漢坤律師事務所
HAN KUN LAW OFFICES

Newsletter

12th Edition of 2011

Insights & Ideas

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Impact of Mandatory Transfer/Reduction of State-owned Shares on Private Equity Funds and Relevant Relief Mechanisms (Authors: James WANG; Maggie TAN, Shen LIN)

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.

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, stated-owned shareholders of an H-share listed company can also covert 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.

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 Stated-owned Entity exclusively hold over 50% of the shares; and incorporated enterprises in which several Wholly Stated-owned Entities aggregately hold over 50% of the shares and its largest shareholder is a Wholly Stated-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:

<u>Amount of share to be transferred by a state-owned shareholder =</u>
<u>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</u>

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.

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.

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.

Legal Updates

1. Three Ministries Jointly Issued Interim Measures on Management of Kindergarten Fees (Authors: Gloria XU, Bing XUE, Lan LI)

In order to regulate the management of kindergarten fees and safeguard the legitimate rights of the children and kindergartens, the National Development and Reform Commission ("**NDRC**"), the Ministry of Education and the Ministry of Finance jointly issued the *Interim Measures on Management of Kindergarten Fees* (Fa Gai Jia Ge [2011] No. 3207, the "**Interim Measures**") on December 31, 2011, which shall take effect as of January 30, 2012.

Set forth below are highlights of the Interim Measures.

Scope of Chargeable Kindergarten Fees

According to the Interim Measures, kindergartens may charge childcare and tuition fees ("**Tuition**"), services fees and third party fees upon approval by provincial governments, lodging fees in case of boarded children. Apart from these fees, no other fees shall be charged. The Interim Measures set forth detailed provisions on pricing of these chargeable fees.

1) Tuition and Lodging Fees

The Interim Measures differentiate the administration of tuition and lodging fees between public kindergartens and private kindergartens. The tuition and lodging fees collected by public kindergartens shall be classified as administrative charges, while those collected by private kindergartens shall be classified as paid-services charges.

a) ***<u>Examination and Management of Tuition and Lodging fees collected by Public Kindergartens</u>***

If a public kindergarten intends to formulate or change the standard of Tuition, the competent provincial education authority shall put forward a proposal taking into consideration of the local economic conditions in both urban and rural areas, the operational cost of the kindergarten and affordability of local residents; the proposal shall subsequently be examined by the competent provincial pricing administration authority and finance authority, which shall jointly submit the proposal to the provincial government for final approval. If a public kindergarten intends to formulate or change the standard of lodging fees, the local education authority shall put forward a proposal and file such proposal with the local pricing administration authority and finance authority for examination. Furthermore, the standard of the lodging fees charged by public kindergartens shall be determined at actual cost and for non- profitable purposes.

b) ***Record Filing Administration of Private Kindergartens***

The Interim Measures states that the standard of the Tuition Fees and lodging fees collected by private kindergartens shall be determined by those kindergartens on a reasonable-cost basis in accordance with the *Laws o f the People's Republic of China on the Promotion of Private Schools* and its *Implementing Regulations*. The measure further requires that such standard shall not be put into implementation before filed with the local competent pricing administration authority and education authority for record.

The Interim Measures further provide that, the competent authority of local governments may impose, by means of contracts, a cap on fees collected by private kindergartens that receive subsidies from local governments. These subsidies include governmental purchase of services, deduction of rental or taxes, award for subsidy, assignment of public school teachers, arrangement for special award subsidy, preferential allocation of land etc.. These subsidized private kindergartens may establish detailed charge arrangement within the cap and file the same with the local pricing, education and finance authorities for record prior to implementation.

2) Services Fees and Third Party Fees

In accordance with the Interim Measures, kindergartens may charge services fees and third party fees upon approval by provincial governments besides the Tuition and lodging fees. However, the collection of the above fees shall follow the principles of voluntary payment, actual charge, timely settlement and periodical publication. Furthermore, those services fees and third party fees shall not be collected simultaneously with the Tuition fees.

The scope of services fees and third party fees collected by kindergartens shall be proposed

by provincial education authority, subsequently examined by the competent provincial pricing administration authority and finance authority, and reported to the provincial government for final approval prior to implementation.

3) Prohibitive Provisions

According to the Interim Measures, kindergartens are prohibited from collecting additional

fees by and in the name of organizing experimental class, special class, interest class, extracurricular training class and parents-children class etc.. Kindergartens are also prohibited from collecting sponsorship fees, contribution fees, school building fees, and compensation fees for educational costs or other fees from parents as a precondition to enrollment. The Interim Measures explicitly provide for that kindergartens are not allowed to collect book fees from students.

Fees Collection Approach and Publication Requirement

1) Fees Collection Approach

Prior to collecting tuition and lodging fees, public kindergartens shall obtain a Fees Collection Permit, subject to annual inspection, from competent pricing authority and shall use the financial receipt printed or supervised by competent finance authority. Private kindergartens shall use the tax invoices printed by tax authorities while collecting tuition and lodging fees. The Interim Measures also requires that kindergartens shall produce account books, financial reports, accounts as required by the competent authorities in the course of pricing supervision.

2) Publication Requirement

Kindergartens are required to publish the items for fees collection, charging standard etc. through various publicities. It is also required that kindergartens shall set forth clearly the school nature, the condition of the school, the charging items and charging standards etc. in the general regulation of enrollment.

Implementation Regulations

To ensure the enforceability of the management of kindergarten fees, the Interim Measures provide that:

a) all provincial pricing, education and finance administration authorities shall enact relevant implementation regulations to specify the relevant policies;

b) pricing, education and finance administration authorities at all levels shall strengthen the administration and supervision on kindergarten charging practice and urge kindergartens to establish and improve their charging management system; and

c) social supervision on, investigation of and punishment on irregularities shall be strengthened.

It is expected that local authorities may promulgate local regulations to ensure the enforcement of the Interim Measures. We will keep a close eye on the latest development in this regard and keep you posed of the same.

2. MOFCOM Revised Its Commercial Franchise Record Filing Measures (Author: Wenyu JIN, Muchun XU)

In order to strengthen the administration of commercial franchising activities and regulate franchising market order, on December 12, 2011, the PRC Ministry of Commerce (MOFCOM) amended the *Administrative Measures on Record Filing of Commercial Franchises* it promulgated in 2007. The amended Measures will come into force as of February 1, 2012 and supersede the 2007 Measures simultaneously.

According to the amended Measures, a nationwide online registration system shall be adopted for the record filing of commercial franchises; MOFCOM and provincial commerce departments shall be responsible for handling the record filing of commercial franchises. Eligible franchisors shall complete the record filing procedures through MOFCOM's commercial franchise information management system according to relevant provisions. The amended Measures stipulate that a franchisor shall file an application for record filing with competent commerce departments within 15 days from the date on which the franchisor signs the first franchise contract with a franchisee within China. In cases any changes occur to the franchisor, the franchisor shall file the changes with the record filing authority within 30 days as of the occurrence of the changes.

Furthermore, a franchisor shall, before March 31 each year, report to the relevant record filing authority the information pertaining to the conclusion, cancellation, termination and renewal of franchise contracts during the previous year. If a franchisor fails to complete the record filing procedures in accordance with provisions of *the Regulations on the Administration of Commercial Franchises* and the Amended Measures, the commerce department at or above the level of city divided into districts shall order the franchiser to complete the record filing procedures within a specified time limit, and impose thereon a fine of more than RMB 10,000 and less than RMB 50,000. If the franchisor fails to complete the record filing procedures within the specified time limit, a fine of more than RMB 50,000 and less than RMB 100,000 shall be imposed, and an announcement shall be made.

Compare with the 2007 Measures, the amended Measures contain the following amendments:

MOFCOM may delegate the record filing work to provincial commerce departments

According to the amended Measures, MOFCOM may, in accordance with relevant provisions, entrust provincial commerce departments to handle the record filing matters in relation to inter-provincial commercial franchises. The entrusted provincial commerce departments shall complete such work by themselves, and shall not further entrust any other organizations or individuals to do the filing. If the entrusted provincial commerce departments fail to perform their record filing duty in accordance with law, the MOFCOM may directly accept the record filing applications submitted by franchisors.

Add new requirements on documents submitting to the authority

According to the amended Measures, in addition to the materials listed in the 2007 Measures, a franchisor in the form of foreign-invested enterprises shall submit the Approval Certificate for Foreign-invested Enterprise (“Approval Certificate”), and the business scope specified in the Approval Certificate shall include the item of “engagement in commercial activities by way of franchise”.

If the application documents are prepared outside the territory of the People's Republic of China, such documents need be notarized by a notary public (with a Chinese translation attached) in the country where the document is prepared, and certified by the PRC embassy or consulate of the People's Republic of China in that country, or the certification formalities prescribed in the relevant treaty signed between the People's Republic of China and that country shall be completed. If the documents are prepared in Hong Kong, Macao or Taiwan region, the relevant certification formalities shall be completed.

Specify changes which requires application for change of registration

According to the amended Measures, where any changes occur to the following record filing information of a franchisor, the franchisor shall submit an application for change of registration with the relevant record filing authority within 30 days from the date of occurrence of such changes:

1) The information of the franchisor registered with the administrative authority for industry and commerce;

2) The information pertaining to the operational resources; or

3) The distribution of all the stores of the franchisees within the territory of China.

The implementation of the amended Measures will further institutionalize and standardize the administration of the record filing of commercial franchises, and promote the record filing work for commercial franchises.

3. The State Council Issued the Draft Law on Promoting China's Film Industry (Authors: Loretta LI, Rae LIU and Jiaxin WU)

On December 15, 2011, the State Council issued *the Draft Law on Promoting PRC Film Industry* (the "**Draft Law**") to solicit public comments. It has been more than ten years since *the Regulations on the Administration of Films* (the "**Regulations**") came into force on February 1, 2002, during which period the total box office revenue of Chinese films has increased from less than RMB one (1) billion to over RMB ten (10) billion. Compared with the Regulations, the Draft Law has made major changes on three aspects: the first is to lower the market access threshold and to facilitate various market participants and social capitals to enter into the film industry; the second is to encourage enterprises, individually-owned businesses and individuals to engage in film related activities by taking fiscal, taxation, financial, land use and other support measures; the third is to strengthen the supervision and administration, standardize the market order, and promote the healthy development of the film market. This article will focus on these three aspects and will also briefly introduce the new rules of the Draft Law on foreign investment in the film industry.

Lower the market access threshold

1) *Place no restrictions on social capitals investing in the film production and other relevant businesses.*

According to Article 15 of the Draft Law, the State encourages enterprises to engage in the film production business. An enterprise shall be entitled to produce a film after filing the film script or the brief of the film script with the administrative authorities for radio, films and television under the State Council (the "Authorities") for examination. Compared with the Regulations, the Draft Law no longer requires that such enterprise shall be sponsored by a competent superior authority acceptable to the Authorities. The enterprise that has produced more than two films that have been approved to project publicly can apply for the License for Producing Films from the Authorities.

2) *Greatly reduce the administrative approvals*

The Draft Law modifies the requirement of the Regulations where the production of every film needs a case-by-case examination. Article 16 of the Draft Law allows the enterprise that has obtained the License for Producing Films to produce a film after filing the film script or the brief of the film script with the Authorities. Besides, according to the Draft Law, for enterprises or individually-owned businesses to engage in the business of flow projecting of films, and for sending the domestically produced films to a film festival (exhibition) outside of the People's Republic of China ("China"), only filing the relevant documents for record is required and there is no longer any requirement for relevant examinations and approvals.

Take various measures to encourage the development of the film industry

1) *Establish special funds for the film industry*

Article 42 of the Draft Law specifies that the State will encourage the development of the film industry by establishing special funds for the film industry and by guiding relevant special culture development funds to increase the investment into the film industry.

2) *Preferential tax policies*

According to Article 43 of the Draft Law, enterprises that are engaged in the following business may be entitled to preferential tax treatment in accordance with the relevant regulations of the State: (i) creating the scripts for domestic films; (ii) producing, distributing and projecting domestic films; (iii) selling film copies or transferring film copyright; (iv) manufacturing film equipments and conducting relevant research and development activities by high-tech enterprises; (v) conducting overseas promotional activities of domestic films; (vi) importing film equipments that cannot be manufactured in China and supporting spare parts for producing domestic films; and (vii) other activities related to the development of the film industry.

3) *Encourage financial institutions, insurance institutions and guarantee institutions to provide services to the film industry*

The Draft Law encourages (i) the financial institutions to provide financing services to film activities and to the improvement of the film infrastructures, to carry out film related intellectual property pledge businesses, and to support the development of the film industry on the aspect of credit loan; (ii)the insurance institutions to develop insurance policy needed for the development of film industry; (iii) the guarantee institutions to provide financing guarantee for the film industry and diverse the risk by re-guarantee, joint guarantee and combination of guarantee and insurance and so on. In addition, the production of the films published by the Authorities may enjoy loan discount and premium subsidies in accordance with relevant State regulations, for which the relevant institutions shall reasonably determine the loan period and interest rate.

In addition to the three encouraging measures mentioned above, the Draft Law also specifies that the State will encourage the foreign trade, cross-border financing and investment of the film enterprises through the simplification and optimization of foreign exchange administration process. The State will also promote and support the construction and renovation of the cinemas by making preferential policies including preferential policies regarding land use right support.

Strengthen the supervision and administration and standardize the market order

1) *Strengthen the protection of intellectual property*

According to Article 5 of the Draft Law, intellectual properties related to films are protected by law. No entities or individuals may infringe upon the intellectual properties related to films. The authorities above the county level responsible for the enforcement of intellectual properties related laws and regulations shall take effective measures to punish infringement of film related intellectual properties and to protect intellectual properties related to films. In addition, as to the practical phenomenon such as secretly recording the films, Article 39 of the Draft Law expressly provides that the staff of cinemas or other public film projecting places shall be entitled to prohibit the audience from conducting any activities infringing the film related intellectual properties.

2) *Standardize the calculation method of box office revenue*

Article 37 of the Draft Law specifies that cinemas shall not make false report of box office revenue. The joint line cinemas shall install the computer ticketing system in accordance with national standards. This requirement will further make the calculation of box office revenue more transparent.

Rules of the Draft Law on foreign investment in the film industry

1) *Standards for foreign investment in the film industry*

Similar to the Regulations, due to the special nature of the film industry, the Draft Law also provides that (i) no foreign enterprise may independently engage in the business of producing films within the territory of China, and (ii)other foreign entities (other than enterprises) and foreign individuals shall not engage in the business of producing films within the territory of China. Nevertheless, according to Article 17 of the Draft Law, a domestic enterprise and a foreign enterprise can cooperate to produce films within the territory of China upon approval by the Authorities, provided that (i) the domestic enterprise has produced at least one film that is legally permitted to project publicly in China; (2) neither the domestic enterprise nor the foreign enterprise has been imposed any administrative punishment in the past two (2) years due to violation of the laws and/or administrative regulations of China.

2) *Determination of the nature of jointly produced films*

As various preferential policies of the Draft Law are applied only to domestic films, the question of whether the films jointly produced by domestic and foreign partners can be identified as domestic films and thus enjoy the national treatment has drawn wide attention. Article 18 of the Draft Law has confirmed that such jointly produced film will be regarded as a domestic film if the domestic enterprise has the copyright of the film.

In conclusion, the Draft Law has provided a wide range of legal basis and policy supports for the sustainable development of the film industry of China. However, the Draft Law has not mentioned the film classification system that people in this industry generally pay close attention to; neither has it made any detailed rules about the film examination system. We expect that the relevant authorities may specify these items in the formally promulgated law or may introduce follow-up regulations in the future.

Important Announcement

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