural training and educational institutions to obtain licensing to operate schools, it is clear that such institutions may not provide educational and teaching activities that would otherwise require a license to operate. In accordance with Article 15 of the Review Draft, training and educational institutions may not provide for the online "enrollment of children and adolescents of kindergartens, primary and secondary school age, and provide other cultural and educational activities related to school cultural and educational curricula or supplementary tutoring related to school admissions and examinations." But, in practice, the distinction between these two types of educational activities needs to be further clarified, i.e.: "[the provision] of language, arts, physical, science and technology, research and other educational and teaching activities conducive to quality improvement and personal development" (which does not require a school license) and "[the provision] of other cultural and educational activities related to school cultural and educational curricula or supplementary tutoring related to school admissions and examinations" (which requires a school license).

IV. Group Schools

Article 12 of the Review Draft stipulates that "a social organization which concurrently holds or actually controls a number of private schools and provides for the group school operations shall have legal person status and have suitable conditions, funds, personnel and organizations for the school operating activities that it undertakes, and shall assume the responsibility of management and supervision over the private schools that it operates. In the case of providing group school operations, non-profit private schools shall not be controlled through mergers and acquisitions, franchise chains or control agreements." In addition to retaining the requirement in the Comment Draft that group schools must possess the corresponding conditions for operating schools and the ability to supervise members of the group, the Review Draft also adds a provision that prohibits social organizations that operate schools in groups from controlling non-profit private schools through mergers and acquisitions, franchising and VIE structures. We understand that this provision will prevent excessive expansion of group schools so as to guarantee the quality of education (especially the quality of compulsory education), and also prevent group schools from profiting through related-party transactions in the name of non-profit private school operations.

We note that the Review Draft does not itself define "group school operations." The regulatory documents of some provinces and municipalities define group school operations, but the definitions differ. However, from the perspective of Article 12 of the Review Draft, it appears that "holding or actually controlling a number of private schools" is the defining characteristic of the term.

V. Public Schools' Involvement in Private Schools

The Review Draft at Article 7 places many restrictions on public schools' involvement in private schools:

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of authority prescribed by the state, and shall be submitted to the administrative department of education of the same level for record."

- Public schools shall not operate or participate in operating for-profit private schools;
- If a public school operates or participates in the operation of a non-profit private school, the public school shall be approved by the competent department and shall not make use of state fiscal funds, shall not affect the teaching activities at the public school, and shall not obtain profits by means of brand extension;
- "Six Independences": private schools run by public schools shall have: i) independent legal personality, ii) separate campuses and basic educational and teaching facilities, iii) independent full-time teachers, iv) independent financial and accounting systems, v) independent enrollment, and vi) independent academic certificates.

The foregoing provisions will restrict public schools from establishing schools-within-schools, and from profiting from the process of operating private schools, and will possibly have an impact on private schools with independent colleges:

- In one respect, what is meant by "shall not obtain profits by means of brand extension"? Pursuant to the *Measures for Establishment and Administration of Independent Colleges*,[6] independent colleges are institutions that offer undergraduate or higher curricula that are run by ordinary institutions of higher learning in cooperation with social organizations or individuals other than state institutions. Ordinary colleges and universities mainly use their school names, intellectual property rights, management resources, educational and teaching resources to participate in operating the independent colleges, and social organizations and individuals mainly use funds, physical resources, land use rights and other means to participate in operating the schools. If "shall not obtain profits by means of brand extension" means that public schools cannot charge brand licensing fees, it will inevitably affect the enthusiasm of public schools to participate in independent colleges. Of course, provided that this restriction only means that public schools may not simply engage in brand extension, it would become necessary for public schools to invest resources together with brand licensing such as intellectual property, management and teaching resources. In this case, the revenue from brand licensing fees could also be interpreted as encouraging the development of substantive (rather than purely nominal) cooperation in operating schools.
- In another respect, if public school participation makes it impossible for cooperative schools to become for-profit private schools, this will also affect the cooperation between the parties. As a result, the revision to the *Regulations for the Implementation of the Law on the Promotion of Privately-run Schools* may accelerate the transformation of independent colleges into ordinary private colleges.

[6] [Measures for Establishment and Administration of Independent Colleges] (Min. of Ed., Decree No. 26; promulgated Feb. 22, 2008, effective Apr. 1, 2008) 2008 ST. COUNCIL GAZ. 26.

VI. Policy trends for non-profit private schools

Compared with the current regulations, the Review Draft strengthens the supervision of private schools (particularly non-profit private schools), while also, on the basis of general support, further showing a bias towards non-profit private schools and encouraging the operation of non-profit schools.

- Local people's governments at or above the county level may, in accordance with a certain proportion of the standard for average expenditures of students in similar public schools at the same level, determine the standard for subsidies for the average expenditure of students in non-profit private schools; among them, subsidies for the funds of non-profit private high schools shall be borne by the people's governments at the provincial level (Article 52);
- Local people's governments shall give priority to non-profit private schools in leasing and transferring idle state-owned assets (Article 52);
- Non-profit private schools shall be subject to the tax policies for public schools issued by the financial department and tax department under the State Council, which will reduce or exempt the corresponding tax burden (Article 53);
- For new construction and expansion of non-profit private schools, local people's governments shall, on the principle of equality with public schools, grant preferential land use by means of allocation (Article 55);
- Local people's governments at or above the county level shall include in their budgets funds allocated to the social security of the staff and workers of non-profit private schools, adopt subsidies, fund incentives, and preferential fees in accordance with law, support and reward private schools in establishing occupational annuity systems for their staff and workers, and may adopt government subsidies, rewards in lieu of allowances, etc. to encourage and support the remuneration of private school teachers (Article 59).

VII. Conclusion

The Review Draft responds to certain public calls regarding practices in the education industry. The Review Draft gives further preferences to non-profit private schools on the basis of general support while also strictly regulates school operations, with the top priorities continuing to be the compliant operation of non-profit private schools and the avoidance of abuse of non-profit private school policy preferences.

If the Review Draft becomes effective in its current form, there will be widespread problems from the perspective of capital management of private schools, particularly arising from VIE structures and related-party transactions involving private schools listed offshore. Feedback from offshore capital markets this week indicates that investors have a pessimistic outlook on these potential regulatory changes. Despite this, the impact of the Review Draft on educational enterprises that intend to list on the A-shares market in China will be less severe than for those listed offshore because domestic

enterprises do not need to adopt VIE structures and are able to avoid related-party transactions that are inherent in the use of VIE structures. From an education industry perspective, the Review Draft imposes stricter compliance requirements on academic education (especially compulsory education). However, for non-academic training, the overall scope does not change significantly, and some aspects are in fact more generous and favorable.

The quoted legal provisions cited in this article are unofficial translations and are to be considered for reference purposes only.

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2. Analyzing the Measures for Administration of Strategic Investment by Foreign Investors into Listed Companies (Draft for Comment) (Authors: Yang CHEN, Zhao ZHANG)

On July 30, 2018, the Ministry of Commerce, State-owned Assets Supervision and Administration Commission, China Securities Regulatory Commission, State Administration of Taxation, State Administration for Market Regulation and the State Administration of Foreign Exchange jointly issued the *Measures for Administration of Strategic Investment by Foreign Investors into Listed Companies (Draft for Comment)* ("**Comment Draft**"). The currently effective *Measures for Administration of Strategic Investment by Foreign Investors into Listed Companies*[7] ("**Effective Measures**"), which became effective on January 31, 2006, have only undergone minor non-principled revisions in 2015 and have been unable to meet practice requirements. The management of foreign-invested enterprises has entered a new age of record-filing, particularly since the promulgation in 2016 of the *Interim Measures for Administration of Record-keeping for Establishment and Alteration of Enterprises with Foreign Investment*[8] ("**Interim Measures**"), (for details, see [Foreign investment in A-share Listed Companies: New Record-filing changes]), and the Effective Measures has proven to be quite inconsistent with current foreign investment management practices. In addition, the Effective Measures has increased uncertainty and transaction costs for foreign investors participating in mergers and acquisitions involving A-share listed companies due to strict requirements as to the types of foreign investors, asset holdings, investment shareholding ratios, lock-up periods and so on.

In light of the current background, the Comment Draft makes significant breakthroughs compared to the Effective Measures with respect to approvals and record-filings for foreign investors that invest in

[7] [Measures for Administration of Strategic Investment by Foreign Investors into Listed Companies] (Min. of Commerce et al., Decree [2005] No. 28; promulgated Dec. 31, 2005, effective Jan. 31, 2006) 2006 ST. COUNCIL GAZ. 33 (*revised by* Min. of Commerce, Decree [2015] No. 2; promulgated and effective Oct. 28, 2015).

[8] [Interim Measures for Administration of Record-keeping for Establishment and Alteration of Enterprises with Foreign Investment (2018 Revision)] (Min. of Commerce, Decree [2018] No. 6; promulgated and effective June 30, 2018).

A-share listed companies, simplified investment examinations and approvals, foreign investor qualifications and requirements related to strategic investment. The Comment Draft also makes breakthroughs with respect to the issue of cross-border equity swaps when contrasted with the *Provisions on Merging and Acquiring Domestic Enterprises by Foreign Investors* [9] ("**M&A Provisions**").

I. Distinguishing between approval and filing administration in industries based upon whether they involve special administrative measures for foreign investment access

i. Key Revisions

The standard in the Comment Draft bases the distinction between approval and record-filing administration on whether special administrative measures for foreign investment access ("**Negative List**") are involved, which is consistent with the Interim Measures.

ii. Han Kun Comment

Before the issuance of the Comment Draft, a foreign investor's investment in an A-share listed company has been subject to the Effective Measures in cases where the Negative List does not apply to the A-share company's industry, and also record-filing administration in accordance with the Interim Measures. However, the approval system under the Effective Measures and record-filing provisions of the Interim Measures have different regulatory requirements for foreign investors investing in A-share listed companies which increases complexity in practice.

The Comment Draft is consistent with the Interim Measures on the issue of approvals and record-filing administration for foreign investors investing in A-share listed companies. The Comment Draft stipulates that "the record-filing institution shall be responsible for record-filing and administration under the provisions of the [Interim Measures] where strategic investments do not involve national provisions on special administrative measures for foreign investment access … the [Ministry of Commerce] shall be empowered by the State Council to examine, approve and administer strategic investments that involve national provisions on special administrative measures for foreign investment access." As a result, the Comment Draft proposes that Ministry of Commerce approval will only be required where foreign investments are to be made in certain restricted industries under the Negative List.

The Comment Draft adopts the same standard for dividing between approval and record-filing administration as the Interim Measures – whether the Negative List is involved. The Comment Draft stipulates that "where a foreign investor holds the shares of a public company and continues to invest through means such as a transfer agreement, the public company's issuance of new shares or a tender offer, when the proportion of the foreign investor's shareholding changes by more than 5% and control or the relative control position has changed, the foreign investor is

[9] [Provisions on Merging and Acquiring Domestic Enterprises by Foreign Investors] (Min. of Commerce, Decree [2009] No. 6; promulgated and effective June 22, 2009) 2009 ST. COUNCIL GAZ. 25.

required to comply with Article 3 of [the Comment Draft] in performing record-filing or approval procedures." **That is, record-filing administration will be adopted where a foreign investor makes an initial investment in an A-share listed company or the foreign investor's shareholding ratio has changed (meeting the stipulated criteria), as long as the Negative List does not apply.**

- **Legal Provisions**

Measures for Administration of Strategic Investment by Foreign Investors into Listed Companies (Draft for Comment)

Article 3: "the record-filing institution shall be responsible for record-filing and administration under the provisions of the [Interim Measures] where strategic investments do not involve national provisions on special administrative measures for foreign investment access.

The Ministry of Commerce or the competent Ministry of Commerce authority of the province, autonomous region, municipality directly under the central government, designated municipality and the Xinjiang Production and Construction Corps (hereafter the "**provincial-level MOFCOM authorities**") shall be empowered by the State Council to examine, approve and administer strategic investments that involve national provisions on special administrative measures for foreign investment access. The provincial-level MOFCOM authorities shall be responsible for the approval and administration of those strategic investments under the threshold amount.

In the case of strategic investments made through transfers by agreement, new listed company share issuances, the above threshold amount shall be calculated according to the purchase amount stipulated in the share issuance or share transfer agreement; for investments through acquisition, the highest amount possible through the offer shall be calculated. Where a strategic investment is made through multiple of the foregoing investment methods concurrently, the amounts shall be aggregated."

Article 15 "where a foreign investor holds the shares of a public company and continues to invest through means such as a transfer by agreement, the public company's issuance of new shares or a tender offer, when the proportion of the foreign investor's shareholding changes by more than 5% and control or the relative control position has changed, the foreign investor is required to comply with Article 3 of these Measures in performing record-filing or approval procedures."

II. Loosening of cross-border equity swap restrictions

i. Key Revisions

The Comment Draft broadens the scope of offshore enterprises in cross-border equity swaps and embodies the policy of encouraging cross-border equity swaps.

ii. Han Kun Comment

Cross-border equity swaps are currently regulated under the M&A Provisions. According to the

M&A Provisions, when a foreign investor acquires a domestic company with equity of a foreign company as consideration (a "**cross-border swap**"), the requirements for the foreign equity to be used as payment consideration are: (1) the equity of the offshore company is listed on a public and legitimate offshore securities exchange market (excluding over-the-counter markets); or (2) the equity is of a "special-purpose company" (which refers to offshore companies directly or indirectly controlled by a domestic company or natural person for the purpose of listing an owned domestic company offshore). The equity of an overseas company that does not meet the above requirements generally cannot be used as a consideration for foreign investors to subscribe for shares of domestic listed companies.

To a certain extent, these restrictions limit the use of offshore equity as payment consideration for A-share listed companies engaging in overseas mergers and acquisitions, thus there have been very few cases in practice where the Ministry of Commerce has approved cross-border swaps.

The Comment Draft loosens the above restrictions on offshore companies by requiring only that the companies be lawfully established, that the companies and their management have not been subject to major penalties imposed by regulatory authorities in the last three years, and that the foreign investors legally hold shares in the foreign companies and that those shares are legally transferrable.

- **Legal Provisions**

Measures for Administration of Strategic Investment by Foreign Investors into Listed Companies (Draft for Comment)

Article 6 "Where a foreign investor makes a strategic investment in a listed company with the equity of a foreign company he holds or with the issuance of additional shares as a mean of payment, the following conditions shall also be met:

There is a sound legal system in the foreign country where the company is lawfully established and registered, and the foreign company and its management have not been subject to major penalties imposed by regulatory authorities in the last three years;

The foreign investor lawfully holds shares in the offshore company which are transferrable in accordance with law;

Compliance with the relevant provisions of the China Securities Regulatory Commission.

III. Adjusting foreign investor entity qualification requirements

i. Key Revisions

a. The Effective Measures requires foreign investors to have capital of no less than USD 100 million or to manage offshore assets of no less than USD 500 million. For foreign investors that do not acquire control of the listed company, the Comment Draft relaxes

the total capital requirement to no less than USD 50 million or to manage total assets of no less than USD 300 million. The Comment Draft does not change the asset requirements for foreign investors that become controlling shareholders of listed companies.

b. The Comment Draft clarifies that foreign natural persons can participate as foreign investors in strategic investments in listed companies.

ii. Han Kun Comment

According to provisions of the Effective Measures, foreign investors are "foreign legal persons and other organizations established and operated in accordance with law," which precludes strategic investments by foreign natural persons. The Comment Draft clarifies that foreign natural persons may make strategic investments, and provides certain requirements for foreign natural persons. It should be noted that the Comment Draft will not apply to the acquisition of listed company shares by foreign natural persons as equity incentives, which will be regulated by the *Measures for Administration of Equity Incentives of Listed Companies*[10] that do not require Ministry of Commerce approval or record-filing, although the disclosure obligations should be fulfilled.

In some respects, the Comment Draft relaxes the qualifications for foreign investors, such as by allowing foreign natural persons to be foreign strategic investors, and by reducing the asset requirements of foreign investors in the event that they do not acquire control of a listed company.

However, the Comment Draft may introduce more stringent requirements for foreign investors that invest in A-share listed companies.

According to Article 2 of the Comment Draft, strategic investment means "the act of a foreign investor acquiring and holding shares of an A-share listed company for a certain term through means such as transfer by agreement, the public company's issuance of new shares (including non-public capital raising share issuances and share issuances for the purchase of assets), tender offer and other means stipulated by national laws and regulations." Foreign investors of the strategic investment should comply with requirements under Article 5 of the Comment Draft, stipulating that the total assets of foreign investors or of the foreign investor's actual controller shall be no less than USD 50 million or the total assets managed shall not be less than USD 300 million. In the case of foreign investors that become controlling shareholders of a listed company, the total assets of foreign investors or of the foreign investor's actual controller shall be no less than USD 100 million or the actual assets managed shall be no less than USD 500 million.

Based on the articles of the Comment Draft, foreign investors will need to fulfill the above-mentioned asset requirements if they are to acquire and hold shares of A-share listed companies

[10] [Measures for Administration of Equity Incentives of Listed Companies] (China Sec. Reg. Comm., Decree No. 126; promulgated July 13, 2016, effective Aug. 13, 2016) 2016 ST. COUNCIL GAZ. 33.

for a certain period of time by means of transfer by agreement, share issuance or tender offer, even if the foreign investor is managed under the record-filing system.

We expect to see a clear answer to this issue when the new *Measures for Administration of* Strategic *Investment by Foreign Investors into Listed Companies* is formally promulgated.

- **Legal Provisions**

Measures for Administration of Strategic Investment by Foreign Investors into Listed Companies (Draft for Comment)

Article 2 "These Measures apply to the act of a foreign investor acquiring and holding shares of an A-share listed company for a certain term through means such as transfer by agreement, the public company's issuance of new shares (including non-public capital raising share issuances and share issuances for the purchase of assets), tender offer and other means stipulated by national laws and regulations (hereafter "strategic investment").

Article 5 Foreign investors shall fulfill the following requirements:

Foreign companies, enterprises or other economic organizations shall be established and operated in accordance with law, with sound financial stability, good credit standing and mature management experience, sound governance structures, good internal control systems and norms of business conduct; foreign natural persons shall have the appropriate capacity to identify and bear risk;

The total assets of foreign investors shall be no less than USD 50 million or the total assets managed shall not be less than USD 300 million; or the assets of the assets of the foreign investor's actual controller shall be no less than USD 50 million or assets managed shall be no less than USD 300 million;

In the case of foreign investors that become controlling shareholders of a listed company, the total assets shall be no less than USD 100 million or the actual assets managed shall be no less than USD 500 million; or the assets of the assets of the foreign investor's actual controller shall be no less than USD 100 million or assets managed shall be no less than USD 500 million;

Foreign investors and their actual controllers have not been severely punished by domestic or offshore regulatory agencies within the past three years; those with fewer than three years since establishment shall be accounted for as of the date of establishment; foreign investors who are foreign natural persons shall also provide records proving no criminal conduct within the past three years.

IV. Modifying requirements related to strategic investment

i. Key Revisions

a. <u>Adjusts the sale lock-up period from three years to twelve months;</u>

b. **Cancels the requirement that foreign investors' strategic investments in A-share listed companies can be no less than 10%;**

c. **Allows foreign investors to acquire listed companies through tender offer.**

ii. Han Kun Comment

The Effective Measures stipulates that foreign investors that strategically invest to acquire shares of A-share listed companies shall not transfer those shares for a period of three years; the Comment Draft shortens this sales restriction period to twelve months. In practice, many foreign investors have avoided the three-year sales limit by arguing that their investments did not constitute "strategic investment."

According to the Effective Measures, the shareholding ratio of the foreign investor upon completing an investment may be no less than 10% of the outstanding shares of the issuing company. In practice, many transactions result in the foreign investor acquiring less than 10% of the shares of the A-share listed company, which is not considered to constitute a strategic investment and does not require Ministry of Commerce review and approval. One such example is the issuance of shares by Harbin Gong Da High-Tech Enterprise Development Co., Ltd. (SH 600701) to acquire 100% of the shares of Opzoon Technology and to raise matching funds. The Comment Draft adjusts this provision by making the sole criterion whether approval by the competent department of the Ministry of Commerce is required to be whether the Negative List applies to the transaction. Thus, approval by the competent Ministry of Commerce department will be required for A-share listed companies in industries subject to the Negative List, even if the foreign investor acquires less than 10% of the company's shares following completion of the transaction. From this perspective, the Comment Draft is more explicit and is also stricter with regards to strategic investments that need to be submitted to the competent Ministry of Commerce department for approval.

➢ **Legal Provisions**

Measures for Administration of Strategic Investment by Foreign Investors into Listed Companies (Draft for Comment)

Article 7 "Shares of A-share listed companies acquired by foreign investors through strategic investment shall not be transferred within twelve months. Where there are other provisions of the Securities Law, the China Securities Regulatory Commission and securities exchanges concerning the period of limitation for the sale of shares, such provisions shall prevail."

V. Simplifying approval procedures

i. Key Revisions

The Comment Draft simplifies approval procedures.

ii. Han Kun Comment

The Effective Measures requires foreign investors that make strategic investments to report to the Ministry of Commerce for review and approval, **while the Comment Draft delegates part of the approval authority to the provincial-level Ministry of Commerce departments.**

According to the Effective Measures, strategic investments should in principle first be submitted to the Ministry of Commerce for approval, undergo foreign exchange and securities registration, and then obtain a foreign-invested enterprise approval certificate from the Ministry of Commerce after completing the strategic investment, and apply for SAIC registration with the approval certificate. **Based on the Comment Draft, foreign exchange registration, securities registration and SAIC registration are no longer linked with Ministry of Commerce approval, and it is only necessary to comply with foreign exchange, securities, industry and commerce-related laws and regulations, thus making the examination and approval process more flexible and convenient.**

- **Legal Provisions**

Measures for Administration of Strategic Investment by Foreign Investors into Listed Companies (Draft for Comment)

Article 3. "The record-filing institution shall be responsible for record-filing and administration under the provisions of the [Interim Measures] where strategic investments do not involve national provisions on special administrative measures for foreign investment access.

The Ministry of Commerce or the competent Ministry of Commerce authority of the province, autonomous region, municipality directly under the central government, designated municipality and the Xinjiang Production and Construction Corps (hereafter the "**provincial-level MOFCOM authorities**") shall be empowered by the State Council to examine, approve and administer strategic investments that involve national provisions on special administrative measures for foreign investment access. The provincial-level MOFCOM authorities shall be responsible for the approval and administration of those strategic investments under the threshold amount.

In the case of strategic investments made through transfers by agreement, new listed company share issuances, the above threshold amount shall be calculated according to the purchase amount stipulated in the share issuance or share transfer by agreement; for investments through acquisition, the highest amount possible through the offer shall be calculated. Where a strategic investment is made through multiple of the foregoing investment methods concurrently, the amounts shall be aggregated."

Article 10, paragraph 2. After a reply in principle has been given by the competent commerce department and completion of the issuance, the listed company shall apply to the competent Ministry of Commerce department for the foreign-invested enterprise approval certificate.

Article 11, paragraph 2. After the competent commerce department gives an approval in principle to the undertaking of the strategic investment by the foreign investor, the foreign investor shall undertake the formalities for transfer by agreement in accordance with the relevant

provisions; after the transfer by agreement is completed, the listed company shall apply to the competent commerce department for a foreign-invested enterprise approval certificate.

Article 12, paragraph 2. After the competent commerce department gives an approval in principle to the undertaking of the strategic investment by the foreign investor, the foreign investor shall undertake the formalities for the tender offer purchase in accordance with the relevant provisions; after the completion of the tender offer, the listed company shall apply to the competent commerce department for a foreign-invested enterprise approval certificate.

Article 18. "Where a strategic investment involves national provisions on special administrative measures for foreign investment access, the foreign investor shall, after obtaining approval in principle from the competent commerce department, apply to open a foreign exchange expense account in accordance with the relevant foreign exchange administrative provisions, and handle procedures for the settlement and cancellation of accounts in accordance with the relevant foreign exchange provisions. The foreign investor shall complete the investment within 180 days of the approval in principle.

Where the foreign investor fails to complete the strategic investment in accordance with the investment plan within the prescribed time, the approval in principle of the competent commerce department shall automatically become invalid. Foreign investors shall handle the remittance procedures for foreign exchange purchases in accordance with the relevant foreign exchange provisions."

Article 19. "Foreign investors that undertake strategic investments that involve foreign exchange administration matters shall handle the formalities such as registration and cancellation, account opening and cancellation, foreign exchange settlement and cross-border receipts and remittances in accordance with the relevant foreign exchange provisions. Strategic investments that involve matters related to securities registration and settlement shall be handled in accordance with the relevant provisions on securities registration and settlement."

Article 24. "Where the foreign investor's strategic investment in a listed company involves changes to the registered items of the listed company, the listed company shall apply to the administration for market regulation department for registration in accordance with law."

The quoted legal provisions cited in this article are unofficial translations and are to be considered for reference purposes only.

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Important Announcement

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