漢坤律師事務所
HAN KUN LAW OFFICES

Newsletter

11th Edition of 2018

Legal Updates

Legal Updates

1. Q&A: Foreign Investors in Real Estate Funds (Author: James Wang Yong, Dong Shiwen, Jing Qing, Wang Qiuran)

Can foreign capital invest in the Chinese real estate industry? That question has long been the subject of attention, and the answer has changed over time with adjustments to macroeconomic policy. Overseas investment in the Chinese real estate industry has become more common in recent years, especially indirectly through real estate private equity investment funds ("**real estate funds**"). As fund lawyers, we are often asked by our clients, "can a real estate fund can foreign capital investment?" and "can an overseas fund be used to invest in domestic real estate funds?" In this article, we will analyze these questions based on our experience in advising foreign investors on investing in domestic real estate and logistics funds.

I. Foreign investment access conditions in real estate industry

Foreign investment access to the real estate industry has fluctuated over the years. While the general trend has been to relax foreign investment restrictions, there was an obvious tightening of restrictions for a brief period beginning in 2006. The 2015 revision to the *Catalogue for the Guidance of Industries for Foreign Investment* removed real estate-related business activities from the restricted category that had first been categorized as restricted in 1995, including "large scale land development (limited to Sino-foreign equity and contractual joint ventures)" "construction and operation of high-end hotels, high-end office buildings and international convention and exhibition centers" and "real estate secondary market transactions and real estate agencies or brokerage companies" (these activities were categorized as permitted following the revision). The 2017 revision to the *Catalogue for the Guidance of Industries for Foreign Investment* implemented negative list treatment for restricted and prohibited categories and removed the special restrictions applicable to foreign investment in real estate-related business activities (business activities not on the negative list are now subject to record-filing rather than administrative approval). The 2017 revision to the Catalogue included the removal of "large-scale theme park construction and operation" from the restricted category, and the removal of "golf course and villa construction" from the prohibited category. The current *Special Administrative Measures (Negative List) for Access of Foreign Investment* (2018 version) does not categorize as prohibited any real estate-related business activities, and provides only that "the construction and operation of cinemas must be controlled by Chinese investors," and "the construction and operation of civilian airports must be relatively controlled by Chinese investors."

It can be observed that the real estate industry is generally not subject to foreign investment access restrictions. Of course, besides general business activity restrictions, it should be noted that foreign investors investing in real estate funds may also be subject to restrictions based on local fund establishment policies and foreign exchange capital account supervision.

II. How can foreign investors invest in domestic real estate funds?

Now that foreign investment restrictions have been relaxed, how do overseas investors typically participate in real estate funds? We have presented the following two relatively common foreign investment structures based upon current cross-border investment laws, regulations and policies and local practices:

i. Overseas investors investing in domestic investment platforms

Under this structure, an overseas investor invests in a domestically-established investment platform, and through the platform makes direct or tiered investments in a real estate project company. Investment platforms generally include qualified foreign limited partnerships, among others ("QFLP funds" [1], which are a means for overseas investors to invest in domestic limited partnerships). Below are the major questions of focus under this structure:

- **Can foreign investors invest in real estate by setting up a QFLP fund?** It is possible to establish a QFLP fund, but the establishment of foreign-invested partnerships strongly depends on the overall tightening of the environment for the establishment of investment enterprises; thus, establishing a QFLP fund must take into consideration:

  i) limitations on the scope of establishment—at present, only QFLP pilot cities have issued relevant policies, including Beijing, Tianjin, Chongqing, Shenzhen, Qingdao, Guizhou, Pingtan in Fujian;

  ii) relatively high establishment requirements—each pilot city places threshold conditions on fund registered capital, investor and officer qualifications, and it is generally necessary to undergo a pre-approval process with the local finance office and other departments before industry and commerce approval;

  iii) Currently effective QFLP fund policies in some areas (e.g., Shanghai[2]) expressly prohibit investment in real estate not for self-use—such QFLP fund policies have been in effect for a long time and the provisions on foreign investment access have been modified substantially following their implementation. It may, therefore, be possible to circumvent such prohibitions in practice, but it will be necessary to confirm the specific foreign investment

[1] For more articles regarding QFLP in various cities, please click the following links.

《上海、天津、北京三地 QFLP 制度比较》（2012/01/05）；

《<北京 QFLP 办法>解读》（2011/11/21）；

《近期上海外商投资股权投资（QFLP）试点工作政策解读会纪要》（2011/04/28）；

《深圳新版<外商投资股权投资企业（QFLP）试点办法>解读》（2017/10/19）；

《福建平潭 QFLP 试点政策简析》（2018/04/13）；

《境外资金如何参与境内股权投资？—— FDI、QFLP/R-QFLP 及更多……》（2018/09/05）；

《FDI, QFLP/R-QFLP & Beyond for Foreign Investors Accessing China》（2018/09/30）.

[2] See Article 5 of the *Several Opinions on Implementation of the Pilot Project of Foreign-invested Equity Investment Enterprises in Shanghai* (Hu Fu Ban [2010] No. 17), promulgated and became effective on March 19, 2010.

access issues with the local authorities in accordance with the circumstances of each proposed investment.

- **Can investments be made domestically through a foreign-invested real estate investment company?** Foreign-invested real estate investment companies are considered to be the last prohibited investment structure. Many foreign private equity investment funds, including Blackstone, have considered establishing foreign real estate investment companies in China for commercial and foreign exchange purposes. However, since 2007 when China imposed strict controls on overseas investment in the real estate industry, we have not found precedent in public records where a commerce department has approved a foreign-invested real estate investment company.

- **At what level do overseas investors receive management fees or shares of income?** If the investment platform is a QFLP fund, the management fees or shares of income may be paid at the QFLP fund level to the overseas investors. In practice, we often encounter funds directly established overseas that accept overseas investors with management fees and income shares paid at the overseas level, since QFLP funds have higher approval requirements, longer approval process times, and sometimes overseas funds may invest in other projects besides domestic real estate. For QFLP funds with both overseas and domestic investors, fees may be extracted separately at the overseas and domestic platform levels.

- **Are there barriers to capital settlement?** QFLP funds have advance approval from the foreign exchange authority, so foreign exchange funds can be directly settled with the custodian bank once the QFLP fund is established, and RMB from the settlement of foreign exchange can be directly invested in projects within the QFLP fund's approved investment scope.

According to our understanding, in addition to QFLP funds, there are still some relatively flexible regional policies in practice which permit the direct application for establishment of general foreign-invested equity investment enterprises. These processes take less time than QFLP fund applications, and there are no fixed requirements for the establishment of local foreign-invested equity investment management enterprises. However, there may be other requirements in such areas, such as the size of the established enterprises and business scope of the underlying investment entity, which will require further consultation with the local authorities.

ii. Overseas investors directly investing in real estate project companies

Direct investment by overseas investors into domestic real estate is an option, particularly considering the higher establishment requirements, longer processing times and greater

dependence on local policies of QFLP funds/foreign-invested partnerships[3]. Questions we are frequently asked regarding this structure include:

- **Is record-filing with the Ministry of Commerce necessary for foreign investment in the real estate industry?** As we have mentioned, foreign investment policies for real estate has undergone a series of changes in recent years, and the competent authorities have issued a series of applicable regulations and policies related to foreign investment in real estate enterprises, covering foreign investment access, foreign exchange, external debt and other aspects. Since July 1, 2008, The Ministry of Commerce has entrusted provincial commerce departments to examine filing materials for foreign investment in the real estate industry in accordance with *Circular on Fulfilling the Work of Record-filing of Foreign Investment in the Real Estate Industry* (Shang Zi Han [2008] No. 23). The Ministry of Commerce and the State Administration of Foreign Exchange issued on June 24, 2014 the *Circular on Improving the Record-filing of Foreign Investment in Real Estate* (Shang Zi Han [2014] No. 340), which further simplified the filing procedures for foreign-invested real estate by allowing for the electronic submission of documents and in-process and ex-post review. The administration of foreign investment in real estate was further simplified in ways seen as advantageous for foreign investment by: (i) delegating administrative authority over foreign investment in real estate to the local competent commerce departments, (ii) introducing information filing procedures, and (iii) cancelling record-filing announcements on the Ministry of Commerce website, pursuant to the *Circular of the Ministry of Commerce and State Administration of Foreign Exchange on Further Improving the Record-filing of Foreign Investment in the Real Estate Industry* (Shang Zi Han [2015] No. 895), issued on November 6, 2015.

- **What are "related-party mergers and acquisitions" in the context of foreign real estate investment?** "related-party mergers and acquisitions" refer to mergers and acquisitions of related domestic companies by domestic companies, enterprises or natural persons through entities that are legally established or controlled overseas in accordance with Article 11 of the Provisions on Merging and Acquiring Domestic Enterprises by Foreign Investors (Min. Comm. Decree [2009] No. 6, the "Provisions"). Related-party mergers and acquisitions are required to be submitted to the Ministry of Commerce for approval. The Interim Measures for Administration of Record-keeping for Establishment and Alteration of Enterprises with Foreign Investment (revised in June 2018) provides that foreign investment is subject to record-filing rather than approval in the case of foreign investment that does not involve negative listed industries, but it is generally believed that the Interim Measures do not supersede the Provisions with respect to Ministry of Commerce examination and approval of related-party mergers and acquisitions. Therefore, the actual controller of the foreign

[3] Please click the link to get an Han Kun newsletter article regarding foreign direct investment: https://www.hankunlaw.com/downloadfile/newsAndInsights/47f3aa0ebb2a2903b2e7ac4a09ae9958.pdf.

investor is recommended to be unrelated to the project company if the project company is a domestic-funded enterprise, so as to avoid involving related-party mergers and acquisitions and upgrading local commerce department approval to Ministry of Commerce approval. After all, we have not found a precedent where the related-party mergers and acquisitions has been approved by the Ministry of Commerce.

- **What is a "return investment"?** The actual controller of an overseas entity that invests in an onshore project company may be required to register the investment as a "return investment" if the actual controller is a PRC national when the project company files the investment with the Ministry of Commerce and registers the investment with the Administration for Industry and Commerce. In practice, failure by a PRC actual controller to register a return investment may result in penalties such as fines[4], and banks in some regions may restrict the opening of capital accounts by the project company.

- **Can overseas investors invest with creditor's rights?** From the perspective of financing costs and channels, overseas investment with creditor's rights (i.e., external debt) was one of the original financing channels for foreign-invested real estate enterprises. However, foreign exchange administrative departments have restricted management of overseas financings of foreign-invested real estate enterprises since 2007 under policies to regulate and control external debt risk in the real estate industry. In 2013, the State Administration of Foreign Exchange promulgated the Operating Guidelines for Administration of External Debt Registration[5], which clarifies the many of the principles for handling the external debts of foreign-invested real estate enterprises, including that "external debt signing and registration formalities will not be accepted for foreign-invested real estate enterprises that have obtained an approval certificate from the competent department of the Ministry of Commerce and filed for record with the Ministry of Commerce on or after June 1, 2007." The 2017 promulgated "all-inclusive" [6] new regulations on borrowing of external debts by domestic enterprises also clearly excluded application to real estate enterprises. Therefore, it is generally believed that foreign investors will face obstacles in the direct investment of external debts to domestic real estate enterprises.

- **Are there any obstacles to the use of settled foreign exchange capital?** Pursuant to the provisions of the Circular of the State Administration of Foreign Exchange on the Policies

[4] See Article 15 of the *Circular of the State Administration of Foreign Exchange on Issues concerning Foreign Exchange Administration over the Overseas Investment and Financing and Round-trip Investment by Domestic Residents via Special Purpose Vehicles* (Hui Fa [2014] No. 37). On October 22, 2018, the State Administration of Foreign Exchange published two violations cases that two enterprises received punishments for failing to disclose the actual controller information of the round-trip investment company and illegally remitting profits overseas. For more information, please click: http://www.safe.gov.cn/safe/2018/1022/10490.html.

[5] See Attachment 2 of the *Circular of the State Administration of Foreign Exchange on Distributing the Administrative Measures for Registration of Foreign Debts* (Hui Fa [2013] No. 19).

[6] See *Circular of the People's Bank of China on Matters relating to the Macro-prudential Management of Full-covered Cross-border Financing* (Yin Fa [2017] No. 9).

for Reforming and Standardizing Management of Foreign Exchange Settlement under the Capital Account (Hui Fa [2016] No. 16) and Circular of the SAFE on Foreign Exchange Concerning Reform of the Administrative Approaches to Settlement of Foreign Exchange Capital of Foreign-invested Enterprises (Hui Fa [2015] No. 19), foreign-invested enterprises can engage in discretionary foreign exchange capital settlement based on the principles of self-use and genuine use of the capital funds within the enterprise's business scope. For foreign-invested real estate enterprises, settled foreign exchange capital can be directly used as consideration for asset acquisitions, real estate development and construction. In practice, some foreign-invested manufacturing enterprises, industrial companies and consulting companies are not considered as real estate enterprises, and their business scopes may not include real estate-related business activities. Obstacles may thus exist if such enterprises wish to use settled capital funds to acquire real estate that is not for self-use[7].

- **At what level do overseas investors receive management fees or shares of income?** Since an overseas investor directly invests in a project company, there is no domestic management entity to raise overseas investor funds and provide fund management services, the investor may consider: (i) to arrange for the overseas collection of management fees and shares of income, that is, the investor invests directly or indirectly in the project company through the overseas fund, which may involve the cost of establishing, maintaining and registering the overseas fund structure entity. For example, the management team will need to set up at least two entities (one corporate entity as a general partner and manager and one partnership entity as a fund) for the purpose of optimizing tax planning and isolating risks, which may involve more entities (such as general partners). Separation from the administrator will result in entity establishment costs and annual fees, etc.; (ii) arrange to collect fees domestically through other legal and effective means such as a contractual agreement.

III. How can foreign general partners establish real estate funds?

In addition to introducing foreign limited partners, overseas investors can also set up real estate funds by establishing general partners/managers of private equity funds. In terms of fund structure, if an overseas private equity fund manager establishes a domestic private equity fund that wishes to introduce a foreign limited partner, the manager may consider launching a QFLP fund and other investment platforms discussed above to invest in real estate projects. If the fund does not involve foreign investors, a wholly-foreign owned enterprise may be used as a fund manager or also as a general partner to initiate the establishment of an RMB private equity fund in China. In recent years, many foreign-invested real estate fund managers have registered with the Asset Management

[7] See Article 4 of the *Circular of the State Administration of Foreign Exchange on Reforming and Regulating Policies on the Control over Foreign Exchange Settlement of Capital Accounts* (Hui Fa [2016] No. 16).

Association of China, including Tishman Speyer, CBRE and GLP.

IV. Logistics real estate funds for logistics real estate

With the rise of e-commerce and the expansion of warehousing demand in recent years, logistics real estate has gradually become an important segment of the real estate industry. These properties meet the distribution needs of manufacturers, retailers, e-commerce, third-party logistics providers and other industries through the construction of warehousing facilities and management support services. The expansion of large-scale logistics networks and integrated services make the financial support of the logistics segment a particularly important fund solution channel.

The common practice is for e-commerce providers to initiate the establishment of a fund, the fund invests in the development and construction of logistics storage facilities. The facilities are leased after construction and joint venture companies provide supporting operations/management. A substantial amount of the initial construction funds are recovered, management fees are collected and new projects are jointly developed and constructed. This model connects the development chain of fund management and the construction and operation of logistics real estate.

Logistics real estate projects and commercial real estate projects generally have stable cash flows in the form of rental income. Funds invest in storage land and storage facilities and, after a period of operation, the fund will exit the project by selling assets, equity, fund shares and so on, forming a complete investment-exit model.

At present, policy support for the logistics industry is relatively high. The Ministry of Finance and the State Administration of Taxation continue to implement tax preferences related to the logistics industry, according to a pronouncement issued in April 2017: "From January 1, 2017 to December 31, 2019, urban land owned by logistics enterprises (including for self-use and rental) for bulk commodity warehousing facilities, will have the applicable land use taxes reduced by 50% according to their land use grades." [8] In May 2018, the Ministry of Finance and the Ministry of Commerce issued a document emphasizing "strengthening the construction of logistics infrastructure and consolidating the foundation of supply chain development," including "building cross-regional and national logistics hubs," "guiding the transformation and upgrading of regional logistics distribution centers" and "strengthening the construction and transformation of commercial logistics infrastructure," and stating "the central treasury department will allocate service industry development special funds to support the construction of modern supply chain systems." [9] It is foreseeable that more domestic and foreign funds will be actively involved in e-commerce warehousing logistics, aviation logistics, cold chain logistics and other fields in the future.

==========

[8] See Article 1 of the *Circular on Continuously Implementing the Preferential Urban Land Use Tax Policy on Lands Used by Logistics Companies for Bulk Commodity Warehousing Facilities* (Cai Shui [2017] No. 33).

[9] See *Notice on the Construction of a Modern Supply Chain System in the Circulation Sector in 2018*.

2. Stock Connect from HK to UK - Similar Stocks, Different Connect (Authors: Yang TieCheng, Ge Yin, Zheng Ting, Sherry Si Yaoyao)

Following the launch of the Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect in November 2014 and in December 2016 respectively, on 12 October 2018 the China Securities Regulatory Commission ("**CSRC**") officially published the *Provisions on the Supervision and Administration of Depository Receipts under the Stock Connect Scheme between Shanghai Stock Exchange and London Stock Exchange (for Trial Implementation)* (《上海证券交易所与伦敦证券交易所市场互联互通存托凭证业务监管规定(试行)》) (the "**New Provisions**"), which formally established the Shanghai-London Stock Connect scheme.

The establishment of the Shanghai-London Stock Connect is an important achievement resulting from discussions between China[10] and the UK regarding the countries' economic and financial futures. The scheme provides a new channel for domestic investors to invest in overseas capital markets as well as an alternative for domestic-listed companies to obtain financing outside of China. The scheme also makes domestic shares available for overseas investors and facilitates the further internalization of domestic capital markets.

In this article, we intend to introduce the main contents of the New Provisions and provide our general understanding of the Shanghai-London Stock Connect scheme.

I General Introduction to Depository Receipts Business under the Shanghai-London Stock Connect

Depository receipts business under the Shanghai-London Stock Connect refers to the depository receipts ("**CDRs**") publicly issued in the Chinese domestic market and listed on the Shanghai Stock Exchange ("**SSE**") by qualified issuers of overseas securities listed on the London Stock Exchange ("**LSE**"), and depository receipts ("**GDRs**") offered overseas and listed on the LSE by qualified SSE-listed domestic companies. Thus the Shanghai-London Stock Connect scheme includes both CDRs and GDRs.

II CDRs under the Shanghai-London Stock Connect

iii. Securities Underlying CDRs

The securities underlying CDRs are existing shares of qualified overseas issuers listed on the LSE. CDRs are not currently permitted to represent newly-issued shares.

iv. Main CDR Participants

[10] "China" and "domestic" (for the purposes of this article only) refer to the territory of the People's Republic of China, excluding the Hong Kong Special Administrative Region, the Macao Special Administrative Region and Taiwan; "overseas" (for the purposes of this article only) refers to countries and regions outside of China.

1) **Issuers of Underlying Overseas Securities**. The New Provisions require overseas issuers to be qualified LSE-listed companies within the scope recognized by CSRC. According to the *SSE's Q&A on the Shanghai-London Stock Connect Scheme (上交所就沪伦通答记者问)*[11], the qualified LSE-listed companies under the Shanghai-London Stock Connect scheme are those with a premium listing on the LSE, and their listings and market values must additionally meet certain criteria set by CSRC[12].

2) **Domestic CDR Investors**. Domestic investors who hold and trade CDRs are required to meet the investor suitability requirements stipulated by the SSE.

3) **CDR Sponsors and Sponsor Representatives**. According to the New Provisions, sponsors and their representatives are required to perform sponsorship duties in accordance with the *Measures for Administration of Sponsoring Business for Securities Issuing and Listing (《证券发行上市保荐业务管理办法》)*, the *Sponsor Due Diligence Code of Conduct (《保荐人尽职调查工作准则》)* and the *Implementing Provisions for Due Diligence Work on Sponsorship of Domestic Offerings of Stocks or Depository Receipts of Innovative Enterprises (《保荐创新企业境内发行股票或存托凭证尽职调查工作实施规定》)*. In addition, overseas issuers and their sponsors are required to file with the local CSRC where the overseas issuer's domestic office is located for the purpose of handling securities matters regarding sponsorship arrangements.

4) **CDR Depositaries**. CDR depositaries are required to comport with the relevant requirements set out in the *Measures for Administration of Issuance and Trading of Depository Receipts (for Trial Implementation) (《存托凭证发行与交易管理办法（试行）)* and assume the corresponding legal obligations. Where a commercial bank serves as a CDR depositary, it is required to obtain a depositary license in according with the *Provisions on Matters Concerning Commercial Banks Serving as Depositaries in the Pilot Program on Depository Receipts (《关于商业银行担任存托凭证试点存托人有关事项规定》)*. The New Provisions do not prohibit foreign-invested banks from acting as CDR depositaries. Thus the foreign-invested banks with a depositary license may also act as CDR depositaries.

5) **Cross-border Conversion Institutions**. "Cross-border conversion" refers to the conversion of underlying shares into depository receipts and vice versa. Institutions in China that perform these services ("**Chinese Cross-border Conversion Institutions**") are required to be domestic securities companies that are licensed for proprietary trading, possess adequate experience in international business and have sound and effective internal controls. Qualified domestic securities companies that engage in cross-border

[11] Please see http://www.sse.com.cn/aboutus/mediacenter/hotandd/c/c_20180831_4631629.shtml.

[12] We note Article 6 of the consultation draft of the *Interim Measures on the Listing and Trading of Depository Receipts under the Stock Connect Scheme between Shanghai Stock Exchange and London Stock Exchange (《上海证券交易所与伦敦证券交易所市场互联互通存托凭证上市交易暂行办法》)* has listed the detailed requirements on the issuers of underlying overseas securities.

Please see http://www.sse.com.cn/disclosure/announcement/general/a/20181012/b4f1c82bee683f7b82210549190a59b1.pdf.

conversion are required to make a filing in accordance with SSE rules. Chinese Cross-border Conversion Institutions may trade the shares that underlie CDRs and certain investment instruments (e.g. money management instruments, financial products or instruments designed to hedge market risks associated with the underlying shares and foreign exchange risks) in accordance with regulations of competent authorities for the purpose of cross-border conversion and risk hedging. The outstanding assets that Chinese Cross-border Conversion Institutions may hold in overseas markets are subject to limitations stipulated by CSRC.

6) **CDR Custodians**. Chinese Cross-border Conversion Institutions are required to appoint banks qualified to hold securities investment funds to serve as CDR custodians. Custodians provide custody services in accordance with the *Trial Measures for the Administration of Overseas Securities Investment by Qualified Domestic Institutional Investors (《合格境内机构投资者境外证券投资管理试行办法》)*; overseas custodians will be appointed to provide overseas custody services.

v. CDR Issuance Approval Procedures

1) **Approval Authorities**. Overseas issuers seeking to list CDRs are required to file an application with CSRC. CSRC has designated the SSE to accept application documents, and the SSE will review the applications it receives and assess the overseas issuers' eligibility to list CDRs in accordance with SSE rules. CSRC will review applications in accordance with applicable laws and make final decisions on all applications.

2) **Application Documents**. The New Provisions set out the detailed application documents which the overseas issuers need to submit when applying to issue CDRs in the Chinese domestic market, including but not limited to the application report, a prospectus and confirmation statement signed by authorized directors, and relevant resolutions of the overseas issuers. The New Provisions expressly require the content and format of the prospectus to comply with *Rules No. 23 on the Preparation of Disclosure Documents by Companies Offering Securities to the Public: Guidelines on the Content and Format of Prospectuses of Pilot Red-Chip Enterprises Publicly Offering Depository Receipts (《公开发行证券的公司信息披露编报规则第 23 号 - 试点红筹企业公开发行存托凭证招股说明书内容与格式指引》)*.

vi. Initial Liquidity Establishing Arrangement

After a CDR issuance has been approved, the Chinese Cross-border Conversion Institution will acquire underlying shares with proprietary funds, by accepting purchase orders from non-specified investors who meeting suitability requirements or through other lawful means. Upon delivery of the underlying shares, the depositary will issue the corresponding depository receipts to the Chinese Cross-border Conversion Institution or investors in accordance with applicable rules and depositary agreements.

Where the amount of outstanding CDRs meets the listing requirements stipulated by the SSE, the overseas issuer can apply to the SSE to publicly list its CDRs.

vii. Cross-border Conversions of CDRs

Once CDRs become listed, the Chinese Cross-border Conversion Institutions may instruct the depositary to convert the overseas underlying securities into CDRs and vice versa. When converting CDRs into the underlying overseas shares, the depositary will cancel the CDRs in accordance with relevant rules and the terms in the depositary agreements, and deliver the underlying overseas shares to the Chinese Cross-border Conversion Institutions. Qualified domestic investors may also have cross-border conversions carried out on their behalf in accordance with SSE rules.

viii. Limit on CDRs Outstanding

CSRC limits the number of CDRs that an overseas issuer may have outstanding. While the New Provisions do not specify how the maximum number of outstanding CDRs is determined, the limit may be adjusted to account for certain transactions that affect an issuer's outstanding CDRs, such as stock dividends, stock splits, reverse stock splits and changes to CDR conversion ratios.

ix. Accounting and Auditing Standards

Overseas issuers are required to prepare financial reports in accordance with Chinese Accounting Standards ("**CAS**") or other accounting standards recognized by the Ministry of Finance ("**MOF**"). The New Provisions require financial reports to be audited in accordance with approved accounting standards by a domestic accounting firm licensed for securities and futures business, or by a foreign accounting firm that has been approved by CSRC and MOF.

x. Rights Issues

Overseas issuers that proceed with rights issues after publicly listing CDRs in the Chinese domestic market must meet the relevant requirements and file an application with CSRC for approval.

xi. Ongoing Supervision

1) **Applicable Regulations**. The New Provisions also govern the ongoing supervision of listed CDRs. Supervision issues not covered in the New Provisions will be handled by reference to the relevant provisions applicable to overseas-listed red-chip enterprises in the *Implementing Measures for Ongoing Supervision of Innovative Enterprises Following Listing of Domestically Offered Stocks or Depository Receipts (for Trial Implementation) (《创新企业境内发行股票或存托凭证上市后持续监管实施办法（试行）)* (the "**Implementing Measures for Ongoing Supervision**"), and other relevant CSRC regulations and SSE rules.

2) **Exceptions to the Application of the Implementing Measures for Ongoing Supervision**.

The following two circumstances are outside the scope of the certain requirements found in the Implementing Measures for Ongoing Supervision. First, the reporting obligations of Article 36 do not apply in the case of material asset transactions by overseas issuers outside the ordinary course of business, such as asset acquisitions, sales or other transactions, unless the asset acquisition is financed through the issuance of CDRs. Second, the Chinese Cross-border Conversion Institutions with holdings of the underlying overseas shares and CDRs as a result of fulfilling market making obligations are not subject to the provisions regarding changes in domestic CDR holdings in Chapter 4, Sec. 2.

3) **Disclosure Requirements**. Overseas issuers are required to disclose periodic reports, including annual and semiannual reports. Disclosure of quarterly reports in an overseas issuer's home market is required to be made concurrently in the Chinese domestic market.

III GDRs under the Shanghai-London Stock Connect

i. Securities Underlying GDRs

The securities underlying GDRs may be either existing shares or newly-issued shares of domestic SSE-listed companies. However, the New Provisions also prohibit the issuance of GDRs representing newly-issued shares in certain circumstances; for example, if the application documents for the current offering contain misrepresentations, misleading statements or major omissions.

ii. Main GDR Participants

1) Domestic Listed Companies. Domestic listed companies seeking to issue GDRs on the LSE are **required** to meet certain criteria set by the LSE. Domestic listed companies are also required to meet the requirements set out in the *Securities Law* of *the People's Republic of China (《中华人民共和国证券法》)*, *Special Provisions of the State Council Concerning the Floatation and Listing Abroad of Stocks by Joint Stock Limited Companies (《国务院关于股份有限公司境外募集股份及上市的特别规定》)*, and other applicable laws, regulations and relevant CSRC provisions regarding offering and listing securities by domestic companies in overseas markets.

2) Overseas GDR Depositaries and Cross-border Conversion Institutions. The overseas depositaries and overseas securities institutions conducting cross-border conversions ("**UK Cross-border Conversion Institutions**") will appoint domestic securities companies that will file with the SSE and trade the underlying domestic shares represented by GDRs. These domestic securities companies will supervise the cross-border conversions conducted by the UK Cross-border Conversion Institutions to ensure compliance with applicable laws and regulations. The UK Cross-border Conversion Institutions may trade the corresponding shares underlying GDRs and certain investment instruments (e.g. money market funds and treasury bonds) in accordance with regulations of the competent authorities for the purpose

of cross-border conversion and risk hedging. The outstanding assets that UK Cross-border Conversion Institutions may hold in domestic markets are subject to limitations stipulated by CSRC.

3) **GDR Custodians**. Overseas depositaries and the UK Cross-border Conversion Institutions will appoint and entrust assets to custodians that serve as custodians to qualified foreign institutional investors or qualified securities investment funds. Such custodians will perform custody obligations with reference to the *Measures for Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors (《合格境外机构投资者境内证券投资管理办法》)*.

iii. Issuing Price of GDRs Representing Newly-issued Shares

The issue of GDRs representing newly-issued shares may not, in principle, be lower than 90% of the average price of the underlying shares in 20 transaction days prior to the date of pricing. However, the New Provisions do not provide specific exemptions to this pricing method. For example, if the current market price does not reflect the true value of the domestic listed companies, whether an alternative method can be adopted to determine the issuing price.

iv. Cross-border Conversions of GDRs

GDRs may be exchanged for the underlying domestic shares in accordance with relevant rules and regulations. However, GDRs that domestic listed companies initially issue to the public are not permitted to be converted into domestic underlying shares within 120 days of the listing date. GDRs subscribed to and held by the domestic listed company's controlling shareholder, actual controller and entities under its control are not permitted to be transferred within 36 months of the listing date.

v. Limit on GDRs Outstanding

CSRC limits the number of GDRs that a domestic issuer may have outstanding. Similar to CDRs, the New Provisions do not specify how the maximum number of outstanding GDRs is determined, although the limit may be adjusted to account for certain transactions that affect an issuer's outstanding GDRs, such as stock dividends, stock splits, reverse stock splits and changes to GDR conversion ratios.

vi. Equity Ownership Limitation by Overseas Investors

A single overseas investor may hold no more than 10% of the equity in a single domestic listed company under the New Provisions. The aggregate A-shares holdings of all overseas investors in a listed domestic company may not exceed 30% of the total outstanding shares. For ownership purposes, equity that investors and persons acting in concert hold in a domestic listed company through GDRs or other means is considered on a consolidated basis. These ownership limitations do not apply to overseas investors' strategic investments in domestic listed companies.

The New Provisions provide a complete picture of the Shanghai-London Stock Connect, with general rules and regulations that will serve as the guidelines for further detailed rules and operating mechanisms. To this end, the SSE has published several consultation drafts of specific rules relating to the Shanghai-London Stock Connect for public comment[13]. The market has also been very active to promote the achievement of the Shanghai-London Stock Connect scheme. As of the date of this article, there have been 17 domestic securities companies which have participated in testing to qualify for CDR cross-border conversion organized by the SSE and it is said that the first market makers of CDR will be selected from those tested securities companies[14]. It has also been reported that HSBC Holdings plc, an LSE-listed company, will become the first company to list CDRs on the SSE[15]. As for the offering and listing of GDRs, the board meeting and the shareholders' meetings of Huatai Securities, which is listed on both the SSE and the Hong Kong Stock Exchange, have approved the company's plan to list GDRs representing newly issued A-shares on the LSE[16].

==========

3. A Look at China's New Criminal Judicial Assistance Law (Authors: Li Xiaoming, Ma Chen, David Tang Zhihua)

The Standing Committee of the National People's Congress promulgated on October 26, 2018 the *Law of the People's Republic of China on International Judicial Assistance in Criminal Matters*[17] (the "**Law**"). This is a landmark legislation because China, like most other countries, treats criminal investigation and prosecution as an extension of sovereignty and any assistance therefor has been rendered pursuant to bilateral treaties of judicial assistance. The reality is that, as of today, there exist a limited number of treaties between China and foreign countries, and yet the needs for judicial assistance in criminal matters are far greater than the geography covered by the existing treaties. This Law is a timely legislation to close the gap.

The Law sets out the legal basis and procedures upon which Chinese entities or individuals may provide judicial assistance in China to foreign parties for criminal investigations or prosecutions undertaken outside of China. Central to the Law is the requirement that approval from the Chinese

[13] Please see http://www.sse.com.cn/disclosure/announcement/general/c/c_20181012_4655446.shtml.

[14] Please see https://baijiahao.baidu.com/s?id=1614551569939278927&wfr=spider&for=pc.

[15] Please see https://www.ft.com/content/e9b519b8-d28b-11e8-a9f2-7574db66bcd5.

[16] Please see http://www.sse.com.cn/disclosure/listedinfo/announcement/ and http://www.hkexnews.hk/listedco/listconews/SEHK/2018/0925/LTN20180925050_C.pdf.

[17] 《中华人民共和国国际刑事司法协助法》 [Law of the People's Republic of China on International Judicial Assistance in Criminal Matters] (Standing Comm. Nat'l People's Cong.; promulgated and effective Oct. 26, 2018).

competent authorities must be obtained before any Chinese entity or individual may render judicial assistance in criminal matters to foreign parties.

The official press release accompanying promulgation of the Law states that the Law will help deter corruption and recover illegal gains. Paradoxically, the press release also indicates that the Law will serve as a countermeasure against long-arm jurisdiction and extraterritoriality as practiced by courts and governments of certain foreign countries relating to criminal cases being prosecuted in foreign countries. Obviously, how the Law is understood, interpreted and implemented is critical as a function of current events and as a matter of substance.

I. Overview

i. Scope of Criminal Judicial Assistance

The Law covers mutual assistance in criminal inquiries, investigations, prosecutions, trials and enforcement activities, including service of documents, investigation and collection of evidence, arranging witnesses to testify, seizing or freezing property, confiscating and returning illegal gains and other property, and transferring convicted persons.

The Law applies to judicial assistance rendered to all foreign countries. Where there exists a treaty on judicial assistance between China and a foreign country, both the Law and the treaty will apply.

ii. Prerequisite for Assistance

The Law at Article 4, paragraph 3 makes it clear for the first time that approval from competent Chinese government authorities is condition precedent to any activity carried out in China to facilitate criminal investigations or prosecutions in foreign countries. In the absence of it, "no foreign institution, organization or individual shall carry out criminal litigation activities specified hereunder within the territory of the People's Republic of China, and no institution, organization or individual within the territory of the People's Republic of China shall provide any evidentiary material or assistance set forth hereunder to a foreign country."

According to the Report on Deliberation Results of the Constitution and Law Committee of the National People's Congress on the Law of the People's Republic of China on International Judicial Assistance in Criminal Matters (Draft), these provisions are designed to put an end to situations in which foreign law enforcement authorities directly request relevant assistance from Chinese institutions and individuals without approval of the Chinese competent authorities and to curtail exercise of extraterritorial jurisdiction by foreign courts and governments.

iii. Division of Responsibilities

The Law demarcates duties of each Chinese government department responsible for providing international criminal judicial assistance, as follows:

- **Foreign affairs liaisons**: Judicial assistance treaties designate a central government

department to be the foreign affairs liaison for international criminal judicial assistance (generally the Ministry of Justice and/or the Ministry of National Security). Where no treaty exists, the Ministry of Foreign Affairs is the foreign affairs liaison. The foreign affairs liaison is responsible for requesting, receiving and transmitting the request for criminal judicial assistance. Where a foreign law enforcement authority requests criminal judicial assistance from China, it is required to prepare a formal request for criminal judicial assistance and submit relevant materials to the foreign affairs liaison for examination. If the form and substance of the request meet the requirements, the foreign affairs liaison will transfer the request to the competent authorities for processing. The foreign affairs liaison may ask the requesting party to provide supplemental materials if it so deems necessary.

- **Competent authorities**: The National Supervisory Commission, the Supreme People's Court, the Supreme People's Procuratorate, Ministry of Public Security, Ministry of National Security are the competent authorities which are tasked to provide international criminal judicial assistance. These authorities are responsible for (i) examining and processing requests for criminal judicial assistance from foreign countries forwarded by the foreign affairs liaison, arranging for the relevant case-handling authority to execute those requests deemed to be in conformity with the Law and mutual judicial assistance treaties; (ii) submitting requests to the competent authorities for criminal judicial assistance from foreign countries.

- **Case-handling authorities**: The case-handling authorities are the departments responsible for handling international criminal judicial assistance cases. These authorities are responsible for (i) timely execution of foreign requests for criminal judicial assistance received from the competent authorities; (ii) submission of requests for criminal judicial assistance to the competent authorities of foreign countries. The Law expressly requires case-handling authorities to safeguard the legitimate rights and interests of the parties and other relevant personnel and to protect personal information when executing requests.

iv. Denial of Assistance

The Law authorizes China's foreign affairs liaisons and competent authorities to deny the provision of judicial assistance to foreign countries under certain circumstances.

Article 14 enumerates six grounds upon which the competent authorities may deny a request for assistance:

- The act underlying the request does not constitute a crime under Chinese law;
- At the time of receipt of the request, the criminal procedure for the crime against which the request is directed is ongoing or has been terminated in China, or the statute of limitation for the crime has expired;
- The crime for which the request is made is a political crime;
- The crime for which the request is made is a purely military crime;

- The purpose of the request is to inquire into, investigate, prosecute, try, or enforce punishment for a crime based on race, ethnicity, religion, nationality, gender, political opinion or identity, etc., or the persons concerned are at risk of being treated unfairly for any of these reasons; and
- There is no substantive connection between the assistance requested and the subject matter of the case.

In addition, Article 15 of the Law provides that a foreign affairs liaison shall deny the provision of assistance if, in its own discretion, the provision of assistance will undoubtedly "harm the sovereignty, security and public interests of the People's Republic of China."

II. Han Kun's observations

In certain countries, notably the United States and United Kingdom, it is common for private individuals and institutions to be involved in criminal investigations. Based on the Law, such private individuals and non-governmental institutions must also obtain approval from the Chinese competent authorities before they can undertake criminal investigation and evidence collection activities in China. We believe the Law does not apply to self-initiated internal anti-corruption investigations by foreign companies. However, the nature of an earlier internal investigation may change if the evidence or materials obtained are submitted to a foreign criminal law enforcement authority, which may thus require prior approval by the Chinese competent authorities in relation to criminal judicial assistance.

III. Summary

The Law fills a blank in Chinese law in the field of international criminal judicial assistance between China and foreign countries. It permits Chinese entities and individuals to provide judicial assistance to criminal investigations and prosecutions conducted in foreign countries and, at the same time, curtails exercise of extraterritorial jurisdiction by foreign courts and governments. As often is the case in Chinese legislative history, major pieces of legislation such as this Law will be subsequently followed by implementation rules to deal with discrepancies in application. In the meantime, a careful read of the Law itself, a good understanding of its legislative intent and practice experience are the best guide to practitioners and clients alike.

It is worth mentioning, though, that the relevant treaties to which China is a party on judicial assistance in civil and commercial matters do not prohibit Chinese persons from directly providing evidence and other assistance to foreign persons or courts. And it is unlikely that in practice this Law will be expanded to cover civil matters.

==========

Important Announcement

This Newsletter 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.

If you have any questions regarding this publication, please contact:

Contact Us

Beijing Office
Tel.: +86-10-8525 5500
9/F, Office Tower C1, Oriental Plaza
No. 1 East Chang An Ave.
Beijing 100738, P. R. China

Wenyu JIN Attorney-at-law
Tel.: +86-10-8525 5557
Email: wenyu.jin@hankunlaw.com

Shanghai Office
Tel.: +86-21-6080 0909
33/F, HKRI Center Two, HKRI Taikoo Hui, 288 Shimen Road (No. 1),
Shanghai 200041, P. R. China

Yinshi CAO Attorney-at-law
Tel.: +86-21-6080 0980
Email: yinshi.cao@hankunlaw.com

Shenzhen Office
Tel.: +86-755-3680 6500
Room 2103, 21/F, Kerry Plaza Tower 3, 1-1 Zhongxinsi Road, Futian District, Shenzhen
518048, Guangdong, P. R. China

Jason WANG Attorney at-law
Tel.: +86-755-3680 6518
Email: jason.wang@hankunlaw.com

Hong Kong Office
Tel.: +852-2820 5600
Rooms 3901-05, 39/F., Edinburgh Tower, The Landmark 15 Queen's road Central, Hong Kong

Dafei CHEN Attorney at-law
Tel.: +852-2820 5616
Email: dafei.chen@hankunlaw.com